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Honduras: 2005 Article IV Consultation, Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Modification and Waiver of Performance Criteria, and Financing Assurances Review; and Enhanced Initiative for Heavily Indebted Poor Countries—Completion Point Document—Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Honduras

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2005 Article IV consultation with Honduras, second review under the three-year arrangement under the Poverty Reduction and Growth Facility, requests for a modification and a waiver of performance criteria, and financing assurances review; and enhanced Initiative for Heavily Indebted Poor Countries—completion point document, the following documents have been released and are included in this package:

- the staff report for the combined 2005 Article IV consultation, Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Modification and Waiver of Performance Criteria, and Financing Assurances Review; and Enhanced Initiative for Heavily Indebted Poor Countries—Completion Point Document, prepared by a staff team of the IMF, following discussions that ended on February 8, 2005, 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 March 15, 2005. 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 March 28, 2005 updating information on recent economic developments.
- a Public Information Notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during its March 28, 2005, discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.
- a statement by the authorities of Honduras.

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

Enhanced Initiative for Heavily Indebted Poor Countries—Completion Point Document
Letter of Intent sent to the IMF by the authorities of Honduras*
Poverty Reduction Strategy Paper Progress Report
Poverty Reduction Strategy Paper Progress Report—Joint Staff Advisory Note
Supplementary Memorandum of Economic Policies by the authorities of Honduras*
Supplementary Technical Memorandum of Understanding*
Statistical Annex
*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.

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INTERNATIONAL MONETARY FUND

HONDURAS

Staff Report for the 2005 Article IV Consultation, Second Review Under the Three–Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Modification and Waiver of Performance Criteria, and Financing Assurances Review; and Enhanced Initiative for Heavily Indebted Poor Countries—Completion Point Document

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

Approved by Markus Rodlauer and G. Russell Kincaid

March 15, 2005

- **Discussions**. Discussions for the Article IV consultation and the second review under the PRGF arrangement were held in Tegucigalpa during January 24–February 8, 2005. The mission met with President Maduro, senior government officials, leaders of congress, and representatives of the private sector and civil society. The team comprised L. Breuer (Head), E. Flores, R. Guimaraes, and C. Macario (all WHD), S. Reichold (PDR) and G. Mitchell-Casselle (MFD), and was assisted by A.L. Coronel, the resident representative. A. Cheasty (WHD) joined the mission on January 31.
- **Second review under the PRGF**. The authorities remain committed to the policy objectives of boosting growth, reducing poverty, and achieving financial stability, through further fiscal consolidation, financial sector reform, and structural reforms. Program implementation has been broadly satisfactory, with one exception. All end-2004 PCs except one were met, and the structural agenda has moved forward broadly in line with the program. However, an end-December PC on issuing regulations to integrate teachers' benefits (effective 2007) was not met due to strong opposition from teachers.
- **2005 Article IV consultation**. The Article IV discussions focused on the medium- and long-term perspectives for Honduras, including the main economic vulnerabilities, growth and competitiveness, and governance and transparency.
- **HIPC completion trigger conditions**. All trigger conditions with one exception have been met. The trigger condition related to the financial sector calls for, inter alia, substantive compliance with Basel Core Principles (BCP); while Honduras is only expected to fully meet BCP by the end of the program, MFD and IDA staff support a waiver on the basis of the progress being made in this area (the financial sector reform program is on track). A companion paper describes the fulfillment of trigger conditions in more detail.
- **Last Article IV consultation**. Directors called for a comprehensive adjustment program, emphasizing the need for broad domestic ownership of a well-sequenced reform agenda aimed at fiscal consolidation and control over the government wage bill, addressing financial sector vulnerabilities, greater exchange rate flexibility, and improving governance.
- **Fund relations**. A three-year PRGF arrangement was approved on February 27, 2004 for SDR 71.2 million (55 percent of quota). The first program review was completed on September 24, 2004.
- **Article VIII obligations**. 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.

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Executive Summary

- **The economic situation has improved significantly since the last Article IV consultation.** Growth has rebounded, led by investment and exports; inflation has stabilized, after increasing in 2004 mostly on account of higher oil prices; and the external position has strengthened significantly.

- **The improved performance reflects sound economic policies—supported by the PRGF arrangement approved in February 2004—and broadly favorable external conditions.** In recent years, slow growth and weak governance contributed to social unrest. However, at end-2003, the government succeeded in garnering domestic consensus on a Fund-supported economic reform program. Key program objectives include fiscal adjustment, containing the increase of the wage bill in a lasting way, reform of the financial system, and improving governance.

- **Program implementation has been satisfactory, although an important step in the reform of the teachers' salary structure is being postponed.** All quantitative PCs for end-December were met, some with ample margin. The budget approved for 2005 is in line with the program, and the authorities are upgrading monetary operations. Structural reforms have moved forward, including changes to the tax and criminal codes and the creation of tax courts. The issuance of regulations to integrate teachers' supplementary benefits into their salary effective from 2007 (a PC for end-December) has been rephased.

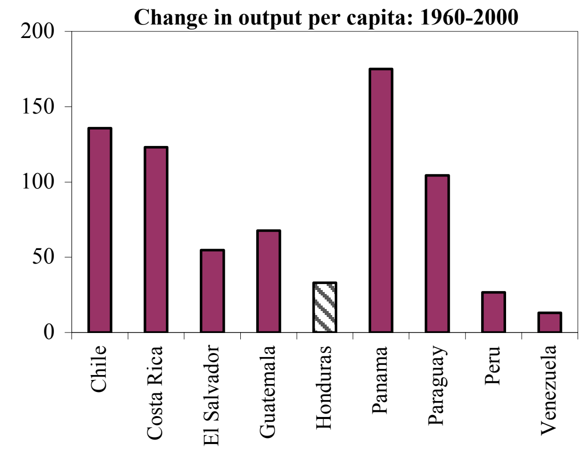
- **The overall policy strategy supported by the PRGF arrangement is being maintained.** The key fiscal policy challenge in 2005 will be to maintain control over the wage bill and sustain the tax effort, while increasing investment and poverty spending. Other priorities are to contain inflation and continue to implement the revised prudential norms for the financial sector.

- **Honduras faces important challenges in the medium term.** A prudent public sector wage policy is a critical element of a sustainable medium-term budget. The implementation of CAFTA and the opening of the telecommunications market will help boost growth prospects, although there will also be a need for measures to offset lower government revenue. The still weak financial sector also poses a risk, particularly if the economy were to take a downturn, and the de facto crawling peg is a constraint to the economy's resilience to external shocks. These issues are being addressed under the program, including through fiscal and financial sector reforms and the program to strengthen monetary operations (as a precondition to any movement toward greater flexibility in the exchange rate regime).

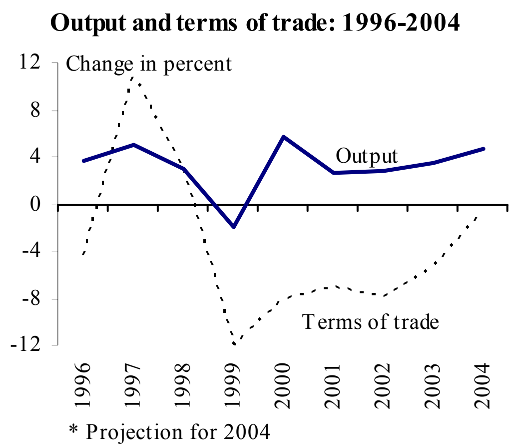
I. BACKGROUND

A. A Brief Medium-Term Perspective

1. **After many years of disappointing growth performance, the authorities are implementing a strategy to boost growth**. In the period 1960–2000, output growth in Honduras ranked among the lowest in the region. During the 1990s when growth recovered in the rest of Central America, in Honduras it only kept pace with population growth. In recent years, natural disasters and a deterioration of the terms of trade, exacerbated by erratic policy efforts and institutional weaknesses, adversely affected growth. Slow growth and weak governance contributed to widespread social unrest, risking a downward spiral of adverse economic, social and political developments. In response, the authorities embarked on an economic reform program that focuses on ensuring macroeconomic stability and strengthening growth prospects through the development of human capital and basic infrastructure, improving the environment for private sector development, and using international trade agreements to boost growth (Annex).



2. **The authorities' program—supported by a PRGF arrangement—is already delivering favorable results**. The government succeeded in garnering the necessary domestic consensus on a medium-term economic reform program with Fund support (Box 1). The program—supported by the PRGF arrangement approved in February 2004—has delivered positive results, including a strong recovery of growth and a significantly improved external position. Key policy achievements include fiscal adjustment, particularly by containing the increase of the wage bill (with full control over the teachers' wage bill expected for 2007), catalyzing the reform of the financial system, and improving governance.



Box 1. Domestic Consensus on the Program

- **Broad consultations facilitated the acceptance of the PRGF-supported program**. After discussions with civil society, the program was well received by most sectors as a means to boost growth, obtain debt relief, and bolster the PRSP. Holding only 61 of the 128 seats in congress, the government was able to get legislative approval for the key elements of its program by garnering the support of two small parties.
- **However, in 2004 social tensions re-emerged**. The implementation of a prudent wage policy was resisted by public sector unions, and coupled with rising oil and basic foodstuff prices, led to broad-based demands to relax fiscal policy. Protests from teachers and health workers caused serious disruptions, and were followed by demonstrations of public transportation and university workers.
- **The government has persevered with the core elements of the program, while responding to the unrest with selective accommodation**. It strengthened the dialogue with public sector unions, and granted small wage concessions to teachers and nurses. The authorities also allowed duty free imports of public transportation units (in line with the regional practice). However, the government has refused to grant further tax concessions, kept expenditure in line with the fiscal targets, and maintained the flexible system of domestic oil prices.
- **There are risks of renewed pressures and unrest in the run-up to the elections, particularly if oil prices remain high**. Teachers are strongly opposed to making the current restrained wage policy permanent. The government has reaffirmed its commitment to the program, and is engaging the main political leaders, including the recently elected presidential candidates, to ensure that the program's core elements are protected during the campaign and to promote policy continuity under the next administration.[1/] The challenge will be to convince the body politic that continued successful program implementation will be crucial for sustained economic recovery, continued external support, and reaping the benefits of HIPC.

[1/] Primaries were held on February 20, 2005 to select candidates for the November 2005 presidential, legislative and municipal elections. The two main presidential candidates emerging from these primaries are Mr. Porfirio Lobo (for the ruling National Party) and Mr. Manuel Zelaya (for the opposition Liberal Party).

3. **Honduras faces significant social and institutional challenges**. It is one of the poorest countries in Central America and social conditions remain depressed, with about two-thirds of the population living in poverty. Policymaking has been constrained by persistent structural problems, including short political cycles, powerful vested interests, and social unrest. The country also faces challenges in the areas of rule of law, corruption, and government effectiveness.

Central America: Comparative Social and Governance Indicators

	Rank in Human Dev. Index	Life Expectancy at Birth (years)	Adult Illiteracy (percent)	Poverty Rate (percent)	Control of Corruption (percentile)
Costa Rica	45	78.0	4.2	9.5	79.4
El Salvador	103	70.6	20.3	45.0	36.6
Guatemala	121	65.7	30.1	56.2	30.9
Honduras	**115**	**68.8**	**20.0**	**53.0**	**27.3**
Nicaragua	118	69.4	33.3	47.9	39.7
Latin America (average)	...	70.5	11.4	...	54.9

Source: UNDP Human Development Report 2004 and World Bank

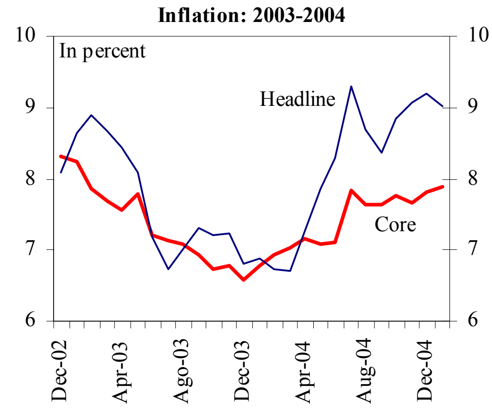
B. Recent Economic Developments

4. **Economic policies have improved since the 2003 Article IV consultation**. Implementation of the Fund's policy advice in recent years has been hampered by the lack of domestic consensus, opposition from vested interests and, at times, social unrest. Echoing recommendations of earlier consultations, Directors in 2003 called for a comprehensive adjustment program, emphasizing the need for broad domestic ownership of a well-sequenced reform agenda aimed at fiscal consolidation and control over the government wage bill, addressing financial sector vulnerabilities, greater exchange rate flexibility, and improving governance. As noted, the authorities in late 2003 started to implement a medium-term program that addresses these issues, in line with Directors' recommendations. In particular, the fiscal position has been strengthened, the financial sector reform program is on track, and the reform of monetary operations has been launched. However, as explained below, further efforts are needed to garner consensus for civil service reform and a sustainable medium-term wage policy for teachers.[1]

5. **Economic growth rebounded strongly in 2004**. After averaging less than 3 percent per year in 2001–03, preliminary estimates suggest that real GDP grew by 4.6 percent in 2004—significantly above projections—with a broad rebound across all sectors, including agriculture. On the demand side, growth reflected mainly private investment and exports, although consumption also rose (reflecting strong growth of remittances).

[1] The reform of the civil service is being supported by the World Bank.

6. **Inflation has stabilized, after moving higher during much of 2004 mainly because of high oil prices**. Following the decline of inflation in 2003, prices drifted upward in 2004 owing mostly to the surge in international oil prices (passed through to domestic petroleum prices), and to a lesser extent the monetary impact after sterilization of capital inflows. By the fourth quarter of 2004, inflation stabilized at around 9 percent (somewhat higher than the 8–8.5 percent targeted under the program).[2]



7. **Despite a widening of the current account deficit, the external position improved significantly in 2004**. The current account deficit rose to 5.2 percent of GDP in 2004 (from 4.2 percent of GDP in 2003) due to a higher oil bill and imports associated with large private sector investments in the energy and telecommunications sectors, which were partially offset by the growth of traditional and *maquila* exports (i.e., from the export processing zones), and the large increase in remittances (Box 2). Higher official and private capital inflows more than compensated for the higher current account deficit. As a result, NIR rose by just under US$1/2 billion.

8. **The Honduran legislature has ratified CAFTA.** With broad support from the main political parties, earlier this month Honduras became the second Central American country to ratify the free trade agreement (after El Salvador).

9. **With one important exception, program implementation under the PRGF arrangement has been satisfactory**.

- **All quantitative performance criteria (PC) and all but one structural PC for end-December were met**. (Tables 1 and 2 of Attachment II). The quantitative PCs covered the deficits of the consolidated public sector and central government, the wage bill for central government, net domestic financing, NIR, and net domestic assets (NDA). Large margins in NIR and NDA targets reflected the much improved external position and the central bank's (BCH) efforts to sterilize the NIR inflows. The budget approved for 2005 is in line with the fiscal program, and the BCH has started to upgrade monetary operations. Other structural reforms moved forward broadly as envisaged under the program.

[2] Inflation reached 9.2 percent at end-2004, or about 2.3 percentage points higher than at end-2003. This increase in inflation was smaller than the average increase in the rest of the region (about 3.8 percentage points), and only slightly above the United States' (1.8 percentage points).

Box 2. Remittances

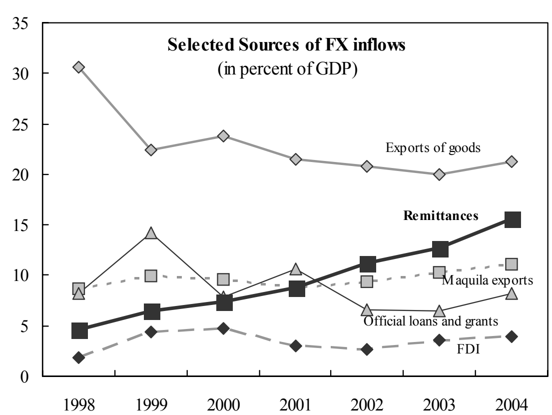
Remittances have become an increasingly important source of foreign exchange to Honduras. In 2004, remittances are estimated to have grown by about 30 percent, continuing the extraordinary growth of the previous 10 years (30 percent annual average growth). Remittances are now equivalent to 15½ percent of GDP—about 3 percentage points more than in 2003—and have become the second most important source of foreign exchange inflows, after exports of goods and significantly exceeding official disbursements of loans and grants, as well as net *maquila* exports and FDI.

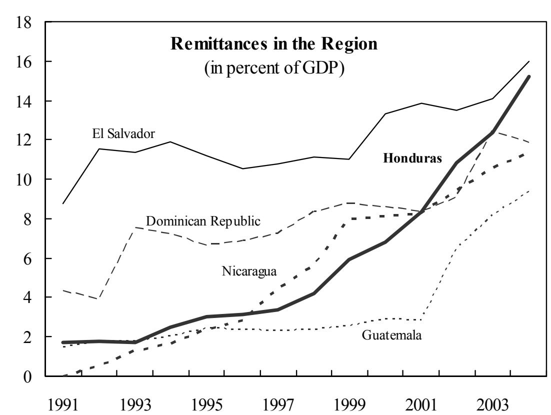
High growth of remittances can be observed throughout Central America, although it has been particularly strong in Honduras. Key factors explaining this development are:

- **Immigration to the United States**. Most Central American countries experienced substantial immigration to the United States, followed by significant flows of remittances. However, in Honduras large waves of emigration took place later than in other countries in the region (in El Salvador and the Dominican Republic, for example, large-scale immigration began in the 1980s and remittance flows stabilized in the early to mid-1990s). In Honduras, immigration to the United States intensified after Hurricane Mitch struck in 1998. The United States granted *temporary protected status* to 105,000 Hondurans in 1998 (which has since been extended until 2006), allowing many immigrants to seek legal employment. As a result, growth of remittances has been particularly strong since the late 1990s.

- **Lower transaction costs**. Traditionally, remittances have been a high-margin business and fees often averaged more than 20 percent of the transferred amounts. In recent years, increased competition (including from banks) lowered transaction costs to about 10 percent. This has created incentives to increase the amount of remittances and to make more use of official channels (rather than the informal market), which in turn raises the share of remittances that is officially recorded.

While overall effects on the Honduran economy are positive, the strong growth in remittances can create difficulties for macroeconomic management. Remittances have generally been a stable source of foreign exchange inflows with important economic benefits. However, further increases could create real appreciation pressures and lead to crowding-out of the export sector.[1/] This may be unavoidable in the long-run, but it can create serious problems as Honduras' exports sectors (*maquila*, tourism, and agriculture) play an important role for growth and employment. Thus, fostering financial services that could help channel more remittances into productive uses (such as by improving financial services associated with remittances' flows) will be an important challenge to help promote growth in the future.





[1/] In El Salvador, for instance, there is some evidence of Dutch disease from remittances.

- **The structural PC for end-December on integrating teachers' benefits into their overall salary was not met**. The PC called for the issuance of regulations to integrate teachers' supplementary benefits to the overall wage starting in 2007, based on the work of a commission.[3] However, the commission (composed of representatives of government and teacher unions) could not agree on a procedure due to strong opposition from the teachers (Box 3).

- **Implementation of the poverty-reduction strategy (PRS) has been broadly satisfactory**.[4] Poverty-reducing spending rose by almost 1 percent of GDP in 2004 (to 8.4 percent of GDP). PRS implementation has been enhanced with expanded consultations and improved public expenditure management, monitoring, and evaluation. In the period 1999–2004, the share of the population living in poverty dropped slightly to 64 percent (from 66 percent), and the share in extreme poverty to about 45 percent (from 49 percent).

10. **Fiscal consolidation has progressed while priority spending (investment and poverty programs) has increased**. During 2002 and 2003, the authorities implemented tax measures to boost government revenue.[5] In addition, congress approved the December 2003 salary law that made important improvements to the public wage regime (see Box 3). These policies, together with strict control over expenditures and improvements in tax administration,[6] contributed to lowering the deficit of the combined public sector to 3 percent of GDP in 2004 (from 5 percent of GDP in 2003). At the same time, poverty spending rose, as noted, and public investment increased to 6.5 percent of GDP.

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[3] As prior action for the approval of the PRGF arrangement, in December 2003 congress approved a salary law that established the new wage regime for the public sector but included a transitory solution for teachers, with a permanent resolution to be adopted by June 2004 (structural benchmark). When the benchmark was missed, reflecting renewed social unrest and strong political opposition, it was converted to a PC for December 2004.

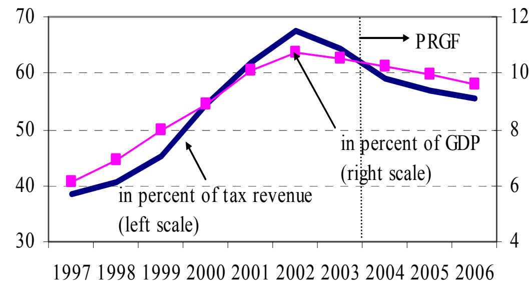
[4] The PRS is covered in greater detail in the accompanying Joint Staff Advisory Note.

[5] These measures included: broadening the income tax base to cover personal income bonuses; raising withholding rates; eliminating some deductions; introducing a tax on corporate net assets; and eliminating some exemptions on the sales tax.

[6] In September 2004, the authorities imposed strict spending limits that could only be exceeded with presidential approval. Tax administration efforts focused on increased audits and the closure of businesses that were delinquent in their tax obligations.

Box 3. Toward a Sustainable Public Wage Policy in Honduras

Wage Bill

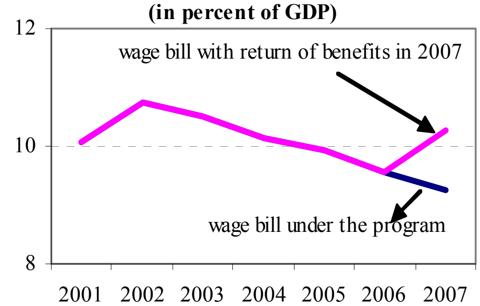


During the late 1990s, special wage regimes led to the rapid increase in the wage bill. Congress created wage regimes for teachers and health workers (which together comprise 3/4 of the wage bill) that gave automatic pay increases detached from the budgetary process on account of time in service and educational credentials.

In December 2003, congress approved a new wage policy but called for a special commission to settle the permanent regime for teachers starting in 2007. The main elements of the salary law were: (i) capping the wage bill for 2004–06; and (ii) using expected inflation to guide wage increases for public workers (except teachers). For teachers, the law set the increase in their overall wage for 2004–06 and limited supplementary benefits during this period to the end-2003 level. It also called for a special commission (with teachers' participation) to propose a procedure to integrate the supplementary benefits to the overall wage starting in 2007. The law also stated that increases in the overall wage of teachers would follow expected inflation starting in 2007, but only if the special commission had established the procedures for integrating the supplementary benefits to the overall wage.

After a prolonged strike by teachers in July 2004, the authorities agreed to allocate additional funds to teachers' benefits. Teacher unions claimed that eligible members were not receiving their benefits. After extended negotiations, the authorities agreed to pay the benefits to a larger number of teachers, at the rates set in the December 2003 law. The somewhat higher spending was compensated with savings in other wages.

Wage Bill
(in percent of GDP)



In the absence of progress by the special commission or other compensatory policies, the wage bill is likely to rise significantly starting in 2007. Preliminary data provided by the authorities show an increase in the wage bill of 0.8 percent of GDP in 2007, assuming that all eligible teachers receive their supplementary benefits but no retroactive adjustments are granted. That year, both the limits on benefits and the congressionally-set increase in their overall wage will expire.

11. **Monetary policy was strengthened in 2004**. In early 2003, a large fiscal deficit and deteriorating confidence led to pressures on NIR.[7] In mid-2003, the BCH raised interest rates by 200 basis points, followed in 2004 by stepped-up open market operations and increases in reserve requirements (by 1 percentage point each in September and November) to sterilize

[7] In a difficult environment, social protests multiplied reflecting concerns about corruption and selective bailouts, fears of new taxes and wage cuts, and demands for poverty alleviation.

the foreign exchange inflows and contain credit growth. The combination of monetary tightening and fiscal consolidation (which led to the accumulation of public sector deposits in the BCH) helped sterilize the large increase in NIR in 2004 (which amounted to about 54 percent of base money). The growth of currency issue was contained at 16½ percent in 2004, with broad money growing by 20½ percent and private sector credit by 18 percent.

12. **The exchange rate continues to follow the crawling peg system**. While officially the exchange rate is allowed to move within a crawling band,[8] it has remained at the appreciated end of the band since 1998. The rate of crawl has been about 5 percent each year in 2003 and 2004.

13. **The 2004 FSAP found significant financial sector vulnerabilities**. In particular**:**

- *Weak compliance with Basle Core Principles* (BCP). Honduras largely complied with three principles, materially noncomplied with 20 principles, and did not comply with another two.[9]

- *Banks had still not fully provisioned loans adversely affected by exogenous shocks*, including Hurricane Mitch (1998) and the coffee crisis (1999 and 2001).

14. **Since then, the authorities have made significant progress in addressing financial sector vulnerabilities**. Consistent with the recommendations of the FSAP, a series of laws and regulations were approved in 2004 that strengthened prudential norms (including on capital adequacy, loan classification, and provisioning); enabled consolidated supervision (including offshores, affiliates and subsidiaries); increased the powers of the supervisory agency (National Bank and Insurance Commission or CNBS); broadened the circumstances that require corrective actions by banks; and improved the bank resolution framework. The CNBS has approved a schedule that gradually implements the new provisioning requirements over three years.

15. **Financial sector indicators are improving**. In 2004, the level of nonperforming loans (NPLs) fell to 6.4 percent, while the ratio of provisions to NPLs rose further to 65 percent. The average reported capital adequacy ratio (CAR) has remained high and bank profitability has improved.[10]

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[8] Officially, the BCH sets the base exchange rate with a range of 7 percent in either direction, which is adjusted periodically according to the anticipated inflation differential between Honduras and its major trading partners and to changes in exchange rates of currencies of trading partners with respect to the U.S. dollar (Appendix I).

[9] This is discussed in more detail in the accompanying Completion Point Document.

[10] Based on CNBS' preliminary data.

Honduras: Banking Sector Indicators

	1999	2000	2001	2002	2003	Prel. 2004
Regulatory capital to risk-weighted assets	11.4	12.3	12.7	12.9	13.0	14.5
Nonperforming loans (NPLs) to total loans	9.2	10.6	11.4	11.3	8.7	6.4
Provisions to NPLs	24.1	27.7	27.2	38.7	38.2	64.6
Return on assets (ROA)	1.4	0.9	0.9	0.8	1.2	1.2
Return on equity (ROE)	11.2	7.6	8.4	8.2	11.8	14.9

Source: Table 8.

II. Policy Discussions

16. **The discussions covered Article IV consultation issues, the second review under the PRGF arrangement, and fulfillment of HIPC completion point trigger conditions**. The consultation discussions focused on the medium-term issues of how best to sustain rapid growth and maximize the benefits of CAFTA, while the program discussion centered on the macro framework for 2005, particularly the budget outlook, medium-term teachers' salary issues, and financial sector reform. The mission also discussed the updated DSA and verified fulfillment of the HIPC completion conditions, including PRSP implementation.

A. Outlook and Risk

17. **The authorities remain committed to their medium-term strategy aimed at raising growth, reducing poverty, and maintaining macroeconomic and financial stability**. The strategy involves continuing structural reforms and prudent macroeconomic policies. Reforms focus on strengthening the development of human capital and basic infrastructure, improving the environment for private sector development, and using international trade agreements to boost growth. Key sectors expected to drive growth over the medium term include *maquila*, tourism, energy, and telecommunications.

18. **Assuming continued prudent policies, the medium-term outlook is favorable**. The baseline scenario envisages real GDP growth of about 4½ percent after 2006, supported by increasing private investment (including FDI) and sustained export expansion. The fiscal deficit is targeted to narrow to about 1½ percent of GDP over the medium term, which—together with HIPC debt relief—would bring down the public debt/GDP ratio to about 50 percent by the end of the decade (35 percent in NPV terms).[11]

[11] A detailed debt sustainability analysis is contained in the accompanying Completion Point Document.

Honduras: Macroeconomic Framework under Active Scenario

	Prel.	Est.	Projection				
	2003	2004	2005	2006	2007	2008	2009
(Percent of GDP, unless otherwise stated)							
Real GDP (percent)	3.5	4.6	4.2	4.5	4.5	4.5	4.5
Inflation (eop, in percent)	6.8	9.2	6.9	5.0	4.0	3.0	2.5
Overall combined public sector balance	-5.1	-3.0	-2.5	-1.7	-1.7	-1.6	-1.6
Primary combined public sector balance	-4.6	-2.7	-2.3	-1.7	-1.7	-1.7	-1.7
Public sector debt	75.3	73.1	56.1	54.0	51.7	49.6	47.7
External current account balance	-4.2	-5.2	-2.5	-2.4	-2.7	-3.3	-3.5
Gross international reserves							
in months of imports	3.7	4.8	4.9	4.9	4.9	4.8	4.6
Public external debt	69.8	68.2	51.6	49.8	48.0	46.1	44.4

19. **Nonetheless, Honduras' medium-term outlook faces important risks**. While most temporary shocks would not put sustainability at risk, provided that sound policies remain in place, a failure to sustain the fiscal adjustment envisaged under the program would endanger debt sustainability. The financial sector and the crawling peg are additional sources of risks.

- **Fiscal**. The implementation of a permanent resolution to teachers' overall salaries before the 2007 budget is key to medium-term fiscal sustainability. Important growth-enhancing reforms envisaged for 2005–06—including the implementation of CAFTA and the opening of the international long-distance market to competition—will require compensatory measures to address their impact on government revenues.[12]

- **Financial sector.** By relying mainly on retained earnings for the necessary capital increases, the authorities' gradual strategy of improving banks' solvency leaves the financial sector exposed to an economic downturn that could adversely affect bank profits.

[12] CAFTA will imply a loss of import duties estimated at about 0.3 percent of GDP in the first full year of implementation, increasing to about 1 percent of GDP in the long run. The authorities are quantifying the potential impact on Hondutel's revenues from the loss of its monopoly on long-distance telephone calls. Hondutel transfers to the central administration averaged about 1 percent of GDP in 2003–04.

- **Crawling peg**. The crawling peg exchange rate system constrains the economy's resilience to external shocks.

20. **A passive scenario illustrates the vulnerabilities**. Failure to achieve fiscal sustainability (e.g., due to a reversion to the pre-program system for teachers' salaries and failure to compensate for revenue losses from CAFTA and the opening of the telecommunications market) would result in slower growth, rising domestic public debt, and a weakening external position. Slower growth would result from lower public and private investment, reflecting lower external financing and investor confidence. The public debt would rise due to the larger fiscal deficit and greater reliance on domestic financing, while higher current account deficits (due to the larger fiscal deficit) and an undermined financial account would put pressure on international reserves.

Honduras: Macroeconomic Framework under Passive Scenario

	Prel.	Est.	Projection				
	2003	2004	2005	2006	2007	2008	2009
(Percent of GDP, unless otherwise stated)							
Real GDP (percent)	3.5	4.6	4.2	4.0	3.0	2.5	2.5
Inflation (eop, in percent)	6.8	9.2	6.9	6.0	7.5	8.0	9.0
Overall combined public sector balance	-5.1	-3.0	-2.5	-3.0	-4.3	-5.5	-6.7
Primary combined public sector balance	-4.6	-2.7	-2.3	-2.9	-4.2	-5.2	-6.2
Public sector debt	75.3	73.1	56.1	55.2	55.1	55.4	55.9
External current account balance	-4.2	-5.2	-2.5	-3.1	-3.9	-5.1	-5.8
Gross international reserves in months of imports	3.7	4.8	4.9	4.6	4.1	3.5	2.8
Public external debt	69.8	68.2	51.6	49.8	48.1	46.5	45.1

21. **The authorities' macroeconomic framework for 2005 aims at keeping the economy on a steady path through the traditionally difficult election period**. Real GDP is projected to exceed 4 percent for the second consecutive year, led by *maquila*, tourism, construction, telecommunications, and energy sectors. The authorities expect growth to be supported by the broadly favorable external environment, an improved business climate, and the prospective implementation of CAFTA.[13] Inflation would fall to just under 7 percent and NIR would rise by about US$210 million. Downside risks include uncertainties in the oil market, while on the upside growth could be somewhat higher if the stronger-than-expected-growth momentum in 2004 carries over to 2005.

[13] At the same time, they expect growth to be somewhat slower than last year due to the near completion of large private investments, lower expected growth in the United States, and a return to a more moderate expansion of the agricultural sector.

Honduras: Selected Economic Indicators

	Prel. 2003	Est. 2004	Proj. 2005
(Percent of GDP, unless otherwise stated)			
Real GDP (percent)	3.5	4.6	4.2
Inflation (eop, in percent)	6.8	9.2	6.9
Combined public sector savings	0.5	3.3	4.4
Anti-poverty spending	7.5	8.4	8.7
Combined public sector balance	-5.1	-3.0	-2.5
Of which			
Central government balance	-6.0	-3.5	-3.0
External current account balance	-4.2	-5.2	-2.5
Gross international reserves (months of imports)	3.7	4.8	4.9

B. Fiscal Policy

22. **The authorities' fiscal strategy for 2005 aims at sustaining the consolidation process, while further increasing investment and poverty spending**. The strategy relies on reaping the full benefits of the tax reforms of 2002 and 2003, further improvements in tax administration, strict control over expenditures, and contingent spending cuts. Consistent with the 2005 budget, both the public sector deficit and the central government deficit will fall by about ½ percent of GDP, while investment and poverty spending are to increase further, on account of higher grants and offsetting savings. The latter are in the wage bill, current transfers, and domestically financed (i.e., non-grant financed) goods and services.

Honduras: Fiscal Objectives 2003-05
(In percent of GDP)

	Actual	2004		2005	
	2003	Prog.	Proj.	Prog.	Rev. prog.
Combined public sector					
Overall deficit	-5.1	-3.0	-3.0	-2.5	-2.5
Domestic financing	3.2	-0.9	-1.6	-0.3	-0.4
Capital expenditure	6.2	6.9	6.5	7.8	7.8
Central government					
Overall deficit	-6.0	-3.5	-3.5	-3.0	-3.0
Wage bill	10.5	10.2	10.1	10.0	9.9
Capital expenditure	5.5	5.4	6.0	5.7	5.9
PRSP spending	7.5	8.1	8.4	8.7	8.7

23. **In 2005, government revenues will benefit from the recent tax reforms, with further progress in tax administration as an additional safeguard**. The authorities are

confident that the fiscal targets will be met without new tax measures. They are committed to implementing decisively the revised tax code approved in December 2004, including by enforcing its recently acquired power to determine taxpayers' income through indirect methods and third-party information. They also have an action plan to further improve tax administration (Box 4).

Box 4. Actions to Improve Tax Administration

Key actions to improve tax administration in 2005 are:

- *Restructuring of the tax office* (DEI). The new organizational structure will be approved by mid-March 2005.
- *Audit plan*. The number of large taxpayer audits will rise by 50 percent in 2005, to 100 by end-June 2005 (structural benchmark) and 225 by year's end.
- *Collection of arrears*. By June 2005, the authorities expect to collect about 0.1 percent of GDP in past-due taxes, using the incentives approved by congress in December 2004 (including a temporary reduction in penalties).
- *Large taxpayer stopfilers*. The rate of stopfilers is targeted to fall to 3.7 percent of large taxpayers in June 2005 (structural benchmark), from 4.5 percent at end-2004, and further to 2 percent in December 2005. To this end, the DEI will strengthen its computerized cross-checking of selected databases.
- *Update of large taxpayers*. The definition of large taxpayers will be revised by end-April 2005, with external technical assistance.
- *Customs administration.* A commission has been established to ensure that hiring of customs officials is fully merit based.

24. **The authorities intend to maintain strict control over expenditures during 2005, including the wage bill**. The wage bill is expected to decline by 0.2 percent of GDP through the strict implementation of the prudent wage policy agreed under the program. Contingent expenditure cuts have been identified in non-poverty spending amounting to about 0.2 percent of GDP.

25. **The issuance of regulations to integrate teachers' salaries starting in 2007 has been delayed**. With no political support for resolving this issue now, in the run-up to the elections, the authorities stressed that insisting on it at this juncture would polarize the country. The staff regretted the postponement of this measure and wondered whether after reaching the HIPC completion point (when the reform momentum would be at its peak), salary integration would be any easier politically. Staff also noted that the timing of implementation should be more definitive. The authorities explained that the problem was the conjunction of the HIPC completion point and the elections, and argued that the political environment would be significantly more conducive for this measure in 2006. They reaffirmed their commitment to resolving teachers' wages before the current (temporary) arrangement expires in 2007, and proposed the rephasing of this measure. Based on these

measures and the controls over the wage bill for the program period (2004–06), the authorities requested a waiver for the end-December PC.

26. **Fiscal consolidation will be underpinned through reforms that include**:

- *Improved fiscal management*. The ministry of finance has embarked on a plan to revise its organizational structure, improve its public expenditure system (SIAFI), and introduce a single treasury account, with assistance from the IDB. The upgraded SIAFI is expected to be operational by January 2006.

- *Restructuring of the public sector***.** The government is proceeding with the plan to restructure the public sector. It has streamlined some decentralized agencies and submitted to congress a law to merge and close several ministries. It has also begun a major reform of the higher education system, with the approval of the new university law in December 2004.

27. **The operating surplus of public enterprises is expected to improve somewhat in 2005**. The improvement is mostly due to better performance of Hondutel due to buoyant revenues from its monopoly on long-distance telephone service. As supported by the staff, the authorities are quantifying the potential revenue loss to Hondutel after its monopoly is removed in January 2006 and identifying measures to address it (structural benchmark).

28. **Although good progress has been made in reforming the main public pension system (IHSS), some special public pension systems still face actuarial deficits**.[14] The authorities estimate the actuarial deficit of the special public pension funds at L 6.7 billion (about 5 percent of GDP in 2004), owing mainly to high administrative costs, low return on investments, and in some cases high dependency ratios. The authorities have taken several steps to strengthen these pension funds, including by issuing guidelines on eligible investments of pension reserves, requiring the publication of their portfolios; and establishing criminal liability for the mismanagement of pension reserves. Looking forward, the authorities are working on a strategic plan aimed at reforming the special pension regimes. The staff encouraged the authorities to make progress in this area, while making sure that the reform plans are consistent with the medium-term fiscal program.

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[14] The special pension systems are for teachers, armed forces, public sectors workers, and university workers. The IHSS, which is the largest system, covers workers employed in the private sector.

C. Monetary and Exchange Rate Policies

29. **The BCH's monetary program aims to reduce inflation to about 7 percent in 2005**.[15] The main goal of monetary policy is to achieve price stability, by gradually reducing inflation to a level consistent with inflation in Honduras' main trading partners. Open market operations will remain the main instrument of monetary control, supported by increasing interest rates, if necessary, to achieve sufficient sterilization of capital inflows. The annual rate of crawl will be reduced to 3 percent, consistent with the current policy of depreciating in line with projected inflation differentials.

30. **The BCH is strengthening monetary operations**. The board has approved a timetable for modernizing the BCH's monetary operations, and announced it to the banking sector (Box 5). The authorities agreed with the staff on the importance of pushing ahead with this critical reform.

Box 5. Reforming Monetary Operations

The BCH has announced a plan to reform of monetary operations, which involves the following key elements**:**

- *Primary auctions***.** Market-based primary auctions and negotiable BCH securities will enhance the efficiency of open market operations.
- *Short-run operational variable*. The 7-day CAM interest rate will become the operational target and repos and reverse repos used to manage systemic liquidity.
- *Interest rate corridor*. The BCH will set a corridor for the overnight rate, with its deposit facility as floor and its new Lombard facility as the ceiling.
- *Signaling of monetary policy*. The BCH will use the 7-day CAM auctions to signal changes in the policy stance.
- *Infrastructure*. The BCH will improve its infrastructure, including by making securities negotiable, adapting its organization, and improving its technical capacity.

Actions in 2005 include:

- By March: organizational reform of the BCH; functioning arrangement for transferring securities; and supporting regulations issued.
- By June: announcement of the interest rate target and band; and introduction of daily interventions through repo auctions.

[15] While policies (including the budget) and projections for 2005 are based on an inflation objective of 6.9 percent (eop), the BCH has announced an inflation range of 6.5–7.5 percent, on account of continued uncertainty in the oil market.

31. **The gradual recapitalization of the BCH has begun**. In line with the revised BCH law, the ministry of finance will recapitalize the BCH through the issuance of government securities. While this constitutes a step in the right direction, the modality chosen is not sufficient to restore BCH's capital because government securities will not bear a market interest rate. [16] The authorities explained that the fiscal situation did not allow for this at this time, but committed to moving toward higher interest rates starting in 2006.

32. **The discussions on monetary strategy took place in the context of the medium-term desirability to move toward greater exchange rate flexibility**. The exchange rate continues to be the nominal anchor. In line with Fund recommendations, the authorities are strengthening monetary operations and the financial sector. The staff reiterated its recommendation to eventually move toward greater exchange rate flexibility, to facilitate adjustment to shocks and structural change.

D. Financial Sector Reform

33. **The authorities intend to continue with their ambitious banking reform program**. The key elements envisaged for 2005 are:

- *Strengthened prudential regulations*. In line with the new financial sector law, the CNBS will enforce the timetable for banks to comply with the new provisioning rule, while at the same time complying with other prudential norms (including on capital and loan classification—continuous structural performance criterion for 2005).

- *Related-party lending*. The CNBS will continue to strictly enforce the gradual reduction of related-party loans, to ensure that all banks comply with the limit of 30 percent of capital by end-June 2006.

- *Supervision*. The CNBS will perform examinations using the strengthened regulations; develop a framework for intensive supervision of weak institutions; approve a contingency plan for systemic financial stress; introduce risk-based supervision practices; and monitor the largest debtors of the financial system.

- *Bank resolution*. The CNBS will complete the procedures to enable the implementation of the new bank resolution mechanism as necessary.

- *Bankruptcy*. The government will submit to congress in 2005 a law to improve corporate reorganization, bankruptcy proceedings, creditor rights, and corporate governance of nonfinancial business corporations.

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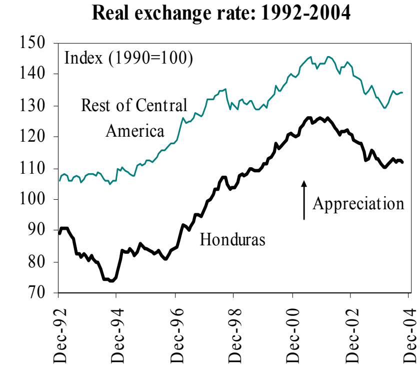
[16] For losses up to 2003, the bond will have a 50-year maturity but carry no interest payment. For losses in 2004 and 2005, 10 percent of the bonds carry market interest rates and the rest an annual interest rate of 2 percent.

34. **The authorities intend to address the risk of the growing dollarization of bank credit**. The BCH currently limits the amount of banks' dollar credit to non-dollar earners to 15 percent of banks' foreign currency deposits, but this limit does not apply when banks finance domestic loans with external credits.[17] The staff noted the rapid increase in dollar lending and urged the authorities to strengthen loan classification rules to include borrowers' unhedged dollar positions. The authorities attribute the increase in dollar loans mainly to the dollar financing of large energy and telecommunications projects by a consortium of local banks. Nonetheless, the CNBS will improve data collection; issue supervisory guidelines and inspection procedures for banks' dollar lending; and include the review of unhedged dollar loans as part of the loan classification and provisioning process (structural benchmark).

E. Competitiveness and Growth

35. **Prudent macro policies and structural reforms are needed to preserve competitiveness**. Although the REER has depreciated by more than 10 percent since its peak in 2001, it is still significantly higher than in the early 1990s. With buoyant foreign direct investment and strong *maquila* exports, the authorities and the staff broadly agreed that the level of the exchange rate is currently not a problem for competitiveness, and staff considers the current level of exchange rate to be broadly in line with (projected) fundamentals. However, the extraordinary growth of remittances and strong capital inflows have recently generated pressures for real appreciation. In 2004, such pressures were neutralized by large international reserve accumulation and sterilization, but staff noted the challenge to resist further appreciation pressures if capital inflows and private remittances continue to grow as in the recent past. To limit the extent of a possible real appreciation, fiscal discipline needs to be maintained, and prudent wage policies and structural reforms will be critical to preserve the competitiveness of Honduras' export industries.

Real exchange rate: 1992-2004



36. **CAFTA plays a key role in the authorities' strategy to maintain the competitiveness of the economy**. In particular, the *maquila* sector is under some threat from the recent elimination of textile quotas under the WTO. While Honduras is generally not considered one of the most vulnerable countries in this context, competition from countries such as China and other East Asian economies will probably increase significantly. To leverage the competitive advantage of close proximity to the U.S. market, the authorities plan to implement CAFTA as soon as possible, thus expanding the current preferential access to the U.S. market under the Caribbean Basin Initiative. The *maquila* sector itself is moving toward vertical integration to increase its value added and preserve its competitiveness.

[17] Banks can borrow externally up to an amount equivalent to twice their capital.

37. **Productivity gains are key to achieving sustainable growth**. To meet this challenge, the authorities are addressing problems in human capital formation, public infrastructure, financial market development, and governance (see Annex).

F. Governance and Transparency

38. **The authorities emphasized the progress made in improving governance and fighting corruption**. The government's strategy, prepared in consultation with civil society, includes judicial and political reforms to improve transparency and accountability. Judges' terms have been extended beyond the election cycle to strengthen their political independence; a more open judicial process for criminal cases has been instituted; and immunities from prosecution has been eliminated for government officials and legislators. Political reforms have included the reduction in length of electoral campaign periods[18] and the direct election of legislators. To improve transparency, procurement practices have been upgraded and the Comptroller's Office has been reorganized.

39. **The authorities report progress has been made in implementing a framework for Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)**. The criminal code was changed to include a broader definition and stiffer sanctions for financial crimes. Enforcement teams have been strengthened through training courses. Bilateral cooperation agreements have been signed with a number of Latin American and Caribbean countries. The CNBS has upgraded its software to monitor banks' compliance with AML norms and to analyze suspicious transaction reports. Future plans include expanding AML norms to cover other businesses such as lawyers and accountants.

40. **Fiscal transparency has been an important element of the authorities' efforts to enhance governance**. Expenditure management has been improved in several areas, including through the full automation of poverty reduction expenditure tracking and the elimination of intra-year unfinanced appropriations. The authorities intend to make further progress in this area by joining the GDDS by end-2005.

41. **Safeguards assessment**. The authorities have implemented the recommendations of the safeguard assessment, including establishing an independent audit committee and the publication of the full financial statements (with the external auditor's opinion and the explanatory notes).

G. Financing Assurances Review

42. **The program is fully financed for 2005, despite lower program loans envisaged**. Program loans are expected to drop to US$31 million, from US$104 million in 2004, due to

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[18] The timing of municipal elections was modified to coincide with presidential and legislative elections.

lower disbursements from the World Bank and the IDB.[19] However, previously identified concessional financing, interim HIPC relief, and expected HIPC and beyond-HIPC relief after the completion point provide adequate financing for the 2005 program.

Disbursements of Program Loans 2004-06

	Actual 2004	2005 Prog.	2005 Rev.Prog.	Rev. Prog. 2006
World Bank	58	25	25	0
PRSC loan	58	...	...	...
FSAC	...	25	25	...
IDB	45	15	0	25
PRSC I	15	...	...	...
PRSC II	15	...	...	...
Financial sector loan	15	...	...	10
Public expenditure management	...	15	...	...
Social sector loan	...	...	...	15
Other	1	...	6	...
Total	104	40	31	25

43. **Appropriate progress is being made in resolving pending official and private debt issues**.[20] Honduras has signed agreements with most individual Paris Club creditors, generally exceeding the terms agreed during the Paris Club negotiations. Good faith efforts are ongoing to resolve disputes regarding the treatment of some bilateral Paris Club creditor claims and to resolve the status of minor arrears to private creditors.[21]

H. Program Monitoring and Risks

44. **The program targets for 2005 have been updated**. Revised PCs for NIR and NDA have been set for end-June 2005, taking into account developments through end-2004, and new PCs were set for December 2005. Enforcement of the new prudential regulations on capital adequacy, loan classification, and provisioning will be a continuous structural PC.

[19] Both institutions front-loaded their program loans, leading to higher disbursements in 2004.

[20] The Fund's lending into arrears policy is in effect because of some arrears to private creditors.

[21] Private creditor arrears amount to about US$5 million. They arose prior to the program, when some creditors did not participate in an earlier IDA repurchase offer (due to failure to submit adequate documentation to support their claims) and have not undermined program implementation. No request for payment has been received since the repurchase offer.

New structural benchmarks for end-June 2005 are on the financial sector (issuing supervisory and inspection guidelines on unhedged dollar loans), the reform of the BCH (operational implementation of the interest rate corridor), and strengthening of tax administration (large taxpayers' stopfilers and audits). The completion of the technical work on teachers' wages (specification of new salary scales) is a prior action for this review (Box 6).

45. **Program risks remain high**. The recent progress with reforms has been made possible in part by the strong domestic consensus in favor of reaching HIPC completion point. This consensus could weaken after the completion point and in the run-up to the presidential elections. In addition, as noted, pending resolution of the medium-term teachers' wage structure remains an important risk, and the financial sector remains fragile and vulnerable to a shift in economic conditions. On the upside, external financing remains conditioned on successful program implementation, which should help promote policy and reform continuity. Moreover, the recent adoption of a prudent budget should also help lock in continued sound fiscal policy in 2005.

I. Statistical Issues

46. **Honduras' participation in the GDDS system will strengthen the statistical system, but further efforts are needed**. One of the key issues is improving the consistency of the fiscal deficit and financing data, where the authorities are working with IDB assistance.[22] Recent Fund technical assistance has focused on improving fiscal and balance of payments data, upgrading the metadata to prepare for participation in GDSS, and on quarterly national accounts. A real sector GDDS metadata mission is planned for the first quarter of 2005.

III. Staff Appraisal

47. **Performance under the PRGF-supported program has been satisfactory**. The staff commends the authorities for their strong ownership of the program and for persevering with implementing it under difficult domestic and international conditions. Program design and ownership have benefited from extensive consultations carried out with a wide segment of society. The authorities attribute the successful implementation of their program to their unrelenting efforts to forge a broad domestic consensus on difficult policy issues, including through a well-developed consultation process with civil society.

[22] The authorities are improving the methodology used to track budget and treasury operations, including the floating debt.

Box 6. Structural Conditionality Under the PRGF Arrangement

Structural conditionality in the first year of the PRGF arrangement (2004)

The structural conditionality reflected the anchors of the overall policy strategy: fiscal consolidation and strengthening of the financial sector. Prior actions for approval of the PRGF arrangement included the adoption of a 2004 budget and wage policy consistent with the program. Other conditionality covered the following areas:

- *Fiscal policy*. On revenue, benchmarks (SB) included the creation of tax courts and changes to the tax code. On expenditures, a continuous PC called for the suppression of unfinanced appropriations; a PC for a 2005 budget in line with the program; and SBs covered the tracking of poverty spending, regulations to integrate teachers' overall salaries in 2007, and public administration reform.
- *Monetary operations*. A structural PCs covered the launching of the reform.
- *Financial sector reform*. A PC was on the approval of new legislation on the financial sector; and SBs were on the publication of BCH and banks' financial statements, asset recovery from failing banks, and the changes to the penal code on financial crimes.

Structural conditionality in 2005

The overall policy strategy remains unchanged. The specification of new salary scales for teachers is a prior action for the second review. Other conditionality include:

- *Fiscal policy.* SBs refer to the reduction of tax stopfilers and increase in tax audits, and designing measures to address the fiscal implications of opening of the long-distance phone market to competition.
- *Monetary operations*. An SB calls for the implementation of the interest rate corridor.
- *Financial sector*. A continuous structural PC will be the enforcement of new prudential regulations, and an SB calls for measures to address credit dollarization.

Structural conditionality covered by the World Bank and the IDB

Both World Bank and IDB loans are subject to a stable macroeconomic framework and implementation of the PRSP. In addition, some World Bank loans are also contingent on passage of a civil service law, implementation of a bank resolution framework, strengthened transparency, adequate HIPC spending tracking, and of a satisfactory competition framework (including through passage of competition law and general ports law). IDB lending (mainly poverty reduction and infrastructure) is linked to progress in the competition strategy, and implementation of the anti-corruption strategy.

HIPC completion point conditions

HIPC trigger conditions include satisfactory performance under the PRGF and implementation of the PRSP, and structural conditions on the anti-corruption strategy, financial sector, social security system, improving public services (particularly in primary education and health) and social safety nets. These are described in detail in the accompanying completion point document.

48. **The authorities' program has delivered good results**. The economy is growing faster than expected, the recent increase in inflation has been contained, and the external position has strengthened significantly. In addition, the country has begun to address the key

medium-term policy issues, such as getting control over the wage bill, strengthening the financial sector, and modernizing key institutions such as the tax office, central bank and supervisory agency.

49. **However, the economy remains vulnerable to shocks and structural weaknesses**. Key vulnerabilities that remain to be fully addressed include the threat to the fiscal framework from the still unresolved teachers' wage issue, a weak financial sector and the constraints imposed by the rigid exchange rate system. While the improved macroeconomic stability has been an important achievement, sustained rapid growth is needed to reduce poverty. Boosting growth in a lasting way will require further investment, especially new private investment, which will depend on sustained prudent policies, greater legal certainty, stronger institutions, and better governance. HIPC completion will be a major milestone for Honduras once approved by the Boards of the Fund and Bank. The challenge then will be to protect the key elements of the program during the election period and beyond. The staff supports the authorities' initiatives to promote policy continuity through the upcoming political transition. The improved economic situation should not be grounds for complacency, but an inspiration for pressing ahead with Honduras' medium-term growth and poverty reduction strategy.

50. **Continued strengthening of the public finances is key to macroeconomic stability**. The staff commends the authorities for strong fiscal performance in 2004. Nevertheless, further efforts are needed to strengthen public finances, including through a sustained medium-term strategy to broaden the tax base, improve tax administration, and raise the quality of public expenditures. While the implementation of CAFTA and the opening of the international long-distance market are expected to boost growth, the potential revenue losses will need to be addressed.

51. **The staff reiterates the need to implement a sustainable public wage policy**. While staff commends the authorities for containing the wage bill under the program—after the unsustainable increases of the late 1990s—the staff regrets that it has not been possible so far to implement a resolution to the teachers' wage issue on a lasting basis. Looking forward, the strict implementation of the 2003 salary law and the July 2004 agreement with the teachers is essential to ensure the continued control of the wage bill in 2005 and 2006. Beyond that, the staff underscores the importance of implementing a permanent resolution to the teachers' wage issue before 2007, when the key provisions limiting the growth of the wage bill expire. The staff strongly supports the authorities' efforts to garner a broad domestic consensus on this critical policy issue.

52. **The staff welcomes the authorities' efforts to improve monetary operations**. The staff supports the BCH's plans to upgrade its securities and the auction process, strengthen liquidity forecasting and its signals to the market, and adopt a new operational target. Improved monetary instruments will enhance the BCH's ability to address changes in liquidity conditions, including from swings in capital flows.

53. **While the crawling peg has helped anchor inflation, it constitutes an important source of vulnerability**. A medium-term strategy to increase resilience to shocks, facilitate adjustment to structural change, and assure adequate competitiveness should include a move toward a more flexible exchange rate system. However, key preconditions for such a move include strengthening the financial sector and the instruments of monetary policy—issues being addressed under the authorities' program.

54. **Despite the significant progress achieved in the financial sector reform program, further strengthening of the sector is needed**. The authorities have succeeded in upgrading the legal and regulatory framework for the financial sector, and have made progress in improving the supervisory regime. The main challenge now for the supervisory agency is to enforce the improved prudential norms across all banks by using the enhanced tools granted by the new laws. The staff urges strict adherence to the program to increase provisioning levels, and encourages the supervisory agency to take the planned steps to further strengthen loan classification practices of banks to include risks associated with borrowers' unhedged dollar positions.

55. **The staff welcomes the ratification of CAFTA by the Honduran legislature.** In addition to greater trade opportunities, CAFTA could also serve as an important external anchor and catalyst for institutional change by breaking through domestic impediments to reforms. In addition, CAFTA and the regional proximity to the U.S. market could assist Honduras in facing the challenges derived from the expiration of the Agreement on Textile and Clothing.

56. **Based on the satisfactory performance under the program, staff recommends completion of the second review under the PRGF, including the waiver of one PC and modifications of PCs**. The staff supports the waiver of the PC on account of the authorities' corrective actions, including the prior action on completing the technical work on teachers' wages and the proposed rephasing of the implementation of the integrated wage structure. While this issue is a difficult judgment call, the staff's assessment is that moving forward would allow the achievements under the program to be preserved, although this might entail risks, as noted above.

57. It is proposed that the next Article IV consultation will be held in accordance with the provisions of the decision on consultation cycles approved on July 15, 2002.

Table 1. Honduras: Selected Economic Indicators

I. Social Indicators

Population	7.0 million	Adult literacy (among people over 15 years old)	76 percent
Per capita income (in U.S. dollars)	1,020	Percent of pop. below poverty line (2004)	64
Ranks in UNDP Development Index 2004 (out of 177)	115	Gini index	55
Life expectancy at birth in years (2003)	69	Oil imports (in U.S. dollars)	519 million

II. Economic Indicators

					Prel.	Proj.	
	2000	2001	2002	2003	2004	2005	2006
(Annual percentage changes, unless otherwise indicated)							
National income and prices							
GDP at constant prices	5.7	2.6	2.7	3.5	4.6	4.2	4.5
GDP deflator	9.7	8.0	6.3	7.7	7.7	7.8	6.4
Consumer prices (end of period, eop)	10.1	8.8	8.1	6.8	9.2	6.9	5.0
Exchange rate (eop, depreciation -)							
Lempiras per U.S. dollar	-4.4	-5.0	-6.3	-5.0	-5.0	...	...
Real effective rate 1/	7.9	4.2	-3.7	-7.8	-0.8	...	...
Money and credit							
Net domestic assets	19.8	8.8	7.9	30.2	6.8	11.8	10.0
Combined public sector credit	2.6	3.1	-0.9	45.9	-38.2	-6.7	-10.3
Private sector credit	15.4	12.2	9.6	9.8	18.1	14.5	13.1
Broad money	20.6	14.2	14.3	13.6	20.5	12.4	10.5
Lending rate (eop, in percent)	24.6	23.2	21.1	18.0	18.3	...	...
Deposit rate (eop, in percent)	14.5	14.3	13.1	11.0	11.0	...	...
(In percent of GDP)							
Combined public sector							
Noninterest revenue and grants	27.1	27.1	25.3	26.0	27.0	27.8	27.7
Noninterest expenditure	26.6	29.8	28.6	30.6	29.7	30.2	29.8
Primary balance	0.5	-2.7	-3.3	-4.6	-2.7	-2.3	-2.3
Net interest payments	1.3	0.5	0.3	0.5	0.5	0.1	0.0
Savings	7.1	3.7	2.1	0.5	3.3	4.4	5.5
Capital expenditure	7.0	7.7	5.8	6.2	6.5	7.8	7.5
Overall balance	**-0.8**	**-3.2**	**-3.6**	**-5.1**	**-3.0**	**-2.5**	**-1.7**
External financing 2/	1.5	3.0	1.9	1.9	4.5	2.9	2.6
Domestic financing	-0.7	0.1	1.7	3.2	-1.6	-0.4	-0.8
Savings and investment							
Fixed capital formation	26.1	23.8	22.2	21.8	25.7	24.5	24.9
Gross national savings	22.2	19.7	19.1	17.6	20.5	22.0	22.5
(In millions of U. S. dollars, unless otherwise indicated)							
Balance of payments							
Gross international reserves	1,285	1,386	1,492	1,398	1,936	2,121	2,311
(in months of imports) 3/	4.4	4.7	4.7	3.7	4.8	4.9	4.9
Change in net international reserves (increase -)	-20	-80	-129	77	-496	-210	-190
External current account balance (percent of GDF	-3.8	-4.1	-3.1	-4.2	-5.2	-2.5	-2.4
(excluding official transfers)	-8.8	-10.4	-7.2	-7.5	-8.2	-6.0	-6.0
Exports, f.o.b. (annual percent change)	18.0	-4.3	-0.8	1.5	14.2	4.0	6.2
Imports, f.o.b. (annual percent change)	6.4	3.7	1.3	9.2	20.2	5.5	8.3
Public sector debt (in percent of GDP) 4/	77.4	75.2	75.5	75.3	73.1	56.1	54.0
Public sector external debt (in percent of GDP) 4/	73.1	70.7	70.8	69.8	68.2	51.6	49.8
Public sector external debt service (in percent of exports of goods and services) 4/5/	8.3	6.3	7.8	8.2	6.2	4.5	4.2

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

1/ As of end-November for 2004.
2/ Includes external financing gap starting in 2005.
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 2. Honduras: Operations of the Central Government

(In percent of GDP)

			Prel.	Prog.	Prel.	Prog.	Rev.	
	2001	2002	2003	2004	2004	2005	2005	2006
Total revenue and grants	**20.0**	**19.4**	**19.6**	**20.4**	**20.5**	**20.8**	**21.1**	**19.8**
Current revenue	18.2	18.3	18.5	19.4	19.5	19.4	19.4	18.4
Tax revenue	16.2	15.9	16.3	17.5	17.3	17.5	17.4	17.0
Nontax revenue	0.9	1.0	0.9	0.8	0.9	0.9	0.8	0.9
Transfers	1.1	1.4	1.3	1.1	1.3	1.0	1.2	0.5
Grants	1.8	1.1	1.1	1.0	0.9	1.4	1.8	1.4
Of which: HIPC relief 1/	0.7	0.5	0.1	0.1	0.1	0.6	0.5	0.6
Total expenditure	**26.1**	**24.7**	**25.7**	**23.9**	**24.0**	**24.0**	**24.1**	**23.5**
Current expenditure	18.6	18.8	19.8	17.9	18.1	17.8	18.0	17.2
Wages and salaries	10.1	10.8	10.5	10.2	10.1	10.0	9.9	9.6
Goods and services	2.8	2.4	2.2	2.3	2.2	2.5	2.6	2.5
Transfers 2/	3.6	3.8	5.1	3.7	4.0	3.5	3.8	3.7
Interest payments	2.1	1.9	1.9	1.8	1.8	1.7	1.7	1.5
External 3/	1.8	1.6	1.6	1.3	1.3	1.2	1.2	1.1
Domestic	0.4	0.3	0.3	0.4	0.4	0.5	0.4	0.4
Capital expenditure	6.7	5.0	5.5	5.4	6.0	5.7	5.9	6.0
Fixed capital formation	2.8	2.2	2.3	2.3	2.6	2.4	2.6	2.1
Transfers	3.9	2.8	3.2	3.1	3.4	3.3	3.3	3.8
Net lending 4/	0.6	0.9	0.4	0.6	0.0	0.5	0.3	0.3
Public sector reorganization savings	...	...	...	0.0	0.0	0.2	0.0	0.2
Additional needed measures 5/	...	...	...	...	...	...	...	1.1
Program balance	**...**	**...**	**...**	**-3.5**	**-3.5**	**-3.0**	**-3.0**	**-2.5**
Financing	**6.1**	**5.3**	**6.0**	**3.5**	**3.5**	**3.0**	**3.0**	**2.5**
External financing	**3.5**	**1.8**	**1.7**	**3.7**	**4.6**	**1.9**	**2.0**	**1.3**
Disbursements	3.9	2.4	2.4	3.4	5.1	3.1	3.1	2.6
Amortization	-1.9	-2.3	-2.5	-2.4	-2.6	-2.2	-2.2	-2.0
Zero coupon bonds	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Exceptional financing	1.6	1.8	1.8	2.8	2.1	1.1	1.1	0.8
Domestic financing	**2.6**	**3.4**	**4.4**	**-0.2**	**-1.1**	**0.0**	**0.0**	**0.2**
Financial system	2.1	0.2	2.4	-0.2	-2.1	0.0	0.0	0.2
Bonds	0.3	0.6	0.3	0.0	0.1	0.0	0.0	0.0
Extraordinary transfers 6/	0.0	2.3	1.2	0.0	0.4	0.0	0.0	0.0
Floating debt	0.2	0.4	0.5	0.0	0.5	0.0	0.0	0.0
New domestic arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap 7/	**...**	**...**	**...**	**0.0**	**0.0**	**1.0**	**1.0**	**1.0**
Memorandum items								
PRSP spending								
New definition	...	7.5	7.5	8.1	8.4	8.7	8.7	9.4
Old definition	2.9	2.4	2.5	3.2	3.8	3.8	3.8	4.5

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

1/ Comprises HIPC interim relief from IBRD/IDA, IDB, and the Fund.
2/ Includes the cost of support plan for agricultural loans (1 percent of GDP in 2003).
3/ On an accrual basis.
4/ Includes the cost of closing financial institutions: Solfisa and Banhcrecer in 2001; and Banco Capital in 2002 (0.2, 0.5, and 0.5 percent of GDP, respectively).
5/ This includes revenue and expenditure measures needed to offset (potential) revenue losses from CAFTA and Hondutel transfers.
6/ From the state telephone company, Hondutel.
7/ To be covered with HIPC and beyond-HIPC debt relief following the HIPC completion point (assumed March 2005).

Table 3. Operations of the Central Government - Quarterly (Cumulative)
(In millions of lempiras)

	2004								2005							
	Q1		Q2		Q3		Q4		Q1		Q2		Q3		Q4	
	Prog.	Actual	Prog.	Actual	Prog.	Actual	Prog.	Prel.	Prog.	Rev.	Prog.	Rev.	Prog.	Rev.	Prog.	Rev.
Total revenue and grants	**5,765**	**5,716**	**13,410**	**13,625**	**20,282**	**20,641**	**27,420**	**27,815**	**6,673**	**7,034**	**15,357**	**15,996**	**23,187**	**24,093**	**31,105**	**32,200**
Current revenue	5,175	5,303	12,496	12,917	19,180	19,585	26,092	26,411	5,773	5,878	13,962	14,206	21,301	21,672	29,021	29,523
Tax revenue	4,478	4,631	11,102	11,447	17,265	17,312	23,480	23,412	5,042	5,112	12,501	12,674	19,110	19,373	26,099	26,459
Nontax revenue	329	390	658	571	812	889	1,141	1,284	339	314	678	627	1,016	941	1,355	1,255
Transfers	368	282	735	899	1,103	1,384	1,470	1,716	392	453	783	905	1,175	1,358	1,567	1,810
Capital revenue	0	0	0	0	0	44	0	115	0	0	0	0	0	0	0	0
Grants	590	414	914	708	1,103	1,013	1,329	1,289	900	1,156	1,394	1,790	1,886	2,422	2,084	2,676
Of which: HIPC relief 1/	0	0	8	0	14	23	110	105	0	0	66	57	113	97	902	775
Total expenditure	**6,335**	**6,280**	**15,170**	**14,023**	**21,976**	**21,856**	**32,172**	**32,549**	**7,418**	**7,555**	**17,187**	**17,663**	**25,393**	**25,986**	**35,885**	**36,761**
Current expenditure	5,381	4,955	12,280	11,011	17,139	17,011	24,109	24,515	5,914	6,053	13,545	13,852	19,276	19,823	26,657	27,441
Wages and salaries	3,004	2,831	6,860	6,565	9,840	9,709	13,750	13,748	3,265	3,299	7,455	7,455	10,694	10,841	14,944	15,149
Goods and services	798	399	1,595	1,063	2,101	1,793	3,050	2,973	948	1,008	1,896	2,017	2,845	3,025	3,793	4,034
Transfers	853	1,019	2,578	2,258	3,315	3,633	4,944	5,380	931	1,014	2,863	3,116	3,662	3,985	5,301	5,769
Interest payments	726	706	1,247	1,126	1,884	1,875	2,364	2,414	770	732	1,330	1,264	2,075	1,973	2,619	2,489
External 2/	567	562	928	879	1,470	1,427	1,815	1,807	578	567	947	929	1,502	1,472	1,854	1,817
Domestic	160	144	319	247	414	449	549	607	191	168	382	336	573	504	764	672
Capital expenditure	742	1,381	2,468	3,065	4,204	4,957	7,218	8,086	1,326	1,397	3,288	3,601	5,587	5,848	8,522	8,902
Fixed capital formation	290	514	1,014	1,035	1,673	1,770	3,059	3,527	701	758	1,440	1,575	2,516	2,724	3,631	3,927
Transfers	452	867	1,454	2,030	2,531	3,187	4,159	4,559	626	639	1,848	2,027	3,071	3,124	4,891	4,975
Net lending	211	-56	422	-52	634	-112	845	-53	177	105	354	210	530	314	707	419
Unidentified expenditure	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Required measures (savings)	0	0	0	0	0	0	0	0	81	0	163	0	244	0	326	0
Overall balance	**-570**	**-564**	**-1,760**	**-399**	**-1,694**	**-1,214**	**-4,751**	**-4,733**	**-663**	**-520**	**-1,667**	**-1,667**	**-1,962**	**-1,892**	**-4,455**	**-4,562**
Financing	**570**	**430**	**1,760**	**477**	**1,694**	**871**	**4,751**	**4,731**	**663**	**520**	**1,667**	**1,667**	**1,962**	**1,892**	**4,455**	**4,562**
External financing	**-3,769**	**877**	**-3,515**	**1,704**	**3,342**	**2,709**	**5,042**	**6,232**	**522**	**467**	**1,328**	**1,272**	**2,277**	**2,003**	**2,916**	**3,007**
Disbursements	818	1,018	1,791	2,082	2,551	3,359	4,565	6,969	901	720	2,147	2,214	3,296	3,070	4,668	4,722
Amortization	-943	-861	-1,654	-1,600	-2,550	-2,538	-3,260	-3,814	-954	-918	-1,674	-1,719	-2,578	-2,573	-3,301	-3,331
Zero coupon bonds	-20	-38	-39	-38	-59	-78	-78	-78	-21	-42	-41	-42	-62	-87	-83	-88
Exceptional financing	-3,624	758	-3,612	1,260	3,400	1,967	3,815	3,156	595	706	896	819	1,622	1,594	1,631	1,704
Domestic financing	**-603**	**-447**	**-923**	**-1,227**	**-1,648**	**-1,838**	**-291**	**-1,501**	**141**	**54**	**-99**	**-99**	**-1,401**	**-1,134**	**0**	**64**
Financial system	-603	-288	-923	-1,748	-1,648	-1,859	-291	-2,814	141	54	-99	-99	-1,401	-1,134	0	64
Bonds	0	-122	0	398	0	240	0	162	0	0	0	0	0	0	0	0
Extraordinary transfers 3/	0	200	0	200	0	200	0	529	0	0	0	0	0	0	0	0
Floating debt	0	-237	0	-78	0	-418	0	623	0	0	0	0	0	0	0	0
New domestic arrears	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Statistical discrepancy	...	-134	...	78	...	-343	...	-3	...	...	...	...	...	...	...	...
Financing gap 4/	4,941	0	6,197	0	0	0	0	0	0	0	439	495	1,085	1,023	1,539	1,490
Memorandum items:																
PRSP spending	1,935	1,995	4,655	4,765	7,195	7,263	10,900	11,356	2,570	3,317	5,783	6,634	8,995	9,950	12,850	13,267

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

1/ Comprises HIPC interim relief from IBRD/IDA, IDB, and the Fund.
2/ On an accrual basis.
3/ From the state telephone company, Hondutel.
4/ To be covered with HIPC and beyond-HIPC debt relief following the HIPC completion point (assumed March 2005).

Table 4. Honduras: Operations of the Combined Public Sector 1/

(In percent of GDP)

			Prel.	Prog.	Prel.	Prog.	Rev.	
	2001	2002	2003	2004	2004	2005	2005	2006
Total revenue and grants	**28.9**	**26.9**	**27.4**	**28.4**	**28.7**	**29.5**	**29.4**	**27.9**
Current revenue	26.8	25.7	26.2	27.1	27.5	27.9	27.5	26.4
Tax revenue	17.0	16.8	17.1	18.3	18.2	18.2	18.2	17.8
Nontax revenue 2/	4.2	4.8	5.1	5.0	5.0	5.3	5.1	5.3
Interest earnings	1.8	1.6	1.5	1.4	1.8	1.7	1.6	1.7
Operating balance of public enterprises	3.8	2.5	2.5	2.4	2.6	2.8	2.7	1.7
Capital revenue	0.3	0.1	0.1	0.2	0.3	0.2	0.1	0.2
Grants	1.8	1.1	1.1	1.0	1.0	1.4	1.8	1.4
Of which: HIPC 3/	0.7	0.5	0.1	0.1	0.1	0.6	0.5	0.6
Total expenditure	**32.0**	**30.5**	**32.5**	**31.4**	**31.7**	**32.2**	**32.0**	**31.0**
Current expenditure	23.1	23.6	25.7	23.1	24.1	23.1	23.2	22.5
Wages and salaries	12.8	13.5	13.2	12.9	13.0	12.7	12.6	12.2
Goods and services	3.8	3.4	3.2	3.3	3.3	3.6	3.7	3.7
Transfers 4/	2.4	2.5	4.2	2.8	2.8	2.7	3.0	2.8
Operating losses of the central bank	0.4	0.9	1.1	1.2	1.1	1.3	1.1	1.0
Interest payments	2.3	2.0	1.9	1.8	2.1	1.8	1.7	1.7
External 5/	1.9	1.6	1.6	1.3	1.3	1.2	1.2	1.1
Domestic	0.4	0.3	0.4	0.4	0.7	0.5	0.5	0.5
Other 6/	1.5	1.2	2.0	1.2	1.9	1.1	1.1	1.1
Capital expenditure	7.7	5.8	6.2	6.9	6.5	7.8	7.8	7.2
Fixed capital formation	6.7	5.3	5.9	6.2	5.9	6.8	6.7	6.0
Transfers	0.7	0.4	0.2	0.7	0.6	0.9	1.0	1.1
Other capital expenditure	0.3	0.1	0.0	0.0	0.0	0.0	0.0	0.1
Net lending	1.2	1.1	0.7	1.4	1.0	1.3	1.1	1.2
Public sector reorganization savings	...	...	...	0.0	0.0	0.2	0.0	0.2
Additional needed measures 7/	...	...	...	...	...	...	...	1.1
Program balance	**-3.2**	**-3.6**	**-5.1**	**-3.0**	**-3.0**	**-2.5**	**-2.5**	**-1.7**
Financing	**3.2**	**3.6**	**5.1**	**3.0**	**3.0**	**2.5**	**2.5**	**1.7**
External financing	**3.0**	**1.9**	**1.9**	**3.9**	**4.5**	**1.8**	**1.9**	**1.2**
Disbursements	4.0	2.5	2.7	3.7	5.4	3.2	3.3	2.7
Amortization	-2.5	-2.4	-2.6	-2.5	-3.1	-2.4	-2.2	-2.1
Zero coupon bonds	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Exceptional financing	1.6	1.8	1.8	2.8	2.3	1.1	0.8	0.6
Domestic financing	**0.1**	**1.7**	**3.2**	**-0.9**	**-1.6**	**-0.3**	**-0.4**	**-0.8**
Banking system	0.4	-1.0	3.6	-0.9	-1.6	-0.3	-0.4	-0.8
Bonds	0.0	0.3	0.1	0.0	0.0	0.0	0.0	0.0
Deposits abroad 8/	-0.7	2.0	-0.2	0.0	-0.2	0.0	0.0	0.0
Floating debt	0.4	0.5	-0.3	0.0	0.2	0.0	0.0	0.0
Financing gap 9/	**...**	**...**	**...**	**0.0**	**0.0**	**1.0**	**1.0**	**1.3**

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

1/ Includes the nonfinancial public sector and the quasi-fiscal deficit of the central bank.
2/ Includes contributions to the social security system.
3/ Comprises HIPC interim relief from IBRD/IDA, IDB, and the Fund .
4/ Includes the cost of support plan for agricultural loans (1 percent of GDP in 2003).
5/ On an accrual basis.
6/ Includes statistical discrepancy due to transfers from central government to the rest of general government.
7/ This includes revenue and expenditure measures needed to offset revenue losses from CAFTA and Hondutel transfers.
8/ Includes the change in deposits of the state telephone company held abroad.
9/ To be covered with HIPC and beyond-HIPC debt relief following the HIPC completion point (assumed March 2005).

Table 5. Operations of the Combined Public Sector - Quarterly (Cumulative) 1/

(In millions of lempiras, cumulative since the beginning of the year)

	2004								2005							
	Q1		Q2		Q3		Q4		Q1		Q2		Q3		Q4	
	Prog.	Actual	Prog.	Actual	Prog.	Actual	Prog.	Proj.	Prog.	Rev.	Prog.	Rev.	Prog.	Rev.	Prog.	Rev.
Total revenue and grants	**8,425**	**8,367**	**18,729**	**17,842**	**28,361**	**28,207**	**38,423**	**39,018**	**9,947**	**10,198**	**21,905**	**22,282**	**33,010**	**33,595**	**44,202**	**44,870**
Current revenue	7,757	7,915	17,660	17,085	27,026	27,061	36,784	37,304	8,987	8,984	20,390	20,425	30,943	31,000	41,877	41,963
Tax revenue	4,752	4,883	11,651	11,699	18,088	18,064	24,577	24,686	5,330	5,417	13,078	13,289	19,974	20,297	27,252	27,692
Nontax revenue 2/	1,734	1,677	3,468	2,864	5,027	4,770	6,761	6,764	1,979	1,954	3,959	3,908	5,938	5,862	7,917	7,817
Interest earnings	450	376	901	877	1,451	1,626	1,902	2,383	637	598	1,275	1,196	1,912	1,793	2,549	2,391
Operating balance of public enterprises	820	979	1,640	1,645	2,460	2,601	3,544	3,471	1,040	1,016	2,079	2,032	3,119	3,048	4,159	4,064
Capital revenue	74	35	149	45	223	124	298	406	57	54	114	109	170	163	227	217
Grants	594	416	921	712	1,112	1,022	1,341	1,308	904	1,159	1,401	1,748	1,896	2,432	2,098	2,690
Of which: HIPC 3/	0	0	8	0	14	23	110	105	0	0	66	59	113	101	902	808
Total expenditure	**9,075**	**8,705**	**20,533**	**18,313**	**29,903**	**28,547**	**42,255**	**43,059**	**10,800**	**10,877**	**23,820**	**24,034**	**35,006**	**35,187**	**48,342**	**48,730**
Current expenditure	7,334	6,670	15,559	14,515	22,673	22,390	31,127	32,759	8,185	8,334	17,363	17,675	25,498	25,995	34,719	35,394
Wages and salaries	3,781	3,689	8,659	7,657	12,415	12,186	17,348	17,680	4,135	4,169	9,472	9,549	13,580	13,727	18,977	19,182
Goods and services	1,138	690	2,276	1,447	3,121	2,707	4,411	4,467	1,338	1,398	2,676	2,797	4,015	4,195	5,353	5,593
Transfers	932	766	1,864	1,489	2,796	2,669	3,728	3,736	1,024	1,140	2,047	2,281	3,071	3,421	4,094	4,562
Operating losses of the central bank	362	444	724	853	1,256	1,131	1,675	1,482	488	438	976	875	1,463	1,313	1,951	1,750
Interest payments	736	745	1,266	1,186	1,912	1,981	2,401	2,806	780	769	1,351	1,332	2,108	2,078	2,662	2,625
External 4/	567	572	928	891	1,470	1,453	1,815	1,830	579	567	948	929	1,502	1,472	1,854	1,817
Domestic	169	173	338	295	443	528	587	976	202	202	404	404	606	606	808	808
Other 5/	385	337	770	1,883	1,172	1,716	1,563	2,588	420	420	841	841	1,261	1,261	1,682	1,682
Capital expenditure	1,269	1,636	4,029	3,097	5,813	5,007	9,240	8,875	2,141	2,141	5,509	5,555	8,087	7,987	11,729	11,729
Fixed capital formation	1,255	1,479	3,815	2,671	5,323	4,394	8,288	7,977	1,961	1,950	4,959	4,990	7,165	7,023	10,243	10,183
Transfers	-2	140	182	408	441	557	887	863	161	173	514	529	867	909	1,412	1,473
Other capital expenditure	16	17	33	17	49	57	65	36	18	18	37	37	55	55	73	73
Net lending	472	399	944	701	1,416	1,149	1,625	1,425	474	402	947	803	1,421	1,205	1,895	1,607
Required measures (savings)	0	0	0	0	0	0	0	0	81	0	163	0	244	0	326	0
Overall balance	**-651**	**-338**	**-1,804**	**-471**	**-1,542**	**-339**	**-4,096**	**-4,040**	**-771**	**-680**	**-1,752**	**-1,752**	**-1,751**	**-1,592**	**-3,814**	**-3,859**
Financing	**651**	**109**	**1,804**	**136**	**1,542**	**286**	**4,096**	**4,008**	**771**	**680**	**1,752**	**1,752**	**1,751**	**1,592**	**3,814**	**3,859**
External	**-3,734**	**713**	**-3,426**	**1,685**	**3,492**	**2,630**	**5,301**	**6,150**	**332**	**456**	**1,165**	**1,105**	**1,770**	**1,900**	**2,745**	**2,877**
Disbursements	882	1,024	1,931	2,290	2,779	3,610	4,925	7,268	905	813	2,175	2,401	3,327	3,352	4,739	5,087
Amortization	-972	-1,032	-1,705	-1,828	-2,628	-2,880	-3,361	-4,207	-1,024	-936	-1,796	-1,742	-2,771	-2,621	-3,543	-3,387
Zero coupon bonds	-20	-38	-40	-38	-59	-78	-78	-78	-21	-42	-41	-42	-62	-87	-83	-88
Exceptional financing	-3,624	760	0	1,262	3,400	1,977	3,815	3,166	472	622	827	489	1,276	1,255	1,631	1,265
Domestic	**-556**	**-604**	**-968**	**-1,549**	**-1,951**	**-2,344**	**-1,205**	**-2,142**	**439**	**223**	**149**	**149**	**-1,104**	**-1,349**	**-470**	**-532**
Banking system	-556	-312	-968	-1,438	-1,951	-1,442	-1,205	-2,108	439	223	149	149	-1,104	-1,349	-470	-532
Bonds	0	-108	0	-34	0	-116	0	-65	0	0	0	0	0	0	0	0
Deposits abroad 6/	0	-99	0	-130	0	-544	0	-264	0	0	0	0	0	0	0	0
Floating debt	0	-85	0	54	0	-242	0	295	0	0	0	0	0	0	0	0
Financing gap 7/	**4,941**	**0**	**6,197**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**439**	**498**	**1,085**	**1,041**	**1,539**	**1,514**

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

1/ Includes the nonfinancial public sector and the quasi-fiscal deficit of the central bank.
2/ Includes contributions to the social security system.
3/ Comprises HIPC interim relief from IBRD/IDA, IDB, and the Fund.
4/ On an accrual basis.
5/ Includes statistical discrepancy due to transfers from central government to the rest of general government.
6/ Includes the change in deposits of the state telephone company held abroad.
7/ To be covered with HIPC and beyond-HIPC debt relief following the HIPC completion point (assumed March 2005).

Table 6. Honduras: Monetary Survey 1/

	2002	Prel. 2003	2004 Prog.	2004 Prel.	2005 Prog.	2005 Rev.	Rev. 2006
I. Central Bank							
(In percent of currency issue at beginning of period)							
Net international reserves	**51.1**	**-5.4**	**49.1**	**127.0**	**34.1**	**52.6**	**45.1**
(Flow in millions of U.S. dollars)	128.8	-77.2	150.0	495.6	100.0	210.0	190.0
Net domestic assets	**-41.6**	**20.7**	**-37.4**	**-110.6**	**-22.8**	**-39.6**	**-34.0**
Combined public sector	1.4	39.8	-15.0	-27.3	-5.1	-5.7	-6.3
Nonfinancial public sector	-14.4	20.5	-35.7	-45.5	-24.1	-24.4	-26.7
Operating losses of central bank	15.8	19.3	20.8	18.2	19.0	18.7	20.4
Rest of the banking sector	-35.7	5.9	-14.5	-71.6	-21.2	-36.6	-27.7
Of which: Open market operations	-16.7	-1.6	-14.0	-44.9	-17.5	-35.0	-21.5
Private sector	-0.8	-15.1	-6.9	-6.4	0.7	-1.6	-1.5
Medium- and long-term net foreign liabilities	2.8	1.8	0.6	2.2	0.5	0.4	-2.0
Other	-9.4	-11.6	-1.6	-7.0	2.3	3.8	3.5
Currency issue	**9.6**	**15.3**	**11.7**	**16.4**	**11.3**	**13.0**	**11.1**
II. Financial System 2/							
(In percent of broad money at beginning of period)							
Net short-term foreign assets	**10.5**	**-0.1**	**10.6**	**16.9**	**5.7**	**6.9**	**5.9**
(Flow in millions of U.S. dollars)	212.7	-88.3	273.8	501.0	127.9	214.0	190.0
Net domestic assets	**3.8**	**13.7**	**3.7**	**3.5**	**5.4**	**5.4**	**4.6**
Combined public sector	-0.2	8.6	-1.9	-3.4	-0.6	-0.7	-1.0
Nonfinancial public sector	-2.2	6.2	-4.4	-5.7	-2.9	-3.0	-3.5
Operating losses of central bank	2.0	2.4	2.6	2.3	2.3	2.3	2.5
Private sector	7.7	7.6	11.7	13.6	8.7	10.7	9.9
Medium- and long-term net foreign liabilities	0.6	0.7	-0.9	-2.0	0.2	0.5	-0.2
Other	-4.3	-3.2	-5.2	1.8	-2.9	1.4	1.1
Broad money 3/	**14.3**	**13.6**	**14.4**	**20.5**	**11.1**	**12.4**	**10.5**
(12-month percentage change)							
Currency in circulation	7.2	17.0	10.6	18.4	12.1	14.0	11.2
Broad money	14.3	13.6	14.4	20.5	11.1	12.4	10.5
Liabilities in lempiras	12.8	13.1	14.1	20.1	10.6	12.1	10.4
Liabilities in foreign currency	18.3	14.8	15.1	21.2	12.2	13.0	10.8
Credit to private sector	9.6	9.8	15.4	18.1	11.4	14.5	13.1
Credit in lempiras	8.8	4.9	10.0	10.6	12.0	12.0	12.7
Credit in foreign currency 4/	12.5	26.3	30.6	39.4	9.8	20.0	14.0
Memorandum items:							
(Average stock in percent of GDP)							
Currency issue	6.2	6.2	6.3	6.4	6.3	6.6	6.6
Broad money	49.2	50.1	51.6	52.1	52.2	53.8	53.9
Credit to private sector	38.8	38.2	39.5	38.7	40.1	40.0	41.0
Open market operations	3.7	5.0	3.9	6.3	4.4	8.1	8.9
(In percent of total deposits/credit)							
Dollarization (end-period stocks)							
Foreign currency deposits	34.2	35.1	35.4	35.7	35.6	35.8	35.8
Foreign currency credit	22.8	26.4	29.8	30.9	29.4	32.4	32.7

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

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: Summary Accounts of the Central Bank

(End-of-period stocks, in millions of lempiras)

	2004				2005							
	Sep.		Dec.		Mar.		Jun.		Sep.		Dec.	
	Prog.	Prel.	Prog.	Prel.	Prog.	Rev.	Prog.	Rev.	Prog.	Rev.	Prog.	Rev.
Net international reserves	**23,501**	**25,220**	**23,964**	**30,240**	**24,761**	**31,030**	**25,527**	**32,207**	**26,301**	**32,635**	**27,034**	**35,178**
(In millions of U.S. dollars)	1,270	1,368	1,277	1,623	1,305	1,653	1,330	1,703	1,355	1,713	1,377	1,833
Net domestic assets	**-16,382**	**-18,224**	**-14,963**	**-20,861**	**-16,368**	**-22,590**	**-17,002**	**-23,379**	**-18,193**	**-24,632**	**-17,019**	**-24,579**
Combined public sector	-6,994	-5,470	-6,139	-7,100	-5,697	-7,047	-5,985	-7,021	-7,235	-7,540	-6,599	-7,636
Nonfinancial public sector	-11,467	-9,844	-11,031	-11,819	-11,017	-12,203	-11,733	-12,615	-13,410	-13,571	-13,202	-14,105
Cumulative losses of central bank	4,473	4,374	4,892	4,719	5,320	5,156	5,748	5,594	6,175	6,031	6,603	6,469
Rest of the banking sector	-10,064	-13,168	-9,145	-14,055	-11,168	-15,580	-12,338	-16,786	-12,606	-17,247	-11,054	-17,492
Of which												
Open market operations	-6,835	-8,484	-5,754	-8,240	-7,855	-10,090	-8,857	-11,217	-9,049	-11,697	-7,334	-11,519
Private sector	-2,732	-2,923	-2,832	-2,791	-2,456	-3,133	-2,406	-2,867	-2,356	-3,209	-2,306	-2,944
Medium- and long-term net foreign liabilities	-2,701	-2,719	-2,691	-2,566	-2,639	-2,585	-2,680	-2,546	-2,731	-2,565	-2,651	-2,524
Other	6,184	6,056	5,919	5,651	6,089	5,755	6,794	5,841	7,148	5,929	6,128	6,017
Currency issue	**7,119**	**6,996**	**9,001**	**9,379**	**8,394**	**8,440**	**8,525**	**8,828**	**7,875**	**8,004**	**10,015**	**10,598**

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

Table 8. Honduras: Structure and Performance of Banking Sector

(In percent unless otherwise indicated)

	2000	2001	2002	2003	Prel. 2004
Total assets (in millions of lempiras) 1/	**60,379**	**66,923**	**75,118**	**89,386**	**106,020**
(In percent of GDP)	67.5	67.6	69.5	74.3	78.8
Number of banks	**21**	**21**	**19**	**16**	**16**
Of which					
In process of liquidation or taken over	0	1	1	0	0
Domestic	19	19	17	10	9
Foreign	2	2	2	6	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	9	8	7	6	6
Bank rating (CAMEL)					
Number of banks (Category IV and V)	5	5	3	2	1
Share of total assets	18.8	16.6	5.3	11.2	8.2
Capital adequacy					
Regulatory capital to risk-weighted assets	12.3	12.7	12.9	13.0	14.5
Capital (net worth) to assets	8.8	9.2	8.1	7.6	8.4
Asset quality and composition					
Nonperforming loans (NPLs) to total loans 2/	10.6	11.4	11.3	8.7	6.4
NPLs net of provisions to capital	51.7	52.6	43.0	37.4	13.7
Restructured loans to regulatory capital	9.9	41.8	47.2	20.5	6.1
Provisions to total loans	2.8	3.4	4.0	3.2	3.7
Provisions to NPLs	27.7	27.2	38.7	38.2	64.6
Sectoral distribution of loans to total loans:					
Commerce	20.3	19.2	17.7	15.8	16.0
Construction and real estate	15.7	15.5	12.9	18.7	19.1
Agriculture and related sectors	16.5	13.8	11.2	7.8	7.8
Manufacturing	18.0	16.9	17.5	19.4	20.3
Consumption	6.9	10.0	13.8	13.0	13.4
Other	22.6	24.6	26.9	25.3	23.4
Profitability					
Return on assets (ROA) 3/	0.9	0.9	0.8	1.2	1.2
Return on equity (ROE)	7.6	8.4	8.2	11.8	14.9
Interest margin to total income	37.4	39.4	41.5	45.0	44.4
Personnel expenses to administrative expenses	39.9	40.8	38.0	36.7	35.4
Liquidity					
Liquid assets to total assets	23.7	26.6	30.1	24.9	28.1
Liquid assets to total short-term liabilities	59.5	58.2	64.1	53.2	60.7
Dollarization					
Foreign currency deposits in percent of total	29.0	33.4	34.2	35.1	35.7
Foreign currency credit in percent of total credit	23.2	22.2	22.8	26.4	30.9

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

1/ Includes contingent assets.

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

3/ Assets include off-balance sheet items.

Table 9. Honduras: Balance of Payments
(In millions of U.S. dollars; unless otherwise indicated)

	2000	2001	2002	2003	Prog. 2004	Prel. 2004	Proj. 2005	2006	2007	2008	2009
Current account	**-226**	**-260**	**-205**	**-293**	**-456**	**-391**	**-200**	**-213**	**-251**	**-330**	**-380**
Trade balance	-1,233	-1,395	-1,442	-1,681	-2,120	-2,106	-2,246	-2,464	-2,687	-2,936	-3,177
Exports	1,437	1,375	1,364	1,384	1,560	1,580	1,644	1,746	1,867	1,999	2,144
Imports 1/	-2,670	-2,769	-2,806	-3,066	-3,679	-3,686	-3,889	-4,211	-4,554	-4,935	-5,321
Of which											
Petroleum products	-384	-397	-410	-512	-730	-637	-729	-745	-769	-803	-850
Services	394	339	432	536	559	614	704	763	827	897	978
Of which											
Value-added maquila industries	575	561	613	710	791	831	914	987	1,066	1,153	1,248
Tourism receipts	260	256	301	350	376	396	436	475	518	564	615
Income (net)	-139	-176	-200	-259	-233	-284	-306	-305	-308	-326	-352
Of which											
Interest payments	-187	-157	-144	-131	-147	-119	-118	-116	-115	-115	-116
Current transfers (net)	753	972	1,004	1,112	1,337	1,385	1,647	1,794	1,917	2,035	2,170
Public sector 2/	306	409	270	229	238	223	281	306	320	321	329
Private sector	447	563	734	883	1,100	1,162	1,367	1,487	1,597	1,714	1,841
Capital account	**-21**	**123**	**154**	**74**	**545**	**616**	**260**	**253**	**314**	**401**	**454**
Foreign direct investment (net)	282	193	176	247	248	293	190	217	243	280	322
Portfolio investments (net)	-61	-4	-4	-4	-4	-4	-5	-5	-5	-5	-5
Public sector loans (net)	-13	107	-29	6	62	73	72	39	81	111	126
Disbursements 3/	169	271	163	221	270	287	265	226	253	270	288
Amortizations 3/	-182	-165	-192	-215	-207	-214	-194	-187	-172	-159	-162
Other medium- and long-term loans (net)	-24	-93	-20	-106	125	217	-3	-2	3	12	18
Short-term loans (net)	-206	-80	31	-69	114	38	6	3	-7	2	-6
Errors and omissions	101	125	70	8	0	33	0	0	0	0	0
Overall balance	**-147**	**-12**	**18**	**-210**	**89**	**258**	**60**	**40**	**63**	**71**	**74**
Net international reserves (- increase)	-20	-80	-129	77	-300	-496	-210	-190	-180	-140	-140
Of which: IMF (net)	4	7	-27	-24	13	24	3	3	-18	-33	-26
Exceptional financing 4/	167	92	111	133	211	238	62	53	30	0	0
Debt relief (incl. rescheduling of arrears)	153	104	36	1	318	328	31	0	0	0	0
Arrears (net)	14	-14	75	132	-212	-194	0	0	0	0	0
Program financing	...	...	...	...	104	104	31	53	30	0	0
Financing gap 5/	**0**	**0**	**0**	**0**	**0**	**0**	**88**	**97**	**87**	**69**	**66**
Memorandum items:											
Terms of trade (percent change)	-8.1	-7.4	-7.9	-5.2	-1.4	-0.9	-0.3	2.2	2.7	2.0	1.9
Exports of goods and services (percent change)	11.5	-2.7	3.5	7.4	11.2	13.8	6.7	7.2	7.5	7.7	7.8
Of goods only	18.0	-4.3	-0.8	1.5	13.0	14.2	4.0	6.2	6.9	7.1	7.3
Imports of goods and services (percent change)	9.3	4.4	1.1	9.1	18.0	18.7	5.6	8.3	8.1	8.3	7.8
Of goods only	6.4	3.7	1.3	9.2	19.8	20.2	5.5	8.3	8.1	8.4	7.8
Current account (in percent of GDP)											
Including official transfers	-3.8	-4.1	-3.1	-4.2	-6.2	-5.2	-2.5	-2.4	-2.7	-3.3	-3.5
Excluding official transfers	-8.8	-10.4	-7.2	-7.5	-9.4	-8.2	-6.0	-6.0	-6.1	-6.5	-6.6
Overall balance (in percent of GDP)	-2.4	-0.2	0.3	-3.0	1.2	3.5	0.7	0.5	0.7	0.7	0.7
Gross reserves (end of period)	1,285	1,386	1,492	1,416	1,715	1,911	2,121	2,311	2,491	2,631	2,712
In months of next year imports of nonmaquila goods and nonfactor services	4.4	4.7	4.7	3.7	4.4	4.8	4.9	4.9	4.9	4.8	4.6
In percent of short term external debt 6/	245	280	261	327	267	408	446	434	547	560	554
Outstanding external debt 7/	4,404	4,526	4,657	4,845	4,495	5,082	4,152	4,324	4,481	4,608	4,759
Debt to GDP ratio (in percent)	73.1	70.7	70.8	69.8	61.0	68.2	51.6	49.8	48.0	46.1	44.4
Public sector debt service paid to exports (in percent) 7/	8.3	6.3	7.8	8.2	7.4	6.2	4.7	4.3	4.1	4.1	3.9
Nominal GDP (millions of U.S. dollars)	6,025	6,400	6,580	6,945	7,369	7,455	8,045	8,686	9,330	10,002	10,720

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

1/ Includes special imports for investment projects of US$400 million in 2004 and US$100 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.

4/ Includes debt relief from Paris Club (1999-2005), the Central American Emergency Trust Fund (1999-2000), HIPC relief from CDC, and program loans from the World Bank and the IADB.

5/ To be covered with HIPC and beyond-HIPC debt relief following the HIPC completion point (assumed March 2005).

6/ External debt due within a year.

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: Summary of Medium-Term Macroframework

	2002	Prel. 2003	Est. 2004	Proj. 2005	2006	2007	2008
	(Annual percentage change)						
National income and prices							
GDP at constant prices	2.7	3.5	4.6	4.2	4.5	4.5	4.5
Of which							
Consumption	4.1	5.1	2.2	4.2	5.0	5.3	4.6
Investment	-5.9	1.2	19.6	-0.4	9.3	7.1	8.5
Exports	4.9	5.1	7.0	6.1	6.4	5.8	6.0
Imports	2.4	7.8	9.1	2.7	10.3	9.0	8.3
Consumer prices (end of period)	8.1	6.8	9.2	6.9	5.0	4.0	3.0
GDP per capita (in U.S. dollars)	963	992	1,039	1,094	1,152	1,208	1,265
Poverty rate 1/	63	64	64	63	62	61	59
	(In percent of GDP, unless otherwise stated)						
Combined public sector							
Savings	2.1	0.5	3.3	4.4	5.5	5.5	5.5
Anti-poverty spending	7.5	7.5	8.4	8.7	9.4	9.4	9.4
Overall balance	-3.6	-5.1	-3.0	-2.5	-1.7	-1.7	-1.6
Of which							
Central government balance	-5.3	-6.0	-3.5	-3.0	-2.5	-2.5	-2.5
General government balance	-2.9	-3.6	-1.1	-0.9	-0.4	-0.4	-0.4
Public sector debt	73.7	75.3	72.8	56.1	54.0	51.7	49.6
Savings and investment							
Fixed capital formation	22.2	21.8	25.7	24.5	24.9	25.0	25.6
Private sector	16.9	15.7	19.6	18.3	19.2	18.7	19.1
Public sector	5.3	6.1	6.2	6.2	5.7	6.4	6.5
Gross national saving	19.1	17.6	20.5	22.0	22.5	22.4	22.3
Private sector	17.0	17.0	17.0	17.4	18.0	16.7	16.6
Public sector	2.1	0.6	3.5	4.6	4.5	5.7	5.7
External current account balance	**-3.1**	**-4.2**	**-5.2**	**-2.5**	**-2.4**	**-2.7**	**-3.3**
Gross international reserves							
(in months of imports) 2/	4.7	3.7	4.8	4.9	4.9	4.9	4.8
External public debt 3/							
NPV of public sector external debt after HIPC	...	55.4	51.7	33.6	32.7	32.3	31.5
(in percent of currrent government revenue)	...	299.6	262.6	173.0	170.2	168.0	163.9
(in percent of exports) 5/	...	151.1	139.6	89.5	86.3	85.4	83.0
Public sector external debt after HIPC relief 4/	70.8	69.8	68.2	51.6	49.8	48.0	46.1

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

1/ Taken from the PRSP progress report 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 11. Honduras: Indicators of External Vulnerability

(In units indicated)

	2000	2001	2002	2003	Prel. 2004
External indicators					
Merchandise exports (percent change, value)	18.0	-4.3	-0.8	1.5	14.2
Merchandise imports (percent change, value)	6.4	3.7	1.3	9.2	20.2
Terms of trade (percent change)	-8.1	-7.4	-7.9	-5.2	-0.9
Current account balance (percent of GDP)	-3.8	-4.1	-3.1	-4.2	-5.2
Gross official reserves (in months of imports)	4.4	4.7	4.7	3.7	4.8
Short-term public sector external debt (in percent of gross official reserves) 1/	15.0	15.5	14.3	13.7	9.8
Medium- and long-term public sector external debt (in percent of GDP)	73.1	70.7	70.8	69.8	68.2
Medium- and long-term public sector external debt (in percent of exports)	183.9	189.5	187.8	190.2	184.0
REER (12-month change, appreciation +)	7.9	4.2	-3.8	-7.8	-3.0

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

1/ Debt due within a year.

Table 12. Honduras: External Financing Requirements and Sources

(In millions of U.S. dollars)

	2000	2001	2002	Prel. 2003	Prog. 2004	Projection 2004	2005	2006
1. Gross financing requirements	**-1,103.1**	**-1,231.5**	**-913.4**	**-903.5**	**-1,474.1**	**-1,641.9**	**-1,028.0**	**-1,058.3**
External current account deficit (exc. official transfers)	-531.9	-668.7	-475.7	-521.7	-693.6	-613.8	-479.7	-519.2
Debt amortization	-502.6	-439.3	-290.8	-435.4	-254.5	-263.3	-335.8	-320.8
Medium and long term debt	-296.2	-358.8	-322.1	-366.0	-368.5	-301.4	-340.7	-324.1
Public sector	-181.7	-164.7	-192.3	-215.0	-207.4	-214.0	-193.8	-186.6
Commercial banks	-88.5	-98.3	-83.7	-57.0	-60.0	-47.9	-80.0	-70.6
Corporate private sector	-26.0	-95.8	-46.1	-94.0	-101.1	-39.5	-66.9	-66.9
Short-term debt (net) 1/	-206.4	-80.5	31.3	-69.4	114.1	38.1	4.9	3.3
Repayment of arrears	-8.1	-14.3	-0.6	0.0	-211.6	-211.6	0.0	0.0
Gross reserves accumulation	-55.6	-100.5	-106.7	94.4	-299.7	-538.4	-184.4	-190.0
IMF repurchases and repayments	-4.9	-8.6	-39.5	-40.9	-14.8	-14.9	-28.1	-28.4
2. Available financing	**1,103.1**	**1,231.5**	**913.4**	**903.5**	**1,474.1**	**1,641.9**	**940.2**	**961.6**
Foreign direct investment (net)	282.0	193.0	175.5	247.2	247.7	293.0	190.0	217.1
Debt financing from private creditors	90.8	101.2	110.0	45.4	286.1	304.2	144.2	135.6
Medium- and long-term financing	90.8	101.2	110.0	45.4	286.1	304.2	144.2	135.6
Public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	48.0	52.4	70.0	47.6	112.0	127.7	70.0	75.6
Corporate private sector	42.8	48.8	40.0	-2.2	174.1	176.5	74.2	60.0
Official creditors 2/	474.6	679.1	428.8	450.2	606.1	606.7	564.7	577.4
Loan disbursements	168.9	271.2	163.0	221.2	374.0	390.3	296.4	278.6
Of which								
Program loans					104.2	103.7	31.0	53.0
Grants	305.7	407.9	265.8	229.0	232.1	216.4	268.3	298.8
IMF 3/	21.3	21.9	4.5	0.0	35.8	36.3	43.5	39.0
Accumulation of arrears (exceptional) 4/	21.7	0.8	75.4	132.5	0.0	17.2	0.0	0.0
Debt rescheduling (already agreed)	...	...	...	...	318.2	328.4	31.2	0.0
Of which: arrears	...	...	...	...	211.6	211.6	...	...
Other flows 5/	212.7	235.5	119.2	28.3	-19.8	56.2	-33.5	-7.6
3. Financing gap	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**87.8**	**96.8**
Of which								
Unidentified financing	...	...	...	...	...	...	0.0	0.0
Possible debt rescheduling (incl. beyond HIPIC)	...	...	...	...	...	...	87.8	96.8

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/ Excluding the IMF.
3/ Including IMF HIPC grants.
4/ The figure for 2004 consists of technical arrears with Paris Club creditors, pending finalization of bilateral agreements following the April 2004 Paris Club rescheduling.
5/ Includes all other net financial flows, and errors and omissions.

Table 13. Status of Compliance in Meeting the HIPC Completion Point Conditions

	Monitoring Institution and Compliance	
1. **Maintenance of macroeconomic stability as evidenced by performance under a program supported by a PRGF arrangement.** The IMF Board approved the PRGF arrangement in February 2004 and the first review in September 2004. The second review is presented for Board approval.	IMF	Done
2. **Successful implementation of the full PRSP for at least one year as evidenced in one comprehensive annual report endorsed by the Boards of IDA and IMF.** The full PRSP was submitted to the IMF and IDA Boards in July 2001 and a first progress report was submitted in December 2003. The second progress report has been submitted for Board endorsement.	IDA/ IMF	Done
3. **Preparation and implementation of a participatory, comprehensive anti-corruption strategy and its presentation to the national and international community.** Key measures include		
a. **Elaboration and publication of a participatory comprehensive anti-corruption strategy in consultation with civil society and the international community.** Anti-corruption strategy prepared and published by the National Anti-Corruption Council in November 2003.	IDB	Done
b. **Measures to strengthen control mechanisms such as the Offices of the Comptroller General and of Administrative Probity.** Offices of Comptroller General and of Administrative Probity were merged in January 2003 to create TSC. TSC personnel has been restructured and a training program for TSC staff has been prepared and is being implemented. Measures to strengthen procurement include the creation of ONCAE, its merger with UPET and designation of its Consultative Council in 2004.	IDA/ IDB	Done
c. **Increasing the automaticity and transparency of regulations that affect the private sector**. Government passed the Administrative Simplification law in 2002, reducing average time to register new businesses.	IDB	Done
4. **Reform of the social security system, which is crucial to increase both the coverage and the quality of health services and ensure a sound pension system**. Key measures include:		
a. **Separation of the health and pension plans of the IHSS.** The separation of plans was completed in March 2004.	IDA	Done
b. **Strengthening of the regulatory capacity of the ministry of health, and the improvement of coverage, efficiency and quality of health service provision.** Norms for the licensing of health facilities were approved in May 2004 and 121 health facilities were rehabilitated and licensed under the health ministry's new health facility certification program.	IDB	Done
c. **In pensions, the IHSS system will be made actuarially sound, its coverage expanded, and pension benefits rationalized to improve the incomes of the neediest.** Passage of Decree 80-2001 and the raising of salary ceilings for pension contributions in 2001 have placed the social security system on a sound financial footing over the medium to long term. HSS affiliation was increased to almost 500,000 by December 2004, and introduction of automated identification card system for IHSS affiliates is well underway.	IDA	Done
5. **Strengthening of the basic health services for the poor.** Specific trigger is the delivery of a basic health services package to at least 100,000 beneficiaries.) During 2004, coverage of the basic package of primary health care services was extended to cover over 285,000 persons in poor communities.	IDB	Done
6. **Improvement in the quality of education by increasing the number of schools with community participation (PROHECO).** (The specific completion point trigger is the implementation of the program in at least 1,350 PROHECO schools.) As of November 2004, the number of PROHECO schools had increased to over 2000.	IDA	Done
7. **Increase in the efficiency and targeting of safety nets.** (Specifically, the implementation of social investment projects based on participatory planning methodologies in all beneficiary municipalities.) As of October 2004, participatory planning processes have been implemented in all Honduran municipalities, including the 87 poorest municipalities.	IDA	Done
8. **Strengthening of the financial sector by application of the Basel Core Principles (BCP)**. (Specifically, improving the efficiency and soundness of the financial system by substantive application of BCP to the banking sector, and by raising the capital adequacy ratio from 9 to 10 percent and enforcing it on all commercial banks.) The capital adequacy ratio was raised to 10 percent at end-2000, and progress toward BCP compliance has been achieved, especially with respect to reforming the legal framework, strengthening supervision and implementing a program to increase the solvency of the financial system. A reform program to gradually increase solvency and improve surveillance further, and create the conditions needed for substantive compliance with BCP in the medium term is under implementation with IMF and IDA support.	IMF/ IDA	Not fully complied with, but significant progress has been achieved (Waiver Recommended)

Table 14. Honduras: Indicators of Fund Credit
(In units indicated)

	2001	2002	Projections 2003	2004	2005	2006	2007	2008	2009
Stock of existing and prospective Fund credit 1/									
In millions of SDRs	175.1	144.6	115.4	125.7	127.8	129.7	118.3	96.6	79.9
In percent of quota	135.2	111.7	89.1	97.1	98.7	100.2	91.3	74.6	61.7
In percent of exports of goods and service	9.1	7.7	6.3	6.3	6.0	5.7	4.8	3.7	2.8
In percent of external debt	4.9	4.2	3.5	3.8	4.7	4.6	4.1	3.2	2.6
In percent of gross reserves	16.0	13.0	12.1	10.0	9.3	8.7	7.3	5.7	4.5
Obligations to the Fund from existing and prospective Fund arrangements									
In millions of SDRs	10.3	32.7	30.7	11.0	19.2	19.3	22.7	22.5	17.5
In percent of quota	7.9	25.2	23.7	8.5	14.9	14.9	17.5	17.4	13.5
In percent of exports of goods and service	0.5	1.7	1.7	0.6	0.9	0.8	0.9	0.9	0.6
In percent of external debt	0.3	0.9	0.9	0.3	0.7	0.7	0.8	0.8	0.6
In percent of gross reserves	0.9	2.9	3.2	0.9	1.4	1.3	1.4	1.3	1.0

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: Millennium Development Goals
(In percent, unless otherwise noted)

	1990 Benchmark	2015 Goal	Latest Available Information Estimate	Latest Available Information Year	Status
1. Poverty					
Halve extreme poverty	...	...	...	...	Unknown
Halve malnutrition 1/	18.0	9.0	16.6	2001	On track
2. Education					
Achieve full enrollment in primary education to 100 percent	89.1	100.0	87.4	2001	On track
3. Gender equality					
Raise girls/boys ratio in primary and secondary education	107.5	100.0			Achieved
4. Children mortality					
Reduce child mortality under 5 years of age by two-thirds	61.0	40.7	42.0	2002	On track
5. Maternal health					
Reduce maternal mortality rate (for each 100,000 live births) by three-fourths	...	...	110.0	2001	Unknown
Births attended by skilled health staff (percent of total)	45.4	100.0	55.7	2001	On track
6. Environment					
Halve the proportion of individuals without access to improved water source	83.0	41.5	88.0	2001	On track
Halt forest degradation (percent of total land)	53.4	26.7	48.1	2001	On track
7. Global partnership for development 2/					
Develop and implement strategies for youth employment unemployment rate in percent of total labor force ages (15/24)	10.5		6.0	2002	Unknown
Make available the benefits of new information technologies (access to personal computers – per 1,000 people)	...		13.6	2002	Unknown

Sources: World Development Indicators Database, April 2004 (World Bank); UNDP: Human Development Report, 2004.

1/ Percentage of children under 5 years old.

2/ Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

ECONOMIC GROWTH

1. **Historically low growth in Honduras reflects primarily slow or negative productivity gains**. While the contribution from labor and capital accumulation has been comparable to the rest of the region, recent studies have suggested that negative total factor productivity growth is the main culprit of slow growth rates.[23]

Growth Accounting: 1961-2000

	GDP Growth	Contribution Labor	Capital	TFP
I. Honduras				
1960s	4.76	1.83	1.95	0.97
1970s	5.39	2.20	2.16	1.04
1980s	2.43	2.30	1.10	-0.98
1990s	3.21	2.27	1.83	-0.89
II. Average of the rest of Central America				
1960s	5.99	2.34	2.35	1.31
1970s	3.48	2.07	2.35	-0.94
1980s	0.38	1.76	0.82	-2.20
1990s	4.29	1.95	1.38	0.96

Source: Loayza et al (2002)

2. **Several elements have affected productivity growth**. A recent study on growth attributes the poor performance of total factor productivity growth to the poor education system, limited public infrastructure, underdeveloped financial markets, and weak governance.[24] An investment climate survey also highlighted security costs, electricity interruptions, corruption, transportation costs, and crime.[25]

3. **The government's growth strategy aims to address these issues**. The plan includes the following elements and actions:

- **Consolidating macroeconomic stability**. Macroeconomic policies are being supported by the PRGF arrangement.

- **Using CAFTA as an engine of growth**. The agreement has generated strong growth expectations for textiles, electronics and for non traditional agriculture, and is seen as a key instrument to address the challenges from the expiration at end-2004 of the textile quotas (known as the Agreement on Textiles and Clothing).

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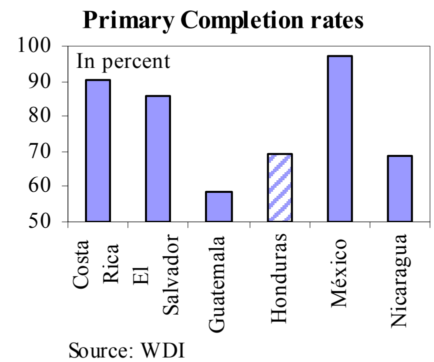
[23] These include Loayza et al (2002) "Economic Growth in Latin America and the Caribbean". World Bank; Juan Ramon, Hugo (1998) "Honduras Growth Performance 1970-1997" IMF policy discussion paper; World Bank (2004a) "Honduras Development Policy Review: Accelerating broad based growth"; and Agosin, Manuel, et al (2004), "*Pequenas economías, grandes desafios*", IDB.

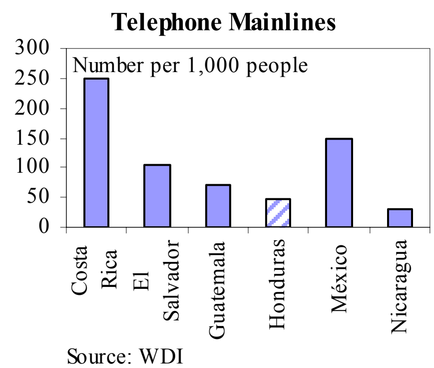
[24] World Bank (2004a).

[25] World Bank (2004b). Honduras: Investment Climate Survey

- **Strengthening human capital formation**. Despite significant achievements in primary enrollment rates, the quality of education remains among the lowest in the region. Completion and secondary enrollment rates remain low. While Honduras has been increasing budgetary resources to education, the quality of education has not improved proportionately. The Education for All-Fast Track Initiative contemplates a series of reforms to improve efficiency at the primary level.

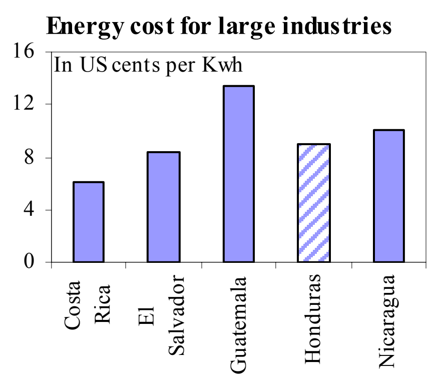


- **Expanding road infrastructure**. The authorities plan to improve the main north-south corridor,[26] which would give nontraditional agriculture producers in the south access to Puerto Cortez, a deep-water port in the north. This will be supported by an expansion of secondary and rural roads under the PRSP strategy.



- **Opening the telecom market**. The international long-distance telephone market will be opened to competition in early 2006. The authorities expect that this measure will lead to a significant decline in the cost of international calls with a positive impact on competitiveness.

- **Fostering private sector participation in the energy sector**. The authorities are analyzing further private sector participation in the electricity sector. The government has a monopoly on transmission and distribution, and the private sector is involved in generation. Electricity prices are comparable to

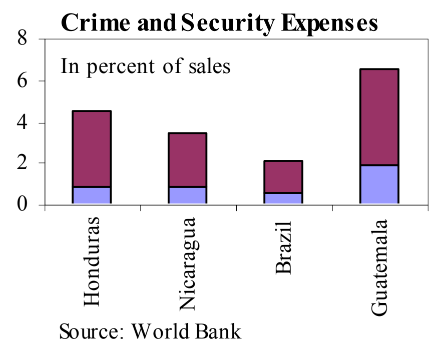


[26] The corridor will connect Puerto Cortez (in the Caribbean) with Puerto Cutuco (a Pacific port in El Salvador), which will enhance access to both U.S. coasts for both countries.

the region for large industrial users,[27] although the World Bank estimates losses of 3 percent of sales associated to electricity interruptions.[28]

- **Enhancing financial intermediation and property rights**. The authorities believe that improving the prudential and supervisory framework is key to strengthening the financial sector's contribution to growth. As described in the main body of this report, they are implementing an ambitious financial sector reform program. The authorities have also modernized the property registry, which is expected to lead to a significant increase in land titling.

- **Improving governance**. In addition to the judicial and political reforms referred to in the main body of this report, the authorities have placed great emphasis in reducing the crime rate. To this end, legal penalties have been strengthened and great efforts are being devoted to improve the security services, including their ability to deal with gang crime—a pervasive problem in Honduras and in some countries in the region. The private sector spends more than 3½ percent of sales on security costs, with an additional 1 percent of sales lost due to crime.[29]



[27] Residential tariffs are lower than the average in the region, while smaller firms and the commercial sector pay higher tariffs.

[28] World Bank (2004b).

[29] World Bank (2004b).

HONDURAS: FUND RELATIONS
(As of January 31, 2005)

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	8.63	6.66

III. SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	19.06	100.00
Holdings	0.11	0.55

IV. Outstanding Purchases and Loans:

	SDR Million	Percent of Quota
PRGF Arrangement	125.71	97.07

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	02/27/2004	02/26/2007	71.20	20.34
PRGF	03/26/1999	12/31/2002	156.75	108.30
PRGF	07/24/1992	07/24/1997	47.46	33.90
Stand-By	07/27/1990	02/17/1992	30.50	30.50

VI. Projected Payments to Fund (without HIPC assistance) (SDR million; based on existing use of resources and present holdings of SDRs):

		Forthcoming				
		2005	**2006**	**2007**	**2008**	**2009**
Principal	...	18.25	18.43	21.66	21.66	16.69
Charges/interest	...	1.02	0.93	0.83	0.72	0.62
Total	...	**19.27**	**19.36**	**22.49**	**22.38**	**17.31**

Projected Payments to Fund (with Board-approved HIPC assistance) (SDR million; based on existing use of resources and present holdings of SDRs):

		Forthcoming				
		2005	**2006**	**2007**	**2008**	**2009**
Principal	...	17.78	18.43	21.66	21.66	16.69
Charges/interest	...	1.02	0.93	0.83	0.72	0.62
Total	...	**18.80**	**19.36**	**22.49**	**22.38**	**17.31**

VII. Implementation of Enhanced HIPC Initiative:

Commitment of HIPC assistance

Decision point date	June 30, 2000[1]
Assistance committed (NPV terms)	End-1999
Total assistance (US$ million)	556.00
Of which: Fund assistance (US$ million)	30.30
Completion point date	Floating

Delivery of Fund assistance (SDR million)

Amount disbursed	8.80
Interim assistance	8.80
Completion point	0.00

VIII. Safeguards Assessments Policy:

A full safeguards assessment of the central bank with respect to PRGF arrangement was completed on February 17, 2004. It found that progress has been made in strengthening the BCH's safeguards framework since a transitional assessment was conducted in 2001, but some weaknesses remain. The most important vulnerabilities relate to non-publication of the audited financial statements and absence of a solid mechanism to follow-up on audit recommendations as well as an independent audit oversight mechanism. The BCH published the 2002 and 2003 financial statements last September, and established a committee to oversight audits.

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

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 31, 2005 was L 18.70 per U.S. dollar.

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. It is proposed that the next Article IV consultation with Honduras be held in accordance with the July 15, 2002 decision on consultation cycles.

XI. FSAP Participation and ROSCs:

FAD ROSC conducted on February 26–March 2, 2001 (IMF 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	Impact of CAFTA on fiscal accounts	May 2004
	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	Follow up on modernization of monetary operations	December 2004
	Flexibilization of exchange rate system	June 2004
	Modernization of monetary operations	April 2004
	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	National income accounts	January 2005
	Government finance statistics	July-Aug. 2004
	Implementation of BPM5	May 2004
	Follow-up on money and banking statistics.	September 2003
	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 November 30, 2004)

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 IMF, 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 remove 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 (FY03–06), 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 November 30, 2004, the IDA active portfolio in Honduras consists of 16 projects for a total commitment of US$360 million, of which US$241 million remain to be disbursed (Honduras was declared IDA-only in September1991). 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 an Access to Land Pilot Credit (US$8 million), a Sustainable Costal 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).

5. In addition to the preceding operations, IDA's Board of Executive Directors approved four new credits during the first half of 2004, but have not yet been declared effective: a Land Regularization and Administration Credit (US$25 million), a *Nuestras Raices* credit to support development in indigenous and Afro-Honduran communities (US$15 million), a Forestry and Rural Productivity Credit (US$20 million), and a PRS Technical Assistance Credit (US$8 million). In addition, a fast-disbursing Poverty Reduction Support Credit (US$61 million) was also approved in June 2004 and was fully disbursed on November 12, 2004.

Future assistance

6. The base case lending scenario of the CAS comprises 12 investment operations for US$226 million over FY03–06, and an additional US$70 million in the form of fast disbursing budgetary support. The investment operations are 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 credits include the recently disbursed Poverty Reduction Support Credit and a possible Financial Sector Adjustment Credit. Under the base case scenario, which is now in effect, World Bank disbursements are expected to average around US$80 million p.a. over the CAS period.

7. With regard to economic and sector work, the CAS includes two types of activities. The first set includes core diagnostic analyses, which are country-specific and address important cross-cutting issues, including deepened understanding of poverty, growth, public expenditures and fiduciary issues. This includes the Development Policy Review, Country Financial Accountability Assessment and Country Procurement Assessment Report that were completed in FY04, as well as a Poverty Assessment (scheduled for FY05) and a Public Expenditure Review (FY06). The second group of activities, are 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 includes sector studies on 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. Active IDA Operations
(As of November 30, 2004) 1/

	Disbursed	**Undisbursed**
IDA projects by sector		
Education	80.9	20.6
Health, Population & Nutrition	233.1	58.4
Rural Sector	142.0	30.7
Environment	40.6	20.5
Municipal Development	2.2	0.0
Tourism	18.2	13.8
Private Sector Development	1.0	30.4
Public Sector Management	26.0	34.6
Electric Power & other Energy	252.5	0.0
Industry	75.2	0.0
Transportation	269.3	31.7
Emergency	196.1	0.0
Adjustment	573.5	0.0
IDA	1,219.7	240.6
IBRD	691.0	0.0
TOTAL	**1,910.7**	**240.6**

B. IBRD/IDA Loan disbursements
(Calendar Year)

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Gross disbursements	67.9	273.0	38.2	98.0	51.4	44.5	110.3
Amortization (cash)	50.1	49.0	35.2	27.3	28.2	29.3	26.5
Net disbursements	17.8	224.0	3.0	70.7	23.2	15.2	83.7

Source: World Bank estimates.

1/ Net of cancellations.

IMF-World Bank Collaboration in Specific Areas

8. Fund and Bank staff have maintained a close working relationship, especially with respect to (i) the PRSP, its subsequent updates and joint assessments; (ii) the HIPC Initiative, (iii) financial sector reform; and (iv) civil service reform. The World Bank and IMF 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 Bank have been supporting the government in the preparation of the PRSP, completed in August 2001, and have followed closely its implementation in 2002–2003, as documented in the first PRSP Progress Report that was completed in December 2003 (the second PRSP-PR is scheduled to be submitted to for Bank/Fund Joint Assessment in December 2004). The Bank and Fund collaborated in the production of Joint Staff Assessments, which accompanied the presentation of the PRSP and PRSP Progress Reports to their respective Boards.

- **HIPC Initiative.** The Fund and 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 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.

Other relevant structural conditions

9. 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 these reforms and providing technical assistance.

HONDURAS: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(In millions of U.S. dollars)

Loans programmed for 2004	**Status**	**Amount**
Financial sector program	Approved	25.0
Poverty Reduction Sector Program	Approved	30.0
Improvement of the PPP Atlantic Corridor (Sections of the CA-5 Norte Highway)	Approved	50.0
Middle Education and Labor Program	Approved	30.6
Strengthening of Fiscal Management	Approval	15.0
Municipal Development Program Tegucigalpa II	Approval	22.5
Social Protection Program	Approval	20.0
PPP support to rural electrification and to the energy sector	Approval	35.0
Approved total		228.1
Expected approval total		228.1
Total		**228.1**

A. Operations (as of December 8, 2004)

	Approved	Disbursed	Undisbursed
Agriculture	45.0	14.7	29.8
Urban Development	104.9	55.5	48.3
Education and Health	104.7	47.6	55.8
Energy and Transport	119.4	23.4	95.1
Social Investment	159.9	60.8	97.5
Water Sanitation	44.3	19.7	23.6
Environmental Protection	95.1	25.5	67.1
Preinvestment	12.0	6.3	5.4
Reform of State	91.2	22.6	66.6
Private Sector Development	10.0	1.2	8.6
Total	**786.5**	**277.9**	**497.9**

B. Net Flow of Resources

	1999	**2000**	**2001**	**2002**	**2003**	**2004e**
Disbursements	76.4	68.2	104.9	47.7	89.7	135.0
Amortization	24.9	33.2	24.4	28.5	-44.8	-47.5
Net flow of resources	51.5	35.0	80.5	19.2	44.8	87.5
Commitments made	85.2	142.1	96.4	67.1	82.5	228.1
Undisbursed commitments	315.9	387.5	378.9	400.3	363.8	456.9

HONDURAS—STATISTICAL ISSUES

Introduction

1. Honduras' data on the banking system, the public finances, trade, and external debt broadly 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.

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

Real sector

3. 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 to 2000.

4. 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 preliminary national accounts series with 2000 as base year have been prepared and a follow-up mission took place in January 2005 to evaluate results and assist the authorities in developing quarterly GDP estimates. Methodological support was provided for the quarterly GDP estimates. A real sector GDDS metadata development mission by a short-term expert is scheduled for February 28-March 4, 2005.

5. The CPI weights used to be 20 years old. A new household expenditure survey was conducted during 1998-1999. As a result of this project, the authorities revised the CPI basket and updated the weights. The price reference period of the new index is December

1999. The CBH produced in parallel the old and new indices during the transition period. The new indices became official in April 2000.

6. 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 a 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

7. 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 for the period January 1996 to December 2001 while still compiling data according to the old methodology. However, the CBH discontinued the new submission shortly afterwards and has been reporting since February 2002 data in the old format despite several requests to resume the reporting of data in the revised format.

8. Further technical assistance in MFS was provided to Honduras in September 2001 and August 2004. The 2004 mission detected major progress in the compilation of the accounts of the central bank, but found still serious shortcomings in the sectorization of the institutional units in the accounts of the other depository corporations. The mission recommended the establishment of an integrated database to report monetary statistics to the Fund for operational and publication purposes. The mission also encouraged the authorities to accelerate the country's participation in the GDDS.

Balance of payments

9. Balance of payments statistics are compiled in broad conformity with the fourth edition of the *BPM4*. Considerable progress has been made, however, in preparations to adopt the *BPM5*, with preliminary annual estimates already available for 1993–2003, although not yet published. No international investment position is compiled. Departures from the criterion of residency underlie the treatment of the *maquila* sector, and some financial sector transactions in foreign currency. Net exports of the *maquila* industry are recorded as net services rather than as exports and imports of goods for processing. Non recording of profits of foreign enterprises operating in the *maquila* industry likely understates the external current account deficit, while direct investment in this industry is excluded from the financial account. Source data on direct investment, several services, and certain foreign

transactions of private enterprises are relatively weak. Most annual surveys have low response rates, and results are obtained with long delays.

10. An STA mission visited Tegucigalpa during May 2004 to assist the CBH in preparing a comprehensive work program to implement the recommendations on balance of payments statistics made by the July 2003 data ROSC mission. Those included (1) completing compilation in accordance with BPM5 and begin disseminating such data and related metadata; (2) improve recording of foreign trade data for the *maquila* (goods for processing) sector; (3) improve quarterly balance of payments statistics using quarterly sample surveys of enterprises; (4) improve the survey design and the compilation process for direct investment and other financial transactions of the nonfinancial private sector; and (5) train CBH staff in methodology and BOP compilation practices.

Government finance

11. The ministry of finance (MoF) disseminates government finance statistics (GFS) covering only the central administration. The MoF also compiles annual GFS for the nonfinancial public sector (NFPS) for internal use and for reporting to the Western Hemisphere Department (WHD). The Central Bank of Honduras (CBH) does report budgetary central government data, although with considerable delay, for publication in the *International Financial Statistics (IFS)*. Neither the MoF nor the CBH has reported GFS data for the *Government Finance Statistics Yearbook (GFSY)* recently.

12. The fiscal ROSC mission in 2002 and the data ROSC mission in 2003 both found that fiscal data in Honduras have serious weaknesses. The GFS issues related to coverage and sectorization can be explained to some extent by the Public Administration Law which excludes the judicial and legislative branches from the data coverage of the central administration. The fiscal data also present large discrepancies between the overall balance compiled by the MoF and the financing data compiled by the CBH. Therefore, there is a need for stronger collaboration between the MoF and the central bank to derive accurate and timely estimates of external financing of the nonfinancial public sector. In general, these data are not fully aligned with international standards, and there is no plan to migrate to the *Government Finance Statistics Manual 2001 (GFSM 2001)*. The July 28-August 14, 2004 GFS mission produced a plan of action to improve fiscal data and proposed the creation of a working group for GFS compilation to implement that plan. The mission also recommended that the envisaged Integrated System of Financial Management be made to support the compilation of GFS data and gradual migration to the GFSM 2001.

HONDURAS: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF FEBRUARY 28, 2005

	Date of latest observation	Date received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of publication[1]
Exchange Rates	2/24/05	2/28/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	2/24/05	02/28/05	D	D	D
Reserve/Base Money	2/24/05	02/24/05	D	D	M
Broad Money	Dec. 2004	01/28/05	M	M	M
Central Bank Balance Sheet	2/28/05	02/28/05	D	D	M
Consolidated Balance Sheet of the Banking System	Dec. 2004	01/28/05	M	M	M
Interest Rates[3]	Sept. 2004	11/4/04	W	W	W
Consumer Price Index	Jan 2005	Feb 2005	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4] – General Government[5]	Dec. 2004	01/28/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4]– Central Government	Dec. 2004	01/28/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[6]	NA	NA	NA	NA	NA
External Current Account Balance	2003	01/28/05	A	A	A
Exports and Imports of Goods and Services	2003	01/28/05	A	A	A
GDP/GNP	2003	Nov 2004	A	A	A
Gross External Debt	2003	01/28/05	A	A	A

[1] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[2] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[3] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[4] Foreign, domestic bank, and domestic nonbank financing.
[5] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[6] Including currency and maturity composition.

Tegucigalpa, Honduras
March 4, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Rato:

1. We are attaching the Supplementary Memorandum of Economic Policies (SMEP) and Supplementary Technical Memorandum of Understanding (TMU) that updates economic developments and policy implementation through end-2004 under the PRGF arrangement approved in February 2004, and sets out specific objectives and targets for 2005. Based on the good track record and policies adopted, we request completion of the second review under the PRGF arrangement; the modification of some performance criteria (PCs) for June 2005 (see attached Supplementary TMU) and the establishment of corresponding PCs for end-December 2005. We also request a waiver for the nonobservance of one PC (paragraph 2 below).

2. Honduras has substantially met the conditions for reaching the completion point under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative and economic performance through December 2004 has been consistent with the program. Macroeconomic policies have been in line with the PRGF arrangement, and progress has been made on the structural agenda. While controls over the wage bill have been effective, the structural PC on issuing regulations to integrate teachers' benefits to their overall salary starting in 2007 was not met as the special wage commission created by law could not reach an agreement. Nonetheless, we remain fully committed to a sustainable wage system for teachers as agreed under the program.

3. We remain committed to continue good faith negotiations with all non-Paris Club official and private creditors to seek debt relief comparable to that granted by Paris Club creditors under the enhanced HIPC Initiative.

4. We are confident that the policies and measures set forth in the SMEP are adequate to achieve the program's objectives under the PRGF arrangement. However, we stand ready to take further measures that may be needed for the successful implementation of the program. To this end, we will continue consulting with the Fund on relevant economic and financial policies, and provide the Fund with the necessary data on a timely basis for monitoring purposes. Consistent with our intention to keep the public informed about our policies and

objectives, the government will publish the SMEP and will report on the progress of the program periodically.

5. We propose conducting the third and fourth reviews under the PRGF arrangement in September 2005 and March 2006, respectively, based on the observance, respectively, of end-June 2005 and end-December 2005 quantitative PCs and structural PCs proposed in the attached SMEP.

6. We assure you that the government of Honduras remains committed to the implementation of the program, and reaching the HIPC completion point by end-March 2005.

Sincerely yours,

/s/

María Elena Mondragón de Villar
President
Central Bank of Honduras

/s/

William Chong Wong
Minister of Finance

SUPPLEMENTARY MEMORANDUM OF ECONOMIC POLICIES OF THE GOVERNMENT OF HONDURAS

1. Following developments in 2004, the Government of Honduras intends to make the changes described below to its economic program.[1] This supplementary memorandum also defines performance criteria for 2005.

Macroeconomic framework

Honduras: Selected Economic Indicators

	Prel.	Est.	Proj.	
	2003	2004 1/	2005	2006
(Percent of GDP, unless otherwise stated)				
Real GDP (percent)	3.5	4.6	4.2	4.5
Inflation (eop, in percent)	6.8	9.2	6.9	5.0
Anti-poverty spending	7.5	8.4	8.7	9.4
Capital expenditure 2/	6.2	6.5	7.8	7.3
Total revenue 2/	27.4	28.7	29.4	29.0
Of which				
Grants	1.1	1.0	1.8	1.4
Central government wage bill	10.5	10.1	9.9	9.6
Combined public sector balance	-5.1	-3.0	-2.5	-1.7
Of which				
Financed domestically	3.2	-1.6	-0.4	-0.8
Central government balance	-6.0	-3.5	-3.0	-2.5
External current account balance	-4.2	-5.2	-2.5	-2.4

1/ For 2004 preliminary estimate.
2/ For the combined public sector.

2. **Growth**. GDP is projected to grow by 4.2 percent in 2005, somewhat higher than originally envisaged, led by *maquila*, tourism, construction, telecommunication, and energy sectors.

3. **Inflation**. Following high oil prices, inflation rose to 9.2 percent in 2004. The central bank expects inflation (eop) to drop to 6.9 percent in 2005 (somewhat higher than the original objective of 6 percent in the program) in the absence of unanticipated external

[1] Paragraph and table references refer to the original Memorandum of Economic Policies.

shocks. The central bank remains committed to return inflation to the agreed medium-term path starting in 2006.

4. **External current account**. With strong family remittances and a robust *maquila* performance expected for 2005, the external current account deficit is now projected at 2.5 percent of GDP (compared to 3.6 percent of GDP originally envisaged) (¶8).

5. **Net international reserves**. In line with the improvement in the current account deficit, the central bank has projected an accumulation of net international reserves of US$210 million.

Fiscal policy

6. **Deficit targets**. The 2005 deficit target for the combined public sector will remain at 2.5 percent of GDP and the central government deficit target at 3.0 percent (¶21). Poverty-reduction spending will rise to 8.7 percent of GDP, in accordance with the original commitment (¶23).

7. **Special wage regimes**. The salaries law passed in December 2003 and the July 2004 wage agreement with teachers will remain in force. The government has asked for a waiver of the performance criterion for end-December 2004 on issuing regulations to integrate supplementary benefits into the overall salary starting in 2007, as the special wage commission could not reach an agreement. Nonetheless, the government remains fully committed to a sustainable wage system for teachers as agreed under the program.

8. **Other wages**. The government remains committed to the wage policy agreed under the program and will continue to strictly apply it to all new public sector wage agreements. Since actual inflation exceeded expected inflation in 2004, a one-time adjustment (not to exceed 0.05 percent of GDP) will be given in 2005 as a catch up for civil servants that have not been subject to special wage regimes.

9. **The 2005 budget**. Currently, the government believes it can meet the fiscal targets for 2005 without taking any further tax measures. However, the government will implement ambitious administrative upgrades on both the revenue and expenditure sides, including to offset any revenue loss from the implementation of CAFTA. These include an action plan to strengthen the tax office (DEI), upgrade SIAFI (the public expenditure system) and identify contingent expenditure cuts in non-poverty spending (amounting to 0.15 percent of GDP). Poverty spending would increase due to higher grants and offsetting savings in the wage bill, current transfers, and domestically financed goods and services.

10. **Restructuring of the public sector**. The government is proceeding with the plan to restructure the public sector. The government has announced the closure of several embassies, streamlined some decentralized agencies, and submitted to congress of a law to merge and close several ministries. It has now begun a major reform of the higher education system, which was initiated with the approval of the new university law in December 2004. Financial measures in the law include the elimination of tenure-for-life salaries, the granting

of legal status to the pension fund, and re-election requirements for university officials. Also, student participation in university decision-making has been rationalized.

11. **Tax revenue**. The government will decisively implement the new tax code, including by enforcing its recently acquired power to determine taxpayers' income through indirect methods and third-party information (expected to yield about 0.1 percent of GDP). The tax code includes a provision for a new law on transfer pricing, which will be sent to congress by end-June 2005. The government reaffirms its commitment to maintain the real rate of specific excises. In addition, the tax office (DEI) is undertaking an ambitious action plan for 2005, which the authorities believe supports the revenue goals. The key elements of the plan, include:

- **Restructuring of the DEI**. The new organizational structure will be approved by mid-March 2005.

- **Audit plan**. The number of large taxpayer audits will rise to 100 by end-June 2005 (structural benchmark) and to 225 (cumulative) by end-December 2005, a 50 percent increase compared to the 150 audits completed in 2004. The audit capacity will be improved through further modernization of computer systems (especially monitoring of large taxpayers' database) and training of staff.

- **Collection of arrears**. Taking advantage of the incentives approved by congress in December 2004 (including a temporary reduction in penalties), the government will launch an aggressive campaign to collect past-due taxes, which is expected to result in collections of L 100 million.

- **Large taxpayer stopfilers**. The rate of stopfiling will be reduced from 4.5 percent of large taxpayers in December 2004 to 3.7 percent in June 2005 (structural benchmark for end-June 2005); and 2 percent in December 2005. To accomplish this, the DEI will (i) strengthen its computerized cross-checking, supported by (ii) an increase in the number of electronic filers, and (iii) will effectively enforce the sanctions introduced in the new Tax Code.

- **Large taxpayers**. The DEI will revise the definition of large taxpayers by end-April 2005, with external technical assistance.

- **Customs administration**. Customs procedures are being streamlined, and risk analysis introduced. A new electronic screening system will be implemented in April 2005, permitting Honduras to improve controls on container shipments. Customs offices in free trade zones are being systematized and audited. A commission has been established to ensure that hiring of customs officials is fully merit-based.

12. **Strengthening fiscal management**. With technical support from the IDB, the ministry of finance has embarked on a plan to reorganize its administrative and functional structure, improve public expenditure management through an upgrade of SIAFI (public expenditure system) and the introduction of a single treasury account. The upgraded system

will be implemented by May 2005 to allow the 2006 budget process to be carried out, and will be fully operational with all components by January 2006.

13. **Hondutel**. Considering the envisaged opening of the long-distance telephone market in January 2006, the government is studying the potential financial cost to Hondutel and will, as a benchmark for end-June 2005, specify policies and an action plan to address the potential revenue shortfall. In the past Hondutel has provided transfers to the government.

Monetary and exchange rate policy and management

14. **Targets on net international reserves and net domestic assets of the central bank**. Reflecting current balance of payments projections, NIR for 2005 will be set at US$1,833 million, and the target will be subject to the adjustor described below. At the level projected, gross international reserves will cover 4.9 months of imports and about 350 percent of short-term liabilities. Net domestic assets will amount to L -24,579 million by end-December 2005.

15. **Monetary policy strategy**. The central bank will use open market operations as the main instrument to contain inflation, including by increasing the interest rate if necessary to achieve sufficient sterilization. This will be assisted by a slowing of the annual rate of crawl to 3.0 percent, which is consistent with the current policy of depreciating in line with projected inflation differentials between Honduras and its main trading partners.

16. **Strengthening monetary management**. The central bank board has approved and announced to the banking system a timetable for modernizing central bank's monetary operations. By May 2005, the central bank will start operating the new scheme. To improve signaling to the market and manage short-term interbank liquidity, the central bank will establish an interest rate operational target (an additional monetary instrument); conduct weekly 7–14 day CAMS auctions with negotiable securities; carry out one day repo auctions when needed; and adopt an interest rate corridor with an automatic liquidity window (ceiling) and issuance of one-day certificates (floor). To manage structural liquidity, the central bank will conduct CAMS biweekly auctions, in which it will announce amounts to be placed and allow interest rates to reflect market conditions.

17. **Central bank recapitalization**. In line with the new central bank law, the ministry of finance and the central bank have agreed on a mechanism to recapitalize the central bank for past and future losses (¶31). By June 2005, the ministry will issue a zero-interest bond to cover the losses incurred between the beginning of 1997 and end-2003 in an amount of L 3,278 million certified by the CNBS, and will also issue a bond to reimburse cash losses for 2004. From now on, bonds will be issued by mid-year to reimburse previous-year losses. The government is not yet in a position to pay market interest rates on the total value of these bonds, but it will increase the proportion of the reimbursement paid at market rates every year, in agreement with the central bank.

Financial sector reform

18. **Strengthening of the financial sector**. The government will continue its ambitious financial sector reform program. The program for 2005 includes the following actions:

- **Application of enhanced prudential regulations to all banks**. The supervisory authority (CNBS) has approved a timetable for financial institutions to comply with the new provisioning requirement (¶36-37), while maintaining at all times a minimum statutory capital level and a capital adequacy ratio of 10 percent and complying with rules governing loan classification. Enforcement of these regulations according to the new financial sector law will be a continuous structural performance criterion for 2005.

- **Related-party lending**. The CNBS will continue to strictly enforce the gradual reduction of related-party loans, to ensure that all banks comply with the reduction in the limit to 30 percent of capital by end-June 2006 (from a level of 120 percent at end-2002).

- **Dollarization**. The government believes that the recent growth of dollar lending to non-dollar earners does not pose a significant risk to the financial sector. Nonetheless, the authorities will adopt measures to assess the risks at the individual bank level and, if necessary, will adopt additional prudential norms in the future. To this effect, the CNBS will expand its data collection of banks' dollar lending activities, including for unhedged positions, commencing with end-March 2005 and quarterly, thereafter. It will also issue supervisory guidelines and inspection procedures for banks' lending in foreign currency by June 2005, and include the review of unhedged dollar loans as a part of the loan classification and provisioning process. These measures will be a structural benchmark for end-June 2005, and will permit a reassessment of the temporary measure that limits banks' external borrowing.

- **Supervision**. The CNBS will perform examinations of all institutions using the enhanced regulations; develop a framework for, and if necessary carry out, intensive supervision of weak institutions; and approve a contingency plan for systemic financial stress. In addition, the CNBS will introduce a framework for risk-based supervision according to international best practices, and monitor the financial situation of the largest debtors of the financial system.

19. **Bank resolution**. The CNBS will complete the procedures to enable the implementation of the new bank resolution mechanism (including the issuance of norms) and the liquidation of financial assets of failed institutions.

- **Bankruptcy**. The government will submit to congress by December 2005 a law to improve the following legal systems: corporate reorganization and bankruptcy proceedings, creditor rights, and corporate governance of nonfinancial business corporations.

Other reforms

20. **Transparency**. The authorities are committed to a policy of transparency (¶44). To this end, they will publish the staff report for the Article IV consultation and second review of the PRGF arrangement; second PRSP progress report; Enhanced HIPC Completion Point Document; Joint Staff Advisory Note; and the updated fiscal ROSC. They will continue the program of statistical improvements to join the GDDS, including the elaboration of quarterly balance of payments data and a systematized reconciliation of above- and below-the-line fiscal data. At that time the authorities will publish the ROSC for data standards. The central bank will provide the Fund with full financial statements (including auditor's notes) and will publish them by end-June 2005. All commercial banks will continue to publish quarterly financial statements.

Program modalities

21. **Conditionality**. Revised performance criteria and financial benchmarks for 2005 are shown in Table 1 and structural targets are included in Table 2. Indicative targets have been also revised.

22. **Adjustors**. The program for 2005 will include the following adjustors:

- Given the recent strong accumulation of NIR and its current level, the NIR floor will be adjusted downwards and the NDA ceiling would be adjusted upwards for shortfalls in NIR accumulation up to an amount of US$100 million.

- To ensure that uncertainties about the timing of disbursements of foreign financial support do not jeopardize the government's compliance with program targets, the 2005 program will include a capped adjuster of L 1,145 million on the ceiling on domestic financing for temporary (within-year) shortfalls in foreign financing.

- The deficit of the central government will be adjusted upwards by the amount of the interest payment on the bonds to recapitalize the central bank; the targets of the consolidated public sector will remain unchanged.

Table 1. Honduras: Financial Benchmarks and Performance Criteria for 2004-05 under the PRGF Arrangement 1/

	2004				Prog. 2005			
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	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 3/	-12,871	-13,827	-16,382	-14,963	-22,590	-23,379	-24,632	-24,579
Actual	-13,857	-15,956	-18,224	-20,861	...	...	...	...
Floor on net international reserves of the central bank 3/ (in millions of U.S. dollars)	1,110	1,155	1,270	1,277	1,653	1,703	1,713	1,833
Actual	1,176	1,297	1,368	1,623	...	...	...	...
(Cumulative amounts in millions of lempiras, for each year)								
Ceiling on the wage bill of the central government	3,004	6,860	9,840	13,750	3,299	7,455	10,841	15,149
Actual	2,831	6,565	9,709	13,748	...	...	...	...
Ceiling on the overall deficit of the central government	570	1,760	1,694	4,751	520	1,667	1,892	4,562
Actual	430	477	871	4,731	...	...	...	...
Ceiling on the overall deficit of the combined public sector	651	1,804	1,542	4,096	680	1,752	1,592	3,859
Actual	109	136	286	4,008	...	...	...	...
Ceiling on net domestic financing of the combined public sector 3/	-556	-968	-1,951	-1,205	223	149	-1,349	-532
Actual	-604	-1,549	-2,344	-2,142	...	...	...	...
Ceiling on contracting or guaranteeing of nonconcessional external debt of the combined public sector (in millions of U.S. dollars) 4/5/	3.3	3.3	3.3	3.3	0	0	0	0
Actual	0	0	0	0	...	...	...	...
Ceiling on accumulation of arrears on external debt-service payments of the public sector (in millions of U.S. dollars) 5/	0	0	0	0	0	0	0	0
Actual	0	0	0	0	...	...	...	...
Financial benchmarks								
Floor on the operating surplus of the public enterprises	820	1,640	2,460	3,544	1,016	2,032	3,048	4,064
Actual	981	1,669	2,633	3,540	...	...	...	...
Floor on anti-poverty spending	1,935	4,655	7,195	10,900	3,317	6,634	9,950	13,267
Actual	1,995	4,765	7,263	11,356	...	...	...	...

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

1/ As defined in the technical memorandum of understanding.

2/ Performance criteria are for end-June and end-December 2005; targets for end-March and end-September 2005 are indicative.

3/ The NIR floor will be adjusted downwards and the NDA ceiling would be adjusted upwards for shortfalls in foreign exchange inflows up to an amount of US$100 million. The 2005 program will include a capped adjuster of 0.75 percent of GDP on the ceiling on domestic financing for temporary (within-year) shortfalls in foreign financing.

4/ Includes short term (up to and including one year) and long-term (over one year) maturities.

5/ Monitored on a continuous basis.

Table 2. Honduras: Structural Targets for 2004-05 under the PRGF Arrangement

	Target Date	Status
I. Actual Targets for 2004		
Prior Action for First Review		
1. Adoption of a new Financial Institutions Law.	September 2004	Completed in September 2004
Structural Performance Criteria		
2. 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	All laws approved in September 2004
3. Finalizing a timetable to comply with new regulations on capital adequacy, loan classification, and provisioning (including on investment in FONAPROVI bonds).	End-June 2004	Completed in June 2004
4. Finalizing a timetable to make the use of indirect instruments of monetary management more effective and improve interest rate signaling.	End-September 2004	Completed in September 2004 with the assistance of technical advisory missions from MFD
5. Launch the mechanism to make the use of indirect monetary instruments more effective and improve interest rate signaling.	End-December 2004	Completed in December 2004
6. Issue of regulations to integrate supplementary benefits into the overall salary from 2007 as envisaged in the salaries law, in accordance with the conclusions of the special wage commission.	End-December 2004	Not done
7. Passage of a 2005 budget consistent with the macroeconomic targets and other objectives of the program supported by the PRGF arrangement, including all tax and tariff measures needed to meet the 2005 deficit target.	End-December 2004	Done. Budget approved in December 2004
8. Permanent suppression of intra-year unfinanced appropriations.	Continuous	Met through end-December 2004
Structural Benchmarks		
9. Amendment of the Penal Code to make financial crimes punishable.	End-September 2004	Completed in December 2004
10. Finalization of an action plan to accelerate asset recovery from failing banks.	End-September 2004	Completed in September 2004
11. Publication of full central bank financial statements, including the external auditor's opinion and the explanatory notes.	End-September 2004	Completed in September 2004

Table 2. Honduras: Structural Targets for 2004-05 under the PRGF Arrangement

	Target Date	Status
12. Enforcement of requirement that banks publish quarterly financial statements.	Continuous	Met through December 2004
13. Finalization of an action plan for public administration reform, consistent with World Bank recommendations.	End-April 2004	Completed in May 2004
14. Amendment of the Tax Code in line with understandings under the program.	End-September 2004	Completed in December 2004.
15. Full automation of poverty-reduction expenditure tracking.	End-December 2004	Completed in December 2004.
16. Establishment of two chambers of Tax Courts	End-December 2004	Supreme Court established Tax Courts chambers in December 2004
II. Proposed Structural Performance Criteria and Benchmarks for 2005		
Structural Performance Criteria		
17. Enforcement of new prudential regulations on capital adequacy ratio, loan classification, and provisioning requirement in line with the new financial sector law. 1/	Continuous	Met through end-December 2004
18. Permanent suppression of intra-year unfinanced appropriations.	Continuous	Met through end-February 2004
Structural Benchmarks		
19. Operational implementation by the central bank of the interest rate corridor.	End-June 2005	
20. CNBS will expand data collection of unhedged dollar loans and issue supervisory and inspection guidelines on these loans.	End-June 2005	
21. The number of large taxpayers' audits will rise to 100, and the rate of stopfilers is targeted to fall to 3.7 percent.	End-June 2005	
22. Enforcement of requirement that banks publish quarterly financial statements.	Continuous	Met through end-December 2004

1/ This measure replaces the proposed PC presented in the original Memorandum of Economic Policies on banks' compliance with prudential norms (which was not included in the Board's proposed Decision).

Supplementary Technical Memorandum of Understanding

1. The Technical Memorandum of Understanding, attached to the Memorandum of Economic Policies of the Government of Honduras dated February 2, 2004, remains in effect, except for paragraph 3 that is replaced by the paragraph below.

2. 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. Funds used to recapitalize the central bank will be recorded below the line in 2005, and hence will not affect the deficit. Interest payments on recapitalization bonds will be included in the deficit.

Statement by the IMF Staff Representative
March 28, 2005

The following information has become available since the staff report was issued. The information does not alter the thrust of the staff appraisal.

1. **Inflation.** Inflation fell slightly to 9.1 percent in February 2005 (y/y), broadly in line with the program. Prices have stabilized in recent months, after drifting up during most of last year.

2. **Net international reserves** rose to US$1,710 million (up by US$87 million since the start of the year), a faster increase than programmed despite higher oil prices. This reflects buoyant exports and remittances as well as private capital inflows.

3. **Fiscal performance.** In January 2005, tax revenue rose by 18 percent (y/y) reflecting a fairly broad-based increase of tax collections and suggesting continued strong economic activity. Public expenditures were slightly below the level envisaged for the month.

4. **Minimum wage.** Negotiations between the private sector and workers concluded with an increase in the minimum wage of 9–12 percent, depending on the size of the firm.

5. **Gasoline prices.** As of mid-March, gasoline prices were up by about 15 percent since end-2004, reflecting trends in international oil prices. As a result, public transportation tariffs were adjusted by 12–20 percent in March. The surge in prices has led to renewed social pressures, including demands for higher adjustments of the minimum wage. The authorities have resisted these demands, noting the importance of avoiding second-round effects of the oil price increase.

6. **Conditionality.** The prior action for the second review has been met. The authorities completed the specification of new salary scales for teachers that integrate the supplementary benefits into the overall salaries, in line with the authorities' medium-term fiscal framework. In addition, the continuous performance criteria on the suppression of intra-year unfinanced appropriation, contracting or guaranteeing of nonconcessional external debt of the combined public sector, and accumulation of arrears on public sector external debt service have been observed through the latest data available (March 15, 2005).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/51
FOR IMMEDIATE RELEASE
April 13, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2005 Article IV Consultation with Honduras

On March, 28, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Honduras.[1]

Background

Growth in Honduras rebounded strongly in 2004, ending a period of low growth. Over the last decade, growth had been adversely affected by natural disasters and worsening terms of trade, exacerbated by a difficult policy environment. To break the unfavorable cycle, the authorities embarked on a medium-term economic reform program in late 2003, aimed at re-establishing macroeconomic and financial stability, strengthening growth, and reducing poverty.

The authorities' program included measures to consolidate the public finances and strengthen monetary policy and the financial sector; address poverty with a focus on education and basic health care; and enhance growth prospects by infrastructure development, improvements in the private investment environment, and trade liberalization. To ensure social consensus in support of the program, it also incorporated measures to improve governance and social equity.

The economy performed robustly in 2004, reflecting sound policies and broadly favorable external conditions. Growth rose to about 5 percent, with a rebound across all sectors, including agriculture. On the demand side, growth reflected mainly higher investment and exports. Inflation stabilized at around 9 percent at the end of the year, after moving higher during much

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

of 2004 mainly because of high oil prices. Despite a sharply higher oil bill, the external position strengthened significantly on account of higher remittances, exports, and capital inflows. Net international reserves rose by just under US$500 million. Moreover, the deficit of the overall public sector fell to 3 percent of GDP (from about 5 percent of GDP in 2003), despite significantly higher spending on poverty-reduction programs and investment.

Important progress was made in structural reform. The legal and regulatory framework for the financial sector was upgraded; the tax code and penal code were amended; and legal, judicial, and electoral reforms were introduced. Honduras ratified the DR-CAFTA in March 2005.

For 2005, growth is projected to remain buoyant, at over 4 percent of GDP. The external current account deficit is expected to narrow significantly (reflecting the completion of last year's large infrastructure projects), and the net international reserves position to remain strong. The 2005 budget envisages a further improvement in the public finances, with the overall public sector deficit declining to 2.5 percent of GDP.

Executive Board Assessment

Executive Directors welcomed Honduras' improved economic conditions, which reflect the implementation of sound macroeconomic policies and progress with structural reforms, supported by strong worker remittances and foreign capital inflows. In 2004, economic growth accelerated and inflation stabilized, after drifting up in response to oil price increases; and the external position has strengthened significantly. The fiscal position improved markedly in 2004, owing in particular to successful control of the wage bill—an important step towards long-term sustainability.

Directors noted that, despite recent achievements, important vulnerabilities and challenges remain. Specifically, they noted the need to make permanent the progress made under the program in containing public sector wages including, in particular, a durable resolution of issues related to teacher's wages. Directors also encouraged the authorities to press ahead with their efforts to strengthen the financial sector further, and stressed the need for continued implementation of prudent fiscal and monetary policies through the upcoming election period. They welcomed the authorities' efforts to promote policy continuity through the political transition.

Directors also observed that the substantially improved medium-term outlook hinged on strengthened institutions and governance, including the modernization of tax administration and the central bank, and judicial, electoral, and administrative reforms. It was noted that these steps would contribute to the achievement of poverty reduction objectives and the Millennium Development Goals.

Directors commended the authorities for keeping the fiscal program on track. Noting the authorities' success in controlling the wage bill in 2004, Directors observed that this policy had permitted a much-needed increase in spending on investment and poverty programs, while at the same time reducing the overall fiscal deficit. Looking forward, Directors stressed the importance of continued adherence to the 2003 salary law and the July 2004 wage agreement, to ensure that the growth of the wage bill remains consistent with macroeconomic stability and the economic and social objectives embodied in the PRSP. To further strengthen the public finances, Directors encouraged the authorities' efforts to broaden the tax base, improve tax administration, and raise the quality of public spending. In this regard, they noted that it would be important to monitor the impact of trade liberalization on public finances and institute offsetting measures, if necessary.

Directors welcomed the authorities' action plan to improve monetary operations, including steps to upgrade securities, improve the auction process, strengthen liquidity forecasting, and adopt a new operational target. Directors noted that these reforms will allow the central bank to further strengthen the framework for monetary policy implementation and thereby enhance its ability to achieve low inflation and safeguard financial stability.

Directors observed that the crawling band exchange rate system has helped to anchor inflation. Looking ahead, to increase the economy's resilience to shocks and facilitate adjustment to structural change, Directors recommended a gradual move toward greater flexibility of the exchange rate, while noting the preconditions for such a move, including the modernization of monetary operations.

Directors welcomed the ratification of the Central American Free Trade Agreement, noting that it would promote competitiveness, and improve growth prospects for Honduras. At the same time, they observed that the implementation of the anticorruption strategy would aid capital formation, and financial market and infrastructure development.

Directors welcomed the progress achieved in strengthening the financial sector. In particular, they noted the improvements in the regulatory framework and the supervisory regime. Directors observed that the main challenge now is to enforce the improved prudential norms across all banks, by using the enhanced tools provided by the new laws. Directors urged strict compliance with the timetable to increase provisioning levels, and encouraged the authorities to further improve banks' loan classification practices by incorporating the risks associated with borrowers' unhedged dollar positions.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Honduras: Selected Economic and Financial Indicators

	2001	2002	2003	Prel. 2004	Proj. 2005
Real economy (percentage change)					
Real GDP 1/	2.6	2.7	3.5	4.6	4.2
GDP deflator	8.0	6.3	7.7	7.7	7.8
Consumer prices (end of period)	8.8	8.1	6.8	9.2	6.9
Public finances (percent of GDP)					
Consolidated public sector deficit	-3.2	-3.6	-5.1	-3.0	-2.5
Consolidated primary deficit	-2.7	-3.3	-4.6	-2.7	-2.3
Public sector debt (percent of GDP, end of period)	75.2	73.7	75.3	72.8	56.1
Money and credit (end-year, percentage change)					
Net domestic assets	8.8	7.9	30.2	6.8	11.8
Of which					
Nonfinancial public sector	3.1	-0.9	45.9	-38.2	-6.7
Private sector	12.2	9.6	9.8	18.1	14.5
Broad money	14.2	14.3	13.6	20.5	12.4
Interest rates (average)					
Deposit rate (six months)	14.3	13.1	11.0	11.0	…
Lending rate (more than one year)	23.2	21.1	18.0	18.3	…
External sector					
External current account balance (percent of GDP)	-4.1	-3.1	-4.2	-5.2	-2.5
Change in net international reserves (millions of U.S. dollars, increase -)	-80	-129	77	-496	-210
Gross international reserves (in months of next year imports of non-maquila goods and services)	4.7	4.7	3.7	4.8	4.9
Terms of trade (percentage change)	-7.4	-7.9	-5.2	-0.9	-0.3
Real effective exchange rate (end of period) 2/	4.2	-3.7	-7.8	-3.0	...

Sources: Central Bank of Honduras; ministry of finance; and IMF staff estimates and projections.

1/ For 2004 preliminary Fund staff estimates.
2/ As of end-December 2004.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 05/69
FOR IMMEDIATE RELEASE
March 29, 2005

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes the Second Program Review and Financing Assurances Review Under Honduras' PRGF Arrangement

The Executive Board of the International Monetary Fund (IMF) has completed the second review of Honduras' performance and the financing assurances review under an SDR 71.2 million (about US$107.5 million) Poverty Reduction and Growth Facility (PRGF) arrangement approved on February 26, 2004 (see Press Release No. 04/29).

The completion of this review allows Honduras to draw a further SDR 10.17 million (about US$15.4 million), bringing the total amount released under the arrangement to SDR 30.5 million (about US$46.1 million). In completing the review, the Board waived the nonobservance of one performance criterion on public sector wages, taking into account compensatory measures and the package of monetary, fiscal, and structural measures that have been implemented to safeguard the program objectives.

Following the discussion of the Executive Board on March 28, 2005, Mr Agustín Carstens, Deputy Managing Director and Acting Chair, stated:

"Honduras' performance under the program supported by the Poverty Reduction and Growth Facility has been satisfactory. The solid implementation of macroeconomic policies and progress with structural reforms had yielded favorable results. In 2004, GDP growth rose to about 5 percent, with a recovery broadly based across all sectors. Moreover, inflation has stabilized, after drifting up in 2004 mainly on account of high oil prices, and the external sector has strengthened significantly. These achievements were facilitated by the authorities' efforts to establish a broad social consensus which made it possible to address challenging policy issues. Looking forward to 2005, growth is expected to continue at a relatively fast pace.

"The authorities remain committed to the policy objectives of boosting growth, reducing poverty, and achieving financial stability. They intend to achieve this through further fiscal consolidation, financial sector reform, and other structural measures aimed at improving productivity and economic efficiency.

"The authorities' fiscal strategy for 2005 aims at a further reduction of the public sector deficit, while public investment and anti-poverty spending are to increase. The higher spending will be financed by higher external grants and by compensating savings elsewhere in the budget, including through the continued implementation of a prudent wage policy.

"Monetary policy, to be effected largely through open market operations, aims to reduce inflation to under 7 percent in 2005. The authorities have also announced that the rate of crawl will be reduced somewhat in 2005, consistent with maintaining a competitive exchange rate, in line with projected inflation differentials.

"Honduras' key challenge in the period ahead will be to protect the core elements of its program during the election period and beyond. Key structural reforms envisaged for 2005 cover the areas of tax administration, central bank monetary operations, and a continuation of the financial sector reform.

"The authorities completed their second annual progress report on the Poverty Reduction Strategy Paper (PRSP) through a broad-based consultation process. The report conveys the authorities' continuing commitment to poverty reduction, and presents a coherent framework for guiding the implementation of the government's poverty reduction strategy.

"However, addressing risks to the strategy will require continued fiscal consolidation; strict implementation of the financial system reform; prioritization of programs; and strengthening public accountability of social programs.

"The authorities have made substantial progress on the structural reform agenda embodied in the HIPC completion point triggers, including satisfactory track record of implementation under the PRGF arrangement and the PRSP. As a result, Honduras has in principle reached the completion point under the enhanced HIPC Initiative, pending action next week by the World Bank's Executive Board. After the provision of enhanced HIPC assistance and additional bilateral assistance, Honduras' debt is expected to fall to sustainable levels," Mr. Carstens stated.

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 Poverty Reduction Strategy Paper, or PRSP. This is intended to ensure that each PRGF-supported program is 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.

**Statement by Moises Schwartz, Executive Director for Honduras and Gerardo Peraza, Senior Advisor to Executive Director
March 28, 2005**

Key Points

- *Successful program implementation is associated to strong ownership and broad consensus.*
- *The program is already achieving favorable results, i.e., strong growth performance spurred by buoyant exports and investment.*
- *The authorities re-affirmed their commitment to fiscal consolidation in line with the original program.*
- *The central bank has maintained a prudent monetary policy and it is pressing ahead with the modernization of monetary operations.*
- *Following the passage of key financial sector legislation, authorities are ready to enforce new regulations and address remaining vulnerabilities.*

On behalf of the Honduran authorities, we thank staff for their valuable policy advice and constructive discussions in the preparation of this review. We acknowledge that, staff and management close cooperation over the past year has been central in building political consensus around key reforms in Honduras. They are also particularly thankful to the international community, and in particular to those development partners based in Tegucigalpa, for their invaluable collaboration to the country effort.

As this Chair indicated at the first review, in contrast to previous arrangements, the successful implementation of the program rests on strong ownership and broad consensus in favor of economic reform and macroeconomic stability. Of course, the road toward reform has not been easy as some sectors are unwilling to renounce to the privileges from past policies. However, the authorities remain true to the objectives of the program such as broadening and strengthening the commitment to fight poverty, sharing resources more equally among social groups, escalating the fight against corruption, strengthening the financial system, and promoting growth through a stable macroeconomic environment. They are again pleased to report that all quantitative performance criteria for end-December were met with margins. On structural PCs and benchmarks for end-December, all but one PC on teachers' wages were also met. As a prior action to this review, the authorities have completed all necessary technical work for the specification of new salary scales for teachers consistent with the PRGF.

In 2005, the authorities' will redouble their efforts to preserve fiscal discipline in the run-up to the presidential elections. While this has proven elusive in previous political transitions, greater citizens' participation in relevant aspects of the poverty reduction strategy has made them more aware on the importance to maintain such discipline. In addition, the authorities are confident that the ongoing dialogue with opposition parties (as demonstrated by the broad support in the ratification of CAFTA) and their unwavering policy to block any unbudgeted expenditure will maintain the program on-track during this year political cycle. Preliminary signals from both leading candidates are very encouraging on this regard.

Background

The authorities' most recent estimates for 2004 show a GDP growth of about 5 percent spearheaded by agriculture and manufacturing (particularly, *maquila* and textiles). On the demand side, fostered by a positive international environment and increased domestic confidence, growth performance reflected mainly buoyant exports and a sharp rise in private investment. The merchandise trade deficit widened to US$2.1 billion (US$1.6 billion in 2003) owing in part to the shock of high oil prices and a sharp increase in imports associated to telecommunication and energy projects. However, higher official and private capital inflows and record high family remittances contributed to a substantial accumulation of international reserves of US$500 million or about 5 months of imports, one of the highest reserve coverage in the Central American region. Following the decline of inflation in recent years, prices increased in 2004 reflecting mostly high international fuel prices that pushed up transportation and electricity generation costs.

On the fiscal front, the authorities moved decisively to address key weaknesses affecting the medium term sustainability. They met all fiscal targets for end-December with margins. A combination of tax reforms and improved tax administration in 2002-03 led to a recovery in tax revenue increasing from an average 17 percent of GDP in 2001-03 to more than 18 percent in 2004. On the expenditure side, the authorities' strategy centered on controlling unjustifiable increases in public sector wages and streamlining of the executive branch (i.e., closing over 60 percent of vacant positions and cuts in non-essential unused budget allocations), while accommodating planned increases in pro-poor spending. As clearly shown in Box 3 of the staff report, the controls over the wage bill have been effective following tough negotiations with the unions in 2002. In 2003, congress approved a new wage policy oriented to reassert executive control over wage policies and restore equity between different groups of civil servants. Despite a prolonged strike by teachers in July 2004 that prompted a revision of the wage agreement with teachers, the authorities were able to maintain the downward trend in the public wage bill (as a share of GDP) as an indication of their commitment to a sustainable wage policy. All in all, the authorities find very encouraging that the combined distributional impact of the tax measures and spending reforms to date under the PRGF program has been strongly progressive as indicated by ongoing PSIA.

Regarding the poverty reduction strategy, the Honduran authorities have been very candid about the modest progress so far and their commitment to step up efforts to achieve the MDGs. Convinced on the importance of governance on the sustainability of the strategy, the authorities have concentrated their efforts in the promotion of greater fiscal transparency and expenditure management. In addition, the new Organic Budgetary Law lay down the legal framework for developing a MTEF, which as staff indicates, it should help to improve the linkages between budgetary programming and PRSP goals. The authorities are pleased that both Fund and IDA staff deemed tracking mechanisms and costing and financing of the PRSP as broadly appropriate.

The Central Bank has pursued a prudent monetary policy, tightening the liquidity resulting from the higher accumulation of international reserves. While policy interest rates have remained broadly unchanged since end-2003, the central bank stepped up the placements of short-term certificates to dampen inflationary pressures. In addition, to contain credit growth and limit banking system vulnerabilities, the authorities introduced temporary measures such as an investment requirement equivalent to 2 percent of total bank deposits, and reduced the existing prudential limit on banks' external borrowing relative to capital.

On financial sector issues, as confirmed by staff, the authorities made significant progress on reforming the legal framework, strengthening supervision and implementing a program to increase the solvency of the financial system. The steadfast implementation of the government reform program—along with the stable macroeconomic framework—has contributed to an overall strengthening and consolidation of the financial sector. The number of banks has been reduced from 21 in 2001 to 16 in 2004. The capital adequacy ratio of the banking system increased to 14.2 percent in 2004 (13 percent in 2003) while the NPL ratio declined to 6.4 percent in 2004 (8.7 percent in 2003).

Macroeconomic policies and structural reforms

Looking forward, the authorities' effort will focus on sustaining the fiscal consolidation process while increasing investment and social spending consistent with the PRS, and carrying on with needed reforms to make Honduras more resilient to shocks.

The authorities are aiming at a reduction in the combined public sector deficit to 2.5 percent of GDP while increasing pro-poor spending to 8.7 percent of GDP, in line with the original targets of the program. To achieve this, the authorities will not only enforce the new tax code but also undertake an ambitious tax administration reform to support the revenue efforts. So far, tax collection in January and February has exceeded government expectations while the tax office is being restructured.

On public expenditures, the authorities will upgrade the current financial management system (SIAFI) and introduce a single treasury account to enforce a strict control on government outlays. Regarding public sector wages, the government remains committed to the salaries law passed in December 2003 and the July 2004 wage agreement with teachers. In addition, a transition team will be appointed over the next few weeks to work closely with all parties to bring them up to speed on specific government actions and to stress on the need to avoid fiscal pressures on the year ahead.

Regarding monetary and exchange rate policies, the authorities' focus will be on the modernization of monetary operations and the recapitalization of the central bank. The authorities have identified, with assistance from MFD, a list of actions to improve the signaling to the market and manage both short and structural liquidity. This enhanced monetary framework constitutes a prior condition to greater exchange rate flexibility, flexibility that will undoubtedly facilitate the adjustment of the economy to shocks.

The authorities will continue its ambitions financial sector reform program. Following the comprehensive set of laws approved by Congress in September 2004, the National Banking and Insurance Commission (CNBS) is ready to enforce the new provisioning requirements and perform closer supervision of financial institutions. Particular attention will be given to address systemic financial issues such as the resolution mechanism for distress financial institutions.

The authorities remain committed to implement governance reforms, combat corruption and improve transparency. As reported by the World Bank[1], public sector financial management, civil service reform and judiciary reform are the areas where the authorities have focused most of their recent efforts to improve governance. While there still remain many systemic deficiencies that affect Honduras' overall investment climate, specific actions include the election of Supreme Court members under new provisions, elimination of the immunity for legislators and other public officials, simplification of administrative requirements to open up new businesses, and the appointment of the UNDP as the procurement agent to handle aid resources. Last week, congress approved the creation of an anti-corruption commission with ample representation from the civil society.

Finally, on behalf of the Honduran authorities, this Chair would like to reiterate its appreciation to management and staff for their decisive support in reaching the completion point under the enhanced HIPC Initiative. The authorities acknowledge that the program faces important challenges particularly as the political campaign moves on. However, the authorities are convinced that by reaching the completion point they will be able to garner additional public support for the pending agenda.

[1] *Honduras Development Policy Review*, World Bank, Report No. 28222-HO, November 8, 2004.