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Honduras: Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Interim Assistance Under the Enhanced Initiative for Heavily Indebted Poor Countries—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Honduras

In the context of the request for a three-year arrangement under the Poverty Reduction and Growth Facility and interim assistance under the enhanced Initiative for Heavily Indebted Poor Countries, the following documents have been released and are included in this package:

- the staff report for the Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Interim Assistance Under the Enhanced Initiative for Heavily Indebted Poor Countries prepared by a staff team of the IMF, following discussions that ended on November 24, 2003, with the officials of Honduras on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 3, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of February 18, 2004 updating information on recent developments.
- a Press Release summarizing the views of the Executive Board as expressed during its February 18, 2004 discussion of the staff report that completed the request.
- a statement by the Executive Director for Honduras.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Honduras*
Memorandum of Economic and Financial Policies by the authorities of Honduras*
Technical Memorandum of Understanding*
*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

HONDURAS

Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Interim Assistance Under the Enhanced Initiative for Heavily Indebted Poor Countries

Prepared by the Western Hemisphere Department
(In consultation with other departments)

Approved by Adrienne Cheasty and G. Russell Kincaid

February 2, 2004

- **Discussions.** Negotiations for a new PRGF arrangement were held in Tegucigalpa during November 10–24, 2003, following staff visits in August and October. The mission met with President Maduro, Central Bank President Mondragón, Finance Minister Alvarado, Minister of the Presidency Cosenza, Superintendent of Banks Mejía, and other officials.

- **Staff team.** The team comprised Mr. Garza (head), Ms. Torres, Messrs. Flores and Papaioannou (all WHD), Mr. Quintyn (MFD), Mr. Reichold (PDR), and Mr. Lachler (IBRD). Ms. Cheasty (WHD) and Ms. Coronel, the resident representative, assisted the mission.

- **Ex-post assessment.** An ex-post assessment of longer-term program engagement was prepared by a separate staff team. The assessment stressed the need to improve the economy's resilience to external shocks, to implement higher-quality fiscal measures and durable structural reforms, and to prepare for greater exchange rate flexibility.

- **Proposed PRGF.** The authorities have requested a three-year PRGF arrangement for 2004–06, with access of 55 percent of quota, and interim HIPC assistance from the Fund. Policies supported by this PRGF arrangement would enable Honduras to unlock loans from the World Bank and Inter-American Development Bank, obtain debt relief from Paris Club creditors, and pave the way to the HIPC completion point, possibly in 2005.

- **Fund relations.** At the last Article IV consultation (May 5, 2003), Directors called for a stronger fiscal stance through wage bill reduction and tax reform; banking reforms to address fragilities identified in the 2003 FSSA; more flexibility in the exchange regime; and improvements in governance.

- **Exchange system.** Honduras has a crawling band with a width of 7 percent on each side of the base rate; the market rate has been kept at the appreciated side of the band. The rate of crawl has been kept in line with the anticipated inflation differential. Honduras has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free from restrictions on payments and transfers for current international transactions

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Executive Summary

- **Honduras has faced depressed economic and social conditions since Hurricane Mitch in 1998.** Institutional problems, including deficiencies in governance and long election campaigns, have complicated policymaking and weakened growth. In recent months, policy management was further constrained by social unrest. The fiscal deficit widened in 2003 and there was a significant reserve loss.

- **The ex-post assessment of Honduras' program engagement recommended that the Fund stay involved with Honduras**, but with more attention to resolving ownership problems and achieving social consensus, making progress on stalled structural reforms, resolving transparency and governance issues, reducing vulnerability to external shocks, and achieving more exchange rate flexibility.

- **Honduras is requesting a third PRGF arrangement for 2004–06.** The program is built on a PRSP progress report and reflects a broad process of social consultation. Its main objectives are to set the basis for reducing poverty to 42 percent of the population by 2015 by reactivating the poverty-reduction strategy, and to strengthen growth by reversing the financial deterioration, implementing important structural reforms, supporting investment, and fostering trade liberalization.

- **The social consultation has allowed the government to implement a vital reform of public sector wage policy.** A reduction in the pressure of the civil service wage bill—currently equivalent to two-thirds of tax revenue—is key for restoring the sustainability of the public finances. To slow the burden of adjustment on wages to a tolerable pace, the program also envisages an increase in tax effort, notably by an increase in fuel tariffs and reductions in tax exemptions.

- **Other structural reforms address financial and social vulnerabilities.** An ambitious financial sector reform is designed to address bank fragilities, and far-reaching transparency and anti-corruption measures aim to improve governance.

- **It will be important that monetary and exchange rate policies are supportive of financial stability and growth.** Hence, a key element of the program is adherence to a reserve floor within the context of the current crawling band exchange regime.

- **The success of the program will also depend on the support of the international community.** Continued support is likely to be contingent on resolute adherence to the revised poverty-reduction targets. Full implementation of the program should allow Honduras to reach the HIPC completion point in early 2005.

- **The program is unusually risky, given difficult political circumstances and little room for financial slippage.** However, the risks are somewhat diminished by the front-loading of the program. The authorities have already taken many of the measures needed to meet the targets for 2004 and to underpin their immediate structural agenda.

I. BACKGROUND

A. Political and Social Environment

1. **Honduras faces difficult political and social conditions.**

- **Long-standing institutional problems have tended to weaken economic performance.** Honduras has been ranked poorly in the areas of rule of law, corruption control, and government effectiveness (Table 1). These deficiencies in governance have deterred private investment and undermined support for reforms. Policy-making is complicated by an unusually long presidential campaign (up to two years, out of a four-year term), intense pressures by labor unions (particularly teachers and health workers), and a congress influenced by interest groups. Social indicators remain among the weakest in Latin America, with an unequal income distribution, two-thirds of the population living in poverty (half in extreme poverty), and a weak social safety net (Table 2). Honduras ranks among the poorest countries in the latest UNDP Human Development Report (115th out of 175 countries in 2002).

- **In recent months, policy-making has been further constrained by social unrest.** Social protests intensified in 2003, in a fractured political environment. Protests covered concerns about corruption and selective bailouts, fears of new taxes and salary cuts, and demands for poverty alleviation. The governing coalition, which has a slim majority in congress, votes together only on a case-by-case basis. The government's scope for action is expected to be further curtailed in 2004 with the start of the campaign cycle for the November 2005 presidential election.

- **To overcome these difficulties, the government has undertaken a broad process of consensus-building to diffuse social tension and rally support for reforms**—through a National Dialogue and the preparation of a Fiscal Responsibility Pact, both following on the PRSP participatory process that has continued since 2000. This effort has built broad acceptance for an adjustment program, but also delivered a key message from participants that, for the burden of adjustment to be acceptable, it must be equitably shared across all sectors of society. Thus, the government has begun ambitious governance reforms, including difficult measures to increase judicial independence and reform the electoral process.

B. Economic Background

2. **Honduran development has been impeded not only by weak institutions and the political cycle but also by a concentrated export base and high dependency on foreign aid.** As a result, standards of living have remained low, the external debt level is high, and the economy has been vulnerable to external shocks.

3. **In 1998–2002, macroeconomic performance was particularly affected by adverse external shocks, and social conditions remained depressed** (Table 3). After Hurricane Mitch struck in 1998, larger foreign assistance than could immediately be spent boosted

international reserves and led to a sharp real appreciation of the lempira. These factors facilitated a steady reduction in inflation, but at the cost of declining external competitiveness. Also, public savings dropped sharply, mainly on account of government wage increases; financial system fragilities increased; and the external current account deficit remained large. Real GDP per capita declined by an average of ½ percent a year; the poverty reduction strategy stalled; while Paris Club rescheduling and interim HIPC assistance helped to alleviate the debt burden.

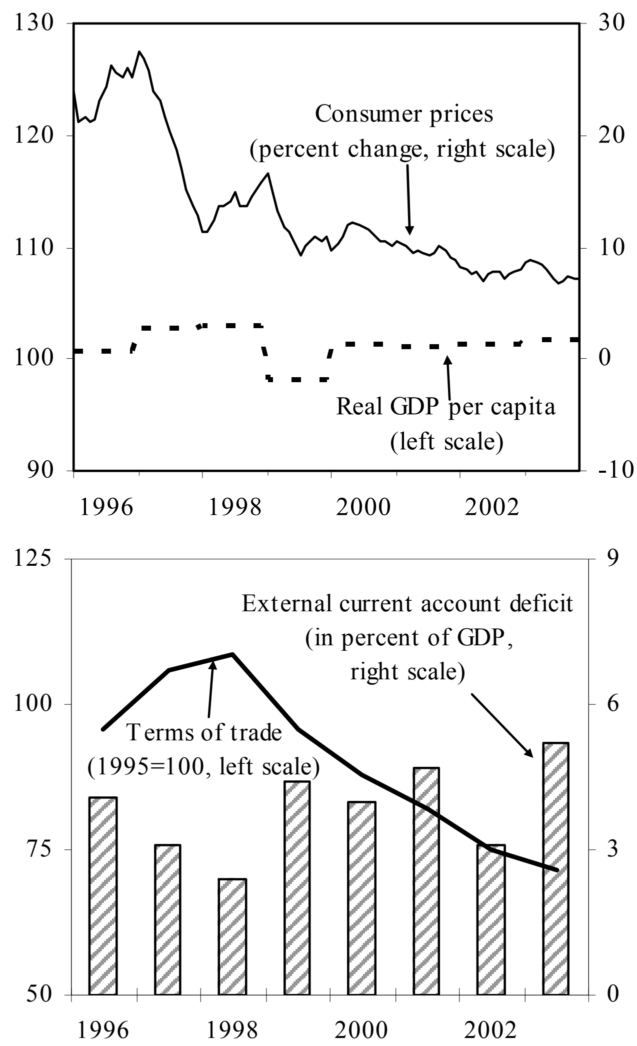
4. **In 2003, despite some improvement in macroeconomic indicators, notably inflation, economic and financial conditions remained difficult.**

- Growth picked up moderately to an estimated 3 percent—still very low in per capita terms—led by construction, tourism, and the re-export industry (*maquila*).

- Inflation slowed to 6¾ percent, in line with the crawling peg, and despite higher world oil prices.

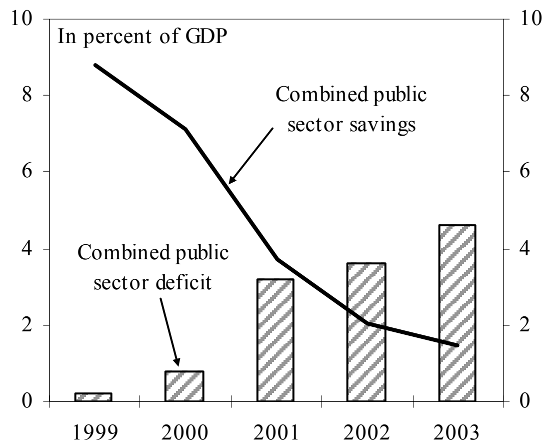
- The external position weakened further. The current account deficit widened to an estimated 5¼ percent of GDP, reflecting higher oil prices and buoyant imports related to investment in the leading sectors. Gross international reserves declined by around 5.2 percent, and now cover about four months of imports.

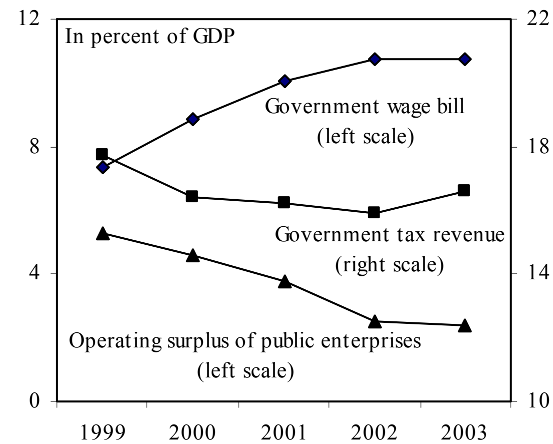
- The fiscal position also deteriorated, contributing to pressure on reserves in the absence of any additional access to foreign financing, and causing domestic bank financing to rise sharply, to 2¾ percent of GDP in 2003 from minus 1 percent in 2002.



- The debt burden remained heavy, with total public debt amounting to 73 percent of GDP at end-2003.

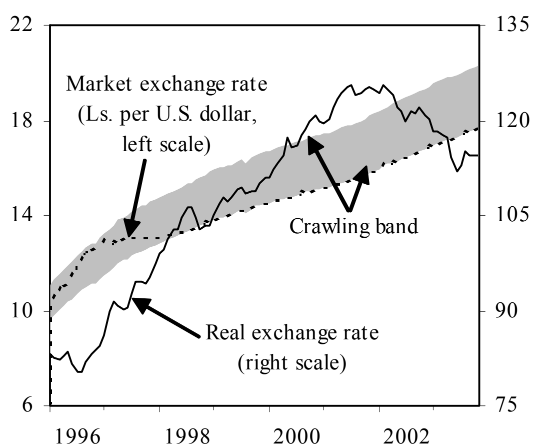
5. **The combined public sector deficit widened to 4½ percent of GDP in 2003.** Revenue measures adopted in April (Box 1) and steps to contain the upward trend of the wage bill were offset by transfers of more than 1 percent of GDP to write off 50 percent of agricultural loans (the Agricultural Decree), a decline in the operating surplus of the public

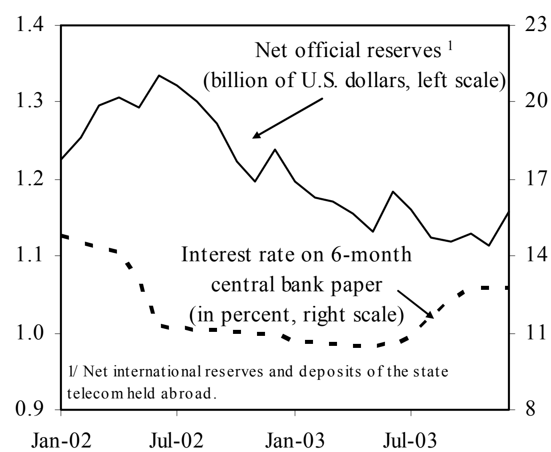




enterprises due to delays in tariff adjustments, and higher quasi-fiscal losses of the central bank. Hence, public savings continued to decline (Tables 4 and 5). The government also assumed the cost associated with the resolution of a small problem bank. To contain the deficit, it was necessary to delay anti-poverty spending and investment outlays.

6. **Monetary policy accommodated fiscal pressures and private sector demand for credit, leading to a sizable loss of international reserves in 2003.** Broad money rose by





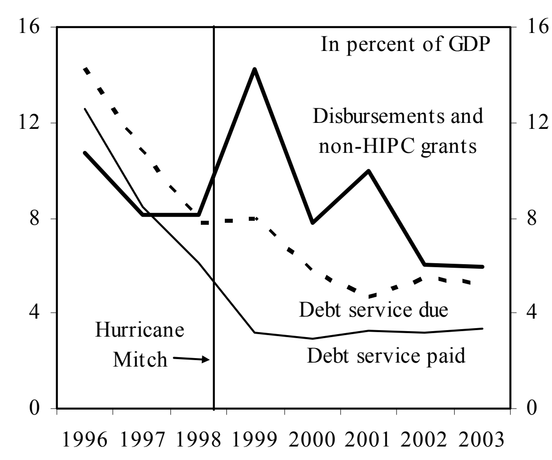
about 11 percent, in line with nominal 2003 GDP. In addition to the fiscal pressures, the maintenance of low interest rates for the first half of 2003 contributed to a pickup in private sector credit growth (to 13 percent, from 7½ percent in 2002). Net international reserves fell by US$78 million during the year (Tables 6 and 7). To contain the loss, the central bank raised open market interest rates by around 220 basis points in the second half of the year.

7. **The lempira depreciated by nearly 6¼ percent in real effective terms through November 2003.** This reflects mainly the depreciation of the U.S. dollar vis-à-vis the euro and other major currencies, and only very partially offsets the lempira's 50 percent real appreciation in 1997–2001. The exchange rate is set in daily auctions, within a crawling band of plus/minus 7 percent around the base rate—but the central bank has kept the rate at the most appreciated side of the band, with the aim of stabilizing expectations. Since October 2001, the rate of crawl has been set in line with the expected inflation differential between Honduras and its main trading partners.

8. **The financial system remains vulnerable, although banking supervision has improved.** Official data put nonperforming loans at 14 percent of total loans in September 2003, with only about one-third covered by provisions; these data may understate the extent of problem loans (Table 8). The banking system fragilities underlie the authorities' reluctance to use interest rates more actively to defend reserves.[1] However, the authorities took steps to improve on-site supervision based on the 2003 FSSA recommendations, and undertook several bank resolutions in 2003. Financial dollarization remained broadly stable at around one-third of deposits; banks' short-term net foreign assets are equivalent to two-thirds of foreign currency deposits.

9. **External sector imbalances remain significant.** The external current account deficit widened in 2003, partly reflecting a continued decline in the terms of trade (Table 9). While the high aid flows that followed Hurricane Mitch have declined, they continue to exceed scheduled debt service.

10. **Honduras reached the HIPC decision point in July 2000, but has not achieved the track record needed to reach the completion point.** Since the decision point, Honduras has received HIPC relief of US$76 million in a stock-of-debt operation and US$104 million in interim assistance. Debt service to the Paris Club was deferred through March 2002 (Table 10). Honduras did not achieve the HIPC completion point as initially envisaged (by mid-2002), because of fiscal and structural policy slippages under the previous PRGF arrangement (Box 2). However, important progress has since been made toward meeting the triggers for the completion point.



[1] The FSSA highlighted vulnerabilities to credit, liquidity, the exchange rate, and to a lesser extent, interest rate risk. Further risks could arise from problems in corporate sector balance sheets.

11. **Honduras has not serviced its debt to the Paris Club since April 2002, except for the small portion contracted after Hurricane Mitch.** Small amounts to other bilateral and commercial creditors are also still outstanding. As a result, arrears of 1¾ percent of GDP accumulated in 2003, more than doubling the end-2002 stock. Only around two-thirds of external debt service due in 2003 was paid, mostly to multilaterals.

C. Ex-Post Assessment of Longer-Term Program Engagement

12. **Since Honduras has had two PRGF arrangements, an ex-post assessment of its program engagement with the Fund has been carried out.** The assessment concluded that the Fund and other international financial institutions need to remain involved with Honduras. It stressed, however, that future programs need to address the key issue of ownership as well as other political economy factors if they are to improve on previous disappointing results. In this connection, the assessment recommended making previously unobserved structural benchmarks prior actions for a new arrangement; ensuring the full participation of all stake-holders; improving fiscal transparency and governance; and taking into account in the design of the program the balance of fiscal power between the legislature and the executive, as well as the constraints imposed by the election cycle. It also concluded that the previous economic program may have placed too much emphasis on politically contentious privatization without adequate preparation and consensus. The assessment stressed the need to improve the economy's resilience to external shocks (notably by incorporating contingency funds in the budget); to implement higher-quality fiscal measures and durable structural reforms; and to prepare for greater exchange rate flexibility. The program described below takes the recommendations of the assessment as core building blocks, with the aim of ensuring the success of the proposed arrangement.

II. The Authorities' Program for 2004–06

A. Program Strategy

13. **The main economic objectives of the program are (MEP ¶8):**[2]

- Raise the annual growth rate gradually from 3 percent projected for 2003 to 4½ percent in 2006–2008 (Table 11);

- Reduce inflation gradually to the level in trading partners, within the context of the existing crawling exchange rate band;

[2] Paragraph references (¶) in the rest of the report are to the Memorandum of Economic Policies (Attachment I).

- Reach the HIPC completion point by early 2005, with a view to reducing the public debt burden by about one-third by 2006; and

- Aim to lower the incidence of poverty to 42 percent of the population by 2015 and achieve the other millennium development goals.[3]

Honduras: Macroeconomic Framework, 2003-2006

	2003	2004	2005	2006
(Annual percentage changes)				
GDP at constant prices	3.0	3.5	4.0	4.5
Consumer prices, end of period	6.8	6.7	6.0	5.0
(in percent of GDP, unless otherwise noted)				
Combined public sector savings	1.4	3.9	4.8	5.9
Anti-poverty spending	7.5	8.1	8.7	9.4
Combined public sector balance	-4.6	-3.0	-2.5	-1.7
Of which :				
Central government balance	-5.5	-3.5	-3.0	-2.5
External current account balance	-5.2	-7.1	-4.5	-3.8
Gross international reserves (months of imports)	4.0	4.0	4.1	4.1

Growth

14. **The program pays particular attention to the authorities' strategy for reactivating growth.** The government and congress stressed that the fiscal adjustment of the magnitude envisaged, and the revitalization of the anti-poverty program, would be sustainable only in the context of stronger sustained growth (MEP ¶9). The main pillars of the authorities' growth strategy are:

- A revival of private investment as key sectors are opened to private participation (notably in electricity generation and telecommunications) and in sectors with high growth performance and potential (tourism, textiles (*maquila*), and nontraditional agriculture);

- Complementary public investment in infrastructure;

[3] Other targets are specified regarding: achieving universal primary education; promoting gender equality; reducing child mortality; improving maternal health; combatting HIV/AIDS and other diseases; and ensuring environmental sustainability.

- Participation in regional free trade agreements, notably CAFTA (MEP ¶10), while continuing to pursue multilateral opening;

- Regulatory and other reforms to meet the goals of the National Competitiveness Plan (MEP ¶11); and

- Governance, judicial, and political reforms.

As shown in Table 11, the projected increase in growth will be driven by large investments already in the pipeline, particularly in infrastructure, and by a recovery in exports—the success of which will depend on progress with the trade and competitiveness reforms in the program. In this connection, it will be particularly important that wages, and in particular, the minimum wage, are set consistently with strengthening productivity and competitiveness. Other prerequisites for improved confidence and growth will be the planned increase in fiscal saving; a stable monetary policy backed by sufficient reserves; adequate private sector access to credit in the context of a comprehensive financial sector reform; and sectoral productivity-enhancing measures.

Poverty reduction

15. **Revitalizing the anti-poverty strategy is a main focus of the program.**

- As discussed in the accompanying JSA, a PRSP progress report has been prepared, reflecting a series of consultations with civil society, and is closely focused on creating the conditions for Honduras to meet the MDGs (MEP ¶13–16);

- In the context of the PRSP progress report, the coverage of anti-poverty spending has been extended, to reflect the need for more flexibility in targeting broader government programs toward poverty reduction; and

- The goals for anti-poverty spending have been retained from the original PRSP, with full recovery from earlier delays by the end of the three-year program.

- The government remains committed to achieving the HIPC completion point as soon as possible. Building on the progress described in Box 3, the triggers for the completion point will be met in full by actions to be taken during the program.

Social consensus

16. **The authorities are committed to ensuring that the program is based on domestic consensus so as to ensure its social acceptance.** The recent social unrest has underscored the need to tailor the size and composition of the adjustment to take account of political and social constraints, while maintaining the over-arching goals of medium-term fiscal sustainability and poverty-reduction. A central element of the strategy is a fiscal adjustment path more gradual than recommended in the 2003 Article IV consultation, but

better anchored in domestic consensus. The government established a broad process of social consultation to determine the acceptable pace and composition of adjustment, drew on the PRSP progress report to revise the poverty-reduction strategy, and has included measures in the program to respond to protesters' concerns (MEP ¶6).

- The program goals are consistent with the main messages of the Fiscal Pact and National Dialogue, and with the framework of the PRSP progress report.

- Wage policy is designed to re-establish equity of remuneration across public sector workers, while ensuring the adjustment is tolerable by capping rather than cutting nominal wages.

- The program contains specific measures to respond to social grievances, including commitments to limit tax exemptions and government bail-outs, and an ambitious package of governance and anti-corruption measures.

17. **To cushion the impact of adjustment measures taken at end-2003 in anticipation of the program, prices of the basic food basket were frozen for six months.** Congress independently froze the prices of 159 food items, in the wake of passing an austere 2004 budget and the sensitive salary law. The authorities agreed with the staff that the measure could cause supply disruptions, risk entrenching distortions, and create new social sensitivities. The authorities have in recent days been able to work with Congress and the private sector to reduce the coverage of the freeze to only 38 specific products of most importance to the poor, and stressed that the June 30 expiration date would be strictly observed.[4] They also hope to bring forward the termination of the freeze by accelerating passage of a competition-promotion law to which the expiry of the freeze is linked (MEP ¶12).

B. Financial Policies

Fiscal policy

18. **Fiscal adjustment under the program is designed to meet a number of goals.** The deficit declines over the program period to a level that can be financed by projected concessional external support (for both the public sector as a whole and central government)—and, with HIPC debt relief, is expected to achieve medium-term fiscal sustainability. Spending is reoriented to make room for the poverty-reduction outlays envisaged in the PRSP progress report. Revenue measures are specified in line with society's preference to slow public sector wage growth rather than cut nominal salaries (MEP ¶20–25).

[4] Products covered are very specific. A broadbrush estimate suggests that the more limited price freeze could affect at most 10–15 percent of the price index. However, this calculation is likely to be an overstatement, since it relies on insufficiently disaggregated CPI weights.

19. **Underpinning the fiscal adjustment are important structural fiscal reforms.** Key among these is the passage of a salary law which returns full control of the wage bill to the executive branch of government by the end of the arrangement period. In the past, a series of costly multi-year wage settlements were voted by congress under pressure from unions—see Box 4. Passage of the salary law, which took place at end-2003, is intended to be followed by additional measures to improve civil service human resource management, consistent with World Bank recommendations. The government has terminated its support for agricultural debtors, and will make the institutional changes necessary to avoid future bail-outs. The government is also taking steps to ensure that the finances of public enterprises remain healthy, as increasing private participation creates new competition in these sectors. It is committed to taking further contingency measures if needed, both to meet central government targets and to ensure that public enterprise operating surpluses are realized (MEP ¶27).

20. **The combined public sector deficit is targeted to decline from an estimated 4½ percent of GDP in 2003 to 1¾ percent of GDP in 2006.** Public savings will increase from 1½ percent of GDP to 6 percent of GDP. This will allow the public sector henceforth to avoid net recourse to domestic financing, with a turnaround from 2.7 percent of GDP in 2003 to a small surplus of nearly 1 percent of GDP by 2006.[5] At the central government level, the deficit will be contained to 2½ percent of GDP by 2006, down from an estimated 5½ percent in 2003. The central government will not borrow domestically after 2004.

21. **Spending will be reoriented to achieve a recovery of public investment and PRSP-spending.** The new wage policy will reduce the wage bill from 10.8 percent of GDP in 2003 to 9.6 percent of GDP in 2006. The authorities have also begun to implement a restructuring of the public administration, by merging and streamlining some agencies and ministries, which aims to generate further savings of around 0.4 percent of GDP by 2006. They are committed to ensuring that their investment program—while expanding—remains consistent with program targets.

22. **Since wage pressures will decline only gradually, the authorities' strategy also contains revenue measures to ensure fiscal targets can be reached.** These include the full implementation of the 2003 revenue package, the elimination of tax exemptions, and tariff increases on petroleum derivatives (see paragraph 30 and Box 1). They have also committed to maintaining the real value of indirect taxes—an important consideration for cushioning the possible impact of CAFTA on revenue.

23. **Poverty-reduction spending will be expanded.** The PRSP envisages an increase of 0.6 percent of GDP in anti-poverty spending in 2004, and equivalent increases in 2005 and 2006. As described in Box 5, the increase will be calculated on a new broader definition of poverty-reduction spending (agreed with World Bank staff), which gives the authorities more

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[5] The deposit build-up takes into account the need to preserve social security fund surpluses.

flexibility in targeting resources to meet social goals. Anti-poverty spending priorities over the period of the program are education and health, rural infrastructure, and the social safety net for the poor, especially ethnic minorities and women. The program sets a floor on anti-poverty spending, to ensure that goals are met and, in particular, that these spending priorities are protected in the event of adverse shocks. (The budget also contains a contingency reserve to provide some cushion against adverse shocks, primarily natural disasters.)

24. **The government is committed to strengthening the finances of the public enterprises over the program period.**[6] To this end, the government recently raised electricity tariffs by about 11 percent, contracted the purchase of privately-generated electricity at a significantly lower cost, and will rebalance domestic and international telephone tariffs to ensure no revenue is lost as the sector is opened to private sector participation. Moreover, wage policy in the public enterprises will be maintained consistent with that of the central government.

Monetary and exchange rate policies

25. **Monetary and exchange rate policy will aim at gradually reducing inflation to the level of Honduras' main trading partners, within the existing crawling band arrangement** (MEP ¶28–34)**.**

- **International reserves and credit.** The central bank will target a gradual recovery in net international reserves over the program. The reserve target will allow gross international reserves to cover four months of imports, more than 100 percent of short-term liabilities (including money base and central bank paper (CAMs)), or some 2.5 times external short-term liabilities. To attain the quarterly NIR targets, the authorities will actively place CAMs at auction-clearing interest rates. With technical assistance from MFD, the central bank plans to enhance the management of CAMs with a view to improving the response of monetary policy and ensuring that the NDA of the central bank will remain within program targets. This monetary program, together with an improved fiscal stance, should permit an increase in real private sector credit in each year of the program—in line with the program goal of supporting private investment.

- **Exchange rate policy.** The central bank will ensure that the exchange rate will remain supportive throughout the program. While its weekly auctions of CAMs will remain the main monetary instrument, the central bank also recognizes the

[6] Public enterprises in Honduras are not run fully at arms-length from government—based on a number of criteria, including the wage-setting policy, and their monopoly position in a number of sectors. The authorities' strategy of introducing private participation into some sectors is intended to improve public enterprise efficiency while stopping short of politically-difficult privatization.

importance of developing additional defenses to protect NIR. To strengthen these defenses, the central bank plans to further develop the interbank market, and improve the effectiveness of its CAMs policy as noted above. For these purposes, the central bank intends to request technical assistance from MFD, to take place in early 2004.

- **Dollarization.** The central bank will continue to take steps to discourage the dollarization of financial system operations. In this connection, it will maintain reserve and liquidity requirements for foreign currency deposits at current levels (12 percent and 38 percent respectively). It will also maintain the present prudential limits on foreign currency credit to the private sector.

- **Quasi-fiscal losses.** The authorities will address the quasi-fiscal deficit of the central bank (which is mainly associated with the high yields on central bank paper). The envisaged reform of the central bank law will require the government to recapitalize the central bank. Also, the authorities will develop an action plan (with assistance of MFD) by the time of the first review, with a view to incorporating the interest cost of open-market operations gradually into the budget starting in 2005.

Program financing

26. **Fiscal and external financing gaps in the program (US$394 million in 2004) will be closed by the following (MEP ¶17–19):**

- Rescheduling by Paris Club creditors of the stock of arrears accumulated in 2002–03 (US$198 million), and of pre-cut-off-date debt service falling due in 2004 (US$105 million) and early 2005;

- Program loans from bilateral donors and multilateral creditors (US$90 million in 2004, US$40 million in 2005, and US$25 million in 2006); and

- Debt relief upon reaching the HIPC completion point,[7] reducing debt service (US$102 million in 2005 and US$87 million in 2006) and unlocking HIPC grants from multilaterals (US$44 million in 2005 and US$48 million in 2006).[8]

At the December 2003 tour d'horizon, the Paris Club provided financing assurances. All non-Paris Club arrears are currently under negotiation. In order to raise additional support from

[7] The authorities intend to seek debt relief beyond initial HIPC commitments from Paris Club creditors.

[8] Reaching the HIPC completion point would contribute to an estimated reduction of the NPV of external debt by about US$875 million between end-2004 and end-2005. (This is equivalent to a reduction in face value of an estimated US$1,175 million.)

donors for 2005–06, the authorities are planning a Consultative Group Meeting in early June 2004.

External Financing of the Combined Public Sector

	2004					2005	2006
	Q1	Q2	Q3	Q4	Total		
(In million of U.S. dollars)							
Total external financing needs	**102**	**104**	**53**	**51**	**309**	**348**	**344**
Grants	**32**	**18**	**18**	**7**	**74**	**121**	**126**
of which: HIPC grants	0	0	0	5	6	44	48
External financing	**-203**	**18**	**6**	**21**	**-159**	**61**	**54**
Net disbursements	-5	18	6	21	40	61	54
Repayment of arrears	-198	0	0	0	-198	0	0
Financing gap	**273**	**68**	**29**	**23**	**394**	**166**	**163**
Program loans	45	45	0	0	90	40	25
Unidentified financing	0	0	0	0	0	24	51
Rescheduling of arrears and debt relief	228	23	29	23	304	102	87

27. While external debt remains high, HIPC relief, together with successful program implementation, is expected to ensure medium-term debt sustainability. The debt ratios are significantly higher than projected at the HIPC decision point (www.imf.org), mostly because of lower than projected GDP, government revenue, and export growth.[9] Notwithstanding these differences, debt relief upon reaching the completion point—expected in 2005—would lower the debt ratios well below the HIPC thresholds (153 percent for NPV of debt to revenue and 79 percent for NPV of debt to exports compared to the HIPC thresholds of 250 and 150 percent respectively). Box 6 summarizes the staff's debt sustainability analysis. The main risk to debt sustainability is a persistent lower primary surplus than targeted under the program. Temporary shocks or a one-time exchange rate depreciation of magnitudes reasonable by historical standards would not necessarily put sustainability at risk—provided the shocks are short-term or accompanied by compensatory measures (Table 12).

III. The Financial Program for 2004

28. **The fiscal adjustment in the program is front-loaded, to take account of the constraints imposed by the election cycle.** For 2004, the authorities intend to reduce the combined public sector deficit by 1.6 percentage points to 3 percent of GDP. At the central government level, the deficit will be cut by 2 percentage points to 3½ percent of GDP. The

[9] Other contributing factors include less debt relief following the delay in reaching the completion point and lower discount rates.

combined public sector will have no net recourse to domestic financing in 2004, while central government domestic financing will decline to ½ percent of GDP.

29. **Measures to achieve the deficit target include revenue-raising actions, wage bill containment, and freezes of other spending items.** Most of these measures have already been taken, at end-2003 or in early-2004 (MEP ¶26).

- **Tax measures.** The authorities aim to increase central government tax revenue by nearly 1 percent of GDP, to 17½ percent of GDP in 2004. Part of this increase will be generated by the full year impact of the 2003 package, which will be boosted by the implementation of some outstanding measures from the package.[10] Tariffs on petroleum derivatives have been increased (by 10–12½ percent), with an expected annual yield of 0.6 percent of GDP. In response to staff concern about the social impact of higher fuel prices, the authorities explained that they believe its social impact will be relatively small and manageable.[11] Staff cautioned that a temporary safety net to cushion the impact of the fuel price increases might still be needed, and stressed that the social situation should be monitored closely. The authorities eliminated sales tax exemptions beyond those in the 2003 package (the additional imputed yield is less than 0.1 percent of GDP), and will seek to eliminate further exemptions during the program (a key demand of protesters).

- **Spending reform.** The authorities plan to reduce the wage bill from 10.8 percent of GDP in 2003 to 10.4 percent in 2004, as the salary law freezes doctors' salaries and allows teachers' base salaries to rise by less than expected inflation. This would achieve the first reduction in the wage bill since 1997. The 2004 budget sets a cap on important supplementary payments to teachers (for seniority and qualifications). Increases for the rest of the civil service will be in line with expected inflation. The salaries of higher-level civil servants will be subject to a ceiling (this is a government proposal to demonstrate burden-sharing), and a provision in the 2004 budget seeks to ensure that wage policy in the rest of the public sector is consistent with civil service policy. The authorities will also contain non-priority spending (including transfers to universities) while gradually increasing poverty-reducing spending in line with the PRSP.

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[10] Part of the sales tax broadening, the cigarette excise increase, and withholding on credit card payments were not implemented until 2004, after legal and technical issues were resolved.

[11] This is in line with World Bank findings in a PSIA on fuel tax increases in Nicaragua.

Monetary and exchange rate policies

30. **Underlying inflation is targeted to continue to decline—though part of the decline will be masked by the price impact of the adjustment measures.** For 2004, the floor on net international reserves has been set at US$1,205 million, consistently with the program objectives for covering imports and short-term liabilities. Currency issue is expected to slow, following a surge during the 2003 reserve outflow. Credit to the private sector is targeted to grow by nearly 8½ percent, i.e., significantly above inflation.

31. **The rate of crawl of the exchange rate will continue to be maintained at least in line with the anticipated inflation differential between Honduras and its main trading partners.** The introduction of enhanced instruments over the course of the program should facilitate exchange rate management.

Program financing

32. **The fiscal and external financing gaps in 2004 will be closed through a combination of program loans and Paris Club rescheduling.** Both IDA and the IDB are planning to disburse program loans of US$45 million each. The Paris Club has provided financing assurances to reschedule accumulated arrears (US$198 million by end-2003) and eligible debt service falling due (US$105 million in 2004) although the exact modalities have not yet been determined. Additionally, bilateral donors are providing program grants (US$17 million) and the Fund could grant additional interim HIPC relief (US$6 million).

IV. Structural Reforms

33. **In addition to the public sector reforms described above, the authorities see other structural reforms as contributing importantly to growth and to the social acceptability of the program** (Box 7). They see financial sector reform as urgent to address the fragilities of the banking system which hinder growth, and see governance reforms as a vital element in responding to current social concerns and uncertainties about the future.

Financial sector reform

34. **The government has begun a comprehensive financial sector reform program.** As described in Box 8, it is designed to strengthen central bank functions, prudential regulations and supervision; improve the financial safety net; and fight financial crime (including money-laundering). Critical elements of the reform are front-loaded, to ensure adequate preparation for the expiration of the universal deposit insurance scheme in October 2004 (MEP ¶35–39). Reforms in 2005–06 will focus on the phased implementation of the institutional reforms and the improvements in prudential ratios.

- **Monetary management.** Key measures will include: the development of indirect instruments; making the lender-of-last resort facility more effective; central bank recapitalization; upgrades to the payments system; and enhancements in transparency.

- **Supervision and prudential indicators.** Consolidated supervision will be established, and prudential indicators reformed and enforced. Importantly, the capital-adequacy ratio will be calculated in line with Basel standards; loan-loss provisioning will be strengthened according to a timetable to be set by the first review; related lending and other risk-indicators gradually reduced; and governance requirements strengthened.

- **The financial safety net.** The crisis management framework will be made more effective, while limiting moral hazard. An improved bank resolution framework will be put in place by June 2004; the deposit insurance scheme (FOSEDE) will be recapitalized during the program; and measures will be taken to combat international and domestic financial crime.

Governance and social equity

35. **Commendably, governance reforms are a high priority of the administration.** Perceived shortcomings in institutions have been a focus of social protest and the authorities are committed to addressing the public's concerns (MEP ¶40–44). The reforms are supported by the IDB and by a World Bank credit in preparation.

- **The government has already begun far-reaching political and judicial reforms.** Steps are being taken to reduce the length and impact of the campaign cycle—a measure expected to importantly improve economic management—and, more generally, to improve the accountability of elected officials. In 2004, the government will build on governance measures already taken to strengthen the independence and probity of the courts by eliminating immunities of public officials and the legislature and by strengthening the civil and penal codes.

- **Fiscal transparency is being enhanced, and red tape curtailed.** Following actions to reform procurement, internal controls, tax administration, budget transparency, and the simplification of official procedures (including property titling), the government intends to limit political appointments, enforce permanently the ban on intra-year unfunded expenditure appropriations (thereby sharply restricting the ability of interest groups to loosen budget discipline), upgrade fiscal accounting and statistics, improve fiscal control of the National University, and establish dedicated tax courts.

- **A key concern of the authorities is to minimize inequities in the use of public monies.** The government is committed to abstaining from bail-outs. Where bail-outs cannot be avoided, their nature and rationale will be transparently communicated, and their cost will be offset by compensatory measures. Access to funds under the Agricultural Decree—estimated to cost the budget 1 percent of GDP in 2003—was terminated at end-2003. Specific goals have been set for asset recovery from failed banks, and sanctions against financial crimes are strengthened. The government intends to bring to congress by end-2004 any further proposals for eliminating tax exemptions that emanate from the Fiscal Pact or the National Dialogue.

Other reforms

36. **Trade liberalization.** Negotiations for CAFTA were concluded in December 2003 (Box 9). The agreement, a key element in the authorities' strategy to stimulate new investment and growth, will be implemented after its ratification, possibly in early 2005. CAFTA will eliminate virtually all tariff and non-tariff restrictions after 15 years. Notably, it will permanently extend access to the U.S. textile market which is currently granted temporarily under the Caribbean Basin Initiative. It also provides a long transition period for Honduras' agricultural goods while significantly raising U.S. import quotas for sugar. Honduras already ranks 1 (least restrictive) on the Fund's trade restrictiveness index, but the phased reduction in import tariffs will further enhance the economy's openness and competitiveness. In preparation for the agreement, Honduras is already upgrading its customs systems and will also need to enhance its labor, investment, and environmental provisions.

37. **Competitiveness.** Building on the launch of the National Competitiveness Plan in May 2003, and to ensure that Honduras captures all potential benefits from CAFTA, the authorities will seek passage of new regulatory frameworks for key sectors, a competition-promotion law, and a reform of property titling (MEP ¶11). The authorities stressed their conviction that the structural reforms under way are sufficient to offset the impact of the previous real appreciation of the lempira on competitiveness; the strong performance of sectors such as *maquila* does not suggest a competitiveness problem. Staff, however, stressed that a fuller use of the flexibility inherent in the current exchange rate system would be helpful in achieving further export diversification, improving thereby Honduras' growth potential, and assisting monetary management by reducing interest rate volatility.

38. **Safeguards.** Safeguards have been strengthened beginning in 2002, when the central bank began to undertake an external audit of its financial statements and adopt a reporting system consistent with international accounting standards. However, the safeguards assessment conducted in November 2003 found that some weaknesses still remain, in particular with regard to the reporting of audited financial statements and independent oversight of audit and internal control mechanisms. The central bank has committed to publishing its full financial statements, including the external auditor's opinion and the explanatory notes, by end-September 2004, in line with recommendations of the assessment.

39. **Statistics.** The authorities acknowledge shortcomings in the quality and delivery of Honduran data. These include incomplete coverage, reporting lags, and difficulties in reconciling data. They stressed, however, that they have participated in all data and transparency standards exercises, and are committed to implementing the recommendations of associated reports. Honduras participated in a ROSC data module in 2003, and is planning upgrades in the timeliness and quality of data in most sectors (including the public finances,

national income accounts, and balance of payments), which should permit improvements in program monitoring and surveillance (MEP ¶43).

World Bank and IDB Involvement

40. **The World Bank's strategy for Honduras has focused on structural adjustment, rural poverty alleviation, human resource development, transportation, and the environment.** A Country Assistance Strategy was established in May 2003 to support the PRSP. The Bank has taken the lead in civil service reform and trade liberalization and is collaborating closely with the Fund on financial reform. The IDB's portfolio includes loans to support competitiveness, security (a key concern in Honduras), regional poverty alleviation, sanitation, and environmental protection.

V. Program Modalities and Risks

Access

41. **Access under the PRGF arrangement is proposed in an amount of SDR 71.2 million (55 percent of quota),** to be disbursed in seven equal semi-annual disbursements. This level of access would make a significant contribution to closing Honduras' large external financing requirements (Table 13), while taking into account that Honduras would be a third-time user of concessional Fund resources. Outstanding Fund credit would peak at 100 percent of quota in 2006 which would amount to a projected 5½ percent of exports of goods and nonfactor services and 11 percent of gross official reserves. Debt service due to the Fund would remain below 1 percent of exports of goods and nonfactor services over the medium term (Table 14). Considering the size of the prospective payments and the fact that in the past Fund obligations were generally serviced on time,[12] Honduras should not have difficulty meeting its future obligations to the Fund.

Monitoring

42. **Program monitoring will rely on eight semi-annual performance criteria and on associated reviews** (as shown in quarterly Tables 16–18; and Table 1 of the MEP). The quantitative performance criteria include a ceiling on the wage bill of the central government. Indicative targets include floors on anti-poverty spending and on the operating surplus of public enterprises, given the importance of these variables. To ensure against crowding out of high-priority public investment, there will be a limited adjustor to certain fiscal targets for higher capital spending by the national telecommunications company. There are three prior actions, designed to minimize the risk of fiscal slippage, and four structural performance criteria, mainly on banking reforms and critical fiscal measures (Table 2 of the MEP).

[12] Exceptions during the last 5 years are two payments that were inadvertently delayed by 3 and 4 days.

43. **Early reviews will address the following main topics.** During the first review, the government will agree with the Fund on the measures needed to meet the fiscal targets for 2005, any reforms needed to enhance monetary and exchange rate management—particularly in light of technical assistance—and the timetable for complying with new rules for capital adequacy, loan classification, and provisioning. The second review will include a focus on the adequacy of anti-poverty expenditure tracking, as well as on progress with reforms in tax administration, governance, and transparency. The third review will, inter alia, address fiscal policy for 2006. The fourth and fifth reviews will address progress with the financial sector reform and with the reforms to consolidate the public sector; the fourth review will also address the appropriateness of the monetary targets for 2006.

Risks

44. **The proposed strategy entails significant risks, though these are being addressed to the extent possible within the program.**

- **Social unrest.** The main risk is the unsettled political situation and uncertain domestic support for reforms. The authorities believe that this can best be addressed by their strategy of ensuring that the program is clearly based (and seen as such) on strong government ownership and domestic consensus.

- **The 2005 election.** The political cycle adds to the risks of the program. The Presidential elections scheduled for November 2005 will soon begin to overshadow the political process (the previous PRGF arrangement went off-track in the run-up to the election). The authorities' strategy is to implement quickly as much of the program as possible and secure broad domestic support, to ensure that the program can be well sustained and serve as a guide to policy-making during the election period.

- **Poor implementation capacity.** Honduras has traditionally suffered from poor implementation capacity and a lack of policy coordination—one of the reasons why previous negotiations have often been overtaken by adverse developments (such as the adoption of inconsistent measures). This risk is intended to be addressed by an enhanced technical assistance effort.

- **Monitoring difficulties.** Recognizing that statistics in Honduras are exceptionally poor, creating risks for adequate program monitoring, the authorities have agreed to form an inter-institutional working group to examine data needs and inadequacies—with the participation of the Fund's resident representative.

- **External pressures.** There are also important risks relating to Honduras' greater than normal susceptibility to external shocks, and to the possibility of delays or shortfalls in program financing. Both the threats to program credibility and the risks to financing underscore Honduras' vulnerability to a potential acceleration in the loss of reserves; the margin to avoid an economic and financial crisis is very thin. The authorities are convinced that the announcement of, and evident government commitment to, a Fund-supported program will reverse the reserve pressures, and have begun work to ensure a successful outcome of the coming consultative group meeting. The staff has, however, cautioned that if the reserve losses continue, more far-reaching actions may be needed than currently envisaged in the program.

VI. Staff Appraisal

45. **Since Hurricane Mitch, per capita income in Honduras has not fully recovered and poverty remains widespread.** Financial indicators deteriorated, reflecting the reconstruction effort and its repercussions, but also the growing burden of the public sector wage bill. The government is now attempting to reactivate growth and make progress in alleviating poverty, in exceptionally difficult political and social circumstances. The government's intention to embark on a program which provides international support for its growth and poverty reduction goals offers the best prospect of an orderly resolution of current social and financial problems, despite the associated risks.

46. **The authorities have demonstrated strong ownership in the design of the program.** Its design responds to the concerns and priorities presented during a broad process of social consultation, and is aimed at ensuring that the program is anchored in domestic consensus. Although the program is based on a more gradual fiscal and wage-bill adjustment than previously recommended, the government has more ownership of the program. The authorities have taken difficult steps to resolve costly inequities in the systems of public sector remuneration and tax collection, and begun a far-reaching financial sector reform. Moreover, they have committed to governance and anti-corruption measures which are a direct response to concerns raised in the National Dialogue, in the discussions leading to the Fiscal Pact, and in social protests.

47. **Achievement of the growth targets of the program will be vital for its success.** Growth is imperative to fulfill social expectations and in particular to make substantive inroads in reducing poverty. Critical prerequisites for achieving the targets include: a smooth and timely implementation of the public enterprise investment program and the planned large private investments in infrastructure; adequate support for competitiveness through the exchange system; and an active response to the challenges posed by CAFTA—as well as timely progress with the programmed structural reform agenda.

48. **Increasing anti-poverty spending is a key objective.** The authorities' commitment to catch up fully with the original PRSP goals by 2006 is both necessary and commendable. A more rapid catch-up in spending would not be feasible, given Honduras' tight fiscal constraints. Moreover, the redefinition of anti-poverty spending should make it more likely than previously that such spending will be effective in laying the groundwork for achievement of the MDGs. To alleviate concerns about the government's ability to track anti-poverty spending effectively, high priority should be placed on the development of a fully automated tracking system.

49. **The staff regrets the imposition of a price freeze, which is not consistent with either the social or growth objectives of the program.** However, it is temporary and now restricted to relatively few goods which have most weight in the food baskets of the poor. If

it can be administered flexibly enough to avoid supply pressures, and if priority is given to accelerating the passage of the competitiveness law to permit an early expiration date, the freeze should not have lasting effects.

50. **The program, if implemented without slippage, should lead to fiscal sustainability.** Its foundation in social consensus strengthens the likelihood of full implementation. The government needs to take every opportunity to explain to the community that the revenue-raising measures and expenditure cuts are the unavoidable implication of the high government wage bill. The authorities are encouraged to make these measures as acceptable as possible by continuing to remain open to the possible need to protect vulnerable groups from their impact—in particular from the higher fuel tariffs.

51. **The fiscal program achieves the needed consolidation, while protecting investment and providing for increased poverty-reduction spending.** It also contains significant structural reforms. The new Salaries Law crucially re-establishes executive branch control over the wage bill, and, hence, is a key structural breakthrough. Supplemented by the authorities' planned public administration reform, it creates the basis for a sustainable and equitable civil service policy. As stressed in the ex-post assessment, these measures are key to the viability of the fiscal program, and also to World Bank support. Hence, it will be particularly important to avoid any reversals.

52. **The fiscal program is frontloaded—as recommended in the ex post assessment.** It has important prior actions to ensure progress with difficult structural reforms and to reduce the need for contingency measures. However, given the risks to the program, the authorities have appropriately identified contingency measures, to which the staff attaches considerable importance.

53. **The authorities intend to achieve the inflation goals of the program within the context of the current exchange regime.** For this to be feasible, it will be important for the central bank to make full use of all of its monetary instruments, and particularly to strengthen the effectiveness of its interest-rate signaling. Interest rates should also be used as a first line of defense to achieve the programmed international reserves target. In this connection, the authorities should however also exploit to the fullest extent the scope for flexibility within the crawling band regime.

54. **The gradual fiscal adjustment path envisaged leaves Honduras vulnerable to shortfalls in external financing and other adverse shocks.** If these were to materialize, stronger macroeconomic policies would be unavoidable, not only on the fiscal side but also in monetary and exchange rate policies.

55. **The structural reforms will, if implemented as envisaged, usher in welcome institutional change.** The financial reform addresses the major vulnerabilities identified in the 2003 FSSA. The authorities' timetable is very ambitious, but feasible and necessary. Its achievement will require vigilance and commitment. The governance reforms are welcome, not only because they signal the authorities' commitment to resolve social grievances, but also because an improvement in Honduras' standing in corruption and governance indices

(such as that of Transparency International) would contribute significantly to enhancing prospects for foreign and domestic investment.

56. **In light of the authorities' commitment to a comprehensive three-year economic program, approval of their request for a PRGF arrangement is recommended, as well as the request for interim HIPC assistance.**

Box 1. Tax Policy

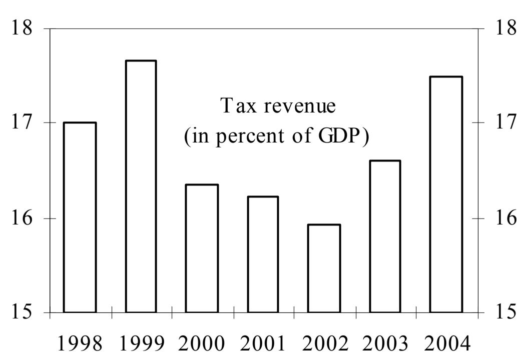
Background. Tax revenue declined by 1½ percent of GDP in 1999–2002, reflecting a proliferation of exemptions, weakening tax administration, and declining import duties. Hurricane Mitch also inhibited tax collection during 1999–2000. In July 2002 and April 2003, the authorities took measures to strengthen the tax system and raise revenue (by 1.4 percent of GDP on an annual basis). Key actions included:

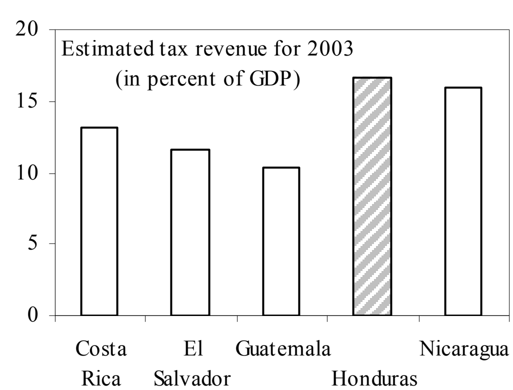
- **Income taxes.** Broadening the income tax base to cover some personal income bonuses; eliminating deductions for personal and corporate expenses; unifying the corporate income tax rates at the top rate of 25 percent; and raising withholding rates (with a yield of 0.2 percent of GDP).
- **Surcharges.** A two-year surcharge of 5 percent on corporate income, except for small companies (0.2 percent of GDP) and introduction of a 1 percent tax on enterprises' net assets (0.2 percent of GDP).
- **Sales tax.** Broadening the sales tax base to include many consumption goods, some inputs, and certain services (mainly distribution of tobacco products and most beverages).
- **Tax administration.** Strengthening tax administration by improving sales tax auditing capacity, the monitoring of large taxpayers, and collection enforcement through temporary closure of delinquent businesses. Cross-checking of sales and income taxes and taxpayer databases are also being improved.

Tax policy for 2004–06. Tax revenue measures are targeted to generate nearly 1 percent of GDP in 2004:

- **Fuel tax.** Increasing tariffs on petroleum derivatives (0.6 percent of GDP).
- **Full implementation of earlier measures.** Implementing fully the tax measures of 2003 by raising the excise tax on cigarettes and collecting sales taxes on credit card operations (0.2 percent of GDP); also, some tax exemptions will be eliminated.
- **Tax and customs administration.** Modifying the tax code to enforce collection and strengthen the powers of the Tax Office, enhancing control of large taxpayers (including by extending the coverage of electronic filing), establishing specialized tax courts, and tightening customs controls.

The tax-GDP ratio is targeted to remain constant in 2005–06. To meet the target, including helping to offset the potential impact of CAFTA on tax revenue, tax policy will aim to extend the income tax surcharge through 2006, maintain the real value of specific excises, and eliminate exemptions as proposed under the Fiscal Responsibility Pact.





Box 2. Performance Under the PRGF of 1999–2001

Honduras is a long-term user of Fund resources. Since 1990, Honduras was involved in Fund-supported programs: (i) the 1990–1992 Stand-By Arrangement, which was fully disbursed, (ii) the 1992–1995 ESAF, and (iii) the 1999–2001 PRGF, which both were not completed owing primarily to policy slippages in the fiscal area. In addition, there was a staff-monitored program in 1997–1998.

The most recent three-year PRGF arrangement, for an amount equivalent to SDR 156.8 million (121 percent of quota), was approved on March 26, 1999. Besides quantitative fiscal and monetary performance criteria, the arrangement also included important commitments for structural reforms—especially in the areas of the banking system, pensions, the civil service, and restructuring of the electricity and telecommunications sectors (including privatization of the state telephone company).

Honduras completed three out of the six reviews under the previous PRGF. Performance on the quantitative targets under the program was initially satisfactory with substantial progress made on planned banking reforms. Following completion of the second review under the PRGF in June 2000, Honduras was able to reach its Decision Point under the enhanced HIPC Initiative on June 30, 2000.

Two key structural performance criteria approved under the second review of the PRGF arrangement were either completed with a delay or not met. The bidding for the state telecommunications company was concluded in October 2000, four months behind schedule, while the approval of a civil service reform law intended to strengthen public wage policy was not observed. Conditionality on the civil service reform was carried over into the proposed program for the third year under the PRGF arrangement. Two other structural performance criteria (the creation of an independent statistical institute and the submission of a law to simplify procedures to establish new companies) were observed.

The PRGF arrangement went off track at the end of 2001 because of slippages in fiscal policy and structural reforms. Fiscal imbalances related to wage pressures and weak tax collections intensified in the course of the presidential elections of November 2001. Two structural performance criteria that were approved under the third review of the PRGF (the submission to congress of a civil service reform draft law that would allow containment of the government wage bill and the elimination of the special wage regimes, and the approval of a budget that would limit central government wages in 2002 to less than 9.1 percent of GDP) were not implemented. However, other structural performance criteria on strengthening the banking sector and adjusting the base rate to improve external competitiveness were implemented, some with delays. Several structural benchmarks covering fiscal and monetary transparency and governance were also implemented.

Box 3. Status of Floating Completion Point Conditions Under the Enhanced HIPC Initiative

Poverty Reduction Strategy and Macroeconomic Stability

1. **Successful implementation of the full PRSP for at least one year as evidenced in one comprehensive annual progress report endorsed by the Boards of IDA and the Fund.** The first progress report of the PRSP that accompanies this staff report was completed in December 2003. It serves as a basis to assess implementation of the poverty reduction strategy (see accompanying JSA).

2. **Maintenance of macroeconomic stability as evidenced by performance under a program supported by a PRGF arrangement.** A request for a new three-year PRGF arrangement is being presented for Board approval.

Structural and Social Reforms

3. **Preparation and implementation of a participatory, comprehensive anti-corruption strategy and its presentation to the national and international community.** Progress has been made in implementing the specific condition; the World Bank is evaluating to what extent the trigger has been complied with. A participatory anti-corruption strategy was published and presented to civil society and international community in March 2002. To strengthen control schemes, a Superior Accounting Tribunal was created in January 2003. Pending actions, which will be taken in 2004, comprise the issue of regulations that govern the tribunal organization, hiring and training of staff for the new tribunal, setting up on-line information systems, and improvements in the automaticity and transparency of regulations that affect the private sector.

4. **Implementation of the social security system reform plan approved by the IHSS Board on May 24, 2000.** Substantial progress has been made in implementing key components of the plan; the World Bank is evaluating the extent of compliance. The plan includes the separation of the health and pension plans of the IHSS; the strengthening of the regulatory capacity of the ministry of health and improving coverage and quality of health services; and making the pension plan of the IHSS actuarially sound and expanding its coverage.

5. **Health services.** The specific condition has been observed, namely delivery of basic health services to at least 100,000 beneficiaries in poor communities (focusing on primary and maternal/ child care). Services have been provided under a contracting scheme with community organizations.

6. **Quality of education.** The specific condition has been observed. At end-2003, the number of schools with community participation (PROHECO) amounted to 1,700, exceeding the targeted amount of 1,350 PROHECO schools.

7. **Safety nets.** The specific condition is the implementation of social investment projects based on participatory planning methodologies in all beneficiary municipalities. As of end-2003, FHIS has applied these methodologies in 50 of the 87 poorest municipalities in the country.

8. **Substantive compliance with Basel Core Principles, and raising the capital adequacy ratio from 9 to 10 percent, and enforcing it on all commercial banks.** The program envisages an ambitious strategy to fulfill the former condition (Box 8). The authorities have raised the capital adequacy ratio as planned, and are taking steps to effectively enforce it across banks.

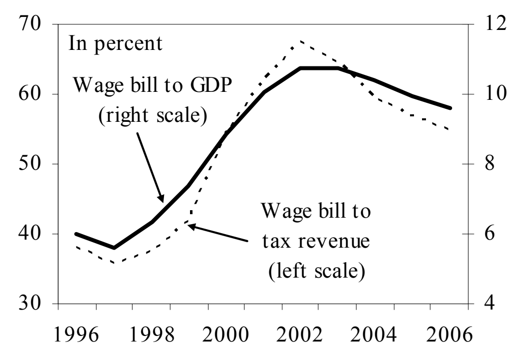
Box 4. Wage Policy and Civil Service Reform

A key element of the program is the reform of the government wage policy, and associated structural reform of the civil service. The first stage of the reform is designed to address structural weaknesses in wage policy and reverse the upward trend of the wage bill (in term of GDP) that had been observed since 1998. The second stage will improve efficiency.

Background

- **Control over the wage bill had been limited by special wage regimes.** These regimes (created by congress starting in 1997) provided for large wage increases delinked from performance and budget considerations. They covered over 80 percent of government staff. The largest regimes were for teachers (one-half of the wage bill) and health workers (one-fifth).

- **Under these regimes, the government wage bill rose sharply.** It rose from 40 percent of tax revenue in 1997, prior to the adoption of these regimes, to over 65 percent by 2003. In terms of GDP, it rose from 6 percent in 1997 to an estimated 10.8 percent in 2003. By comparison, the average government wage bill in the Central American region is 6 percent of GDP and in all PRGF arrangements is 5¼ percent of GDP.



Reform

Congress approved a new wage policy framework law in December 2003. The new framework allows the government to regain control over the wage bill by the end of the arrangement. Measures include:

- **Re-establishing the equity of the wage regime.** Eliminating special wage regimes; broadening the scope of wage policy to cover all government employees; and allowing government (instead of congress) to formulate wage policy in line with anticipated inflation.

- **A transition.** Allowing a transitional period through end-2006 to fully incorporate teachers into the wage policy. Meanwhile, base salaries for teachers will increase slightly below targeted inflation in 2004–06 while special wage payments related to seniority and education will be capped.

- **Decelerating wage growth.** Freezing base salaries for doctors in 2004; increasing wages for civil service staff in line with targeted inflation; and capping government salaries. Moreover, the budget calls for wage increases in decentralized agencies in line with targeted inflation for 2004.

- **Human resources management.** Strengthening some aspects of the civil service framework to provide the basis for a professional civil service, including merit-based recruitment and promotion, limits on political appointments, and creation of an independent regulatory body. The World Bank will support this strategy with envisaged policy loans.

Under these reforms, the government wage bill is expected to gradually decline to 10.4 percent of GDP in 2004 and further to 9.6 percent by 2006. Moreover, the structural reforms are intended to depoliticize the civil service and improve the efficiency of public sector management, permitting further wage-bill savings beyond the period of the program.

Box 5. Poverty Reduction Strategy Paper (PRSP) and Progress Report

The goal of the PRSP is to reduce the overall rate of poverty from 66 percent of the population in 1999 to 42 percent by 2015. The PRSP was completed in August 2001, and a progress report completed in December 2003. The PRSP was based on the adoption of strong macro and structural policies to support a gradual increase in real growth to 5½–6 percent a year, with ambitious social policies to improve education, health, safety nets, give the poor more access to basic infrastructure, and strengthen governance and transparency. The cost of the PRSP was to be covered through a combination of concessional external financing and increased public savings.

Performance under the PRSP has been disappointing mainly as a result of significant policy slippages and an adverse external condition. Little progress was made in alleviating poverty during 2001–03 as real growth was lower than anticipated while anti-poverty spending only reached 2.6 percent of GDP a year, well below a target of 4–4½ percent per year envisaged under the PRSP. A sharp decline in public sector savings (mainly on account of large increases in the government wage bill) limited anti-poverty spending in this period. As a result, targets for child mortality and coverage of education, and water and sanitation were missed.

Risks to the sustainability of the strategy identified by the JSA in 2001 are being addressed in the progress report. These included lack of national consensus, limited implementation capacity, fiscal weaknesses, shortfalls in external financing, and external shocks. To address some of these risks, the government strengthened participation of the civil society and international community through a broad consultation process of the PRSP progress report conducted during the first half of 2003. The strategy reflects increased government ownership, as it is based on a more realistic macroeconomic framework and structural reforms to strengthen fiscal policy. It also uses a programmatic approach that is expected to facilitate the consecution of additional foreign resources.

The strategy in the progress report, completed in December 2003, contains the following elements:

Redefining the macroeconomic framework. There was consensus that more realistic GDP assumptions would result in more efficient anti-poverty programs. Real GDP is now expected to increase gradually from 3 to 4½ percent. While consistent with medium term sustainability, the fiscal path for the next few years will be less ambitious than originally anticipated, following a higher-than-expected deficit for 2003. This will imply a slower decline in non PRSP spending, and a more gradual increase in anti-poverty expenditure compared to the original strategy.

Maintaining the poverty reduction targets while improving efficiency. Society decided to preserve the original poverty reduction targets for 2015. However the annual targets were redefined to take into account the delays in 2001–02, and the social indicators were reformulated to facilitate their measurement. With less ambitious GDP and anti-poverty expenditure goals in the next few years, this will require substantial improvements in the cost-efficiency of programs that would translate into higher growth-poverty elasticity. This would only be possible through the implementation of policies to increase investment in human capital, and strengthen competitiveness.

Broadening the definition of anti-poverty spending. This broadens the spectrum to include all nationally funded resources oriented to social programs and not only the domestic counterpart of external loans financing these programs. It also encompasses all capital and current expenditures of PRSP programs, but contains safeguards to exclude any non poverty reduction expenditure in social programs and all salary increases (by defining an allowable wage equal to 3.5 times per capita GDP for teachers and 5 times per capita GDP for medical doctors).

Reformulating the PRSP budget. The updated PRSP includes budgetary projections until 2007, with PRSP expenditure consistently rising from 7.5 percent of GDP in 2003 to 9.7 percent of GDP in 2007. Domestic financing accounts to about 60 percent of the PRS, on average, and the rest is financed with external funds, except for a financing gap of 0.7 percent of GDP in 2006 and 1.1 percent in 2007. Budgetary projections from 2008 on are not included in the update.

Improving monitoring systems. The government will strengthen poverty spending monitoring, establishing a fully automated tracking system. Interfaces will be completed to allow information-sharing between the different account management systems. Moreover, information on donor funding is being improved, and efforts are being made to improve budget classification and to report spending financed with own-revenues from the ministries of health and education.

Remaining risks to the updated PRS include political impediments to meet the PRGF targets, difficulties to mobilize the necessary external resources, delays in the update of budgetary and monitoring systems, failures in the implementation capacity, and inability to maintain a participatory approach to the strategy.

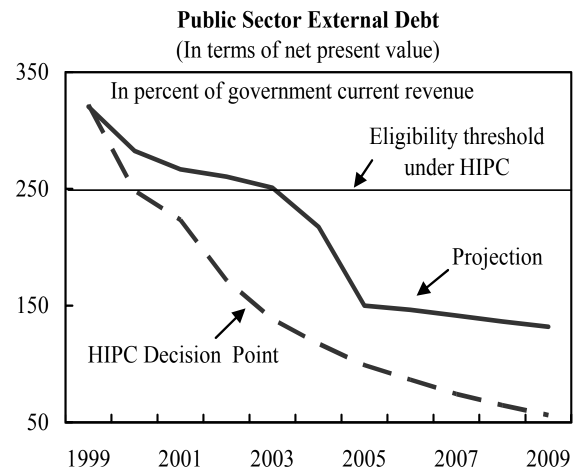
Box 6. External Debt Dynamics

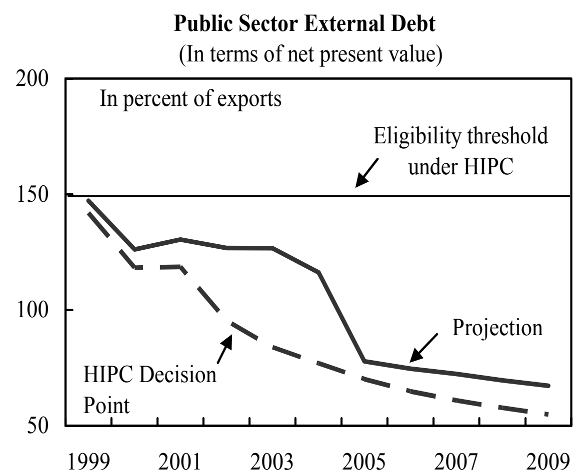
The burden of the external debt would be significantly alleviated under the proposed program.

Background

- **Macroeconomic performance during 2000–03 was weaker than projected at the HIPC decision point (www.imf.org).** The outturn reflects large policy slippages and adverse external conditions (weaker terms of trade and export demand). Real GDP growth was lower than anticipated and the HIPC completion point has not been obtained (originally expected in 2002). Notwithstanding, through October 2002, Honduras received interim HIPC debt relief broadly as anticipated.

- **As a result, debt ratios improved at a slower pace than expected.** At end-2003, the net present value (NPV) of public sector external debt stood at 248 percent of government current revenue and 127 percent of exports, well above the ratios envisaged in the HIPC decision point document (www.imf.org)—mainly because of lower GDP and export growth.





Prospects

- **The burden of external debt would decline further under the proposed program.** The NPV of public sector external debt would decline to 141 percent of government current revenue and 68 percent of exports by 2009. Domestic debt would fall from around 6 percent to around 4½ percent of GDP over the period. The debt dynamics is based on the following key assumptions:

-- Macroeconomic. A gradual pick up in real GDP growth to 4½ percent by 2006; an increase in government current revenue to 19.5 percent of GDP by 2006; and a rise in export growth to 8 percent a year over the projection period, reflecting a gradual recovery in the terms of trade and export demand.

-- Debt relief. The projection assumes that the HIPC completion point would be reached in 2005 while Paris Club creditors would be granting debt relief beyond HIPC for some US$600 million in NPV terms (43 percent of 2003 government current revenue).

Sensitivity

If the primary balance of the combined public sector were two percentage points of GDP less than projected, the NPV of external debt in terms of government current revenue would gradually rise starting in 2005. Table 12 displays the external debt dynamics under various temporary shocks (such as lower than projected real GDP growth, export growth, or real exchange rate depreciation).

Box 7. Structural Conditionality

Status of structural conditionality from earlier programs

The previous PRGF arrangement went off track at the end of 2001 because of slippages in fiscal policy and structural reforms. The two structural performance criteria that were approved under the third review of that PRGF arrangement but not implemented were (i) the submission to congress of a draft of a civil service reform law that would allow the government to set a limit on its wage bill in relation to GDP, and had as an objective the absorption of special wage regimes into the government's overall wage policy, and (ii) the approval of a budget that would limit central government wage bill in 2002 to no more than 9.1 percent of GDP. The draft law that was sent to congress failed to strengthen wage policy as envisaged, and the approved limit was 10 percent of GDP. However, two other structural performance criteria (the requirement of banks to publish quarterly financial information, including adjusted CARs, and the adjustment of the base rate so as to prevent a real appreciation of the lempira) were implemented, while the requirement that any bank not meeting the 10 percent CAR should be subject to action plans, and any bank with a CAR below 6 percent should be subject to an "auditoria preventiva," was implemented in May–July 2002, seven months behind schedule.

Coverage of structural conditionality in the proposed program

During the first year of the arrangement, structural performance criteria focus on steps to (i) strengthen the sustainability of the fiscal position, including through the amendment of the tax code and the suppression of the intra-year unfinanced appropriations; (ii) strengthen financial regulation, supervision, and the financial safety net through the adoption of a new Financial Institutions Law and amendment of the CNBS Law, the Deposit Insurance Law, and the Central Bank of Honduras Law; and agree on timetables to comply with new regulations on capital adequacy, loan classification and provisioning, and to make the use of indirect instruments of monetary management more effective; and (iii) agree on a plan for managing the exchange rate in the context of the current exchange regime. Structural benchmarks cover fiscal and monetary transparency and governance.

Structural areas covered by World Bank and IDB lending and conditionality

The private sector role in telecommunications and the production and distribution of electricity continues to be important to improve economic efficiency. The World Bank is currently providing financial management technical assistance in the telecommunications area. Subject to agreement on a PRGF arrangement, the World Bank's base-case Country Assistance Strategy envisages loans for budgetary support and in support of reforms in trade and competitiveness, land regularization, forestry and rural productivity, education, and judicial reforms. New IDB lending, linked also to a PRGF agreement, includes loans for poverty reduction, financial sector reform, and public sector reform.

Other relevant structural conditions

Conditions to reach the HIPC completion point include strengthening of the financial sector by compliance with the Basel Core Principles, preparation and implementation of a participatory anti-corruption strategy, adoption of the social security reform plan approved by the IHSS Board in May 2000, strengthening of the basic health services to the poor, improvement in the quality of education by increasing the number of schools with community participation, and increases in the efficiency and targeting of safety nets. The World Bank and IDB are monitoring many of these reforms and providing technical assistance.

Box 8. Financial System Reform

In response to the findings of the 2003 FSAP, the authorities have embarked on a comprehensive financial system reform aiming at: (i) strengthening the regulatory framework and ongoing supervision, (ii) enhancing the efficiency and effectiveness of the financial safety net, and (iii) improving mechanisms to prevent money laundering and financing of terrorism. Critical elements will be implemented in 2004, as the current universal deposit insurance scheme will expire by October 2004.

Prudential regulation and supervision. The planned reform should provide the National Banking and Insurance Commission (CNBS) with the instruments to ensure and maintain a sound financial system. This effort includes:

- Legal and regulatory changes to introduce consolidated reporting and supervision. By end-2006 consolidated statements should be available for each financial holding company.

- Regulatory changes to strengthen loan classification and loan loss provisioning. By the first review the authorities will agree with the Fund on a timetable for each bank to be fully provisioned and recapitalized by end-2006. Provisioning requirements will also apply to the banks' investments in FONAPROVI bonds that resulted from the debt relief to agricultural producers.

- Bringing all banks in compliance with all prudential rules and regulations (mainly regarding related lending and bank investments in nonfinancial firms).

- Introducing new regulations to improve the banks' risk management practices and governance structures.

Financial safety net. The plan calls for a reform of the financial safety net, to make it more effective and efficient, and limit moral hazard. The following measures are planned under the program (in conjunction with the reform of the central bank's lender of last resort facility):

- An improved bank resolution framework will put more emphasis on early detection, least resolution cost principles, and preservation of debt discipline. Resolution will henceforth be the CNBS' mandate (instead of FOSEDE's).

- FOSEDE will be recapitalized and its mandate limited to managing the deposit insurance scheme.

Anti-money laundering and combating terrorist financing. During 2004 the CNBS will improve multilateral and bilateral cooperation to combat money laundering. Regulations on confiscation, freezing and seizure will be upgraded and onsite verification of the supervised entities' policies regarding customer acceptance will start. The government will also introduce amendments to the Penal Code to make financial crimes, including fraud and money laundering, punishable, allowing judicial action. This measure will meet a main concern of the public—that financial wrongdoing, leading to bank failures can go on unpunished.

Box 9. U.S. Central American Free Trade Agreement (CAFTA)

Honduras together with El Salvador, Guatemala, and Nicaragua reached a free trade agreement with the United States on December 17, 2003, which will be effective upon full ratification. Costa Rica has postponed its decision and the Dominican Republic is expected to join the agreement later. Ratification in the Central American countries is largely expected by mid-2004; approval by the U.S. Congress, on the other hand, is likely to take more time.

CAFTA will extend preferential access to the U.S. market currently granted on a temporary basis under the Caribbean Basin Initiative. In addition to the phased liberalization of trade in goods, it broadens market access for services and strengthens discipline in areas such as intellectual property rights, investment, government procurement, competition policies, and labor regulations.

The agreement will provide new growth opportunities for Honduras' export industries including *maquila*. The exact details of the agreement have not yet been released, thus preventing a detailed analysis. Nevertheless, it appears that in particular the textile industry will benefit through changed rules of origin which will allow more inputs to be sourced from third countries while maintaining the duty-free and quota-free access to the U.S. market.

The fiscal impact will be spread out over the unusually long transition periods for agricultural goods (up to 20 years). No quantitative assessment of the impact is yet available. Import tariffs on several sensitive items (such as sugar and corn) remain. So do some import quotas, although at higher levels.

Table 1. Honduras: Comparative Governance Indicators 1/

	Voice and Accountability	Political Stability	Government effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Costa Rica						
2002	84.8	86.5	66.5	72.7	72.2	79.4
1997/98	87.8	81.2	73.5	90.9	71.5	76.6
El Salvador						
2002	51.5	56.8	35.6	56.2	39.7	36.6
1997/98	49.4	48.1	44.5	99.4	29.7	41.6
Guatemala						
2002	35.4	32.4	32.0	52.1	21.5	30.9
1997/98	33.1	22.1	45.8	66.7	10.3	18.8
Honduras						
2002	**46.0**	**38.4**	**27.3**	**41.8**	**23.7**	**27.3**
1997/98	**51.2**	**36.4**	**36.1**	**43.6**	**17.0**	**11.0**
Nicaragua						
2002	52.0	47.6	17.5	39.7	32.0	39.7
1997/98	57.6	37.7	29.7	37.0	25.5	18.2
Average for Central America						
2002	53.9	52.3	35.8	52.5	37.8	42.8
1997/98	55.8	45.1	45.9	67.5	30.8	33.2
Average for Latin America						
2002	61.2	51.2	53.3	58.4	53.2	54.9
1997/98	59.1	45.0	48.3	66.4	43.9	46.7

Source: Kaufmann, Kraay, Zoido-Lobaton (2002), http://info.worldbank.org/governance/kkz/

1/ Percentile rank with a higher number denoting better governance.

Table 2. Honduras: Comparative Social Indicators

	Costa Rica	El Salvador	Guatemala	**Honduras**	Nicaragua	Average for Latin America and the Caribbean
Rank in 2002 UNDP Human Development Index (out of 173 countries)	43	104	120	**116**	118	...
GDP per capita PPP, U.S. dollars (2000)	8,650	4,497	3,821	**2,453**	2,366	7,234
Life expectancy at birth (years) (2000)	77.5	70.2	65.2	**66.0**	68.9	70.0
Under-5 mortality (per 1,000 live births) (2000)	13.4	35.4	38.8	**43.8**	40.8	32.0
People not expected to survive to age 40 (in percent of population) (1999)	4.0	10.9	15.6	**16.0**	11.5	9.7
Undernourished people (as percent of total population)	5	12	22	**21**	29	12
Population without access to safe water (1999)	2	26	8	**10**	21	22
Per capita health exp. in PPP, U.S. dollars (1998)	257	143	78	**74**	54	...
Physicians per 100,000 people (1990-99)	141	107	93	**83**	86	...
Adult illiteracy (2000)	4.4	21.3	31.4	**25.4**	33.5	11.7
Primary school net enrollment (1997) (percent of relevant age of the population)	91.8	89.1	73.8	**87.5**	78.6	93.3
Secondary school net enrollment (1997) (percent of relevant age of the population)	55.8	36.4	34.9	**36.0**	50.5	65.3
Income share of:						
the richest 20 percent of the population	51	56.4	60.6	**59.4**	63.6	...
the poorest 20 percent of the population	4.4	3.3	3.8	**2.2**	2.3	...
Gini Index (1997-98)	45.9	52.2	55.8	**56.3**	60.3	...
Percent of population below official poverty line 1/	19.0	50.3	54.3	**63.1**	47.9	50.7

Sources: World Bank World Development Indicators 2002; Szekely, Lustig, Cumpa, and Mejia (2000); and UNDP Human Development Report 2001 and 2002.

1/ Not comparable across countries due to methodological issues. For Guatemala, Honduras, and Nicaragua, the information refers to the Poverty Reduction Strategy Paper.

Table 3. Honduras: Selected Economic Indicators

					Est.	Program		
	1999	2000	2001	2002	2003	2004	2005	2006
	(Annual percentage changes, unless otherwise indicated)							
National income and prices								
GDP at constant prices	-1.9	5.7	2.6	2.7	3.0	3.5	4.0	4.5
GDP deflator	11.6	9.7	8.0	6.3	6.4	7.7	7.3	6.0
Consumer prices (end of period, eop)	10.9	10.1	8.8	8.1	6.8	6.7	6.0	5.0
Exchange rate (eop, depreciation -)								
Lempiras per U.S. dollar	-4.8	-4.2	-4.9	-5.9	-5.0	...	...	...
Real effective rate 1/	7.5	7.9	4.2	-3.8	-6.2	...	...	...
Money and credit								
Net domestic assets	-3.4	19.8	8.8	5.2	23.9	8.9	10.8	9.2
Combined public sector credit	-78.8	2.6	3.1	-0.9	27.3	-3.1	-7.2	-18.1
Private sector credit	20.9	15.4	12.2	7.6	13.0	8.3	8.8	8.0
Broad money	23.4	20.6	14.2	14.3	12.4	10.7	11.7	10.7
Lending rate (eop, in percent)	29.5	24.6	23.2	21.1	18.1	...	...	...
Deposit rate (eop, in percent)	19.0	14.5	14.3	13.1	11.3	...	...	...
	(In percent of GDP)							
Combined public sector								
Noninterest revenue and grants	28.7	27.1	27.1	25.3	26.1	27.2	27.8	27.8
Noninterest expenditure	26.7	26.6	29.8	28.6	30.2	29.7	30.0	29.5
Primary balance	2.0	0.5	-2.7	-3.2	-4.1	-2.5	-2.3	-1.8
Net interest payments	2.1	1.3	0.4	0.4	0.6	0.5	0.3	-0.1
Savings	8.8	7.1	3.7	2.0	1.4	3.9	4.8	5.9
Capital expenditure	8.2	7.0	7.7	5.8	6.0	6.8	7.8	7.5
Overall balance	**-0.2**	**-0.8**	**-3.2**	**-3.6**	**-4.6**	**-3.0**	**-2.5**	**-1.7**
External financing 2/	7.2	1.5	3.0	1.8	1.9	3.2	2.9	2.6
Domestic financing	-7.0	-0.7	0.1	1.8	2.7	-0.2	-0.4	-0.9
Savings and investment								
Fixed capital formation	29.9	26.1	23.6	22.1	23.6	26.1	24.9	25.3
Gross national savings	25.4	22.2	18.9	19.0	18.3	18.9	20.5	21.6
	(In millions of U. S. dollars, unless otherwise indicated)							
Balance of payments								
Gross international reserves	1,230	1,285	1,386	1,492	1,415	1,492	1,592	1,712
(in months of imports) 3/	4.4	4.4	4.7	4.7	4.0	4.0	4.1	4.1
Change in net international reserves (increase -)	-340	-20	-80	-129	78	-78	-100	-120
External current account balance (percent of GDP)	-4.4	-4.0	-4.7	-3.1	-5.2	-7.1	-4.5	-3.8
(excluding official transfers)	-11.5	-9.1	-11.1	-7.2	-8.4	-10.1	-7.9	-7.1
Exports, f.o.b. (annual percent change)	-24.4	18.0	-4.2	-1.3	2.1	8.6	8.7	7.7
Imports, f.o.b. (annual percent change)	5.9	6.4	5.2	0.8	8.8	11.6	3.9	6.1
Public sector debt (in percent of GDP) 4/	81.8	75.8	74.1	72.9	72.1	66.7	51.5	50.7
Public sector external debt (in percent of GDP) 4/	77.8	71.5	69.6	68.1	66.4	61.1	46.5	46.2
Public sector external debt service (in percent of exports of goods and services) 4/5/	7.8	7.0	8.7	8.3	8.7	7.7	5.9	5.4

Sources: Central Bank of Honduras; Ministry of Finance; and Fund staff estimates and projections.

1/ As of end-October for 2003.
2/ Includes external financing gap starting in 2004.
3/ Refers to the following year's imports of nonmaquila goods and nonfactor services.
4/ Includes medium- and long-term public and publicly guaranteed external debt, after HIPC and beyond HIPC debt relief. HIPC completion point is assumed in March 2005.
5/ Debt service paid.

Table 4. Honduras: Operations of the Central Government
(In percent of GDP)

	1999	2000	2001	2002	Est. 2003	Prog. 2004	2005	2006
Total revenue and grants	**20.0**	**18.7**	**20.0**	**19.4**	**19.8**	**20.7**	**20.9**	**20.9**
Current revenue	19.4	17.7	18.2	18.3	19.0	19.7	19.5	19.5
Tax revenue	17.7	16.4	16.2	15.9	16.6	17.5	17.5	17.5
Nontax revenue	1.2	0.8	0.9	1.0	1.0	1.0	1.0	1.0
Transfers	0.5	0.6	1.1	1.4	1.3	1.1	1.1	1.0
Grants	0.6	1.0	1.8	1.1	0.9	1.0	1.4	1.4
Of which								
HIPC relief 1/	0.0	0.1	0.7	0.5	0.1	0.1	0.6	0.6
Total expenditure	**23.8**	**24.4**	**26.1**	**24.7**	**25.4**	**24.2**	**23.9**	**23.4**
Current expenditure	16.7	17.4	18.6	18.8	19.9	18.3	17.8	17.3
Wages and salaries	8.0	8.9	10.1	10.7	10.8	10.4	10.0	9.6
Goods and services 2/	2.1	2.7	2.8	2.4	2.5	2.4	2.5	2.7
Transfers 3/	3.5	3.2	3.6	3.8	4.6	3.6	3.6	3.5
Interest payments	3.1	2.6	2.1	1.9	2.0	1.9	1.8	1.6
External 4/	2.4	2.1	1.8	1.6	1.5	1.4	1.2	1.1
Domestic	0.8	0.4	0.4	0.3	0.5	0.5	0.5	0.4
Capital expenditure	5.9	5.9	6.7	5.0	4.8	5.2	5.6	5.7
Fixed capital formation	2.7	2.7	2.8	2.2	1.9	2.2	2.0	1.5
Transfers	3.2	3.2	3.9	2.8	3.0	3.0	3.6	4.2
Net lending 5/	1.2	1.1	0.6	0.9	0.6	0.6	0.5	0.4
Overall balance	**-3.8**	**-5.7**	**-6.1**	**-5.3**	**-5.5**	**-3.5**	**-3.0**	**-2.5**
Financing	**3.8**	**5.7**	**6.1**	**5.3**	**5.5**	**3.5**	**3.0**	**2.5**
External	7.4	1.4	3.5	1.7	1.7	-2.4	0.8	0.5
Disbursements	7.1	2.2	3.9	2.4	2.5	2.9	3.1	2.7
Amortization	-3.7	-6.5	-1.9	-2.3	-2.5	-2.5	-2.3	-2.1
Zero-coupon bonds	0.0	-1.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Exceptional financing	4.0	6.6	1.6	1.8	1.8	-2.7	0.0	0.0
Domestic	-3.6	4.3	2.6	3.5	3.8	0.5	0.0	0.0
Financial system	-4.7	1.6	2.1	0.2	2.4	0.5	0.0	0.0
Bonds	0.0	0.5	0.3	0.7	0.3	0.0	0.0	0.0
Extraordinary transfers 6/	0.0	0.0	0.0	2.3	1.3	0.0	0.0	0.0
Floating debt	1.1	2.3	0.2	0.4	-0.1	0.0	0.0	0.0
Financing gap 7/	**...**	**...**	**...**	**...**	**...**	**5.4**	**2.2**	**2.0**
Memorandum items								
Current account balance	2.6	0.3	-0.6	-0.5	-1.0	1.4	1.7	2.2
Primary balance	-0.7	-3.1	-4.0	-3.4	-3.6	-1.6	-1.2	-0.9
PRSP spending								
Current definition	...	...	...	7.5	7.5	8.1	8.7	9.4
Previous definition	...	5.1	2.9	2.4	2.6	3.2	3.8	4.5

Sources: Central Bank of Honduras; Ministry of Finance; and Fund staff estimates and projections.

1/ Comprises HIPC interim relief from IBRD/IDA starting in 2000, and the IDB and the Fund starting in 2001.
2/ Assumes savings from a central administration reform equivalent to 0.2 percent of GDP per year in 2005-06. However, these savings could materialize in other current expenditures.
3/ Includes the cost of support plan for agricultural loans (1 percent of GDP in 2003).
4/ On an accrual basis.
5/ Includes the costs of closing and merging financial institutions: Bancorp (1999), Solfisa and Banhcrecer (2001), and Banco Capital (2002), and Banfaa (2003), equivalent to 0.6, 0.2, 0.5, 0.5, and 0.2 percent of GDP, respectively.
6/ From the state telephone company, HONDUTEL.
7/ Assumed to be covered with program loans from the World Bank and the IDB and rescheduling from the Paris Club with comparable treatment from non-Paris Club official bilateral and commercial creditors.

Table 5. Honduras: Operations of the Combined Public Sector

(In percent of GDP)

	1999	2000	2001	2002	Est. 2003	Prog. 2004	Prog. 2005	Prog. 2006
Total revenue and grants	**30.4**	**28.8**	**28.9**	**26.9**	**27.6**	**28.7**	**29.5**	**29.6**
Current revenue	29.6	27.3	26.8	25.7	26.4	27.5	27.9	28.0
Tax revenue	18.2	17.3	17.0	16.8	17.5	18.4	18.3	18.3
Nontax revenue 1/	4.3	3.8	4.2	4.8	5.2	5.3	5.3	5.2
Interest earnings	1.7	1.7	1.8	1.6	1.4	1.4	1.5	1.7
Operating balance of public enterprises	5.3	4.6	3.8	2.5	2.4	2.5	2.7	2.7
Capital revenue	0.1	0.4	0.3	0.1	0.2	0.2	0.2	0.2
Grants	0.7	1.0	1.8	1.1	0.9	1.0	1.4	1.4
Of which								
HIPC 2/	0.0	0.1	0.7	0.5	0.1	0.1	0.6	0.6
Total expenditure	**30.6**	**29.5**	**32.0**	**30.6**	**32.2**	**31.8**	**32.0**	**31.3**
Current expenditure	20.7	20.2	23.1	23.6	25.0	23.6	23.0	22.6
Wages and salaries	10.2	11.4	12.8	13.5	13.6	13.1	12.7	12.3
Goods and services 3/	3.1	3.5	3.8	3.4	3.5	3.4	3.6	3.7
Transfers 4/	2.3	1.8	2.4	2.5	3.6	2.8	2.8	2.8
Operating losses of the central bank	0.2	0.0	0.4	0.9	1.1	1.1	1.1	1.1
Interest payments	3.8	3.0	2.2	2.0	2.0	1.9	1.8	1.6
External 5/	3.0	2.4	1.9	1.7	1.5	1.4	1.2	1.1
Domestic	0.8	0.5	0.4	0.3	0.5	0.5	0.5	0.5
Other	1.1	0.6	1.5	1.2	1.2	1.2	1.1	1.1
Capital expenditure	8.2	7.0	7.7	5.8	6.0	6.8	7.8	7.5
Fixed capital formation	7.3	5.8	6.7	5.3	5.5	6.2	6.5	5.5
Transfers	0.4	1.0	0.7	0.4	0.5	0.6	1.2	1.9
Other capital expenditure	0.5	0.2	0.3	0.1	0.0	0.0	0.0	0.1
Net lending	1.7	2.3	1.2	1.1	1.3	1.4	1.3	1.2
Overall balance	**-0.2**	**-0.8**	**-3.2**	**-3.6**	**-4.6**	**-3.0**	**-2.5**	**-1.7**
Financing	**0.2**	**0.8**	**3.2**	**3.6**	**4.6**	**3.0**	**2.5**	**1.7**
External	7.2	1.5	3.0	1.8	1.9	-2.3	0.7	0.6
Disbursements	7.2	2.4	4.0	2.5	2.8	3.1	3.2	2.8
Amortization	-4.0	-6.7	-2.5	-2.4	-2.6	-2.5	-2.4	-2.1
Zero-coupon bonds	0.0	-1.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Exceptional financing	4.1	6.7	1.6	1.8	1.8	-2.7	0.0	0.0
Domestic	-7.0	-0.7	0.1	1.8	2.7	-0.2	-0.4	-0.9
Financial system	-6.3	0.4	0.4	-1.0	2.7	-0.2	-0.4	-0.9
Bonds	-0.4	0.5	0.0	0.3	0.0	0.0	0.0	0.0
Deposits abroad 6/	-1.3	-1.3	-0.7	2.0	0.0	0.0	0.0	0.0
Floating debt	1.1	-0.3	0.4	0.5	0.0	0.0	0.0	0.0
Financing gap 7/	**...**	**...**	**...**	**...**	**...**	**5.4**	**2.2**	**2.0**
Memorandum items								
Current account balance	8.8	7.1	3.7	2.0	1.5	3.9	4.9	5.4
Primary balance	2.0	0.5	-2.7	-3.2	-4.1	-2.5	-2.3	-1.8
Current primary balance	11.0	8.4	4.2	2.4	2.0	4.4	5.1	5.3

Sources: Ministry of Finance; Central Bank of Honduras; and Fund staff estimates and projections.

1/ Includes contributions to the social security system.

2/ Comprises HIPC interim relief from IBRD/IDA starting in 2000, and the IDB and the Fund starting in 2001.

3/ Assumes savings from a central administration reform equivalent to 0.2 percent of GDP per year in 2005-06. However, these savings could materialize in other current expenditures.

4/ Includes the cost of support plan for agricultural loans (1 percent of GDP in 2003).

5/ On an accrual basis.

6/ Includes the change in deposits of HONDUTEL held abroad.

7/ Assumed to be covered with program loans from the World Bank and the IDB and rescheduling from the Paris Club with comparable treatment from non-Paris Club official bilateral and commercial creditors.

Table 6. Honduras: Monetary Survey 1/

	1999	2000	2001	2002	Prel. 2003	Program 2004	2005	2006
I. Central Bank								
(In percent of currency issue at beginning of period)								
Net international reserves	**115.4**	**16.3**	**34.7**	**51.1**	**-5.4**	**32.3**	**35.0**	**34.5**
(Flow in millions of U.S. dollars)	340.5	20.0	79.9	128.8	-77.7	77.7	100.0	120.0
Net domestic assets	**-93.4**	**-12.5**	**-26.7**	**-41.6**	**20.7**	**-26.3**	**-23.3**	**-23.7**
Combined public sector	-86.6	1.8	-10.2	1.4	39.0	-2.5	-6.7	-16.1
Nonfinancial public sector	-90.0	1.9	-16.6	-14.4	20.5	-20.4	-25.0	-34.9
Operating losses of central bank	3.5	0.0	6.3	15.8	18.5	17.9	18.4	18.8
Rest of the banking sector	-1.9	-12.9	-4.8	-35.7	0.8	-9.8	7.8	-5.8
Of which								
Open market operations	-6.0	-5.2	-6.9	-16.7	-0.6	-11.4	-2.7	-1.0
Private sector	-5.9	-8.9	-4.8	-0.8	-16.1	-0.8	0.0	-0.5
Medium- and long-term net foreign liabilities	3.2	4.0	3.9	2.8	1.8	2.8	2.0	6.6
Other	-4.9	2.9	-10.6	-9.4	-4.8	-16.0	-10.8	-7.9
Currency issue	**22.1**	**3.8**	**8.0**	**9.6**	**15.3**	**6.0**	**11.6**	**10.8**
II. Financial System 2/								
(In percent of broad money at beginning of period)								
Net short-term foreign assets	**25.5**	**7.4**	**7.9**	**10.5**	**0.6**	**6.1**	**6.3**	**6.1**
(Flow in millions of U.S. dollars)	471.8	119.0	143.6	212.7	-65.0	111.3	145.1	171.1
Net domestic assets	**-2.1**	**13.2**	**6.3**	**3.8**	**19.8**	**4.6**	**5.4**	**4.5**
Combined public sector	-17.9	0.8	0.8	-0.2	5.0	-0.3	-0.8	-2.0
Nonfinancial public sector	-17.3	0.8	-0.1	-2.2	2.8	-2.6	-3.1	-4.3
Operating losses of central bank	-0.6	0.0	0.9	2.0	2.3	2.3	2.2	2.3
Private sector	18.3	13.2	10.0	7.7	8.5	6.3	6.6	5.8
Medium- and long-term net foreign liabilities	0.7	0.4	0.6	0.6	0.2	0.5	0.5	1.1
Other	-3.3	-1.2	-5.1	-4.3	-1.9	-2.0	-1.0	-0.5
Broad money 3/	**23.4**	**20.6**	**14.2**	**14.3**	**12.4**	**10.7**	**11.7**	**10.7**
(12-month percentage change)								
Currency in circulation	26.1	0.4	9.3	7.2	17.8	4.6	11.6	10.8
Broad money	23.4	20.6	14.2	14.3	12.4	10.7	11.7	10.7
Liabilities in lempiras	22.6	19.6	8.3	12.8	12.7	10.4	11.8	10.6
Liabilities in foreign currency	26.2	23.8	32.7	18.3	11.7	11.3	11.6	10.7
Credit to private sector	20.9	15.4	12.2	7.6	13.0	8.3	8.8	8.0
Credit in lempiras	26.9	17.5	13.7	8.8	9.3	8.3	8.8	8.0
Credit in foreign currency 4/	5.7	9.1	7.1	12.5	16.4	8.3	8.8	8.0
Memorandum items								
(Average stock in percent of GDP)								
Currency issue	6.7	6.6	6.2	6.2	6.3	6.3	6.1	6.1
Broad money	42.3	45.0	47.0	49.2	50.8	50.9	50.3	50.4
Credit to private sector	36.7	37.8	38.3	38.8	39.1	38.4	37.4	36.5
Open market operations	3.4	3.3	3.3	3.7	3.8	3.8	3.8	3.5
(In percent of total deposits/credit)								
Dollarization (end-period stocks)								
Foreign currency deposits	28.7	29.0	33.4	34.2	34.9	34.9	34.9	34.9
Foreign currency credit	24.6	23.2	22.2	22.8	23.9	23.9	23.9	23.9

Sources: Central Bank of Honduras; and Fund staff estimates and projections.

1/ At current exchange rate.

2/ Comprises the central bank, commercial banks, savings and loans, and development banks, including a second-tier bank.

3/ Includes open market paper held by the private sector.

4/ percentage change refers to amount in lempiras.

Table 7. Honduras: Indicators of External Vulnerability

(In units indicated)

	1999	2000	2001	2002	Est. 2003
External indicators					
Merchandise exports (percent change, value)	-24.4	18.0	-4.2	-1.3	2.1
Merchandise imports (percent change, value)	5.9	6.4	5.2	0.8	8.8
Terms of trade (percent change)	-12.0	-8.1	-6.7	-8.5	-4.6
Current account balance (percent of GDP)	-4.4	-4.0	-4.7	-3.1	-5.2
Gross official reserves (in months of imports)	4.4	4.4	4.7	4.7	4.0
Short-term public sector external debt (in percent of gross official reserves) 1/	15.2	13.5	16.7	15.8	15.6
Medium- and long-term public sector external debt (in percent of GDP)	77.8	71.5	69.6	68.1	66.4
Medium- and long-term public sector external debt (in percent of exports)	188.6	172.5	183.3	178.8	171.7
REER (12-month change, appreciation +) 2/	7.5	7.9	4.2	-3.8	-4.6
Financial indicators					
Gross international reserves, in percent of:					
Base money	171.6	182.6	217.1	218.4	201.5
Base money and open market paper 3/	160.7	156.0	146.0	148.3	132.1
Broad money	49.5	44.8	44.5	44.5	39.4
Broad money (percent change, 12-month change)	23.4	20.6	14.2	14.3	12.4
Private sector credit (percent change, 12-month change)	20.9	15.4	12.2	7.6	13.0
Interest rate on CBH 90-day certificates (end of period)	14.0	14.0	13.5	10.6	12.3
Real interest rate 4/	2.8	3.5	4.3	2.3	5.1
Share of foreign-currency loans in total credit to the private sector	24.6	23.2	22.2	23.2	23.9
Share of foreign deposits in total deposits	28.7	29.0	33.4	34.2	34.9

Sources: Central Bank of Honduras; and Fund staff estimates.

1/ Debt due within a year after exceptional financing.
2/ End-of-period change. As of end-August for 2003.
3/ Held by commercial banks and domestic private investors.
4/ Refers to the interest rate on CBH 90-day certificates.

Table 8. Honduras: Structure and Performance of Banking Sector
(In percent unless otherwise indicated)

	1999	2000	2001	2002	Prel. 2003
Total assets (in millions of lempiras) 1/	**53,071**	**60,379**	**66,923**	**75,118**	**89,386**
(in percent of GDP)	68.8	68.4	67.6	69.3	75.4
Number of banks	**22**	**21**	**21**	**20**	**16**
Of which					
In process of liquidation or taken over	1	0	1	2	...
Domestic	20	19	19	18	10
Foreign	2	2	2	2	6
Bank concentration					
Number of banks accounting for at least:					
25 percent of total assets	2	2	2	2	2
75 percent of total assets	10	9	8	8	6
Bank rating (CAMEL) 2/					
Number of banks (Category IV and V)	4	5	5	7	2
Share of total assets	11.9	18.8	16.6	28.2	11.2
Capital adequacy					
Regulatory capital to risk-weighted assets	11.4	12.3	12.7	12.9	13.0
Capital (net worth) to assets	9.1	9.4	9.5	9.1	7.6
Asset quality and composition					
Nonperforming loans (NPLs) to total loans 3/	11.2	12.5	13.0	12.4	10.6
NPLs net of provisions to capital	56.1	56.9	55.8	48.9	42.0
Restructured loans to regulatory capital	0.0	9.9	41.3	47.8	17.2
Provisions to total loans	11.2	12.5	13.0	12.4	3.5
Provisions to NPLs	23.1	26.7	29.5	37.4	34.4
Sectoral distribution of loans to total loans:					
Commerce	21.7	20.3	19.2	19.4	16.1
Construction and real estate	14.9	15.6	15.5	16.1	18.7
Agriculture and related sectors	20.2	21.5	19.1	17.3	10.2
Manufacturing	19.4	17.9	16.9	15.9	18.8
Consumption	6.9	7.1	10.0	11.8	12.5
Other	16.9	17.5	19.3	19.5	22.9
Profitability					
Return on assets (ROA) 4/	1.2	0.8	0.8	0.7	0.9
Return on equity (ROE)	14.0	9.0	8.9	8.2	13.3
Interest margin to total income	44.2	40.7	37.8	36.7	...
Personnel expenses to administrative expenses	42.4	39.8	40.8	38.0	36.7
Liquidity					
Liquid assets to total assets	26.4	26.3	26.6	31.7	28.3
Liquid assets to total short-term liabilities	44.2	42.4	43.0	48.0	61.8
Dollarization					
Foreign currency deposits in percent of total deposits	28.7	29.0	33.4	34.4	34.9
Foreign currency credit in percent of total credit	24.6	23.2	22.2	22.7	23.9

Sources: National Commission of Banking and Insurance; and Fund staff estimates.

1/ Includes contingent assets.

2/ As of end-August for 2003.

3/ NPLs exclude restructured loans, mostly to the agricultural sector.

4/ Assets include off-balance sheet items.

Table 9. Honduras: Balance of Payments

(In millions of U.S. dollars; unless otherwise indicated)

					Est.	Program			Proj.	
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Current account	**-241**	**-240**	**-301**	**-205**	**-354**	**-512**	**-343**	**-306**	**-315**	**-335**
Trade balance	-1,292	-1,233	-1,432	-1,471	-1,690	-1,927	-1,929	-2,020	-2,155	-2,291
Exports	1,218	1,437	1,376	1,358	1,386	1,505	1,637	1,763	1,905	2,061
Imports 1/	-2,510	-2,670	-2,807	-2,829	-3,076	-3,433	-3,566	-3,783	-4,061	-4,351
Services	477	394	336	451	497	544	607	672	738	811
Of which										
Value-added *maquila* industries	539	575	561	613	674	728	786	849	917	990
Tourism receipts	208	260	256	301	337	374	412	453	498	548
Income (net)	-164	-153	-178	-190	-195	-202	-193	-193	-195	-206
Of which: Interest payments	-192	-187	-154	-142	-135	-145	-124	-120	-117	-114
Current transfers (net)	737	753	973	1,004	1,034	1,073	1,172	1,235	1,297	1,351
Public sector 2/	383	306	410	270	223	214	263	272	278	272
Capital account	**159**	**-24**	**171**	**173**	**123**	**393**	**275**	**262**	**317**	**340**
Foreign direct investment (net)	237	282	193	176	198	195	213	236	260	278
Portfolio investments (net)	-16	-61	-4	-4	-4	-4	-4	-4	-4	-4
Public sector loans (net)	118	-13	107	-29	-14	15	43	38	66	83
Disbursements 3/	387	169	271	163	189	223	245	229	244	259
Amortizations 3/	-270	-182	-164	-192	-202	-207	-202	-191	-178	-176
Private sector including banking system (net)	42	-24	-44	-26	7	115	13	13	13	13
Short-term loans (net)	-222	-210	-82	56	-64	72	11	-19	-17	-29
Errors and omissions	164	117	118	46	28	0	0	0	0	0
Overall balance	**83**	**-147**	**-12**	**14**	**-203**	**-119**	**-67**	**-44**	**2**	**4**
Net international reserves (- increase)	-340	-20	-80	-129	78	-78	-100	-120	-120	-120
Of which: IMF (net)	98	6	4	-24	-32	15	3	3	-16	-31
Exceptional financing 4/	258	167	92	115	125	-197	1	1	0	0
Financing gap 5/	**0**	**0**	**0**	**0**	**0**	**394**	**166**	**163**	**118**	**116**
Memorandum items										
Terms of trade (percent change)	-12.0	-8.1	-6.7	-8.5	-4.6	1.9	3.1	1.1	1.0	0.9
Exports of goods and services (percent change)	-8.6	11.5	-2.7	3.2	5.4	8.5	8.4	8.0	8.2	8.2
Imports of goods and services (percent change)	6.9	9.3	5.7	0.0	8.8	10.8	4.2	6.2	7.3	7.2
Current account (in percent of GDP)										
Including official transfers	-4.4	-4.0	-4.7	-3.1	-5.2	-7.1	-4.5	-3.8	-3.6	-3.6
Excluding official transfers	-11.5	-9.1	-11.1	-7.2	-8.4	-10.1	-7.9	-7.1	-6.8	-6.6
Gross reserves (end of period)	1,230	1,285	1,386	1,492	1,415	1,492	1,592	1,712	1,832	1,952
In months of next year imports of nonmaquila goods and nonfactor services	4.4	4.4	4.7	4.7	4.0	4.0	4.1	4.1	4.1	4.0
In percent of short-term debt 6/	270.0	271.8	261.8	265.0	271.4	237.2	232.2	235.8	236.7	246.7
Outstanding external debt 7/	4,222	4,307	4,455	4,485	4,538	4,400	4,185	4,377	4,534	4,690
of which: external debt arrears	29	0	0	75	198	0	0	0	0	0
Debt to GDP ratio (in percent)	77.8	71.5	69.6	68.1	66.4	61.1	54.9	53.9	52.3	50.7
Public sector debt service paid to exports (in percent) 7/	7.8	7.0	8.7	8.3	8.7	7.7	5.9	5.4	4.7	4.7
Nominal GDP (in millions of U.S. dollars)	5,424	6,025	6,402	6,583	6,834	7,200	7,617	8,123	8,674	9,251

Sources: Central Bank of Honduras; and Fund staff estimates and projections.

1/ Includes special imports for private energy projects of US$177 million in 2004 and US$78 million in 2005.
2/ Includes HIPC grants from the World Bank, IDB, and the Fund.
3/ Net of debt relief operation granted by the Central American Bank for Economic Integration (CABEI) in 2000, with purchase of zero-coupon bond recorded in portfolio investment.
4/ Includes debt relief from Paris Club (1999-2002), the Central American Emergency Trust Fund (1999-2000), and HIPC relief from CDC.
5/ To be covered with program loans from the World Bank and the IDB and rescheduling from the Paris Club with comparable treatment from non-Paris Club official bilateral and commercial creditors.
6/ Public sector external debt due within a year after exceptional financing.
7/ Medium- and long-term public and publicly guaranteed external debt, after HIPC and beyond HIPC debt relief. HIPC completion point is assumed in March 2005.

Table 10. Honduras: The Fiscal Impact of the HIPC Initiative, Current Situation

(In percent of GDP, unless otherwise noted)

				Est.	Prog.		
	2000	2001	2002	2003	2004	2005	2006
1. HIPC assistance given							
A. Interest due before HIPC assistance 1/	2.6	2.0	1.9	1.7	1.5	1.4	1.2
B. Interest paid before HIPC assistance	2.6	2.0	1.9	1.7	1.5	1.4	1.2
C. HIPC assistance on interest (as a result of stock-of-debt operation only) 2/	0.2	0.3	0.3	0.2	0.2	0.4	0.2
D. Interest due after HIPC assistance	2.3	1.7	1.6	1.5	1.4	1.0	1.0
E. Amortization due before HIPC assistance 1/	3.1	2.7	3.5	3.6	3.1	3.0	2.7
F. Amortization paid before HIPC assistance	3.1	2.7	3.5	3.6	3.1	3.0	2.7
G. HIPC assistance on amortization (as a result of stock-of-debt operation only) 2/	0.0	0.3	0.4	0.4	0.6	0.8	0.7
H. Amortization due after HIPC assistance	3.1	2.4	3.2	3.1	2.5	2.2	2.0
I. HIPC assistance provided as grants (to cover debt service due) 3/	0.1	0.7	0.5	0.1	0.1	0.6	0.6
J. HIPC assistance provided as exceptional financing (to cover debt service due) 4/	0.2	0.0	0.3	0.7	0.7	0.0	0.0
Total HIPC assistance (C+G+I+J)	0.5	1.3	1.4	1.5	1.6	1.7	1.4
Total HIPC assistance (in millions of U.S. dollars)	30	82	93	99	115	130	117
Net cash flow to the budget from HIPC assistance B+F-(D+H-I-J)	0.5	1.3	1.4	1.5	1.6	1.7	1.4
Memorandum items							
Total net external transfers 5/							
Before HIPC assistance	1.4	2.5	-0.6	-0.8	1.1	1.3	1.4
After HIPC assistance	1.9	3.8	0.8	0.7	2.7	3.0	2.8
2. Poverty reducing government expenditures							
Total poverty reduction strategy related expenditures							
Current definition	...	...	7.5	7.5	8.1	8.7	9.4
Previous definition							
Actual	5.1	2.9	2.4	2.6	...	...	...
Envisaged in previous PRSP	5.0	5.4	5.9	4.9	4.5	4.2	...
Additional cost of poverty reduction strategy							
Current definition	...	...	...	0.5	1.1	1.7	2.4
Previous definition	0.2	0.4	0.5	...	...	...	...
Memorandum items							
Central government tax revenue	16.6	16.2	15.9	16.6	17.5	17.5	17.5
Overall fiscal balance before HIPC assistance	-6.0	-7.0	-6.2	-6.5	-4.0	-3.0	-1.5
Overall fiscal balance after HIPC assistance	-5.7	-6.1	-5.3	-5.5	-3.5	-3.0	-2.5

Sources: Central Bank of Honduras; Ministry of Finance; and Fund staff estimates and projections.

1/ After deferral of debt service falling due during April 1999-March 2002 agreed with Paris Club creditors. Includes the Fund.

2/ Reflects stock-of-debt reduction obtained from the Central American Bank for Economic Integration in April 2000.

3/ Comprises assistance from World Bank/IDA, IDB, and the Fund.

4/ HIPC assistance resulting from the rescheduling of arrears to the Paris Club expected in 2004, is recorded as relief at the time of the initial accumulation of the respective arrears in 2002 and 2003.

5/ Sum of external disbursements, exceptional financing, and grants less debt service due.

Table 11. Honduras: Summary of Macroframework

	2002	Est. 2003	Program 2004	Program 2005	Program 2006	Projection 2007	Projection 2008
(Annual percentage change)							
National income and prices							
GDP at constant prices	2.7	3.0	3.5	4.0	4.5	4.5	4.5
Of which							
Consumption	4.4	1.7	2.6	4.7	3.9	4.1	4.0
Investment	-5.7	6.4	15.1	1.1	7.2	7.6	7.1
Exports	5.1	4.7	3.7	5.3	6.0	6.2	6.3
Imports	3.2	3.0	8.7	4.9	6.0	6.8	6.5
Consumer prices (end of period)	8.1	7.2	6.7	6.0	5.0	4.0	3.0
GDP per capita (in U.S. dollars)	964	976	1,003	1,035	1,077	1,123	1,169
Poverty rate 1/	59	58	57	55	54	52	51
(In percent of GDP, unless otherwise stated)							
Combined public sector							
Savings	2.0	1.4	3.9	4.8	5.9	6.4	6.7
Anti-poverty spending	7.5	7.5	8.1	8.7	9.4	9.4	9.4
Overall balance	-3.6	-4.6	-3.0	-2.5	-1.7	-1.1	-1.1
Of which							
Central government balance	-5.3	-5.5	-3.5	-3.0	-2.5	-1.9	-1.9
General government balance	-2.9	-3.1	-1.1	-0.9	-0.5	-0.4	-0.4
Public sector debt	72.9	72.1	66.7	51.5	50.7	49.4	48.3
Savings and investment							
Fixed capital formation	22.1	23.5	26.0	25.0	25.4	25.9	26.4
Private sector	16.8	18.0	19.8	18.5	19.4	20.4	20.8
Public sector	5.3	5.5	6.2	6.5	6.0	5.5	5.6
Gross national saving	19.0	18.3	18.9	20.5	21.6	22.3	22.8
Private sector	17.0	17.0	15.0	15.6	15.7	15.9	15.8
Public sector	2.0	1.4	4.0	4.9	5.9	6.4	6.7
External current account balance	-3.1	-5.2	-7.1	-4.5	-3.8	-3.6	-3.6
Gross international reserves							
(in months of imports) 2/	4.7	4.0	4.0	4.1	4.1	4.1	4.0
External public debt 3/							
NPV of public sector external debt before HIPC relief	48.4	44.8	42.3	39.9	37.6	35.4	33.8
NPV of public sector external debt after HIPC relief 4/	47.8	47.0	43.8	29.9	29.4	28.6	27.8
(in percent of currrent government revenue)	260.5	247.7	222.8	153.4	150.9	147.4	144.5
(in percent of exports) 5/	126.9	127.0	118.0	79.3	76.7	73.6	70.8
Public sector external debt after HIPC relief 4/	68.1	66.4	61.1	46.5	46.2	45.3	44.5

Sources: Central Bank of Honduras; Ministry of Finance; and Fund staff estimates and projections.

1/ Based on Honduras Multipurpose Household Survey. Projections based on income-poverty elasticity of 0.6 percent.
2/ Refers to the next year imports of nonmaquila goods and nonfactor services.
3/ Comprises medium- and long-term public and publicly guaranteed external debt.
4/ Assumes HIPC completion point in March 2005 and beyond HIPC relief from Paris Club creditors.
5/ Three-year backward-looking average of exports of goods and services.

Table 12. Honduras: External Debt Sensitivity Analysis

(In percent of GDP, unless otherwise noted)

		Est.	Prog.			Proj.	
	2002	2003	2004	2005	2006	2007	2008
I. Active Scenario							
External public debt 1/							
NPV of public sector external debt	47.8	47.0	43.8	29.9	29.4	28.6	27.8
(in percent of current government revenue) 2/	260.5	247.7	222.8	153.4	150.9	147.4	144.5
(in percent of exports) 3/	126.9	127.0	118.0	79.3	76.7	73.6	70.8
Public sector external debt	68.1	66.4	61.1	46.5	46.2	45.3	44.5
Indicators							
Central government revenue	18.3	19.0	19.7	19.5	19.5	19.4	19.3
Exports of goods and services (percentage change)	3.2	5.4	8.5	8.4	8.0	8.2	8.2
Real GDP growth (in percent)	2.7	3.0	3.5	4.0	4.5	4.5	4.5
Combined public sector primary balance	-3.2	-4.1	-2.5	-2.3	-1.8	-2.0	-1.9
II. Sensitivity Analysis							
1. Lower current revenue and expenditure							
(by 2 percentage points of GDP per year)							
NPV of public sector external debt							
(in percent of current government revenue)	260.5	247.7	248.0	170.9	168.1	164.3	161.2
Central government revenue	18.3	19.0	17.7	17.5	17.5	17.4	17.3
2. Lower export growth							
(by 2 standard deviations for 2004-05)							
NPV of public sector external debt							
(in percent of exports)	126.9	127.0	126.1	96.5	106.9	109.6	105.3
Exports of goods and services (percentage change)	3.2	5.4	-11.1	-11.1	8.0	8.2	8.2
3. Lower real GDP growth							
(by 2 standard deviations for 2004-05)							
Public sector external debt	68.1	66.4	64.4	51.7	51.3	50.4	49.4
Real GDP growth (in percent)	2.7	3.0	-1.8	-1.3	4.5	4.5	4.5
4. Lower primary balance							
(by 2 percentage points of GDP per year)							
Public sector external debt	68.1	66.4	63.1	50.4	51.9	52.6	53.3
Combined public sector primary balance	-3.2	-4.1	-4.5	-4.3	-3.8	-4.0	-3.9
5. Real exchange rate depreciation							
(by 15 percent in 2004)							
Public sector external debt	68.1	66.4	71.9	54.7	54.4	53.3	52.3
Memorandum items							
Standard deviation for period 1992-2002							
Real GDP growth	2.7						
Exports of goods and services (percentage change)	9.8						

Sources: Central Bank of Honduras; Ministry of Finance; and Fund staff estimates and projections.

1/ After debt relief under the enhanced HIPC Initiative. Includes beyond HIPC relief from Paris Club creditors.
2/ Central government current revenue excluding grants.
3/ Three-year backward looking average of exports of goods and services.

Table 13. Honduras: External Financing Requirements and Sources

(In millions of U.S. dollars)

					Prel.	Program		
	1999	2000	2001	2002	2003	2004	2005	2006
1. Gross financing requirements	**-1,685**	**-1,120**	**-1,223**	**-889**	**-933**	**-1,303**	**-1,060**	**-1,072**
External current account deficit (exc. official transfers)	-624	-545	-711	-475	-577	-726	-605	-578
Debt amortization	-625	-506	-388	-266	-393	-286	-328	-348
Medium-and long- term debt	-403	-296	-307	-322	-329	-359	-339	-328
Public sector	-270	-182	-164	-192	-202	-207	-202	-191
Commercial banks	-111	-89	-98	-84	-60	-74	-75	-75
Corporate private sector	-23	-26	-44	-46	-66	-77	-62	-62
Short-term debt (net) 1/	-222	-210	-82	56	-64	72	11	-19
Repayment of arrears	-7	-8	-14	-1	0	-198	0	0
Gross reserves accumulation	-426	-56	-101	-107	77	-77	-100	-120
IMF repurchases and repayments	-4	-5	-9	-40	-41	-14	-26	-26
2. Available financing	**1,685**	**1,120**	**1,223**	**889**	**933**	**1,303**	**1,060**	**1,072**
Foreign direct investment (net)	237	282	193	176	198	195	213	236
Debt financing from private creditors	176	91	99	104	133	266	151	152
Medium- and long-term financing	176	91	99	104	133	266	151	152
Public sector	0	0	0	0	0	0	1	2
Commercial banks	100	48	52	70	67	76	80	80
Corporate private sector	76	43	47	34	66	190	69	69
Official creditors 2/	770	475	679	429	412	431	499	496
Loan disbursements	387	169	271	163	189	223	245	229
Grants	383	306	408	266	223	208	254	267
IMF 3/	104	21	22	5	0	35	38	34
Accumulation of arrears (exceptional)	100	22	1	75	124	0	0	0
Financing gap	0	0	0	0	0	394	166	163
Of which:								
Possible rescheduling of arrears	…	…	…	…	…	198	0	0
Possible program financing	…	…	…	…	…	90	40	25
Possible debt rescheduling (incl. beyond HIPC)	…	…	…	…	…	105	101	84
Other flows 4/	298	229	229	100	67	-18	-7	-8

Sources: Central Bank of Honduras; and Fund staff estimates and projections.

1/ Original maturity of less than 1 year. Stock at the end of the previous period.
2/ Excludes the IMF.
3/ Includes IMF HIPC grants.
4/ Includes all other net financial flows, and errors and omissions.

Table 14. Honduras: Indicators of Fund Credit

(In units indicated)

	2001	2002	2003	2004	2005	2006	2007	2008
Stock of existing and prospective Fund credit 1/								
In millions of SDRs	175.1	144.6	115.4	125.7	127.8	129.7	118.2	96.6
In percent of quota	135.2	111.7	89.1	97.1	98.7	100.2	91.3	74.6
In percent of exports of goods and services	9.1	7.8	6.2	6.3	5.9	5.6	4.7	3.5
In percent of external debt	4.9	4.4	3.6	4.1	5.2	5.0	4.3	3.4
In percent of gross reserves	15.9	13.2	11.7	12.1	11.5	10.9	9.3	7.1
Obligations to the Fund from existing and prospective Fund arrangements								
In millions of SDRs	10.7	32.7	30.6	11.0	19.2	19.3	22.6	22.5
In percent of quota	8.3	25.2	23.6	8.5	14.8	14.9	17.5	17.4
In percent of exports of goods and services	0.6	1.8	1.7	0.5	0.9	0.8	0.9	0.8
In percent of external debt	0.3	1.0	1.0	0.4	0.8	0.7	0.8	0.8
In percent of gross reserves	1.0	3.0	3.1	1.1	1.7	1.6	1.8	1.7

Sources: Central Bank of Honduras; and Fund staff estimates.

1/ End of period.

Table 15. Honduras: Review and Phasing of Disbursements under the PRGF Arrangement, 2004-2007

Date	Expected Disbursements: In millions of SDRs	Expected Disbursements: In percent of quota	Conditions to be Observed
February 2004	10.171	7.85	Board approval of PRGF Arrangement
September 2004	10.171	7.85	First review; and end-June 2004 performance criteria
March 2005	10.171	7.85	Second review; and end-December 2004 performance criteria
September 2005	10.171	7.85	Third review; and end-June 2005 performance criteria
March 2006	10.171	7.85	Fourth review; and end-December 2005 performance criteria
September 2006	10.171	7.85	Fifth review; and end-June 2006 performance criteria
February 2007	10.171	7.85	Sixth review; and end-December 2006 performance criteria

Source: Fund staff projections.

Table 16. Honduras: Operations of the Central Government - Quarterly

(In millions of lempiras)

	2004					Percent
	Q1	Q2	Q3	Q4	Total	of GDP
Total revenue and grants	**5,765**	**7,645**	**6,888**	**7,034**	**27,331**	**20.7**
Current revenue	5,175	7,321	6,565	6,904	25,965	19.7
Tax revenue	4,478	6,624	5,869	6,207	23,178	17.5
Nontax revenue	329	329	329	329	1,316	1.0
Transfers	368	368	368	368	1,470	1.1
Grants	590	324	323	130	1,367	1.0
Of which HIPC relief	0	8	6	96	110	0.1
Total expenditure	**6,335**	**8,835**	**7,164**	**9,608**	**31,942**	**24.2**
Current expenditure	5,381	6,899	5,217	6,683	24,180	18.3
Wages and salaries 1/	3,004	3,856	2,980	3,911	13,750	10.4
Goods and services	798	798	798	798	3,191	2.4
Transfers	853	1,725	737	1,470	4,784	3.6
Interest payments	726	521	703	505	2,455	1.9
External 2/	567	361	543	345	1,816	1.4
Domestic	160	160	160	160	639	0.5
Capital expenditure	742	1,725	1,736	2,714	6,917	5.2
Net lending	211	211	211	211	845	0.6
Unidentified expenditure	0	0	0	0	0	0.0
Overall balance	**-570**	**-1,191**	**-277**	**-2,575**	**-4,611**	**-3.5**
Financing	**570**	**1,191**	**277**	**2,575**	**4,611**	**3.5**
External	-3,769	254	34	310	-3,170	-2.4
Disbursements	818	973	950	1,029	3,771	2.9
Amortization	-943	-711	-897	-711	-3,263	-2.5
Zero coupon bonds	-20	-20	-20	-20	-79	-0.1
Exceptional financing	-3,624	12	1	12	-3,600	-2.7
Domestic	-603	-320	-304	1,826	600	0.5
Financial system	-603	-320	-304	1,826	600	0.5
Financing gap 3/	**4,941**	**1,257**	**546**	**438**	**7,181**	**5.4**
Memorandum items						
Current account balance	-207	422	1,348	221	1,784	1.4
Primary balance	157	-669	426	-2,070	-2,156	-1.6
Current primary balance	519	943	2,051	726	4,239	3.2
PRSP spending (new definition)	1,935	2,720	2,540	3,504	10,698	8.1

Sources: Ministry of Finance; Central Bank of Honduras; and Fund staff estimates and projections.

1/ Benefits in the amount of one month base salary are paid on the second and fourth quarters.

2/ On an accrual basis.

3/ To be covered with program loans from the World Bank and the IDB and rescheduling from the Paris Club with comparable treatment from non-Paris Club official bilateral and commercial creditors.

Table 17. Honduras: Operations of the Combined Public Sector - Quarterly
(In millions of lempiras)

	2004					Percent
	Q1	Q2	Q3	Q4	Total	of GDP
Total revenue and grants	**8,425**	**10,304**	**9,547**	**9,693**	**37,970**	**28.7**
Current revenue	7,757	9,903	9,147	9,486	36,293	27.5
Tax revenue	4,752	6,898	6,143	6,481	24,275	18.4
Nontax revenue 1/	1,734	1,734	1,734	1,734	6,936	5.3
Interest earnings	450	450	450	450	1,802	1.4
Operating balance of public enterprises	820	820	820	820	3,280	2.5
Capital revenue	74	74	74	74	298	0.2
Grants	594	327	326	133	1,379	1.0
Of which	0	8	6	96	110	0.1
HIPC						
Total expenditure	**9,075**	**11,457**	**9,541**	**11,863**	**41,937**	**31.8**
Current expenditure	7,334	8,225	7,285	8,264	31,109	23.6
Wages and salaries 2/	3,781	4,878	3,756	4,933	17,348	13.1
Goods and services	1,138	1,138	1,138	1,138	4,551	3.4
Transfers	932	932	932	932	3,728	2.8
Operating losses of the central bank	362	362	362	362	1,448	1.1
Interest payments	736	531	712	514	2,492	1.9
External 3/	567	361	543	345	1,816	1.4
Domestic	169	169	169	169	676	0.5
Other	385	385	385	385	1,540	1.2
Capital expenditure	1,269	2,760	1,784	3,127	8,940	6.8
Net lending	472	472	472	472	1,889	1.4
Overall balance	**-651**	**-1,153**	**6**	**-2,170**	**-3,967**	**-3.0**
Financing	**651**	**1,153**	**-6**	**2,170**	**3,967**	**3.0**
External	-3,734	308	81	369	-2,977	-2.3
Disbursements	882	1,049	1,024	1,110	4,065	3.1
Amortization	-972	-733	-925	-733	-3,363	-2.5
Zero coupon bonds	-20	-20	-20	-20	-79	-0.1
Exceptional financing	-3,624	12	1	12	-3,600	-2.7
Domestic	-556	-411	-633	1,363	-237	-0.2
Banking system	-556	-411	-633	1,363	-237	-0.2
Bonds	0	0	0	0	0	0.0
Deposits abroad	0	0	0	0	0	0.0
Floating debt	0	0	0	0	0	0.0
Financing gap 4/	**4,941**	**1,257**	**546**	**438**	**7,181**	**5.4**
Memorandum items						
Current account balance	423	1,678	1,862	1,222	5,184	3.9
Primary balance	-365	-1,073	268	-2,106	-3,277	-2.5
Current primary balance	708	1,758	2,124	1,286	5,875	4.4
Nominal GDP	...	...	...	...	132,080	

Sources: Ministry of Finance; Central Bank of Honduras; and Fund staff estimates and projections.

1/ Includes contributions to the social security system.
2/ Benefits in the amount of one month base salary are paid on the second and fourth quarters.
3/ On an accrual basis.
4/ Assumed to be covered with program loans from the World Bank and the IDB and rescheduling from the Paris Club with comparable treatment from non-Paris Club official bilateral and commercial creditors.

Table 18. Honduras: Summary Accounts of the Central Bank

	Prel.	2004			
	2003	Mar.	Jun.	Sept.	Dec.
(End-of-period stocks, in millions of lempiras)					
Net international reserves	**20,011**	**19,979**	**21,079**	**21,557**	**22,613**
(In millions of U.S. dollars)	1,127	1,110	1,155	1,165	1,205
Net domestic assets	**-11,955**	**-12,871**	**-13,827**	**-14,839**	**-14,075**
Combined public sector	-4,950	-5,471	-5,884	-6,513	-5,154
Nonfinancial public sector	-8,150	-9,036	-9,808	-10,796	-9,796
Cumulative losses of central bank	3,200	3,564	3,924	4,283	4,642
Rest of the banking sector	-7,908	-8,120	-8,407	-8,479	-8,699
Of which					
Open market operations	-4,554	-5,142	-5,372	-5,364	-5,475
Private sector	-2,345	-2,106	-2,206	-2,306	-2,406
Medium- and long-term net foreign liabilities	-2,743	-2,755	-2,676	-2,596	-2,516
Other	5,991	5,582	5,345	5,055	4,700
Currency issue	**8,056**	**7,109**	**7,252**	**6,718**	**8,538**

Sources: Central Bank of Honduras; and Fund staff estimates and projections.

HONDURAS—FUND RELATIONS
(As of December 31, 2003)

I. Membership Status: Joined December 27, 1945; Article VIII

II. General Resources Account:

	SDR Million	Percent of Quota
Quota	129.50	100.00
Fund holdings of currency	120.87	93.34
Reserve position in Fund	8.63	6.66

III. SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	19.06	100.00
Holdings	0.08	0.40

IV. Outstanding Purchases and Loans:

	SDR Million	Percent of Quota
ESAF/PRGF Arrangements	115.42	89.13

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
PRGF	03/26/1999	12/31/2002	156.75	108.30
ESAF	07/24/1992	07/24/1997	47.46	33.90
Stand-by	07/27/1990	02/17/1992	30.50	30.50

VI. Projected Obligations to the Fund (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	10.05	18.25	18.43	21.66	21.66
Charges/Interest	0.88	0.79	0.69	0.59	0.48
Total	**10.93**	**19.04**	**19.12**	**22.25**	**22.14**

VII. Implementation of Enhanced HIPC Initiative:

Commitment of HIPC assistance

Decision point date	June 30, 2000[13]
Assistance committed (NPV terms)	End-1999
Total assistance (US$ million)	556.00
Of which: Fund assistance (SDR million)	22.66
Completion point date	Floating

Delivery of Fund assistance (SDR million)

Amount disbursed	4.50
Interim assistance	4.50
Completion point	0.00
Amount applied against member's obligations (cumulative)	3.63

VIII. Safeguards Assessments Policy:

A full safeguards assessment of the central bank with respect to the request for a new PRGF arrangement was conducted in November 2003. It found that the central bank is yet to publish a complete set of audited financial statements for 2001–02 and needs to reinforce its oversight mechanisms for audit, internal control, and financial reporting. The safeguards assessment advised full publication of audited financial statements and set up of an independent Audit Committee with adequate oversight responsibility. Under the transitional safeguards procedures with respect to the previous PRGF arrangement, the central bank completed an external audit of 2001 financial statements and adopted a financial reporting framework in accordance with International Financial Reporting Standards.

IX. Exchange Arrangement:

Honduras' *de jure* exchange arrangement is a crawling band. The exchange rate for the lempira is determined daily in foreign exchange auctions. Banks and exchange houses must sell to the central bank 100 percent of their daily net purchases of foreign exchange at the exchange rate established the previous day. Buyers of foreign exchange (banks, exchange houses, and private individuals) bid at a price that cannot differ by more than 7 percent from the base exchange rate, in either direction. The base exchange rate is adjusted every five auctions according to the anticipated inflation differential between Honduras and its major trading partners and to changes in the exchange rates of currencies of trading partners of Honduras with respect to the U.S. dollar. The official buying exchange rate on January 21, 2004 was L 17.79 per U.S. dollar.

[13] World Bank Board, July 6, 2000.

Honduras has accepted the obligations under Article VIII, Section 2, 3, and 4 of the Articles of Agreement, and maintains a system that is free of restrictions on the making of payments and transfers for current international transactions.

X. Article IV Consultation:

The last Article IV consultation with Honduras was concluded on May 5, 2003. On the occasion, Directors considered the Financial System Stability Assessment. Honduras is on the standard 12-month Article IV consultation cycle.

XI. FSAP Participation and ROSCs:

FAD ROSC conducted on February 26–March 2, 2001 (Fund Country Report No. 02/16).
FSAP conducted on October 14–19, 2002 and January 20–February 4, 2003.
STA ROSC data module conducted on July 8–24, 2003.

XII. Technical Assistance:

Dept.	Purpose	Time
FAD	Public expenditure management, tracking of poverty reducing spending, and fiscal transparency.	Sep. – Oct. 2003
	Resident expert in tax administration.	May 2001–June 2003
	Tracking capabilities of poverty-reducing spending.	March 2001
	Reform of the tax system and its administration.	January 2001
	Implementation of an administrative control system and operations of autonomous and other public agencies.	November 1997
INS	Course on trade and exchange rate policies.	February 2002
MFD	Banking crisis management framework.	August 2003
	Peripatetic short-term advisor for bank supervision, on-site inspection, and the bank restructuring framework.	Jun. 1998–Dec. 2002
	Financial supervision and the regulatory framework	September 1996 and April 1997
	Operation of interbank market for foreign exchange.	June 1994
STA	Follow-up on money and banking statistics.	September 2001
	Follow-up on money and banking statistics.	Aug.–Sept. 2000
	Follow-up on money and banking statistics.	July–Aug. 2000
	National income accounts.	January 1999
	Development of money and banking statistics.	May 1998
	Balance of payments statistics.	April–May 1995

XIII. Resident Representative:

Ms. Coronel assumed duty in February 2003.

HONDURAS—RELATIONS WITH THE WORLD BANK
(As of December 31, 2003)

Partnership in Honduras' Development Strategy

1. Honduras' Poverty Reduction Strategy Paper (PRSP), which was completed in October 2001 and endorsed by the Boards of the World Bank and the Fund, has placed poverty reduction squarely at the center of the government's development agenda. The main objective of the strategy, which analyzes the causes of poverty and encompasses investment programs and reforms in a broad range of sectors, is to reduce poverty by 24 percentage points over the period 2001–15. The strategy itself is structured around six pillars as follows: (i) accelerating equitable and sustainable growth to levels consistent with the income poverty reduction targets; (ii) reducing rural poverty; (iii) reducing urban poverty; (iv) enhancing investment in human capital; (v) strengthening social protection for specific vulnerable groups; and (vi) ensuring the sustainability of the strategy through governance and institutional reforms and enhanced environmental sustainability. A PRSP Progress Report which was finalized in December 2003, maintains the same long-term vision and targets of the PRSP.

2. The Fund and World Bank will continue to cooperate closely, within their respective mandates, in assisting the government to implement its poverty reduction and economic growth strategy and the related reform agenda. The Fund will continue to lead the policy dialogue on macroeconomic issues (i.e., fiscal, monetary, and exchange rate policy), while the World Bank leads the policy dialogue on poverty reduction, governance, public sector management, and sectoral structural reforms (in areas including the social sectors, land regularization, environment, competitiveness, and judicial reform). They will collaborate closely and jointly manage the dialogue in the areas of PRSP preparation and implementation, HIPC, financial sector issues and civil service reform.

Bank Group Assistance Strategy

3. The World Bank completed a new Country Assistance Strategy (CAS) in May 2003, which is fully aligned with the six pillars of the Honduras' Poverty Reduction Strategy. The core goal of the CAS is to support Honduran efforts to shift to a sustainable and inclusive higher-growth trajectory as a principal means of reducing poverty and inequality. Within this broad objective, the main emphasis of the Bank's lending and knowledge services to Honduras are threefold: (i) to increase productive economic opportunities by helping to address structural and institutional barriers to economic growth and broad-based participation in growth; (ii) to invest in human capital and the protection of vulnerable groups; and (iii) to support the transparent and responsive functioning of the public sector. In terms of new lending, the CAS program comprises 14 operations over a 4-year period (FYs03–06), amounting to about US$296 million, of which, about US$70 million would be in the form of quick-disbursing budgetary support.

4. As of December 31, 2003, total loans/credits disbursed and undisbursed from the Bank/IDA for Honduras amounted to US$2,087 million, of which US$214 million remain to be disbursed. In view of Honduras' severe indebtedness and poverty level, Honduras was declared IDA only in September 1991.

5. The current portfolio consists of 13 IDA operations under implementation, totaling approximately US$301 million, net of cancellations. Lending for rural poverty and human resource development includes four credits: Fifth Social Investment Fund Credit (US$60 million), a Learning and Science Promotion Credit-PROFUTURO supplementary credit (US$4 million), a Community Based Education Credit (US$42 million), and a Health System Reform Credit (US$27 million). Lending for transport and infrastructure includes a Road Reconstruction and Improvement Credit (US$67 million). Lending for natural resource management and environment consists of a Rural Land Management Supplementary Credit (US$8 million), an Access to Land Pilot Credit (US$8 million), a Sustainable Coastal Tourism Credit (US$5 million), and a Regional Development in the Copan Valley Credit (US$12 million). Lending for modernization of the state consists of an Economic and Financial Management Technical Assistance Credit (US$19 million), and a Financial Sector Technical Assistance Credit (US$10 million). Lending for disaster preparedness consists of an Emergency Disaster Management Credit (US$11 million). Lending for improvement of the investment climate and private sector participation consists of a Trade Facilitation and Productivity Enhancement Credit (US$28 million).

6. **Future assistance**: The CAS includes a low case lending scenario of US$226 million over the period FY03–06, which comprises 12 investment operations aimed at strengthening governance and transparency, investing in human capital and addressing long-standing barriers to the inclusion of the poor in economic growth. The base case lending scenario would include an additional US$70 million over the low case scenario in the form of fast disbursing budgetary support through a possible Poverty Reduction Support Credit and a possible Financial Sector Adjustment Credit. The base case scenario would be triggered on the basis of accelerated implementation of key PRSP objectives, improved public resource management, approval of new civil service legislation and satisfactory IDA portfolio performance. Under the base case scenario, World Bank disbursements are expected to reach around US$100 million on average per year over the period covered by the CAS.

7. With regard to economic and sector work, the CAS includes two types of activities. The first set includes core diagnostic analyses, which would be country-specific and address important cross-cutting issues including deepened understanding of poverty, growth, public expenditures, and fiduciary issues. This will include a Poverty Assessment (FY05), a Country Economic Memorandum (FY04), a Public Expenditure Review (FY06), and a Country Procurement Assessment Report (FY04). The second group of activities, would be Central America-wide or sub-regional in scope, focusing on topics and themes relevant to several countries but including sufficient country-specificity to further Honduras' development agenda and support the design of lending operations. This will include studies on sectoral topics such as the coffee shock, rural growth, CAFTA, HIV/AIDS, decentralization, and disaster mitigation.

Honduras: Financial Relations with the World Bank Group

(In millions of U.S. dollars)

A. IBRD/IDA/IFC Operations

(As of December 31, 2003) 1/

	Disbursed	Undisbursed
IBRD/IDA		
Agriculture	140.4	6.4
Education	117.3	40.2
Health & Nutrition	205.8	59.7
Transportation	262.4	37.5
Public Sector Management	53.6	22.9
Tourism	15.1	16.5
Environment	40.6	0.0
Electric Power & Other Energy	252.5	0.0
Structural Adjustment	512.3	0.0
Municipal Development	2.2	0.0
Industry	75.2	0.0
Emergency & Disaster Preparedness	196.1	0.0
Competitiveness	0.0	30.3
Total	**1,873.4**	**213.5**
IDA	1,182.5	213.5
IBRD	691.0	0.0
Of which		
Outstanding 2/	1,227.7	
Repaid	644.8	
IDA	43.3	
IBRD	601.5	

B. IBRD/IDA Loan disbursements

(Calendar Year)

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Net disbursements	43.4	17.8	224.0	3.0	70.7	23.2	15.2
Gross disbursements	95.0	67.9	273.0	38.2	98.0	51.4	44.5
Amortization (cash)	51.6	50.1	49.0	35.2	27.3	28.2	29.3

Source: World Bank estimates.

1/ Net of cancellations.
2/ Net of loans sold to a third party.

IMF-World Bank Collaboration in Specific Areas

8. Fund and Bank staff have maintained a close working relationship, especially with respect to (i) PRSP, its subsequent updates and joint assessments; (ii) the HIPC Initiative; (iii) financial sector reform; and (iv) civil service reform. The World Bank and Fund Resident Representatives routinely consult and coordinate with each other on major public policy matters, and Bank staff have participated in the Fund's PRGF missions.

- **Poverty Reduction Strategy paper (PRSP)**. The Fund and the Bank collaborated with the government while the PRSP was being drafted, and produced the Joint Staff Review, which was presented to their respective Boards in September 2001. Both institutions have followed closely its implementation in 2002 and 2003. The government has prepared the first PRSP Progress Report in December 2003, and the Fund and Bank will again work jointly to prepare the staff assessment of the PRSP-PR.

- **HIPC Initiative.** The Fund and the Bank have been tracking the status of floating completion point conditions established under the Enhanced HIPC Initiative. The structural and social reforms being monitored involve measures in the areas of governance and transparency, social security system reform, provision of basic health services for the poor, quality of education, safety nets, and financial system reform.

- **Financial Sector.** The Fund and the Bank co-managed the preparation of the 2003 Honduras Financial Sector Assessment Program (FSAP). Based on the FSAP, the government embarked on a comprehensive financial system reform that aims at strengthening the regulatory framework and ongoing supervision, enhancing the efficiency of the financial safety net, and improving mechanisms for antimoney laundering and financing of terrorism. The Fund and the Bank continue to assist the government on these issues through a comprehensive technical assistance program.

- **Civil Service Reform**. The Fund and the Bank have been supporting civil service reforms that aim to create a better trained, efficient and professional civil service, and to limit the unsustainable growth in the public sector wage bill observed over the last decade.

HONDURAS—RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(In millions of U.S. dollars)

Loans programmed for 2003	**Status**	**Amount**
Program to Foster Business Competitiveness	Approved	10.0
Sula Valley Citizen Security	Approved	20.0
Poverty Alleviation and Local Development Phase II	Approved	35.0
Pro-Bosque Program	Approved	17.5
Total approved 2003[1]		**82.5**

[1] Please note that the Financial Sector and Poverty Reduction Programs will be approved in 2004

A. Operations (as of December 4, 2003)

	Approved	**Undisbursed**[2]	**Disbursed**
Agriculture	45.0	27.0	17.2
Urban development	82.4	44.2	36.9
Education and health	74.1	48.0	24.8
Energy and transport	74.2	45.6	28.2
Social investment	183.7	93.1	88.9
Water sanitation	44.3	27.7	15.4
Environmental protection	59.4	36.8	21.2
Preinvestment	12.0	8.5	3.1
Reform and modernization of the state	72.2	58.8	11.8
Total	**647.2**	**389.8**	**247.6**

[2] Does not include committed undisbursed amount

B. Net Flow of Resources

	1998	**1999**	**2000**	**2001**	**2002**	**2003e**
Disbursements	55.1	76.4	68.2	103.8	47.7	85.0
Amortization	-24.9	-24.9	-33.2	-24.4	-28.6	-39.5
Net flow of resources	**30.2**	**51.5**	**35.0**	**79.4**	**19.1**	**45.5**
Commitments made	197.2	85.2	142.1	96.4	67.1	82.5
Undisbursed commitments	313.6	315.9	387.6	378.9	400.3	397.8

HONDURAS—STATISTICAL ISSUES

Introduction

Honduras' data on the banking system, the public finances, trade, and external debt satisfy the minimum criteria required for surveillance and program monitoring purposes. However, incomplete coverage of institutions and reporting lags inhibit a full and timely assessment of financial sector developments, and a consistent and reliable method is needed for deriving estimates of national accounts by expenditure, and private capital flows.

The Honduran authorities participated in a ROSC data module (July 2003), signaling their interest in participating in the General Data Dissemination System (GDDS). Participation would act as a spur to strengthening the country's system, and provide a framework for channeling technical assistance resources in an optimal fashion.

Real sector

The published series of national accounts are based on the conceptual framework of the 1953 SNA. Estimates are prepared at current prices and at constant prices of 1978. Estimates are limited to GDP by industrial origin and by final uses. The latter is incomplete, as private consumption and change in inventories are calculated as a residual (allocated to the two categories using an erroneous methodology). The main shortcomings of these estimates are the lack of universal coverage and the deficient quality of the data sources. The Central Bank of Honduras (CBH) has been implementing a program to improve the national account estimates since 1993, and revised estimates for the period 1978–97 have been prepared, based on almost the same data sources but following improved procedures for the calculation at both current and constant prices. The CBH has started a four-year program for implementing the 1993 SNA and changing the base year.

An STA mission (January 1999) recommended the replacement of the old series with the new ones, and made some recommendations for further improvements in the calculation at constant prices by industries, as well as for the calculation of changes in inventories and private consumption. The mission also recommended that high priority be given to the implementation of the 1993 SNA and the change of the base year, and made detailed recommendations to this effect.

The CPI weights used to be 20 years old. A new household expenditure survey has been underway since April 1999. As a result of this project, the authorities have revised the CPI basket and updated the weights. The CBH has been producing in parallel the old and new indices during the transition period. The new indices became official in April 2000.

The new indices reflect improved coverage and quality of the data sources. The main improvements in coverage refer to inclusion in the survey of (i) population at all levels of income; (ii) goods and services with a participation of over 0.02 percent of total expenditure from a universe of 2,480 items; (iii) the concept of generic groups for similar items to be incorporated in the calculation; (iv) the use of geometric mean; and (v) all representative urban areas. There are no official wage indices for minimum wages and data on employment are limited to a single estimate per year.

Monetary accounts

An STA mission (July–August 2000), reviewed the procedures used by the CBH for compiling the detailed (sectorized) balance sheet for the CBH and other depository corporations as well as the analytical surveys. The mission designed new forms for reporting data to STA for publication in *IFS* and to WHD for operational purposes. In addition, the mission made recommendations to improve the timeliness and quality of data reported monthly to STA. Accordingly, the authorities reported monetary data in the revised format from January 1996 to December 2001, but since February 2002 data had been reported only in the old format, despite several requests made to the CBH to resume the reporting of data in the revised format. In general, the revised formats for reporting of monetary data by the CBH followed the methodology recommended in the new *Money and Financial Statistics Manual*. However, there are some shortcomings that need to be addressed such as the lack of fully sectorized balance sheet for the depository corporations.

Balance of payments

In order to report current account transactions in accordance with the *Balance of Payments Manual (Fifth Edition)*, imports and exports of goods are to be defined on a gross basis (and not as exports net of imports). Transport data and their subsequent breakdown (sea, air, and other) are missing for the whole period 1995–97. The rest of the items also have to be reported in gross figures (e.g., processing abroad, computer and information, government services, investment income, workers' remittances). For 1998, the data seem to indicate that all transportation statistics originate from sea transport only. A breakdown for the capital account was disseminated to STA on the period 1996–2001 in annual data. In the financial account, no data have been reported for direct investment abroad and very little annual data are reported for portfolio investment for the period 1994 through 2001. With respect to other investment (assets), instruments and sectoral breakdowns are not provided, while a detailed breakdown of assets (e.g., general government, banks, other sectors) should be made. No International Investment Position is reported.

Government finance

There is a need for stronger collaboration between the ministry of finance and the central bank to derive accurate and timely estimates of external financing of the nonfinancial public sector.

Honduras: Core Statistical Indicators

(As of December 19, 2003)

	Exchange Rates	Interna-tional Reserves	Central Bank Balance Sheet 1/	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	12/17/03	12/17/03	12/17/03	12/17/03	9/03	12/08/03	11/03	03/03	02	6/03	02	02
Date Received	12/19/03	12/19/03	12/19/03	12/19/03	11/13/03	12/19/03	12/05/03	7/17/03	12/10/03	12/10/03	10/22/03	5/03
Frequency of Data 2/	D	D	D	D	M	W	M	M	Q	M	A	M
Frequency of Reporting 3/	D	D	D	D	M	W	M	M	V	V	A	V
Source of Update 4/	N	A	A	A	A	A	N	A	A	A	A	A
Mode of Reporting 5/	E	E	E	E	E	E	E	E,V	E,V	E,V	E,V	E,V
Confidentiality 6/	C	B	B	B	C	C	C	C	C	B	C	B
Frequency of Publication 3/	D	M	M	M	M	W	M	A	A	V	A	A

1/ Summary version.
2/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annual, or O-other.
3/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, V-irregularly in conjunction with staff visits, or O-other irregular basis.
4/ A-direct reporting by central bank, ministry of finance, or other official agency, N-official publication or press release, P-commercial publication, C-commercial electronic data provider, E-EIS, or O-other.
5/ E-electronic data transfer, C-Cable or facsimile, T-Telephone, M-mail, V-staff visits, or O-other.
6/ A-for use by the staff only, B-for use by the staff and the Executive Board, C-for unrestricted use, D-embargoed for a specified period and thereafter for unrestricted use, or E-subject to other use restriction

Tegucigalpa, Honduras
February 2, 2004

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Köhler:

1. We enclose with this letter the Memorandum of Economic Policies (MEP) that underpins our economic program and poverty-reduction strategy during 2003–06, and sets out specific objectives and quarterly financial and structural targets for 2004.

2. To strengthen our efforts to alleviate poverty in Honduras, we need a stable macroeconomic framework to revitalize growth while keeping inflation low and improving our external position. Given the importance of ensuring that the macroeconomic adjustment in the program is acceptable to the Honduran public, our government has made every effort to reflect social concerns in the program, following an ample participatory process to update the poverty reduction strategy and the establishment of a National Dialogue. The updated PRSP, which is the key policy document underpinning this program, was sent to the Fund on December 11, 2003. The participatory strategy aims at establishing strong ownership of the goals of the program.

3. The key components of the program are:

- A medium-term macroeconomic framework consistent with an increase in sustained growth and achievement of the targets in the updated poverty reduction strategy;

- A strong fiscal adjustment that will contain the wage bill and strengthen the revenue effort, while allowing a steady increase in anti-poverty spending;

- A far-reaching reform of the financial system to strengthen its financial health; and

- Improvements in governance and transparency.

4. To support these objectives and policies, Honduras hereby requests a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in a total amount equivalent to SDR 71.2 million (55 percent of quota), to be provided in seven equal semi-annual disbursements. The Government of Honduras also requests the resumption of interim assistance under the Enhanced HIPC Initiative in an amount equivalent to SDR 4.3 million, which will cover 42.8 percent of principal obligations falling due to the Fund between

February 18, 2004, and February 17, 2005, assuming Board approval of the proposed PRGF arrangement by mid-February 2004, and that Honduras will reach the completion point in March 2005.

5. Our government believes that the policies set forth in the attached Memorandum of Economic Policies (MEP) are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate to this purpose. Honduras will consult with the Fund on the adoption of these measures, and in advance of the revisions to the policies contained in the MEP, in accordance with the Fund's policies on such consultation. Honduras will provide the Fund with all necessary data on a timely basis for monitoring purposes. During the program period, the government will not introduce or intensify any exchange rate restrictions or multiple currency practice, conclude any bilateral payment agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement, or introduce or intensify import restrictions for balance of payments purposes. Consistent with its intention to keep the public informed about its policies and objectives, the government will publish the MEP and will report periodically on progress under the program.

6. We propose that the Fund carry out reviews under the 2004 program in September 2004 and March 2005 based on the observance, respectively, of end-June and end-December 2004 quantitative and structural performance criteria established in Tables 1 and 2 of the attached memorandum.

7. We are confident that the program will deliver sustained growth and substantive poverty-reduction, and hence that it deserves the support of the international community.

Sincerely yours,

/s/

María Elena Mondragón de Villar
President
Central Bank of Honduras

/s/

Arturo Alvarado Sánchez
Minister of Finance

MEMORANDUM OF ECONOMIC POLICIES OF THE GOVERNMENT OF HONDURAS

I. INTRODUCTION

1. The Government of Honduras has decided to implement a three-year program for poverty reduction and growth that can be supported by the International Monetary Fund and will give Honduras access to further debt relief from the international community under the enhanced HIPC Initiative.

A. Program Objectives

2. A main goal of the program will be to address the rising fiscal pressures the government has been facing since it assumed office in January 2002. The elimination of these pressures is the only way to make adequate funding available for programs which support growth and fight poverty, the two basic objectives of Honduran society, as reconfirmed by the participatory process for the updated Poverty Reduction Strategy.

3. The government, conscious of the need to ensure that such a program is acceptable to the Honduran public, has supplemented the unavoidable adjustment measures in the program with reforms which respond to social concerns raised in the National Dialogue. The aim is to ensure the program is one which goes beyond a narrow resolution of our fiscal problems by broadening and strengthening the commitment to fighting poverty, sharing resources more equally among social groups, escalating the struggle against corruption, fortifying the financial system, and articulating the government's macroeconomic strategy for increasing growth. The program deserves the financial support of the international community, not only because of the courageous adjustment measures it contains, but more importantly because its fundamental goal is to raise the living standards of the Honduran people.

B. The Economic Background

4. When President Maduro took office in January 2002 the fiscal situation was very weak. The consolidated public sector deficit, which had averaged 1.8 percent of GDP in 1995–2000 rose to 3.2 percent of GDP in 2001, and the quality of expenditure deteriorated markedly with increasing current expenditure, particularly from generous salary increases granted beginning in 1998, and low investment in social sectors. Furthermore, the new government inherited substantial wage demands that had not been incorporated in the 2002 budget. As a result, the deficit widened further to 3.6 percent of GDP in 2002 despite a package of revenue measures adopted midyear. For 2003, the wage bill would have grown to more than 11 percent of GDP (from 6½ percent in 1997) if the government had not begun to take remedial action.

5. In addition, the Honduran economy had been hurt by numerous external shocks, some of which continue to have repercussions. These include natural disasters, the slowdown of the U.S. economy, and a persistent decline in the terms of trade caused by unprecedentedly

low coffee prices and rising world oil prices. This situation has put severe pressure on the external current account deficit, and, despite large aid inflows, on the financing needs of the balance of payments. Real GDP per capita declined by an average ½ percent a year over the last five years, while two-thirds of the population remains poor—with half in extreme poverty.

C. The Social Framework for the Program

6. The government's ability to implement the program will critically depend on the public support that can be assembled.

- In the first half of 2003, the government asked civil society and the international community to review the Poverty Reduction Strategy Paper (PRSP) completed in 2001. Based on that review, a Progress Report on the implementation of that strategy was completed in November 2003. This exercise has served to reconfirm and clarify society's priorities and commitment to the PRSP process. The prioritization of programs in the progress report, and the macroeconomic framework presented in it, serve as the basis for the economic program described in the rest of this Memorandum. By using the Poverty Reduction Strategy as the framework for the program, the program's policies aim to respond to the needs of the population (and in particular of the less privileged) as fully as public financial resources permit without endangering fiscal sustainability.

- The encouraging participatory process that evaluated and updated the Poverty Reduction Strategy has been followed by two complementary consultation processes, the National Dialogue and the Fiscal Responsibility Pact, in which all sectors of society have been invited to participate. These ongoing discussions have served to develop understanding of the nature of the adjustment problem, while drawing attention to the more deep-rooted concerns of society which need to be taken into account if the adjustment is to be socially acceptable. We believe that these consultations have established the social legitimacy of the program we propose to implement, and we will maintain and deepen ownership over the period of the program.

II. Strategy and Targets for the Program

7. The program contains the following major components: (1) a medium-term macroeconomic framework reflecting the debt relief and other international financial support associated with the program, consistent with a reactivation of growth and with the targets in the updated Poverty Reduction Strategy; (2) detailed fiscal, monetary, and external sector policies and structural reforms; and policies intended to respond to social concerns, including strategies for (3) reforming the financial sector, and (4) improving governance and transparency in other areas of the economy.

A. The Medium-Term Macroeconomic Framework

8. In line with the goals of the updated Poverty Reduction Strategy, the program aims to raise growth to an annual 4½ percent by 2006, targets a gradual decline in inflation to the level in trading partners by 2008, and provides funds considered sufficient to lower the incidence of poverty to 42 percent of the population by 2015. The external current account deficit will widen temporarily to reflect large investments of vital importance to the government's growth strategy, while gross international reserves will be accumulated to a level consistent with maintaining import coverage of four months to ensure external sustainability.

Macroeconomic Framework

	2003	2004	2005	2006
(Annual percentage changes)				
GDP at constant prices	3.0	3.5	4.0	4.5
Consumer prices, end of period	6.8	6.7	6.0	5.0
(In percent of GDP, unless otherwise noted)				
Combined public sector savings	1.4	3.9	4.8	5.9
Anti-poverty spending	7.5	8.1	8.7	9.4
Combined public sector balance	-4.6	-3.0	-2.5	-1.7
Of which:				
Central government balance	-5.5	-3.5	-3.0	-2.5
External current account balance	-5.2	-7.1	-4.5	-3.8
Gross international reserves (months of imports)	4.0	4.0	4.1	4.1

B. Growth

9. The strategy for revitalizing growth has several elements. First, public investment will increase to meet key infrastructure needs and complement private investment. For 2004, the public investment program focuses on road construction and low-income housing (particularly in rural areas), and the expansion and upgrading of the telephone network. Second, large private investments are expected, in particular, in electricity generation, telecommunications, tourism, textiles (*maquila*), and agriculture. The monetary program has been designed to allow adequate provision for financing potential private sector investment. Third, recent and pending reforms in governance and transparency (e.g., of the judicial system and of the property cadastre and titling) are expected to improve the investment climate and attract further new investment—as will the consolidation of price stability and external sustainability. Fourth, structural reforms to improve the efficiency of the public sector and the soundness of the financial system should provide a stronger institutional

backdrop for growth. Fifth, a successful conclusion of the Central American Free Trade Agreement is expected to open additional markets and create pressures to enhance efficiency. And finally, the government is committed to maintaining competitiveness in the more open environment through its exchange rate policy, and enhancing it through improvements in productivity.

10. The government sees participation in the Central American Free Trade Agreement (CAFTA) as a key element of its strategy for boosting Honduras' growth potential. Participation in CAFTA is expected to make access to the U.S. market more permanent and grant exporters and investors a fuller set of protection and dispute resolution rules. Furthermore, the agreement will motivate us to upgrade existing rules and institutions regarding investment and trade (e.g., involving intellectual property rights, and labor and environmental regulations). These changes are expected to lead to higher foreign and domestic investment. Also, the government plans to review, with support from IDA, the potential impact of CAFTA on the poor and most vulnerable members of society, in order to prepare timely compensatory actions.

11. The objective of the National Competitiveness Plan, launched in May 2002, is to improve the climate for private investment over the next five years, thereby ensuring that Honduras captures all potential benefits from CAFTA. The plan places priority on the development of agribusiness, forestry, maquila, and tourism, which are areas with particular growth potential. It contains actions to increase factor productivity, foster a more competitive business environment, and promote export growth. With a view to upgrading regulatory practices and encouraging private sector investment, the government will seek passage of a competition-promotion law during 2004, changes in the framework law for telecommunications by mid-2004, of a new framework law for transportation by end-2004, and possibly also a framework law for the electricity sector. With these laws, the private sector will be able to obtain concessions to operate Puerto Cortes, and carry out projects to increase the number of telephone lines, and broaden the power sector network. To facilitate the goals of the National Competitiveness Plan, the Government will: (1) implement the administrative simplification law passed in 2002 to shorten the time required to start up new businesses; (2) merge by June 2004 the land registry and cadastral functions into a single agency to enhance land tenure security; and (3) improve the public vocational training system, through the reorganization of INFOP (the National Institute for Vocational Training) and separation of the provision and certification of training activities. Furthermore, within the context of the annual minimum wage negotiations, the government will encourage containment of minimum wage increases in real terms to what is justified by productivity.

12. One of the measures taken to cushion the social impact of the program, especially on lower-income groups, is a selective price freeze until June 30. The government is aware of the distortions associated with price controls and the likely negative implications for growth. Hence, in agreement with the private sector, the price freeze has been limited to a few basic products of most importance to the poor, and the June 30 expiration date will be strictly observed. Moreover, the government will seek to accelerate the approval of the competition-

promotion law to before June 30 if possible—upon which the price freeze would automatically expire. No further price freezes will be introduced during the program.

C. Poverty Reduction and HIPC Goals

13. In line with the priorities established in the consultation process for the Poverty Reduction Strategy, anti-poverty spending for 2004–06 will focus on projects to: (1) broaden the quality and coverage of education and health; (2) improve basic rural infrastructure (water and sanitation, roads, electricity, and telecom networks); and (3) enhance the social safety net for the poor, particularly ethnic minorities and women.

14. The updated Poverty Reduction Strategy redefines eligible poverty-reduction spending to cover a broader range of priorities than in the original version (including, for instance, the hiring of teachers for rural areas as well as the investment projects previously emphasized). The broader definition of such spending should help ensure that the budget devotes enough resources to anti-poverty programs—and allows these to be sufficiently flexibly targeted—to make reaching the Poverty Reduction Strategy goals feasible.

15. To ensure these resources are spent as promised, the government will continue enhancing its mechanisms to track anti-poverty spending. All poverty-reduction spending under the new definition will be identified by budget code before the program is approved, so that it can be fully monitored under the program. To minimize the possibility of misuse of the spending, monitoring according to the revised definition will be fully automated by end-2004. Automation of the reporting process will be developed over the year, with expected deadlines of March 2004 for automated reporting of poverty-reducing spending financed by external funds, May 2004 for the linking of spending, debt and grant data (under an UNCTAD contract), and full operation of the automated system by September 2004. For monitoring purposes under the revised definition, the database recording the number of teachers will be maintained up to date.

16. The government intends to maximize the debt relief available to Honduras by attaining the HIPC completion point as soon as possible (in early 2005). This will require maintaining a track record of compliance with the program and successful implementation of the PRSP, as well as implementing the structural and social reforms laid out in the decision point document. The government has already implemented most of these reforms but will continue to make reforms in relevant areas during 2004. Specifically: (1) a comprehensive participatory anti-corruption strategy has been presented to the national and international community, and implementation has begun; the abolition of immunities for officials will strengthen the program in 2004; (2) the Social Security Law has been reformed to increase contributions by a factor of eight, permitting the IHSS health program to expand coverage; IHSS pension and health funds have been separated; and work is underway to strengthen the regulatory capacity of the health secretariat with support from the World Bank and IDB; (3) to strengthen basic health services for the poor, a package of services has been delivered to 181,000 people in 749 communities as of November 2003, almost double the targeted figure of 100,000; (4) to improve the quality of education, 1,700 PROHECO (community

managed) schools have been established as of November 2003, well above the targeted 1,350 schools; (5) to improve the efficiency and targeting of social safety nets, FHIS has continued to base its programming on participatory planning methodologies, and a national model for participatory municipal-level planning is being developed; and (6) to strengthen the financial sector, the financial sector reform includes a timetable for compliance with Basel principles.

D. International Financial Support

17. The government is confident that this program will be backed by the support of the international community. International financial support (including debt relief) will help pay for poverty-reduction programs and will allow the pace of fiscal adjustment to be more gradual than would otherwise be possible.

18. The government envisages that the fiscal financing gaps in the program can be closed through the combination of: (1) a flow rescheduling by Paris Club creditors of the debt service falling due in 2004 and early 2005, and of the stock of arrears incurred in 2002–03; (2) program grants and loans from bilateral donors and multilateral creditors for poverty alleviation and reforms in the financial system and the public sector; and (3) debt relief upon reaching the HIPC completion point. The government will also explore with Paris Club creditors options to obtain additional debt relief (beyond HIPC) and will seek additional support from donors in the context of the upcoming Consultative Group Meeting tentatively scheduled for the first half of 2004.

19. The combination of domestic adjustment and external debt relief should, according to the medium-term policy framework, make the public debt manageable. Total public debt is expected to decline to 51 percent of GDP by 2006, down from 72 percent of GDP in 2003 and 82 percent in 1999, before Honduras reached the HIPC decision point in 2000 and first began to receive HIPC debt relief. Specifically, the NPV of external debt could be reduced gradually to 29 percent of GDP by 2006 (47 percent in 2003), to 151 percent of government revenue (248 percent in 2003), and to 77 percent of exports of goods and services (127 percent in 2003). Domestic debt will remain small over the medium term.

III. ECONOMIC AND FINANCIAL POLICIES

A. Fiscal Policy

20. The fiscal program will decisively tackle the imbalances that have threatened sustainability, but with a mix of adjustment measures chosen by the government to be least painful to society and to spread the adjustment burden as broadly as possible.

The fiscal strategy for 2004–06

21. The deficit of the combined public sector will be limited to 3 percent of GDP in 2004, 2½ percent in 2005, and 1¾ percent in 2006. The central government deficit will be targeted at 3½ percent of GDP in 2004, 3 percent in 2005, and 2½ percent in 2006. Meeting these

goals will result in a significant increase in public sector savings to close to the level of the late 1990s by 2006.

22. To attain the needed increase in public sector savings, it will be necessary to slow the rate of increase of public sector wages, and ensure that wages are equitable across different groups of public sector workers. To avoid putting an intolerable adjustment burden on government wage-earners, the government has also made savings in other areas of non-poverty-reducing spending, and has taken the difficult step of restoring fuel tariffs. The need to raise taxes has been lessened by the elimination of numerous tax exemptions outside the basic consumption basket, and measures to improve the operating balance of public enterprises. The government will also pursue a long-term strategy of pursuing noncompliant taxpayers, recovering assets from sectors which received taxpayer-financed support, and prohibiting new bail-outs, with a view to raising significant additional resources which can be used to improve the equity of spending over the medium term.

23. The increase in public savings will allow poverty-reduction spending to rise by 0.6 percent of GDP in each year of the program, from 7.5 percent in 2003 to 9.4 percent in 2006. In light of the need to demonstrate progress in poverty reduction, the government has agreed that the poverty-reduction spending target should be subject to program conditionality.

24. If fiscal deficits can be contained to the targeted levels, the need for domestic financing of the central government will sharply decline (from 4 percent of GDP in 2003) and be eliminated by 2005—assuming that sizable financing gaps (close to 5½ percent of GDP in 2004 and 2–2½ percent a year in 2005–06) can be filled by external support. If this additional support falls short of what is estimated, the government will implement further measures to preserve poverty-reduction spending and investment, while maintaining the combined public sector deficit at financeable levels throughout the program.

25. During the period of the program, the government commits to the contracting of external debt only on concessional terms—with the exception of up to US$3.3 million for the purchase of a building for the diplomatic missions of Honduras in Washington, D.C. The government will make every effort to maintain the deficit of the central government at a level consistent with concessional external financing starting in 2005.

The 2004 fiscal program

26. The combined public sector deficit will be reduced by 1.6 percent of GDP to 3 percent in 2004, and the central government deficit by 2 percent of GDP to 3½ percent (5½ percent in 2003); central government domestic financing will be limited to ½ percent of GDP. The adjustment will be reinforced by structural reform to achieve a sustainable government wage policy, the termination of government sectoral support including to agricultural debtors, and steps to improve fiscal governance and transparency. The expenditure envelope for the 2004 budget will be set in line with that of the program.

- To achieve the fiscal targets of the program, the government will reverse the sharp upward trend in the wage bill. No nominal wages will be cut, but no new salaries above L 60,000 a month will be granted. Mid- and high-level civil servants will receive no increase in 2004 and others will receive an adjustment depending on expected inflation—according to a new permanent salary determination formula developed in consultation with employees. Employees in decentralized agencies (including public enterprises) will be subject to the same wage policy in 2004 to the extent that the resources of these agencies permit and excepting any agreements covering the period which were concluded before mid-November 2003.

- The wage reform eliminates all special wage regimes by end-2006, broadening the scope of wage policy to cover all government employees, and allowing the government to set wage bill ceilings in line with fiscal objectives and financial constraints. The reform fully incorporates the wage bill of medical doctors into the wage policy from the beginning of 2005 (with the only distinction being an annual inflation catch-up from 2006 onward) and that of teachers (half of total wage outlays) by January 2007, with salaries in 2004 maintained constant for doctors and with a lower than previously envisaged increase for teachers in 2004 and 2005. Existing supplementary payments to teachers will be set at end-2003 nominal values, and new supplementary payments will be capped through 2006 as described in the 2004 budget law. These measures will permit the wage bill to continue to grow but at a slower pace than in recent years, thereby causing it to decline in terms of GDP.

- Though the wage containment strategy described above is gradual, the government is strongly committed to re-establishing an affordable and equitable wage system, and to that end will take additional rationalization measures. The government has already begun a process of 're-engineering' the public sector, with a view to merging and streamlining institutions, and expects that savings from this process will amount to 0.2 percent of GDP in 2005 and 0.4 percent in 2006. The ongoing first step includes detailed analytical work and implementation of restructuring strategies in the three largest ministries: education, health, and agriculture, to be concluded by March 2005. The process of identifying ghost workers and eliminating them from the payroll will be widened, and the likely savings will be taken into account in the first review. The government intends to pursue a more far-reaching human resources reform in the context of a World Bank credit, to be agreed before April 2004.

- The government will also contain expenditure by around 0.3 percent of GDP relative to the draft budget submitted to congress in September 2003, by maintaining some current transfers constant in nominal terms and other efficiency savings. On the tax side, besides the significant reduction in tax exemptions, the government has fully implemented tax measures approved in April 2003 by raising the excise tax on cigarettes and collecting sales taxes on credit card transactions. These measures, together with the restoration of fuel tariffs, are projected to increase tax revenue from 16.6 percent of GDP in 2003 to 17½ percent in 2004, though this projection is subject to risks from tax administration constraints and the potential impact of lower import duties following the implementation of CAFTA (more likely in 2005). In the case that deviations from the fiscal projections start to emerge, the government will take prompt corrective steps to ensure the deficit target for the central government.

- The government is committed to enforcing current tax laws to the fullest extent, to minimize the need for further tax measures. Since 2002, 1,600 businesses were sanctioned with temporary closure for noncompliance with the sales tax law, and the DEI will build on this achievement through an action plan for improving tax and customs administration in 2004 and beyond. The Tax Code will be modified (by September 2004) to strengthen the collection and enforcement powers of the DEI (inter alia by the introduction of appropriate payment facilities, and more realistic penalties against tax fraud and evasion). The National Tax Register will be overhauled by the second quarter of 2004. Filing, control, and audit procedures for large taxpayers will be improved, including by extending the coverage of electronic filing to 100 percent of large taxpayers by September 2004, by training of auditors, and by the establishment of a new tax office in San Pedro Sula. The DEI intends to more than double the number of audits in 2004. The government intends to introduce two chambers of specialized tax courts before end-2004, to streamline the appeals process.

- The customs administration will be made more efficient by the elimination of internal customs facilities and transit procedures, and the concentration of resources at points of entry by June 2004. Control of trade will be much enhanced by requiring all large exporters and importers (including depots, industrial parks, those eligible for special customs regimes, customs agents, shipping companies, transport agencies, etc.) to complete import/export procedures on line from March 2004. To limit the undervaluation of imports, the government is negotiating, in tandem with other governments in the region, with pre-shipment companies to have prices of imports valued at origin, starting in 2004.

- The program contemplates steps to contain the deterioration in the operating surplus of public enterprises in 2004, to help finance the pro-poor capital outlays identified in the Poverty Reduction Strategy. These steps comprise the implementation before end-2003 of the modification in the formula for adjusting electricity tariffs defined in note CNE00155-2003 of the National Energy Commission, and a wage increase of up to 6.7 percent in all public enterprises, in line with the wage policy outlined above. Two large thermal projects by the private sector are scheduled to come on stream this year, which will result in important savings in operating outlays (by 0.4 percent of GDP in 2004 and a further 0.4 percent in 2005) for the state electricity company. In the case that the envisaged operating savings do not materialize as planned, the authorities will implement further corrective measures in 2004 to ensure that the targets on the public enterprises' operating balance and the combined public sector overall balance can be met, while taking into account any impact from the investment adjuster described in paragraph 46.

- During 2003 the government awarded a second mobile concession to a private operator and launched the program Telephones for All, that opened up the fixed telephone market to private operators without tariff regulation. With these actions, significant private projects will be carried out to expand the fixed telephone network, new operators will interconnect through HONDUTEL, and telephone lines are expected to expand by at least 50 percent over two years. International calls will be opened to private operators starting in December 2005. In preparation, the National Telecommunications Commission will take steps to rebalance tariffs on local calls (these are among the lowest in the region) starting in 2004 to offset the impact of an expected significant decline in international tariffs. HONDUTEL will limit its investment spending to maintenance of the current network and rural expansion, which will keep investment at about 1¼ percent of GDP for 2004 and 2005.

The fiscal program in 2005–06

27. To achieve the fiscal goals of the program for 2005–06, the government will extend the income tax surcharge (5 percent) through 2006, and as noted below, eliminate those tax exemptions supported by the fiscal pact and the national dialogue. Moreover, it is the government's policy to prevent any decline in the real value of specific excises. Adjustments on the basis of these policies will need to more than offset the potential impact of CAFTA on revenue. In addition, we anticipate savings of 0.2 percent of GDP in 2005 and 0.4 percent of GDP in 2006 from our plans to downsize the central administration through the restructuring of the ministries of education and health, and closure of redundant offices. Increases in public investment in each year of the program are a high priority for the government, but such increases will be maintained consistent with overall program goals. Measures to close any remaining fiscal gaps will be identified during the first and third reviews of the program. The government will take all measures necessary to ensure that the deficit targets of the program are met.

B. Monetary and Exchange Rate Policy

Targets and strategy

28. In the context of the existing crawling band arrangement, monetary policy will aim at reducing inflation to 6.7 percent in 2004, 6.0 percent in 2005, and 5.0 percent in 2006, and in the medium term to the levels of Honduras' main trading partners. To this end, the central bank will conduct cautious policies during the program period. The stock of net domestic assets will be limited to L -14,075 million at end 2004, while the floor on the stock of net international reserves of the central bank (NIR) will be set at US$1,205 million. This floor should allow end-2004 gross international reserves to remain at 4.0 months of imports, and provide more than 100 percent coverage of short-term liabilities (including money base and CAMs).

- The improved fiscal stance expected for 2004 will facilitate meeting the targets specified above. This, in turn, will be consistent with private sector credit growth faster than inflation. The quantities of CAMs placed at the auctions will be consistent with the achievement of the quarterly NIR targets, and interest rates on CAMs will be allowed to increase if necessary to clear the auctions.

- While the central bank's weekly auctions of CAMs will remain its main monetary policy instrument, the central bank recognizes the importance of developing further defenses to protect its NIR. The central bank will use technical assistance to develop these defenses, and will ensure that the rate of crawl and other aspects of the band regime remain appropriate over the period of the program.

- The central bank will continue to take steps to discourage the dollarization of financial system operations, and in this connection, will maintain reserve and liquidity requirements for foreign currency deposits at the current levels. It will also maintain the present limits on foreign currency credit to the private sector.

Strengthening monetary management

29. To enhance the effectiveness of monetary policy, the central bank will, with the assistance of an MFD technical assistance mission in early 2004, (1) make the use of indirect instruments of monetary management more effective; (2) improve interest rate signaling to the market; and (3) define the appropriate limit on open market operations denominated in dollars. The central bank will implement these modifications within a timetable to be finalized by end-September 2004. Prior to agreement on the appropriate limit for dollar-denominated open-market operations, the ceiling on these operations will be US$65 million.

30. To improve the lender-of-last-resort facility, the central bank will seek to redefine the legal framework for its liquidity support to the financial system by June 2004, and fully implement the framework by the first review, so as to ensure that this support takes the form of quick-disbursing short-term loans with the highest interest rates in the market. Central bank liquidity support will be provided only to illiquid, but solvent banks and clear limits will be set on it, not to exceed the recipient bank's capital. While the government does not anticipate supporting insolvent banks, if, in an extreme case, such support were necessary to avert a systemic crisis, these funds will be provided by the government, and offset by compensatory measures in the fiscal program.

31. In consultation with the ministry of finance, the central bank will design a mechanism through which the government will capitalize the central bank for past operating losses, and will gradually assume all future central bank cash losses. The MFD technical assistance mission will provide recommendations on this front and the timetable of actions will be agreed during the first review of the program. The fiscal implications of these operations will be reflected in the central government accounts.

32. The central bank will upgrade the payments system. Plans will be prepared by December 2005 to separate large-value and low-value payments. Large value payments will be moved to a parallel payments system with adequate risk management mechanisms. The securities settlement infrastructure will be modernized to support the development of an efficient interbank market.

33. The central bank will improve transparency in monetary policy by keeping the public informed about monetary developments, and publishing the full set of financial statements, including the opinion of the external auditor and the explanatory notes, beginning with the 2003 Annual Report. It will complete the process of appointing the external auditor by end-September each year. It will expand the scope of the Internal Audit Department's audit plan from 2004 on, to include audits of the process of reporting monetary data to the IMF and audits of controls over central bank investments.

34. The central bank will seek congressional approval by June 2004 of reforms to the Central Bank Law to redefine the lender of last resort mechanism, will require the government to capitalize the bank and assume cash losses in the future, and will adopt provisions to prohibit the central bank from guaranteeing debts of other entities and to preclude distribution of unrealized profits.

C. Financial Sector Reform[14]

35. To improve the soundness of the Honduran financial system, the government has embarked on a comprehensive reform program that includes actions to: (1) improve the prudential regulatory framework and ongoing supervision, and (2) enhance the efficiency and effectiveness of the financial safety net. The reform will also strengthen mechanisms to prevent money laundering and financing of terrorism and deter domestic financial crime. Critical elements of this reform will be implemented in 2004, as the current universal deposit scheme is scheduled to expire by October 2004.

Prudential regulation and supervision

36. Strengthening supervision and prudential regulations means giving the National Banking and Insurance Commission (CNBS) the tools to guarantee that all financial institutions reach and maintain healthy solvency and liquidity indicators. The main actions will include:

- The introduction of legal changes by June 2004, and, by December 2004, of the regulatory reforms necessary for the implementation of consolidated supervision, followed by the training of supervisors to conduct consolidated supervision in pilot

[14] The Technical Memorandum of Understanding contains a more detailed description of some of the modalities of the financial system reform.

exercises from June 2005 onward, with the goal of having consolidated statements of the entire sector by December 2006.

- Finalization by the CNBS of a timetable to comply with new regulations on capital adequacy, loan classification, and provisioning (including for investment in FONAPROVI bonds) by end-June 2004.

- Implementation of regulations issued in December 2003 to bring the calculation of the capital adequacy ratio in line with Basel standards.

- A strengthening of loan loss provisioning, as provided by the new regulations issued in December 2003. At the time of the first program review, the CNBS will discuss with the Fund a timetable for each bank to bring provisioning requirements into full compliance by December 2006. Meanwhile, the CNBS will continue to reinforce compliance with existing provisioning requirements. Provisioning requirements will also apply starting from January 2004, to the banks' investments in FONAPROVI bonds that resulted from the debt relief to agricultural producers.

- A gradual reduction in banks' related lending and the share of banks' equity in nonfinancial firms as mandated by congress in August 2002.

- Establishment of the legal basis for better risk management practices in the financial system through a set of new regulations by June 2004. In June 2004 and June 2005 the CNBS will conduct surveys to follow up on the compliance with these new measures, to ensure full compliance by December 2006.

- A regulation to reinforce governance requirements for banks' boards of directors, with clear accountability rules (June 2004).

- By the time of the first review, the CNBS will have put in place mechanisms to improve the breadth and quality of, and access to, credit bureau information.

37. By the time of the first program review, the CNBS will provide the Fund with a list of required capital increases by bank resulting from the enforcement of the new regulations described above, and will agree on a timetable for the increases, to be completed by December 2006. The modalities governing resort to the recapitalization fund will be agreed with the Fund during the first program review.

38. The CNBS will also by June 2004 introduce legal reforms to (1) strengthen its autonomy and accountability and take over some functions that correspond to the supervisory authority but are now carried out by the central bank; (2) strengthen sanctions against institutions not complying with regulations; and (3) introduce a special supervision framework for weak banks. The CNBS will train staff to enhance on- and off-site inspections, and will continue to enforce the requirement that banks publish quarterly financial statements.

Financial safety net

39. Action will be taken to make the financial safety net more effective and efficient, and to limit moral hazard. The authorities have recently taken resolute actions to deal with troubled banks.[15] In dealing with these cases, the CNBS has realized that it is imperative to upgrade the financial safety net—the deposit insurance system and the bank resolution framework, as well as the lender of last resort function already discussed in paragraph 29. The government intends to address these issues, in line with IMF recommendations.

- The government will improve the financial position of FOSEDE, by recapitalizing FOSEDE through the recovery of past government loans to troubled financial institutions, by US$10 million in 2004 and a further US$10 million in 2005. FOSEDE will also be recapitalized by an additional US$10 million from IDB resources, currently scheduled for early 2006. Bank premia will remain at 0.25 percent of total bank deposits until banks are adequately recapitalized. The adequacy of the premia will be revisited at the second review. By June 2004 the government will introduce legal changes to adapt FOSEDE to its new exclusive role of manager of the deposit insurance scheme. Thus, its capacity to resolve stressed banks through intervention and recapitalization will be discontinued.

- An improved bank resolution framework will be put in place by June 2004. It will put more emphasis on early detection, to minimize the cost of bank resolution to government while preserving debtor discipline. The new framework will allow the CNBS to request, at an early stage, rehabilitation plans from weak institutions, and will bring the resolution mechanism under the CNBS' authority to expedite intervention. By December 2005, the CNBS will take action to resolve any non-viable institutions based on this new framework.

- In June 2002 congress approved a Law for Money Laundering Prevention and in September 2003 made the financing of terrorism a criminal offense. During 2004 the CNBS will improve multilateral and bilateral cooperation to combat these offenses; upgrade regulations on confiscation, freezing and seizure; and begin on-site verification of the supervised entities' policies for accepting clients. It will also introduce software systems to control unusual transactions, train specialized investigators, and apply for EGMONT membership.

- The government continues to be concerned about domestic financial crime. Hence, it will introduce amendments to the Penal Code by June 2004 to make such a crime a

[15] In 2002, FOSEDE took over two troubled banks and capitalized them to avoid contagion to other financial institutions. The CNBS liquidated one of the banks as it did not restore its viability and in mid-2003, FOSEDE sold the other to a local bank. Four mergers have taken place since 2002 and the CNBS will continue to authorize mergers in the coming months.

punishable act, and define adequate sanctions. Besides its inherent value, this measure will meet a main concern of the public—that financial wrongdoing leading to bank failure should not go unpunished.

- To achieve the changes mentioned above, the government will submit to congress a set of legal reforms that will be approved before June 2004. These include a new Financial Institutions Law, as well as amendments to the Deposit Insurance Law, the National Banking and Insurance Commission Law, and the Penal Code.

IV. Governance and Social Equity

40. The government is aware that social concerns about governance could undermine support for the needed reforms in the economy. Moreover, Honduras' disappointing standing in the recent Transparency International Index of Perceptions of Corruption risks damaging prospects for investment, both local and from abroad. The government has always been committed to fighting corruption and improving governance in Honduras. An Anti-Corruption Commission was established in 2001. The government has recently taken fundamental reform measures to address perceived shortcomings, and will continue to pursue an agenda for enhancing the transparency and probity of the public sector.

41. Recent governance and anti-corruption measures include fundamental judicial and political reforms and transparency measures.

- As regards judicial reform, (1) the independence of the Supreme Court has been strengthened by extending judges' terms of office beyond the election cycle and making reappointment possible; (2) a new Penal Procedures Code has been adopted, providing for open process; (3) judges are to be evaluated by an independent international company; and (4) plaintiffs may choose their own lawyers to handle foreclosure cases (an important anti-corruption measure). Before end-2004, the government intends to take further far-reaching measures to: (5) eliminate immunities from prosecution of congressmen and public officials; (6) strengthen the Penal Code to ensure that sanctions against financial crime are adequate and comprehensive; and (7) adopt a Civil Procedures Code to complement the Penal Procedures Code.

- Recent political reforms expected to improve governance include: (1) a reduction in the campaign cycle (to the last year of every presidential term)—a measure also expected to greatly improve economic management; (2) a more direct congressional election process; and (3) electronic voting in congress so that all voting records are known.

- In the area of fiscal transparency: (1) a large share of government procurement has been delegated to the UNDP (which has cut costs as well as limiting corruption) and an independent auditing process has been established for procurement; (2) the Comptroller General's office and Office of Public Ethics have been merged into an independent Superior Accounting Tribunal; (3) more than 1,200 businesses have been temporarily closed for nonpayment of tax and other fiscal fraud; and (4) the annual budget was submitted in full and in good time to congress, together with quarterly execution reports (for the first time in Honduran history). The government intends to build on these achievements in 2004 by: (5) strictly limiting the number of political appointments to the public sector and establishing a system of advancement based on merit; (6) incorporating in a permanent law the prohibition of intra-year unfinanced expenditure appropriations; (7) preparing finalized reconciled fiscal accounts as a prerequisite for the eventual goal of submitting audited fiscal accounts to congress; (8) enacting a new law to enhance control over National University decisions; and (9) establishing specialized tax courts.

- The government is particularly committed to reducing red tape to help improve the investment climate. A Simplification Law was approved by congress in 2002, and the Competitiveness Commission is pursuing further simplification of procedures. This reform, together with the adoption of a new property law facilitating the titling of land, will reduce transaction costs and speed up the process of starting a new company.

42. The government is also aware of concerns that bail-outs (*condonaciones*) and support for depositors in failed banks have pre-empted scarce public resources that could otherwise have contributed to poverty-reduction programs. The government has decided to abstain from all possible bail-outs over the period covered by the program. When bail-outs are unavoidable, their cost will be fully reflected in the budget and offset by compensatory fiscal measures—with a view to ensuring full public scrutiny of the bail-outs and congressional prioritization of the use of public resources.

- Successive support plans for agricultural loans approved in recent years have resulted in large fiscal cost, unfair distributional impact, and weakened incentives for creditors to remain current with loan obligations. To demonstrate its commitment to discontinuing bail-outs, the government has decided to prioritize the eligibility for support under the Agricultural Decree to small beneficiaries. Access to relief under the decree will terminate on December 31, 2003, and no further support to the agricultural sector will be extended over the course of the program.

- A limited amount of future public support for weak banks is provided for under the program as described above, to resolve previously identified problems in banks without unnecessary losses to savers. However, the government is committed to recovering as much as possible of the public resources used to support banks, with the goal of recovering L 360 million by December 2005. The strengthened sanctions against financial crimes referred to above should both limit misappropriation of bank assets and help enforce their recovery.

43. A goal of the government is to spread the tax burden as equitably as possible across society, to minimize its impact on any single group. The reduction in tax exemptions and measures to enforce tax collection described above represent the government's commitment

to minimize tax increases by ensuring that existing taxes are fully collected. If consensus from the Fiscal Pact and the National Dialogue support a further elimination of tax exemptions, the government will submit these proposals for congressional approval before end-2004.

44. The government is committed to improving transparency in every domain. Honduras has participated in all evaluations of standards and codes for which the IMF takes lead responsibility. By the first review, the government will develop an action plan to improve Honduran statistics according to a prioritized list of reforms, with a view to participating in the IMF's General Data Dissemination Standards (GDDS).

V. Program Modalities

45. The program will have semiannual quantitative performance criteria, for end-June and end-December, and indicative targets for end-March and end-September, on (1) the stock of central bank net domestic assets and net international reserves; (2) the central government wage bill; (3) the overall deficit of the central government; (4) the overall deficit of the combined public sector; (5) net domestic financing of the combined public sector; (6) the non accumulation of external payments arrears; and (7) the contracting or guaranteeing of nonconcessional external debt. These are specified in Table 1. Quarterly indicative targets will be set on the operating balance of public enterprises and on (the new definition of) poverty-reduction spending.

46. Given the importance of a rapid implementation of key public sector investments to growth and the public finances, the program for 2004 envisages an adjustment of some of the fiscal targets (up to ¼ percent of GDP) to accommodate a higher execution rate of telecommunications projects than currently anticipated. In particular, the target on the combined public sector deficit and its domestic financing will be adjusted upward by up to L 335 million, in the event that investment by HONDUTEL exceeds the amount of L 1,543 million (1¼ percent of GDP) envisaged in the program.

47. Structural conditions (performance criteria and benchmarks) will focus on progress with the social objectives of the program and in particular with financial sector reform. These are listed in Table 2.

48. The program will be subject to semiannual reviews, to assess observance of performance criteria and benchmarks, and ensure that future targets remain viable. During the first review, scheduled for September 2004, the government will agree with the Fund on any measures needed to meet the fiscal targets for 2005, any reforms needed to enhance monetary and exchange rate management, and the timetable for complying with new rules for capital adequacy, loan classification, and provisioning. The review will also assess the consistency with understandings under the program of the regulations issued to implement the conclusions of the special wage commission created by Decree 220-2003. The second review, scheduled for March 2005, will include a focus on the adequacy of anti-poverty expenditure tracking, as well as on reforms in tax administration, governance, and

transparency. The third review will, inter alia, address fiscal policy for 2006. The fourth and fifth reviews will address progress with the financial sector reform and with re-engineering of the public sector; the fourth review will also address the appropriateness of the monetary targets for 2006.

49. Access under the PRGF arrangement is requested in an amount of SDR 71.2 million (55 percent of quota), with seven equal semiannual disbursements. Outstanding IMF credit to Honduras would peak at 100 percent of quota in 2006, which would amount to a projected 5½ percent of exports of goods and nonfactor services and 11 percent of gross official reserves.

Table 1. Honduras: Financial Benchmarks and Performance Criteria for 2004
Under the PRGF Arrangement 1/

	2004			
	March	June	Sep.	Dec.
Performance Criteria 2/				
(End-of-period stocks in millions of lempiras, unless otherwise specified)				
Ceiling on net domestic assets of the central bank	-12,871	-13,827	-14,839	-14,075
Floor on net international reserves of the central bank (in millions of U.S. dollars)	1,110	1,155	1,165	1,205
Ceiling on stock of arrears on external debt-service payments of the public sector (in millions of U.S. dollars)	0	0	0	0
(Cumulative amounts in millions of lempiras from December 31, 2003)				
Ceiling on the wage bill of the central government	3,004	6,860	9,840	13,750
Ceiling on the overall deficit of the central government	570	1,761	2,037	4,611
Ceiling on the overall deficit of the combined public sector	651	1,804	1,798	3,967
Ceiling on net domestic financing of the combined public sector	-556	-968	-1,600	-237
Ceiling on contracting or guaranteeing of nonconcessional external debt of the combined public sector (in millions of U.S. dollars)	3.3	3.3	3.3	3.3
Financial Benchmarks				
Floor on the operating surplus of the public enterprises	820	1,640	2,460	3,280
Floor on anti-poverty spending	1,935	4,654	7,194	10,698

Sources: Central Bank of Honduras; Ministry of Finance; and Fund staff estimates.

1/ As defined in the technical memorandum of understanding.
2/ Benchmarks for end-March and end-September 2004 and performance criteria for end-June and end-December 2004.

Table 2. Honduras: Proposed Structural Targets for 2004 under the PRGF Arrangement

	Target Date
A. Prior Actions	
Approval of a salaries bill to achieve the targeted decline of the government wage bill and restore government control over wage policy, as well as legislation containing wages in public enterprises and decentralized agencies	...
Passage of a 2004 budget consistent with the program, including all tax and tariff measures needed to meet the 2004 deficit target.	...
Full tabulation of revised definition of PRSP spending consistent with World Bank/IMF specifications	...
B. Structural Performance Criteria	
Adoption of a new Financial Institutions Law and amendment of the CNBS Law, the Deposit Insurance Law, and the Central Bank of Honduras Law to strengthen financial regulation, supervision, and the financial safety net.	End-June 2004
Finalizing a timetable to comply with new regulations on capital adequacy, loan classification, and provisioning (including on investment in FONAPROVI bonds)	End-June 2004
Finalizing a timetable to make the use of indirect instruments of monetary management more effective and improve interest rate signaling	End-September 2004
Permanent suppression of intra-year unfinanced appropriations	Continuous
C. Structural Benchmarks	
Amendment of the Penal Code to make financial crimes punishable.	End-June 2004
Finalization of an action plan to accelerate asset recovery from failing banks.	End-September 2004
Publication of full central bank financial statements, including the external auditor's opinion and the explanatory notes	End-September 2004
Enforcement of requirement that banks publish quarterly financial statements.	Continuous
Finalization of an action plan for public administration reform, consistent with World Bank recommendations	End-April 2004
Issue of regulations to integrate supplementary benefits into the overall salary from 2007, following the conclusions of the special wage commission	End-June 2004
Amendment of the Tax Code in line with understandings under the program	End-September 2004
Full automation of poverty-reduction expenditure tracking.	End-December 2004
Establishment of two chambers of Tax Courts.	End-December 2004

TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This technical memorandum sets out the understandings between the Honduran authorities and the Fund for the monitoring of the first-year program during 2004 supported under the Poverty Reduction and Growth Facility (PRGF) arrangement. It defines the concepts used to assess observance of quantitative performance criteria and benchmarks specified in Tables 1 and 2 of the Memorandum of Economic Policies (MEP). It also specifies the frequency of the data to be provided to the Fund for monitoring the program.

A. Fiscal Targets

2. **For the purposes of the program, the deficit of the combined public sector (CPS)** will be measured from the financing side, which corresponds to the net borrowing requirements of the combined public sector, from both external and domestic sources. The combined public sector comprises the nonfinancial public sector (NFPS) and the operating result (quasi-fiscal balance) of the central bank. The NFPS covers the central government (including deconcentrated agencies), local governments and decentralized agencies, the social security institute (IHSS), the pension institutes for executive branch staff (INJUPEMP) and teachers (IMPREMA), and the public enterprises.

3. **The deficit of the central government** will also be measured from the financing side. The central government includes the executive, judicial, and legislative branches of government. It also consolidates the operations of the trust fund created by decree no. 68-2003 approved in April 2003 to support agricultural loans.

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

5. **Anti-poverty spending** comprises all spending on programs and projects of the Poverty Reduction Strategy (whether financed by domestic savings, HIPC debt relief, grants, and external loans), as presented in the relevant annex of the PRSP, approved in December 2003. Programs and projects in the PRSP will be labeled in the 2004 budget and tagged through the SIAFI. Anti-poverty spending will be presented by economic classification, type of program, and source of financing.

6. **The operating surplus of the public enterprises** is the difference between the operating revenue (excluding interest earnings and transfers) and the operating expenditure (excluding interest payments and transfers) of the enterprises. For the purposes of the program, the public enterprises comprise the state electricity company (ENEE), the state telecommunications company (HONDUTEL), the state water and sewerage company (SANAA), and the state ports company (ENP).

7. **Net domestic financing of the CPS** comprises the operating result of the central bank and the change relative to end-2003 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) outstanding deposits held abroad; and (4) outstanding suppliers' credit and floating debt (uncashed and undelivered checks, and unpaid invoices and orders) of the central government, and unpaid orders of the rest of the NFPS (all domestic debt is in domestic currency).

8. **Discrepancies.** The authorities will undertake periodic reconciliations to minimize potential discrepancies between above-the-line and financing data. If needed, these reconciliations should be carried out prior to completion of the first and second reviews under the program.

9. **Adjustor.** The ceilings on the cumulative CPS deficit and its net domestic financing will be adjusted upwards by up to L 335 million, in the event that investment by HONDUTEL exceeds the program amount of L 1,543 million.

B. Monetary Targets

10. **Net international reserves (NIR) of the central bank.** For program purposes, NIR will be measured as gross international reserves that are readily available (excluding the zero coupon bonds related to the CABEI rescheduling and contributions in gold/foreign exchange to international organizations other than the Fund) minus short-term reserve liabilities (including purchases and credits from the Fund) and minus foreign currency deposits of financial institutions at the central bank for reserve requirements, as described in the international reserves table of the weekly executive summary prepared by the central bank. Readily available reserves also exclude those 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 excludes (1) any conversion of short-term reserve liabilities; (2) foreign assets stemming from foreign currency deposits of financial institutions at the central bank; and (3) transfer to the central bank of foreign currency deposits of HONDUTEL, INJUPEMP, and IHSS held abroad, which amounted to US$85 million at end 2003. NIR will be valued at current exchange rates.

11. **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.

12. **Open market bills.** The monetary program assumes that foreign currency open market bills (CADDs) will not exceed US$65 million during 2004. This assumption will be reassessed in line with the conclusions of the MFD technical assistance mission scheduled for the first quarter of 2004.

C. External Targets

13. **Stock of external debt arrears.** For the purpose of the program 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.

14. **Borrowing on nonconcessional terms.** For the purposes of the program, this ceiling applies to the contracting or guaranteeing of nonconcessional external debt by the CPS or any other agencies on their behalf—with the exception of up to US$3.3 million for the purchase of a building for the diplomatic missions of Honduras in Washington, D.C. The ceiling applies not only to debt as defined in the Point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted by the Fund on August 24, 2000, but also to commitments contracted or guaranteed for which value has not been received.

15. **External debt definition.** The definition of debt set forth in Point No. 9 of the guidelines noted above 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 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 some time 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 lessor 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 No. 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are 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."

16. **Concessionality** will be based on a currency-specific discount rate based on the 10-year (6-month) average of the OECD's commercial interest reference rates CIRR for loans or leases with maturities greater (less) than 15 years. Maturity will be determined on the basis of the original loan contract. Under this definition of concessionality, only debt with a grant element equivalent of at least 35 percent (relative difference between nominal value and present value of debt) will be excluded from the debt ceiling.

17. **Excluded** from the debt ceiling are: (1) the use of Fund resources; (2) debts classified as international reserve liabilities of the central bank; (3) short-term import financing (with a maturity of less than one year); (4) debts to restructure, refinance, or prepay existing debts; and (5) central bank instruments placed in the domestic market held by nonresidents.

D. Structural Reforms

This section provides further technical detail on structural reforms, mainly the changes in government wage policy and the financial sector actions.

Government wage policy

18. The measures below will permit the wage bill to continue to grow but at a slower pace than in recent years, thereby causing it to decline in terms of GDP to 10.4 percent of GDP in 2004 and to 9.6 percent in 2006.

- **Civil servants.** No new salaries above L 60,000 a month will be granted to civil servants. Civil servants with salaries higher than L 30,000 a month will receive no increase in 2004. Henceforth, civil servants outside special regimes will receive wage increases equivalent to expected inflation.

- **Special regimes.** Increases in teachers' base salaries originally agreed for 2004–05 will be spread over 2004–06, and salaries will rise by expected inflation from 2007. All existing supplementary payments will be set at their end-2003 nominal values through 2006 and incorporated into the integral salary in 2007. New supplementary payments will be calculated on the basis of the base salary for 2003 and capped through 2006 at 1,200 teachers for seniority and 300 teachers for academic qualifications. The reform also freezes high-paid wages for medical doctors in 2004, allows them to increase by expected inflation in 2005, and by expected inflation adjusted for any difference between the previous year's expected and actual inflation from 2006 onward. No supplementary payments will be granted to doctors.

- **Human resources reform.** Measures envisaged include the issuance of regulations to professionalize the civil service by promoting competitive hiring practices, merit-based promotion, and administrative separation between civil servants and political appointees; the implementation of a new salary scale for central government employees and the development of a performance evaluation system for civil servants. The human resource information system will be strengthened, and, as an input to the re-engineering, public posts and personnel functions will be redefined.

Financial sector reform

19. **Consolidated supervision and reporting.** The new Financial Institutions Law (to be passed by June 2004) will introduce the concepts of financial groups and financial holding companies as well as the responsibility for groups to calculate capital in a consolidated way.

The law will also empower the Commission for Banking and Insurance Supervision (CNBS) to undertake consolidated supervision and require reporting on a consolidated basis. Intensive training of CNBS staff and establishment of new internal systems for consolidated supervision will start in 2004. The related regulations will be issued by December 2004, with pilot exercises starting in June 2005. A first set of consolidated financial statements of each group will be ready by December 2006.

20. **Stricter calculation of capital adequacy ratio.** Regulations issued in December 2003 bring the calculation of the capital adequacy ratio (both the capital base as well as risk-weights attached to different asset categories) in line with the Basel standards.

21. **New regulation on loan classification and provisioning.** Regulations issued in December 2003, deal with: (a) new guidelines for loan classification on the basis of credit risk (rather than quality of collateral); (b) a reduction from 8 to 5 loan categories according to quality; and (c) an increase in required provisioning from 1 to 2 percent for Category II loans; from 10 to 15 percent for Category III loans; and a unification of various rates (ranging from 25 to 75 percent) to a single rate of 50 percent for Category IV loans.[16]

22. **Provisioning for investment in FONAPROVI bonds.** At end-2003, banks swapped their agricultural loans eligible under decree 68 of April 2003 for bonds issued by the FONAPROVI trust fund. Banks will be required by CNBS (by special regulations) to classify in January 2004 the loans that are represented by those bonds guaranteed by the banks in Categories III and IV, and provision them accordingly by end-2006. Banks will also fully provision the losses incurred in the settlement of liabilities to FONAPROVI with government-guaranteed bonds.

23. **Limit on related lending.** A timetable has been agreed for those banks whose related lending exceeds the new ceiling of 40 percent of capital. The timetable sets quarterly targets leading to full compliance by December 2005. For monitoring purposes, the timetable has been provided to the Fund.

24. **Limit on ownership of banks in nonfinancial firms.** This limit was set at 20 percent of banks' capital. For those banks currently in breach, a timetable with quarterly targets has been agreed to attain full compliance by December 2005. For monitoring purposes, the timetable has been provided to the Fund.

25. **Risk management regulations.** By June 2004, the CNBS will issue a set of regulations to manage risks (i.e., credit, interest rate, foreign exchange, conglomerate, liquidity, and operational risks), as well as to introduce stricter standards for financial institution corporate governance.

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[16] These regulations also introduced guidelines for loan classification in microfinance institutions as well as for the valuation of collateral to determine the level of provisions.

26. **Reform of the lender-of-last-resort facility.** Amendments to the Central Bank of Honduras Law will be adopted by June 2004 to ensure that this facility can be used more flexibly. By September 2004, the central bank will prepare regulations to: (1) shorten the maturity of loans under the facility; (2) define conditions for granting the loans and possible rollover; (3) ensure rapid disbursements by the central bank; and (4) define the interest rate conditions. Interest rates should be the highest in the market. For monitoring purposes, the regulations will be provided to the Fund before issuance.

27. **Revision of the mandate of FOSEDE and its recapitalization.** The Deposit Insurance Law (to be approved by June 2004) will: (1) narrow the mandate of FOSEDE to the collection, management, and pay-out of funds related to deposit insurance; and (2) define the terms of a recapitalization of FOSEDE, which will be completed in 2006 when the second IDB tranche has been received. After that date, FOSEDE will no longer have any access to credit from the central bank.

Governance

28. **Unfinanced appropriations.** Intra-year appropriations will be deemed financed only if ordinary revenues (i.e., not borrowing) are identified to pay for them, or compensating expenditure savings are made elsewhere.

E. Monitoring and Reporting Requirements

29. **The information required to monitor the compliance with quantitative and structural performance criteria and benchmarks** specified in the MEP will be supplied to the Fund monthly (and electronically, to the extent possible) within 45 days of the end of the previous month (unless otherwise noted) according to the following sources:

30. **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 del Gobierno Central* and *Honduras: Financiamiento del Sector Público no Financiero*, 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 bond, and accumulation of arrears. This information is 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 *Panorama Financiero* monthly report; (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.

31. **The ceilings on the wage bill of the central government** will be monitored monthly on the basis of the ministry of finance report: *Información institucional por objeto de gasto - servicios personales y aportes patronales.*

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

33. **The floors on the operating surplus of the public enterprises and on anti-poverty spending** will be monitored quarterly on the basis of the information provided by the ministry of finance. Anti-poverty spending will be obtained from the detailed central government report: *Cuenta Financiera*. The ministry of finance will also provide the breakdown between poverty and non-poverty reduction spending by expenditure category (i.e., wages and salaries, goods and services, current transfers, fixed capital formation, and capital transfers).

34. **The floor on NIR and the ceiling on NDA of the central bank** will be monitored on the basis of monthly information included in the *Panorama Financiero* and *Resumen de Cuentas del Banco Central* produced by the central bank. This monthly information will be provided within two weeks of the end of the previous month.

35. **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 central bank. The accounting of nonreschedulable external debt-service arrears by creditor (if any), with detailed explanations, will be transmitted by the central bank 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.

Statement by the IMF Staff Representative
February 18, 2004

1. We would like to inform the Board of information that has become available since the staff report was issued. This information does not alter the thrust of the staff appraisal:

- **Recent developments have been broadly in line with the program.** Preliminary data indicate that growth was 3.2 percent in 2003, somewhat higher than reported in the staff report. The combined public sector deficit for 2003 was consistent with the staff report, as were tax revenue and the government wage bill.

- **To respond to concerns about the impact of the fuel tax on the most vulnerable sectors, the authorities have reversed tax increases in kerosene and LPG.** The expected revenue yield from the measure remains in line with the program, because the increase in gasoline and diesel taxes was somewhat larger than envisaged.

- **Around US$35 million of the December gain in international reserves was reversed in January.** However, projections remain consistent with meeting the end-March target on net international reserves.

- **The authorities have already taken steps toward financial reform.** They have presented to congress a financial law to introduce consolidated supervision. They also issued regulations on capital adequacy, loan classification, and provisioning, which will become effective soon. These are key steps toward compliance with end-June performance criteria.

2. **Financial support for the program is materializing as envisaged:**

- On February 11, the IDB approved policy-based loans for US$55 million, with disbursements starting this month. The assistance will support Honduras in its effort to implement its poverty-reduction strategy and financial reform.

- In April, Paris Club creditors will meet to consider Honduras' request for debt rescheduling, and the World Bank is expected to consider a policy-based loan (US$45 million) during the second quarter of 2004. These actions will ensure the financial viability of the program, as they will fill the external financing gap for 2004.

- Finally, the authorities have scheduled a Consultative Group meeting with donors in June, 2004.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 04/29
FOR IMMEDIATE RELEASE
February 18, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves In Principle Three-Year US$107.6 Million Poverty Reduction and Growth Facility Arrangement for Honduras and Grants Additional Interim Assistance Under the Enhanced HIPC Initiative

The Executive Board of the International Monetary Fund (IMF) today approved in principle a three-year, SDR 71.2 million (about US$107.6 million) Poverty Reduction and Growth Facility (PRGF) arrangement for Honduras to support the government's economic program. The decision will become effective upon a further decision following the World Bank's Executive Board review of Honduras' Poverty Reduction Strategy Paper (PRSP), which is scheduled for February 26, 2004. At that time, Honduras will be entitled to the release of SDR 10.17 million (about US$15.4 million). In addition, the Executive Board today approved SDR 4.3 million (about US$6.5 million) for Honduras in additional interim assistance under the enhanced Heavily Indebted Poor Countries Initiative.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and articulated in a PRSP. This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5 ½-year grace period on principal payments.

Following the Executive Board's discussion on Honduras, Agustín Carstens, Deputy Managing Director and Acting Chairman, said:

"Honduras' new three-year PRGF-supported economic program has been developed through a process of social consultation and collaboration, in recognition that broad public support for the program is crucial to its success. In line with the PRSP, the overriding objectives of the program are to alleviate poverty and move the economy to a path of higher economic growth and lower inflation.

"To achieve these objectives, the authorities are committed to pursuing prudent macroeconomic policies and stepping up the implementation of structural reforms. Measures crucial to achieve the fiscal objectives of the program have already been taken. The program is based on private sector-led growth, with the public sector playing a supportive role by reallocating resources toward infrastructure and the social sectors and developing more transparent institutions. It envisages, among other things, a strengthening of the public finances, a far-reaching financial system reform, and improvements in governance. Particularly important will be the reform of the public sector wage policy framework, which is essential to control the wage bill, and other measures to ensure that the fiscal targets for 2004 are achieved.

"Notwithstanding its strengths, Honduras' program faces important challenges—in particular, the approaching presidential elections, the limited implementation capacity, the vulnerability to external shocks, and the fragility of the financial system. The medium-term program addresses these challenges by establishing a clear framework for the sustained implementation of prudent macroeconomic policies and structural reforms. It will be important for the success of the program to deepen the broad political and social consensus that has underpinned the poverty reduction strategy. This is most likely to be achieved by further strengthening transparency and governance in public sector operations and by extending the national consultation process," Mr. Carstens stated.

Background

During the period 1998-2002, Honduras' macroeconomic performance was particularly affected by adverse external shocks, and social conditions remained depressed. In 2003, despite some improvement in macroeconomic indicators, economic and financial conditions remained difficult. Growth picked up moderately to slightly more than 3 percent, led by construction, tourism, and the re-export industry. Inflation slowed slightly to 6¾ percent, despite higher world oil prices. The external position weakened further. The current account deficit widened to an estimated 5¼ percent of GDP, reflecting higher oil prices and buoyant imports related to investment in the leading sectors. The debt burden remained heavy, with total public debt amounting to 72 percent of GDP at the end of 2003, and the combined public sector deficit widened to 4½ percent of GDP in 2003.

Program summary

The main objectives of Honduras' 2004-2006 economic program are to reduce poverty by reactivating the poverty-reduction strategy, and to strengthen growth by reversing the financial deterioration, implementing important structural reforms, supporting investment, and fostering trade liberalization.

Under the program, annual growth is expected to raise gradually from an estimated 3.2 percent in 2003 to 4½ percent in 2006-2008. The main pillars of the authorities' growth strategy are: a revival of private investment as key sectors are opened to private participation; complementary public investment in infrastructure; participation in regional free trade agreements, notably CAFTA; regulatory and other reforms to meet the goals of the National Competitiveness Plan; and governance, judicial, and political reforms.

Fiscal adjustment under the program is designed to lower the deficit to a level that can be financed by projected concessional external support and, with HIPC debt relief, is expected to achieve medium-term fiscal sustainability. The combined public sector deficit is targeted to decline from an estimated 4½ percent of GDP in 2003 to 1¾ percent of GDP in 2006. Spending will be reoriented to achieve a recovery of public investment. The PRSP envisages an increase of 0.6 percent of GDP in anti-poverty spending in 2004, and equivalent increases in 2005 and 2006.

Monetary and exchange rate policies will aim at gradually reducing inflation to the level of Honduras' main trading partners, within the context of the existing crawling band exchange rate arrangement.

On the **structural reform** agenda, the authorities see the financial reform as urgent to address the fragilities of the banking system, and see governance reforms as a vital element in responding to current social concerns and uncertainties about the future. In the financial sector, the government has begun a comprehensive reform program, designed to strengthen central bank functions, prudential regulations and supervision; improve the financial safety net; and fight financial crime. On governance, the government has already begun political and judicial reforms and is working to enhance fiscal transparency.

Honduras is an original member of the IMF. Its quota is SDR 129.5 million (about US$195.8 million), and its outstanding use of IMF credit currently totals SDR 114.40 million (about US$172.9 million).

Honduras: Selected Economic and Financial Indicators

	1999	2000	2001	2002	Proj. 2003
(Annual percentage changes, unless otherwise indicated)					
National income and prices					
GDP at constant prices	-1.9	5.7	2.6	2.7	3.0
GDP deflator	11.6	9.7	8.0	6.3	6.4
Consumer prices (end of period)	10.9	10.1	8.8	8.1	6.8
Exchange rate (depreciation -)					
Lempiras per U.S. dollar 1/	-4.8	-4.2	-4.9	-5.9	-5.0
Real effective rate 1/2/	7.5	7.9	4.2	-3.8	-6.2
Money and credit					
Net domestic assets	-3.4	19.8	8.8	5.2	23.9
Combined public sector credit	-78.8	2.6	3.1	-0.9	27.3
Private sector credit	20.9	15.4	12.2	7.6	13.0
Broad money	23.4	20.6	14.2	14.3	12.4
Average lending rate (end of period, in percent) 3/	29.5	24.6	23.2	21.1	18.1
Average deposit rate (end of period, in percent) 3/	19.0	14.5	14.3	13.1	11.3
(In percent of GDP)					
Combined public sector					
Revenue and grants, net of interest earned	28.7	27.1	27.1	25.3	26.1
Non-interest expenditure	26.7	26.6	29.8	28.6	30.2
Primary balance	2.0	0.5	-2.7	-3.2	-4.1
Interest payments, net	2.1	1.3	0.4	0.4	0.6
Overall balance	-0.2	-0.8	-3.2	-3.6	-4.6
External financing	7.2	1.5	3.0	1.8	1.9
Domestic financing	-7.0	-0.7	0.1	1.8	2.7
Savings and investment					
Fixed capital formation	29.9	26.1	23.6	22.1	23.6
Gross national savings	25.4	22.2	18.9	19.0	18.3
(In millions of U. S. dollars, unless otherwise indicated)					
Balance of payments					
Gross international reserves	1,230	1,285	1,386	1,492	1,415
(in months of imports) 4/	4.4	4.4	4.7	4.7	4.0
Change in net international reserves (increase -)	-340	-20	-80	-129	78
External current account balance (percent of GDP)	-4.4	-4.0	-4.7	-3.1	-5.2
(excluding official transfers)	-11.5	-9.1	-11.1	-7.2	-8.4
Exports, f.o.b. (annual percent change)	-24.4	18.0	-4.2	-1.3	2.1
Imports, f.o.b. (annual percent change)	5.9	6.4	5.2	0.8	8.8
Public sector debt (in percent of GDP) 5/	81.8	75.8	74.1	72.9	72.1
Public sector external debt (in percent of GDP) 5/	77.8	71.5	69.6	68.1	66.4
Public sector external debt service (in percent of exports of goods and services) 5/6/	7.8	7.0	8.7	8.3	8.7

Sources: Central Bank of Honduras; Ministry of Finance; and IMF staff estimates and projections.

1/ End-of-period change.
2/ As of October for 2003.
3/ As of November for 2003.
4/ Refers to the following year's imports of nonmaquila goods and nonfactor services.
5/ Includes medium- and long-term public and publicly guaranteed external debt, after interim HIPC debt relief.
6/ Debt service actually paid.

Statement by Luis Martí, Executive Director for Honduras and Roberto Simán, Advisor to Executive Director February 18, 2004

Our Honduran authorities would like to convey their appreciation to the staff and management for the valuable policy advice and for the ongoing constructive discussions and support received in the preparation of the proposed PRGF arrangement for 2004-06.

They are particularly appreciative of the close cooperation with staff over the last few months that, together with a broad process of social consultation, is allowing the authorities to present a very well designed economic program that is based in the key pillars of the updated Poverty Reduction Strategy. Authorities and staff believe that the agreed program should allow Honduras to continue implementing key structural reforms, strengthening growth and alleviating poverty.

The government of President Maduro is committed to sound macroeconomic policies and believe that, despite social and political pressures, significant progress has been made in many areas since the 2003 Article IV consultation. In the last nine months, our authorities and the staff jointly explored many program design alternatives taking into account the implications of different policy options and after extensive social consultation, agreed on a gradual adjustment program while maintaining the key principles of the PRGF program.

The three-year PRGF arrangement being presented to the Board has been built on strong ownership and domestic consensus. The program is frontloaded, and several key structural reforms are defined as *prior actions* for the proposed arrangement. These reforms include the following: 1) the recently approved salaries bill, including legislation containing wages in public enterprises and decentralized agencies, 2) tax and tariff measures to meet fiscal targets, 3) approval of the 2004 budget in line with the program, and 4) full compliance with the revised definitions of poverty-reducing spending.

Moving ahead

In spite of severe external shocks (commodities prices, natural disasters, recession in the US market) and of substantial domestic challenges, the authorities did move in the right direction during 2003 in an attempt to achieve social consensus on the most sensitive elements in the program, reactivate the poverty-reduction strategy and implement important governance reforms.

Several macroeconomic indicators improved during 2003. GDP growth increased to 3.2 percent, reflecting a rebound of construction, tourism and maquila industry. Inflation remained at manageable levels despite higher oil prices and it is targeted to continue to decline to the level in trading partners. Despite strong international competition, exports in 2003 increased by 5.5 percent and international reserves have been maintained at more than 4 months of imports.

Significant progress has also been made in fostering trade liberalization and Honduras' trade regime has been given the highest rating in the Fund's openness index. Last December, jointly with other Central American countries, it concluded the negotiations with the U.S. for Central American Free Trade Agreement (CAFTA). In addition to improving trade flows with its largest trading partner, CAFTA is likely to improve the investment climate, increase investment opportunities, and consolidate the regional integration.

Solving one of the key challenges

One of the most important problems facing the Honduras government has been the increase in public sector wages, following agreements made under previous administrations. With nearly 11 percent of the GDP devoted to the government bill in 2002, there was an urgent need to establish a coherent wage policy. As discussed in the 2003 Article IV consultation, the authorities set themselves the goal to bring under control public sector employment and remuneration by 2007. Social opposition forced the government to postpone the plan for a few months and to rethink the strategy jointly with the Fund. The authorities set up a broad consultation process through the National Dialogue and Fiscal Pact, to gain the necessary consensus for the need to resolve the costly inequities in the public sector wage system. In December 2003, Congress approved a new policy framework that is designed to achieve the targeted decline in the government wage bill and, even more importantly, to restore government control over wage policy. The approved legislation will also contain wages in public enterprises and decentralized agencies. Staff in Box 4 of EBS/04/10 nicely summarizes the full scope of the wage policy reform.

A fiscal effort

In order to increase revenues, in December 2003, Honduran authorities complemented the 2002 and 2003 fiscal measures by restoring the gasoline and diesel tariffs. They also eliminated numerous tax exemptions and are committed to a long-term strategy of enforcing tax collections and abstaining from new bailouts. All these measures are projected to increase tax revenue from 16.6 percent of GDP in 2003 to 17.5 in 2004, a significant figure in that the Honduran revenue-to-GDP ratio is the highest in the region. The improved fiscal stance will facilitate the achievement of all the program targets. The planned increase in public savings is expected to allow Honduras to increase its poverty-reduction spending by 0.6 percent of the GDP in each year of the program, from 7.5 percent in 2003 to 9.4 in 2006.

The approved 2004 budget is consistent with the program. In addition to addressing the structural weakness in the wage policy, our authorities will also generate savings in other areas of non-poverty-reducing spending, mostly through the envisaged process of merging and re-engineering the public sector. In the new PRGF, the combined public sector deficit will be limited to 3 percent of GDP in 2004, 2.5 percent in 2005 and 1.7 percent in 2006.

Improving the health of the financial sector

The strengthening of Honduras's financial sector continues to be a key priority in the government's agenda. As indicated in the staff report, the authorities are aware of its vulnerabilities despite recent improvements in banking supervision. They have embarked in a comprehensive financial system reform agenda. To this date, several important actions have been taken such as the strengthening of onsite supervision, limiting related lending and new regulations on loan classification and provision. As a confirmation of the government advances in this area, the IDB approved on February 11 a policy–based loan to support these financial sector reforms and the World Bank is proving technical assistance to further strengthen the supervisory process and ensure compliance with the Basle principles.

Because of the improvements the supervisory role, the Government has been able to reduce the number of troubled financial intermediaries, encouraging the use of market mechanisms for mergers and acquisitions, maintaining integrity of total assets and liabilities within the domestic financial system and minimizing the use of fiscal resources.

Other actions are intended to provide the system with a more effective and efficient safety net. A major reform will be the new Deposit Insurance Law, to be approved by June 2004, which should clearly define the recapitalization and role of the deposit insurance agency.

The government also got approval of reforms that have strengthened the mechanisms to prevent money laundering (law approved by Congress in June 2002) and financing of terrorism (financing terrorism was made a criminal offense in September 2003). Additionally, amendments to the legislation, to be introduced by June 2004, will make domestic financial crime a punishable act with specific sanctions.

Monetary policy and exchange rate policies

To enhance the effectiveness of monetary policy, the Honduran Central Bank has requested an MFD technical assistance mission in early 2004. This assistance should help authorities to enhance the management of the central bank paper and gradually develop defenses to protect its level of international reserves. Our authorities consider that the existing monetary and exchange rate policies have proven to be effective in maintaining stability, increasing international reserves to the present levels and reducing inflation.

Importance of governance

The Honduran authorities are aware of the structural weakness in the country. They have stated that without taking steps to build a strong democracy, fight corruption and strengthen the rule of law, gains in macroeconomic performance, however significant, would not be sufficient to capture the potential benefit of long-term, sustained economic growth. In this regard, the authorities have consistently been committed to fight corruption and improve governance. Some of the key reform actions initiated recently concern transparency and an overhaul of the judicial system. The scope and depth of the reforms underway is clearly set out in section IV of the Memorandum of Economic Policies, pages 89 to 91, EBS/04/10.

Another key element in the government's strategy for revitalizing growth is to enhance private participation by accelerating the removal of administrative impediments to private sector investments. The main objective of the National Competitiveness Plan, launched in mid-2002, is to improve the climate for private investment in export-oriented sectors through technical training and assistance, and incentives for groupings of small and medium exporters focused on common projects abroad. A major underlying concern is how the country can best seize the business opportunities opened by the CAFTA. The Plan has strong IDB support. The authorities will also seek approval by Congress of the competition-promotion law during 2004, of changes in the telecoms law by mid-2004, and of a new framework law for transportation by end-2004.

Now, looking into the future

This program embodies a number of quite distinctive elements when compared to previous Fund engagements in Honduras. It has rallied an unprecedented amount of public support first, through the involvement of civil society in the review of the PRSP, then through wide-ranging communication initiatives, such as the National Dialogue and the Fiscal Pact. This consultative process has focused on the deep-rooted weaknesses hindering economic and social progress in Honduras and, in the short run, on attainment of Completion Point under HIPC (expected now by mid-2005). There is little doubt that government success in complying with some of the prior actions –such as the rationalization of the public wage bill, or the increase in fiscal pressure- owes much to their own efforts in raising national awareness of a critical situation. Going forward, Honduras sees the donor community, Fund, World Bank and other multilateral institutions as key partners in the continued implementation of the country's development strategy.

It is legitimate to ask whether this strong momentum will be kept after Completion Point. At that time, a new government will be in about to take office. This must remain an open question now, but two points can be made at this stage.

One is that a satisfactory performance under the proposed program will go a long way towards endowing Honduras with the state-of-the-art institutions that are required to sustain a modern and competitive economy. Needless to say that, given the obvious current needs, Honduras expects to receive strong Fund support by way of technical assistance.

Second, and closely related. Much will depend on the success of the authorities in raising growth rates to the levels necessary to ensure a higher standard of living for the population (and for the population to actually notice improvements in their daily life). A framework of macroeconomic stability is, to be sure, a necessary condition, and the government is committed to it. However, growth does not flow spontaneously from stability, and this accounts for the concern expressed by the authorities in their LOI. This is an area where the Fund is expected to provide sound and practical advice in the future. In a relatively poor country, such as Honduras, a poverty-reduction strategy is of need limited if it has to ride on national wealth that is also limited and growing slowly.