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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/64-2

10:05 a.m., July 15, 2019

2. Honduras—2019 Article IV Consultation and Request for a Stand-By Arrangement and an Arrangement Under the Standby Credit Facility

Documents: EBS/19/62 and Correction 1; and Correction 2; and Supplement 1; and Supplement 1, Correction 1; SM/19/169

Staff: Vesperoni, WHD; Corbacho, SPR

Length: 30 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors Alternate Executive Directors

| | |
|-------------------|----------------------------------|
| | A. Nainda (AE), Temporary |
| | H. Razafindramanana (AF) |
| G. Lopetegui (AG) | N. Heo (AP) |
| | P. Fachada (BR) |
| | Y. Zhao (CC), Temporary |
| | J. Suazo (CE), Temporary |
| L. Levonian (CO) | C. Just (EC) |
| | A. Castets (FF) |
| S. Meyer (GR) | M. Siriwardana (IN) |
| | F. Spadafora (IT), Temporary |
| T. Tanaka (JA) | |
| J. Mojarrad (MD) | P. Al-Riffai (MI), Temporary |
| | V. Rashkovan (NE) |
| T. Ostros (NO) | L. Palei (RU) |
| | F. Rawah (SA), Temporary |
| | K. Tan (ST) |
| | R. Makhhammadiev (SZ), Temporary |
| | T. Hemingway (UK), Temporary |
| M. Rosen (US) | |

C. McDonald, Acting Secretary
 E. Tsounta, Summing Up Officer
 E. Mannefred, Board Operations Officer
 L. Nagy-Baker, Verbatim Reporting Officer

Also Present

Asia and Pacific Department: P. Cashin. Fiscal Affairs Department: C. Alonso. Finance Department: M. Kida, M. Spinella, R. van Greuning. Legal Department: G. Otokwala, G. Rosenberg, I. Rossi, J. Swanepoel. Secretary's Department: J. Lin. Strategy, Policy, and Review Department: F. Arizala Escamilla, A. Corbacho. Western Hemisphere Department: N. Geng, J. Kapsoli Salinas, E. Vesperoni. Executive Director: H. Beblawi (MI), P.

Inderbinen (SZ), R. Kaya (EC), A. Mahasandana (ST), D. Mahlinza (AE), M. Mouminah (SA), S. Riach (UK), L. Villar (CE). Alternate Executive Director: S. Geadah (MI), A. Guerra (CE), I. Mannathoko (AE), A. McKiernan (CO), K. Merk (GR), P. Moreno (CE), M. Psalidopoulos (IT), F. Sylla (AF). Senior Advisors to Executive Directors: W. Abdelati (MI), P. Harvan (EC), J. Weil (CO). Advisors to Executive Directors: A. Arevalo Arroyo (CE), M. Bernatavicius (NO), M. Coronel (BR), A. Grohovsky (US), K. Osei-Yeboah (MD), M. Shimada (JA), D. Vogel (AG), S. Yoe (ST), J. Montero (CE), A. Sode (FF).

2. HONDURAS—2019 ARTICLE IV CONSULTATION AND REQUEST FOR A STAND-BY ARRANGEMENT AND AN ARRANGEMENT UNDER THE STANDBY CREDIT FACILITY

Mr. Villar and Mrs. Suazo submitted the following statement:

Aided by a Fund-supported economic program from 2014 to 2017, Honduras managed to secure macroeconomic stability, mainly by implementing a front-loaded fiscal consolidation and by laying the groundwork for a modern policy framework. Fiscal deficit was reduced by 7 percent of GDP in three years, and the 2016 Fiscal Responsibility Law, overperformed since its enactment, institutionalized fiscal prudence.

As an anchor to support the policy reforms, address the remaining challenges, and build on past gains, authorities have requested a new Fund program—to be treated as precautionary. The main objective of the program is to maintain macroeconomic stability while enacting economic and institutional reforms to foster inclusive growth aimed at enhancing the quality of fiscal policy, improving governance and the business environment. The main elements of the program include: (1) reforms to increase the quality of fiscal policy, mainly by securing financial sustainability of the public electricity company (ENEE) as well as sustaining revenue mobilization efforts and protecting investment and social spending, (2) continued progress to modernize the monetary policy framework, 3) efforts to strengthen governance and AML/CFT, bolster anti-corruption initiatives, and improve the business climate.

Fiscal Policy

The government's fiscal policy will continue to be guided by the FRL in coming years. This will be instrumental in maintaining confidence and keeping Honduras' risk premium low, reducing financing costs for the economy. Relatedly, in June 2019, Moody's maintained Honduras' rating at B1 with a stable outlook.

However, challenges in the fiscal front remain, in particular in the electricity sector, revenue mobilization, fiscal transparency and governance. The proposed program will help Honduras address these challenges.

Electricity Sector

Authorities are committed to address the long-standing challenges in the electricity public company, ENEE. The structural overhaul of the

electricity market is critical and represents a cornerstone in the authority's economic program. Because of its complexity, this will take time and be gradual. The general framework law of the electricity sector was enacted in 2014 (although still not fully implemented) a very positive development at this juncture as no further related legislation is pending in Congress. An important component of the overhaul is its implementation to achieve the rehabilitation and upgrading of the sector's infrastructure, including appointing the system operator in charge of managing the power grid to ensure reliable delivery of electricity, which will contribute to foster private investment. Notably, the first steps in this endeavor have already been taken.

All prior actions considered in the proposed program for the electricity sector reform have already been met. The periodic tariff adjustment aligned with the energy reduction cost were being modified before the program started, and the plans to secure financial sustainability for ENEE and to reduce electricity losses have been drawn out.

The reform plan is designed to include the following:

Unbundling of the company. As mandated by the electricity framework law and with technical support from the Inter-American Development Bank, ENEE will be unbundled into three independent companies—generation, transmission, and distribution. This segregation should improve governance, gradually facilitating needed investment in the electricity sector.

Addressing financial and generation issues. Authorities plan to reach market-friendly restructuring agreements with ENEE's creditors to reduce financing costs. Additionally, in strict adherence to the legal framework, they will seek a more efficient generation—including revision of approved contracts not yet in operation.

Reducing electricity losses. Authorities will review the strategy to reduce electricity losses both in transmission and distribution. As part of this, they will (i) revise, following due process, the contract with Empresa Energía Honduras (EEH)—the operator of the distribution system—to strengthen an effective loss-reduction plan; (ii) deploy a law enforcement task force to prevent theft and fraud; and (iii) continue upgrading the metering infrastructure.

Authorities are conducting a full review of arrears that ENEE has accumulated to private operators and will gradually clear them.

Revenue Mobilization

The authorities are committed to maintaining the gains of the recent revenue mobilization efforts which will require several tax policy and administrative measures, such as: (i) streamlining exemptions while protecting the poor; (ii) propose legislative changes to return control and verification procedures for tax exemptions -now held by the Ministry of Finance- to the Tax Administration Office (SAR). Additionally, the creation decree for the new customs administration (temporarily COPRISAO) will be enacted, an electronic notification procedure for taxpayers will be introduced, and SAR's systems will be upgraded to modernize based on timely tax refunds. Furthermore, SAR, the Ministry of Finance, and COPRISAO will sign an agreement at the end of July to share information on a timely basis.

Fiscal Transparency and Trust Funds

Authorities are committed to enhancing the quality of public expenditure and will implement the recommendations of the Fiscal Transparency Evaluation (FTE) recently conducted by the Fund, which will be published shortly. Benchmarking of Honduras' reporting, projections and risk management against the Fund's fiscal transparency code suggests that most practices are consistent with the FTE, but it helped identifying areas for improvement, notably regarding trust funds.

On trust funds, authorities will take steps to transfer well-established programs to the budget and include an annex on spending by trust funds in the 2020 budget proposal to Congress. Also, a mandatory assessment by the Ministry of Finance will be set up as a pre-condition for contracting debt by trust funds. Starting with the 2021 budget, authorities will present a plan to execute spending currently channeled through social and infrastructure trust funds under full public financial management regulations.

Governance and Procurement

Technical assistance on governance that included issues such as procurement and the selection of public investment projects ended in June 2019. The authorities, committed to strengthening governance, plan to evaluate the recommendations and develop a plan to address them which will be discussed during the first review of the program.

Monetary Policy

The Central Bank of Honduras (BCH) stands ready to maintain inflation within the target range (as it did in January 2019 when it hiked the policy rate, the first time since 2012) and to maintain an adequate level of international reserves. BCH authorities will continue to improve the operational framework for conducting monetary policy, seeking the implementation of full-fledged inflation targeting in coming years. To meet this goal, a new central bank charter will be submitted to Congress by December 2019, supported by continued technical assistance from the Fund. The new charter aims to safeguard operational autonomy, increase transparency and accountability by making price stability the policy mandate of the BCH, introducing the International Financial Reporting Standards, securing a sound central bank governance structure, and clarifying responsibilities for operational, oversight and policy decision.

As of May 2019, Honduras has liberalized 30 percent of the foreign exchange market. The exchange rate policy will include gradual steps towards a flexible exchange rate regime. A plan will be presented for the gradual removal of the remainder 70 percent foreign exchange surrender requirements (obligation to sell export proceeds to BCH) by December 2019.

As part of the transition towards full-fledged inflation targeting, authorities are working to improve statistics on pricing and economic activity that are critical for monetary policy decision making. Authorities will complete the National Household Income and Expenditure Survey by September 2020, with the goal of publishing a new consumer price index by December 2021. Additionally, a new national accounts series will be published by December 2021, rebasing the national accounts series to 2016.

Financial Policies

The supervisory authority has continued to improve regulatory framework and supervisory practices in line with the FSSR recommendations and the Basel III standard. It plans to establish a timeframe for the introduction of an additional capital charge for systemic banks, assess improvements to the investment policy framework of public pension funds and will work with Congress to approve a new securities market law to support the development of domestic capital markets. It will remain vigilant to tightening the macro-prudential framework depending on the evolution of credit growth, especially in foreign currency. It is worth noting that, as projected by authorities, foreign currency credit from the banking system to

the private sector has decelerated in 2019, reaching a y/y growth of 9.3 percent in May 2019 down from a high of 21.5 percent in August 2018.

The public agricultural development bank (BANADESA) was created by a special law that limits the actions of the supervisory authority, and its financial deterioration has been brought up to Congress for several years now. The reforms made to the new Financial Sector Law in 2017, provided new tools that made it possible for the supervisory authority to seize BANADESA's administrative and operational control to protect depositors and operations. The authorities will follow the procedure envisaged in the financial sector law, which requires the CNBS to submit a report to Congress, including a proposal to address the financial situation of the bank by September 2019.

Social Policies

Reducing the high poverty rate is one of the main objectives of the current government, accordingly, it will expand its flagship cash-transfer program "Bono Vida Mejor", (aimed at covering population in extreme poverty by end-2021) which according to a study done by the IDB has been successful in reducing the intergenerational transmission of poverty. Significant and ongoing progress in the fight against violence over the last years has resulted in a sharp decline in violent crime, but this continues to be a challenge. Both high poverty and violence aid fueling migration; to counter these authorities have assigned a task force within the state department, the Social Development Ministry, and the Human Rights Ministry to articulate a comprehensive effort to assist potential and returning migrants, which is going to complement the FOSMIH -an existing fund to support Honduran migrants.

As raising female labor participation is critical to boost potential growth, the authorities' strategy will combine new programs with ongoing initiatives to improve opportunities for women by supporting childcare services, facilitating credit for women, and supporting women with young children.

Business Environment

To foster the private sector, ongoing administrative simplification and a one-step window are being implemented for international trade. Furthermore, legislation requiring public regulatory agencies to streamline and advertise requirements for obtaining permits, and to reduce discretion and

speed up approvals will be submitted to Congress. Additionally, to simplify public administration procedures, electronic signature will be introduced.

The supervisory authority has continuously strengthened their AML/CFT framework following recommendations of the Financial Action Task Force of Latin America (GAFILAT). In line with this, coverage of Designated Non-Financial Businesses and Professions (DNFBPs) will be expanded. Additionally, a plan for identification of shareholders and beneficial owners of incorporated companies for AML/CFT purposes, is being evaluated.

Trade Policy

Honduras and Guatemala are part of a customs union that went into effect in 2016 and allows free circulation of around 80 percent of goods traded between the two countries; El Salvador joined the union in August 2018. The customs union will support greater integration among these countries. Honduras is also strengthening its ties with Asia-Pacific economies, recently finalizing a free-trade agreement (FTA) with South Korea that is likely to come into effect by end 2019.

Final Remarks

Supported since 2014 by a Fund program that expired in 2017, Honduras made great strides in reducing macroeconomic imbalances and improving confidence, institutionalizing fiscal prudence and strengthening its policy framework. To build on previous achievements and make progress in solving long-standing issues, authorities have requested a new Fund program -precautionary – as an anchor to support reforms and address remaining vulnerabilities and risks, including still high level of poverty, the deteriorating financial situation of ENEE, and the continued need to strengthen the macroeconomic policy framework, and improve governance and the business environment. On behalf of our Honduran authorities, we thank staff, Management and the Executive Board for the consideration of this program.

Mr. Obiora and Ms. Nainda submitted the following statement:

We support the authorities' request for a Stand-By Arrangement (SBA), a Stand-By Credit Facility (SCF), and the associated decisions. Driven by public investments, exports and higher remittances, Honduras' economic recovery continues to make progress since the 2008 financial crisis. The

authorities' prudent policies supported by a three-year Fund program reduced macroeconomic imbalances, institutionalized fiscal discipline, and recalibrated the monetary policy framework. Despite these favorable outcomes, the country's economic outlook still faces major challenges, with over 60 percent of the population living in poverty. Given the strong commitment to address these challenges going forward, we believe that the recommendations of staff, which we broadly agree with, as well as the support provided under the SBA and SCF will be critical during the ensuing periods.

We welcome the role of the country's Fiscal Responsibility Law (FRL) in anchoring the improvement in the fiscal position. It is critical that the financial situation at the state-owned National Electricity Company (ENEE) is resolved using a comprehensive plan that addresses longstanding issues and restores its financial sustainability. In this context, we are encouraged by the authorities' commitment thus far in meeting all prior actions for the electricity sector reform, as documented in the buff Statement by Mr. Villar and Mrs. Suazo. Notwithstanding the large informal sector, we commend the authorities' progress in institutionalizing and improving domestic revenue mobilization over the past few years. Reflecting statutory rates, tax revenue collection ratios are relatively high compared with peers in the region. Nevertheless, we see merit in pursuing further boost to tax revenues through strengthening efficiency and compliance. That said, the Selected Issues Paper (SIP) indicates that the threshold for companies liable to minimum Corporate Income Tax (CIT) is set to double from \$12 million in 2018 to \$24 million in 2019 and further to \$40 million by 2020. Could staff comment on the rationale behind, and impact of, these somewhat sharp increases in the threshold?

Strengthening the institutional foundation for inflation targeting (IT) should remain a key objective for the monetary authority. We are encouraged by efforts to build on recent progress toward the implementation of a fully-fledged inflation targeting framework and look forward to the finalization of the new central bank charter, a critical component in the deployment of IT. The authorities' commitment to gradually transition towards a flexible exchange rate regime appears strong. In this regard, we concur with staff that a more flexible exchange rate regime would help buffer against external shocks, especially since Honduras is susceptible to terms-of-trade and other external shocks. We note that the previous safeguard assessment flagged the need for adopting International Financing Reporting Standards (IFRS) but its implementation has been significantly delayed. Could staff explain the main obstacles faced by the Central Bank of Honduras (BCH)

in implementing IFRS, and whether the authorities are requesting Fund TA in this regard?

It is imperative to tackle structural impediments towards realizing inclusive and sustainable growth. We welcome authorities plans to prioritize spending on high-impact interventions aimed at alleviating poverty and promoting human capital investment. Sustained investments in education and agriculture are critical in this respect, given that a large share of the poor are uneducated and depend on agriculture for their livelihoods. We applaud the authorities for their efforts to fight crime and violence, which has borne positive fruits in recent years. Yet, Honduras continues to have one of the highest rates of gang-related violence in the world. This therefore highlights the need for further efforts to address this social evil, which remains one of the main impediments to sustained foreign investment in the country. We also welcome authorities' resolute determination to tackle governance issues and improve the business climate, as these would be a fillip for increased private sector participation in, and contribution to, economic activities in the country.

Mr. De Lannoy, Mr. Fanizza, Ms. Levonian, Mr. Spadafora, Mr. Weil and Ms. Harutyunyan submitted the following joint statement:

We thank staff for the informative report and Mr. Villar and Ms. Suazo for their candid buff statement. Given the authorities' actions and strong commitment to the new economic program, we support their request for the SBA/SCF arrangements.

Amid a favorable growth outlook, Honduras' authorities should capitalize on recent attainments on macroeconomic stabilization and fiscal consolidation to overcome structural impediments, with a view to achieving faster and more inclusive growth and, ultimately, a further reduction in poverty and inequality.

The new Fund program requested by the authorities – which they intend to treat as precautionary – can be instrumental in supporting much-needed economic and institutional reforms while maintaining a prudent fiscal policy and strengthening the social safety net.

In this regard, the macro-criticality of the public electric company (ENEE) stands out, given its pervasive adverse impact on economic and fiscal outcomes. It is regrettable that the deceleration in growth projected for this year is to some extent a by-product of ENEE's financial problems and their impact on public investment. We thus share the focus in program

conditionality on measures to secure ENEE's financial sustainability, which will also create fiscal space for investment and social spending, including through targeted cash transfers to protect the poor. Continued efforts at revenue mobilization – through a broadening of the tax base and reduction of tax exemptions – remain critical (as well-documented in the interesting SIP) to complement the all-important, multi-faceted reforms in the electricity sector.

We note staff's emphasis on these reforms – centered on a new tariff scheme to restore ENEE's financial sustainability – as a key source of domestic risks, given their complexity and implementation challenges. Given the significant adjustment in electricity tariffs of last October, we ask staff to share their views on the scope for further increases, which will very likely face political and social resistance.

The banking system is stable and well-capitalized, but the acceleration of credit growth – particularly in foreign currency – deserves specific attention, although is partially related to ENEE's financial constraints. In this regard, the ceiling on the accumulation of domestic arrears by ENEE is appropriate to avoid excessive credit growth and facilitate the allocation of credit to strategic projects that can help diversify the economy and reduce its dependence on a single commodity export.

Recent actions by the central bank (BCH) aimed at curbing a resurgence of inflation are instrumental in facilitating a convergence of inflation and inflation expectations toward the midpoint of the BCH's target band. The implementation of the recapitalization agreement between the BCH and the Treasury is a welcome step toward a further strengthening of the monetary policy framework in its gradual transition toward inflation targeting and a more flexible exchange rate. The planned submission of a new BCH charter – which includes a clear price stability mandate – will contribute to improve governance, operational autonomy and accountability.

We stress the importance of the reforms to improve governance, transparency and anti-corruption initiatives. We thus welcome the authorities' initiatives in the area of public finance management and commend them for developing a national AML/CFT strategy, which should be further strengthened in line with GAFILAT's recommendations.

Finally, we very much welcome the program's focus on bolstering gender equality. In particular, planned programs to help create employment opportunities for women, especially young mothers, are appropriate to address

Honduras' low female labor participation rate, which lies below the regional average.

Mr. Ostros and Mr. Bernatavicius submitted the following statement:

We thank staff for the set of reports and Mr. Villar and Mrs. Suazo for their informative buff statement. Significant progress has been achieved in recent years in stabilizing the economy and strengthening its institutional framework. Nevertheless, business climate and institutional quality should be further improved and the fight against corruption stepped-up. Informality, poverty, and gender inequality remains high and social the safety net too thin. We welcome the authorities' comprehensive reform agenda and support the request for SBA/SCF arrangements for SDR 224.8 million. We would like to offer the following points for emphasis.

Honduras performs well in terms of tax collection, but there is room for further improvements. We welcome the authorities' plans to broaden the tax base, as tax exemptions remain the largest in the region. It is indispensable to enhance transparency of the public budget and put the financial situation of the main public electricity company (ENEE) on a sustainable path. A very useful analysis in the selected issues paper shows, that if tax inefficiencies were removed, Honduras could increase tax collection by about 4 percentage points of GDP. In addition to this, some elements in the current tax policy, such as large and periodically extended tax amnesty, and a 5 percent CIT surtax to the most profitable companies, could create negative economic incentives. Staff comments would be welcome.

We welcome the authorities' plans to continue a gradual transition towards inflation targeting and a flexible exchange rate regime. The governance of the central bank (BCH) and monetary policy framework should be further enhanced and strengthened. We strongly welcome the authorities' plant to submit a new legislation to Congress by December 2019, which should strengthen the BCH's operational autonomy and increase its transparency and accountability. The implementation of the BCH's recapitalization agreement signed with the treasury should further strengthen the central bank's institutional independence.

Governance and institutional reforms are crucial to reduce the widespread corruption and strengthen growth prospects. We support anticorruption initiatives and strongly encourage the authorities to implement measures to improve the business environment. We also urge the authorities to

continue strengthening the AML/CFT framework in line with GAFILAT's recommendations.

Poverty and gender inequality remain one of the most important policy challenges. We urge the authorities to implement a more inclusive economic growth agenda by protecting social spending and providing better opportunities for women to access education and enter labour markets.

Mr. Meyer and Mr. Fragin submitted the following statement:

We thank staff for the informative report and Mr. Villar and Ms. Suazo for their helpful buff statement.

We agree to the request for a SBA/SCF arrangement that the authorities intend to treat as precautionary due to a lack of a BOP need. We acknowledge that the previous Fund-supported program has yielded fruit in terms of macroeconomic stability and confidence building, though challenges remain. The new program could help to lock in macroeconomic stability gains, advance further economic and institutional reforms and build buffers while strengthening the economy's resilience vis-à-vis global risks associated with large swings in energy prices.

Prudent budgets complemented by deeper reforms are necessary for maintaining a sustainable fiscal path. We welcome the authorities' expressed commitment to compliance with the Fiscal Responsibility Law, which has helped curbing the fiscal deficit. While revenue mobilization has developed favourably until 2016 before further progress stalled in 2017, it remains important to consider further reductions of undue tax exemptions, in particular those with highly unequitable features. Improving transparency and governance of all public spending, including trust funds, and allowing the treasury to exercise effective control over spending entities to ensure sound public financial management practises should also feature prominently on the authorities' agenda. The program duly defines priority social spending to preserve hard-won social achievements and to empower citizens through human capital investments.

A sustained improvement in the overall fiscal position will remain difficult in the absence of comprehensive reforms in the electricity sector. We agree with staff that the energy sector is in urgent need of reform, including the governance of the state electricity operator ENEE. Overall, the reform elements presented by the authorities appear promising. We are, however, not fully convinced that maintaining price subsidies for low-consumption

households is an adequate way to support the poor. Referencing the subsidy to electricity consumption per month runs the risk of both benefitting better-off households using electricity sparingly and missing poor households with many members and therefore higher consumption. Protecting affected vulnerable households by targeted compensatory measures embedded in the social safety net would thus seem preferable. Staff comments would be welcome. In addition, we would be interested in whether the reform package also foresees repealing the decrees exempting various entities from paying their electricity bill, as mentioned in Box 2?

Strengthening the central bank's operational autonomy and governance are important elements backing the transition towards inflation targeting. In this context, it will also be important to cautiously proceed towards greater exchange rate flexibility and to design and implement such a process being mindful of potential risks and pitfalls.

We take positive note of the banking sector's robustness as evidenced by its resilience to a broad range of shocks. It is also reassuring that staff considers the problems of the agricultural development bank BANADESA as not posing systemic risks. Alertness is needed towards FX risks with a view to put dollarization of private borrowers on a downward trend in the medium to long run. We also appreciate the authorities' commitment to strengthening the AML/CFT framework and making compliance more effective.

We encourage the authorities to address shortcomings in the business climate. Limiting undue administrative discretion contributes to legal certainty and enhances the public sector's accountability. Plans to streamline administrative procedures and revise standards in public service delivery that allow easing pressures on business and citizens are particularly welcome. We also concur with staff on the importance of supporting female labor force participation. Furthermore, with violent crime being a drag on economic activity, efforts to uphold the rule of law are critical.

We would be interested to what extent the tightening of migration policies in major host countries is having an impact on remittances?

Mr. Lopetegui and Mr. Vogel submitted the following statement:

We thank the staff for the report and Mr. Villar and Mrs. Suazo for their helpful buff statement.

Considering Honduras's positive economic trend, the authorities' commitment to continue reinforcing macroeconomic policies, improving social policies, and pushing structural reforms, as well as the staff's assessment about the country's capacity to repay the Fund, we support the authorities' request for a Stand-By Arrangement and an Arrangement under the Standby Credit Facility. The fact that the authorities intend to treat the program as precautionary provides a good signal.

We welcome Honduras' progress over the past years. Taking advantage of the three-year IMF-supported program, and based on prudent policies, the country has been able to exhibit solid growth rates, a substantial reduction of overall fiscal deficit (from 7.5 percent of GDP in 2013 to about 4 percent in 2014 and to less than 1 percent currently), stable debt ratios, and relatively healthy financial indicators. However, much remain to be done on many areas. To cite one of the many challenges Honduras faces, it is the poverty ratio of 60 percent which has been at those levels for more than twenty years, as underlined in the staff report. As noted by Mr. Villar and Mrs. Suazo, high poverty and violence fuel migration, which has hurt Honduras' potential growth. Thus, the authorities' efforts should aim to achieve a virtuous cycle of better quality of policies and institutions, good governance, reducing corruption, inclusive growth, less violence, giving more incentives to citizens to remain in the country and return from abroad. We think that the main objective of the program and its elements noted in the buff statement, will contribute to this cycle.

We are encouraged by Honduras' progress in terms of revenue mobilization, a key development to meet the country's substantial needs in the social and infrastructure areas, among others. Chapter on Revenue Mobilization in the Selected Issues report illustrates the significant challenges Honduras is facing, among which are the very high level of tax expenditure. Staff rightly suggests to undertake a cost-benefit assessment of existing tax exemptions vis-a-vis their objectives. As clearly noted in Box 1 of the report, the gains in terms of tax collection that Honduras may get in case of closing efficiency gaps. Therefore, we welcome the authorities' intentions to streamlining exemptions while protecting the poor, and other legislative measures aimed at addressing the above-referred fragilities. At the same time, we note that a new tax code may tend to weaken institutions, incentives to pay, and thus tax collection and, in this regard, we would like a further elaboration from staff on the reasons of these tax policy measures. Measures aimed at improving transparency and governance in public spending are also critical.

As underlined in Box 2 of the report, the financial situation of the public electricity company is a matter of concern. The authorities rightly focus on this issue, and their commitment to address the related challenges are demonstrated by the implementation of all prior actions on the electricity reform, and their ambitious plan.

We note the staff's comments in Box 3 that empirical evidence suggests that Honduras could benefit from exchange rate flexibility, but, at the same time the staff poses a right dose of caution by alerting that risks from balance sheet vulnerabilities and a high exchange rate pass call for a gradual approach. Therefore, the authorities' approach, liberalizing 30 percent of the foreign exchange market, leaving to remove the rest by the end of the year, seems to be headed in the right direction. In any case, is it strictly necessary to eliminate surrender requirements to achieve exchange rate flexibility? Staff comments will be welcome.

We welcome the efforts aimed at improving governance and reducing corruption, all of which will contribute to foster inclusive growth. We are also encouraged by the country's right steps towards strengthening trade ties with its neighbors and with Asia-Pacific economies. As noted in the report, assistance to migrants is also important in the social agenda; the best policy in this regard, as noted above, is to create proper and durable incentives to stay, all related to economic growth and social improvements.

With these comments, we wish Honduras and its people every success in their future endeavors.

Mr. Inderbinen and Mr. Makhammadiev submitted the following statement:

We support the authorities' request for the SBA/SCF arrangements. We welcome the significant progress in strengthening the policy framework that the authorities have made under the previous Fund program. The program resulted in macroeconomic stabilization, with a restored fiscal stance, a more sustainable path of public debt, and an enhanced monetary policy framework. Nevertheless, corruption, weak rule of law, high poverty and widespread violence remain major challenges. A new Fund-supported program should appropriately target the root causes of Honduras's growth impediments and facilitate the implementation of reforms buttressing inclusive growth.

We encourage the authorities to reinforce fiscal discipline. In view of the large financing needs for investment and social spending, the authorities should preserve the higher tax revenues achieved in recent years. We are

concerned that the new tax code may weaken enforcement. Tax expenditures have reached an alarming rate and should be curtailed. Strengthening of the revenue envelope will hinge on eliminating tax exemptions, broadening the tax base and streamlining statutory rates. We also encourage the authorities to continue improving fiscal governance to protect spending on education, health and infrastructure from corruption and misuse. We welcome the completion of the Fiscal Transparency Evaluation and the authorities' commitment to implement its recommendations.

We call on the authorities to strengthen governance and press ahead with structural reforms, including in the electricity sector. Weak governance in the electricity sector has led to severe deterioration of ENEE's financial position. We take positive note that all three prior actions for the electricity sector reform have been met, as noted by Mr. Villar and Mrs. Suazo in their helpful buff. Further efforts should focus on the clearance of ENEE's arrears to private generators, a restructuring of the company, the reduction of electricity losses, and the further reforms necessary to bring the sector in line with the international best practice.

We welcome the modernization of the monetary policy framework. The planned institutional reforms to strengthen BCH's autonomy, governance and mandate are encouraging. To facilitate transition to inflation targeting, the authorities should phase out the remaining foreign exchange controls and allow exchange rate flexibility. Credible monetary policy, complemented by a liberalized FX market, would contribute to lowering the high rate of dollarization. The acceleration in FX credit, which is mainly allocated to unhedged borrowers, calls for vigilance and the readiness to take macroprudential measures.

We urge the authorities to step up their fight against corruption. Combating corruption and impunity, as well as ensuring judicial independence, are critical for addressing structural poverty and violence in Honduras. The anti-corruption action plan that the authorities intend to develop in collaboration with staff should include bold and concrete measures demonstrating reform commitment. Strong action to combat corruption would also critically improve the business climate and donor sentiment.

We encourage the authorities to expand the social safety net judiciously. We take positive note of the authorities' intention to expand social programs through well-targeted cash transfers and similar programs, as described in the MEFP. Social safety nets are clearly critical as a short- and medium-term measure in alleviating poverty. Spending of safety nets has by

necessity to compete with other social expenditure and is not, in and of itself, sufficient to generate higher growth over the long term. Also, social safety nets should not be misused for short-term political ends.

Mr. Tan and Ms. Yoe submitted the following statement:

We thank staff for a well-written report, and Mr. Villar and Mrs. Suazo for their informative buff statement.

Honduras has made significant progress in achieving macroeconomic stability, reducing its fiscal deficit and strengthening its institutional and policy framework. Much of this can be credited to the authorities' steadfast commitment and decisive action in implementing ambitious reforms. However, challenges remain for the country, and we welcome the authorities' economic program to maintain macroeconomic stability and foster inclusive growth. A new Fund program will complement and support the authorities' push for economic and institutional reforms. Given staff's assessment that the economic plan is well designed and the authorities' strong commitment to follow through on the reform agenda, we support the request for SBA/SCF arrangements and the proposed decisions.

We encourage the authorities to accelerate reforms in the electricity sector, so as not to lose the hard-won progress in consolidating public finances. The authorities' efforts to institutionalize fiscal prudence through the enactment of the FRL has yielded results for fiscal consolidation. The NFPS deficit stayed below the FRL ceiling for three consecutive years, which has helped to put public debt on a more sustainable path. Prudent macroeconomic policies have underpinned economic recovery and market confidence. In this regard, we welcome the continued efforts to maintain revenue mobilization with a broadening of tax base and reduction of tax exemptions. However, the deteriorating financial situation of ENEE is putting a strain on public finances, and weighing on fiscal resources for public investment. While the authorities have laid the foundation for a structural overhaul of the electricity sector, by enacting the general framework law of the electricity sector, the process will take time given the complexity. We take comfort from the ambitious plans set out and we encourage the authorities to accelerate efforts to restructure ENEE and reduce electricity losses.

A gradual transition towards inflation targeting and a flexible exchange rate regime will help the economy to buffer shocks better. The authorities have outlined a clear plan to modernize its monetary policy framework and are taking steps towards it. They have also liberalized the

foreign exchange market and will be gradually removing the 70 percent foreign exchange surrender requirements. We trust that the transition will be smooth and on track, as the authorities have shown themselves to be clear-sighted on the end goal and are confident in achieving it. We also take comfort from the authorities' readiness to take further policy actions to maintain inflation within the target range, should there be changes in global financial conditions or domestic inflationary pressures.

Although the banking system is broadly resilient to shocks, pockets of vulnerabilities warrant closer monitoring. Strong FX credit growth and the high proportion of unhedged FX borrowers warrant close monitoring. It is also important to move the investment policy framework for public pension funds towards international best practices to ensure good governance and sustainability of the funds. We also encourage the authorities to continue to address the financial situation of BANADESA. Although the agricultural development bank does not pose systemic risk given its relatively small size and modest interlinkages with the rest of the banking system, it is important to ensure that the weak financial position of BANADESA does not weigh on access to credit for small and medium agricultural producers.

We welcome the authorities' social agenda to address high poverty and inequality. Despite the improvement in macroeconomic outlook, Honduras continues to be one of the poorest countries in the region, with poverty level at 60 percent. We are pleased to note that priority social spending is protected, and the authorities continue to provide support and protection for the poor even amid the push for fiscal consolidation.

With these remarks, we wish the authorities the very best in their reform efforts.

Mr. Heo and Mr. Kim submitted the following statement:

We thank staff for the report and Mr. Villar and Mrs. Suazo for their informative buff statement. We welcome that Honduras' continued prudent macroeconomic policies have reduced macroeconomic imbalances. Despite a generally positive medium-term outlook, it is still important to maintain macroeconomic stability while also creating the conditions for inclusive growth. We agree with the thrust of staff's recommendations and make the following comments for emphasis.

We support the request for a Stand-By Arrangement and an Arrangement under the Standby Credit Facility. Honduras faces challenges on

reform in the electricity sector and reduction of poverty and inequality. However, Honduras completed a similar three-year Fund-supported program successfully. While economic performance is close to potential, reserve adequacy is around 110 percent of the Fund's Reserve Adequacy Metric. It is also noteworthy that the authorities intend to treat this arrangement as precautionary. Against this backdrop, could staff elaborate on why SBA/SCF agreements have an advantage over the Fund's non-financial Policy Support Instrument?

Continued prudent fiscal policies are required to achieve the fiscal space to address Honduras' social needs. We note that nearly 60 percent of the population are living in poverty and 40 percent in extreme poverty. A successful reform in the electricity sector is essential to create fiscal space to increase targeted pro-poor spending and strengthen the social safety net. In this vein, we concur with staff that a strong political will and reliable regulatory framework for the electricity sector are critical to successful reform. We acknowledge that Honduras has made considerable progress in revenue mobilization and tax collection ratios are higher than that of peers. We still encourage the authorities to rationalize large tax expenditures and restore criminality to tax fraud.

The acceleration in private credit should continue to be monitored carefully and greater exchange rate flexibility must be the first line of defense to external shocks. We see rapid credit growth as a normal transition to financial deepening, but excess FX credit may point to emerging risks to financial stability. We agree with staff that a gradual transition toward a more flexible exchange rate regime will be instrumental to buffer external shocks given the large amount of remittance and volatile international price of coffee and oil. We would appreciate it if staff could elaborate on the track record of Honduras' access to international financial market (e.g. borrower, size, frequency, spreads etc.) and staff's view on its future condition of market accessibility.

Structural reforms should include a focus on improving governance and fostering inclusive growth. We welcome the authorities' commitment to improving the rule of law, strengthening anticorruption, and enhancing gender equality. Particularly, we encourage the authorities to make further improvements to female labor participation as Honduras is still below the regional average.

Mr. Beblawi and Ms. Al-Riffai submitted the following statement:

We wish to thank staff for their report and Mr. Villar and Mrs. Suazo for their buff statement. The Honduran authorities have made significant progress in stabilizing the economy and strengthening the foundations for sustainable growth since 2014. Building on these gains, which were supported by a Fund program, the authorities have requested a new precautionary Fund program to maintain macroeconomic stability and foster inclusive growth. With persistent poverty that is related to large informality and violence, the program appropriately addresses governance issues, while protecting the poor and promoting gender equality. We broadly concur with the staff appraisal and support the proposed decisions.

Honduras has made substantial progress on revenue mobilization, over the past five years, which has helped to stabilize the fiscal position, a noteworthy achievement given the size of the informal economy. However, Honduras has one of the highest tax expenditure levels in the world, which not only adversely affects revenue receipts, but also hinders a fair business environment. We are encouraged that the authorities aim to broaden the tax base and strengthen tax administration. We also support their plan not to offer new tax amnesties or widen the scope for rescheduling tax liabilities under the current regime and would encourage them to assess existing tax exemptions/amnesties.

The banking system is stable, liquid, and well capitalized, and NPLs are at record-low levels. We positively note the authorities' implementation of Basel III standards. We also welcome their monitoring of private credit growth. The authorities plan to address the financial situation of BANADESA, the agricultural development bank, which is currently under severe financial distress. How will the bank's resolution plans affect the agricultural sector and the economy?

The authorities plan to address the structural challenges in the electricity sector, through the implementation of the 2014 electricity sector general framework law. We note that despite efforts during the previous Fund-supported program, ENEE's financial situation has continued to deteriorate. We commend the authorities on the recent progress toward securing the financial sustainability of ENEE.

We wish the authorities success in their economic program.

Mr. Fachada and Mr. Coronel submitted the following statement:

We thank staff for the reports and Mr. Villar and Mrs. Suazo for their insightful statement. We support the request by the Honduran authorities for a 2-year blended Stand-By Arrangement (SBA) and Stand-By Credit Facility (SCF), aimed at strengthening macroeconomic stability and supporting Honduras's ongoing economic and institutional reforms agenda. We take note that the authorities have indicated their intention to treat the arrangement as precautionary, as was the case of the previous 3-year SBA/SCF program that expired in December 2017.

Real growth has remained robust despite losing momentum since 2017. Over the period 2015-2017, real GDP growth averaged 4.2 percent as the economy strengthened under the previous IMF-supported program. Growth moderated to 3.75 percent in 2018 and it is expected to decline further to about 3.4 percent this year. That said, the economic performance in Honduras will continue to be closely associated with the US business cycle due to strong trade and investment linkages, as well as worker's remittances. Despite downside risks, the medium-term outlook remains positive, underpinned by stronger macroeconomic fundamentals and structural reforms. Accordingly, we believe that the timely actions under the envisioned reforms agenda to improve infrastructure and human capital formation, enhance the rule of law, fight corruption, and further improve the investment climate will be key in sustaining long-term growth and improving the living standards of the Honduran people.

Fiscal discipline is underpinned by the fiscal responsibility law (FRL) and the authorities' strong commitment to macroeconomic stability. Against the background of the new tax code and the phasing out of the minimum income tax, we commend the authorities for abiding to the FRL parameters, adopting a conservative approach to spending and boosting revenue mobilization by eliminating tax exemptions and tackling tax evasion. Finalizing the restructuring plan for the state-owned electricity company ENEE is key to the program success. We welcome the reforms to resolve the structural challenges in the electricity sector and to ensure that finances of ENEE are put on a sustainable path. While increasing operational efficiency and reducing commercial losses of ENEEs will take some time, it would provide much-needed fiscal space for public investment and social spending.

Inflation remains well-behaved, within the target band of the Central Bank of Honduras (BCH). We agree with the program's objectives to further enhance monetary policy and strengthen the transmission mechanism.

Monetary policy should continue to focus on keeping inflation within the target band and maintaining international reserves at a comfortable level. This would support the move towards an inflation targeting regime. We take note that the financial system remains broadly stable, liquid, well-capitalized, and with NPLs at historic lows.

Security in Honduras has improved markedly but remains macro-critical and an obstacle to long-term growth, foreign investment, and social stability. We commend the authorities for their efforts in significantly reducing homicides, but more needs to be done to converge to the regional average. We encourage the authorities to continue their policies and initiatives on this front. Job creation and strengthening the social safety net would also contribute to fostering a safer, more stable socioeconomic environment.

In closing, we wish the authorities success in program implementation and praise their ongoing commitment to sound macroeconomic policies to generate more inclusive growth and economic development.

Mr. de Villeroché, Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their documents and Mr. Villar and Ms. Suazo for their insightful buff statement. While Honduras made significant progress over the last years in terms of macroeconomic policies, the country is still facing tremendous challenges, notably high poverty level, violence and a weak rule of law. We support the authorities' request for the SBA/SCF arrangements since this program will help the country to maintain macroeconomic stability and to implement the reforms warranted to tackle the country key economic bottlenecks. While we agree with the thrust of staff report, we would like to make the following points for emphasis:

Deepening past reforms of the fiscal, monetary and financial policy frameworks is essential. The achievements of the last few years brought back investors' confidence and improved financial conditions for the State and the economy at large. Public revenues gains achieved through reforms of the tax system need to be preserved as it will help to finance much-needed public investments and social spending. Reducing tax expenditures and modernizing the revenue administration could bring additional valuable resources to the State while improving economic efficiency. One of the key challenges for the authorities is to demonstrate that enhanced domestic revenue mobilization efforts will translate into concrete benefits for Hondurans. Improving fiscal transparency and public expenditure management could help in this direction. Regarding monetary policy, progress achieved since the last program will help

to improve macroeconomic stability and paves the way for the adoption of a flexible exchange rate regime.

While we support the roadmap established by the program to reform the electricity sector, we urge staff and the authorities to carefully sequence the phasing in of the new electricity tariff and the strengthening of the social safety nets for the most vulnerable. Given the difficult social climate and complex political context, it is of the utmost importance that the authorities, and by extension the IMF through this program, carefully implement these difficult reforms without neglecting their social impact. As highlighted during the recent discussion on the Fund strategy for social spending, communication will be key. Could staff elaborate on the concrete timing of these reform and provide more details about the incidence of the tariff reforms (in terms of disposable income and by revenue deciles) as well as of the one of the compensation measures?

Fostering inclusive growth through ambitious governance reforms is crucial to bring back social stability. Current political polarization indeed stems from a widespread perception of corrupted institutions and misuse of public money. We are encouraged by the authorities' willingness to address these issues and we welcome the commitment to conduct a governance diagnostic with the Fund before the 1st review. Could staff detail how this diagnostic will be realized and under what form it will be reported? In parallel, we also very much agree with the authorities that reducing the high level of inequality is essential to obtain the political buy-in for ambitious structural reforms. While we agree with the authorities' commitment to expand social spending and enhance gender equality, we also encourage the authorities to ensure that the most affluent members of society contribute to their fair share of the national effort.

Ms. Riach and Mr. Hemingway submitted the following statement:

We thank staff for their papers and Mr. Villar and Mrs. Suazo for the informative buff.

We support the proposed 24 month Stand by Arrangement and an arrangement under the Standby Credit Facility with access of SDR 224.8 million (90 percent of quota) for Honduras. We understand that the authorities wish to treat this as precautionary.

We praise Honduras for its efforts to strengthen the policy framework since the start of their previous program in 2014. The authorities have

demonstrated fiscal prudence and progress in mobilizing revenue, which has resulted in a reduction in the overall deficit from 4 percent of GDP to 1 percent, stabilizing gross debt levels. Growth levels remain high at 3.7 percent in 2018 despite a slowdown. Despite these achievements, there is still progress to be made through reforms to the electricity sector and improvements to social conditions. Addressing these domestic risks will help insure against external shocks alongside further work to improve governance. We agree with staff's appraisal and consider that the new program focuses on the right issues for structural reform.

We agree with staff recommendations to improve social conditions and make growth more inclusive through social spending and structural reforms. Poverty levels remain high at around 60 percent for the last 20 years. Income inequality continues to rise, there are high and increasing illiteracy levels as well as the high levels of violence. Female labour force participation remains one of the lowest in the region even with a decline in the gender gap. Improvements in these conditions could see growth in the business environment and foreign investment. We agree with staff that there should be an increase in social and infrastructure spending, but considering the scale of the challenge, we ask staff how progress will be measured in this area and whether a floor priority social spending will do enough to ensure improvement?

Reform of the electricity sector is an important objective of the programme due to the sharp deterioration in the financial situation of the state-owned National Electricity Company (ENEE). As the deficit reached 1 percent of GDP in 2018, creating debt levels close to 11 percent of GDP, we are encouraged by the authority's commitment to reform the sector. We note that although this challenge will require a strong political will from the authorities, it would bring long term rewards. Pursing this reform would increase finances available for social spending and infrastructure investment, bringing further long-term growth.

We welcome the focus of the programme on governance reform and fighting corruption. We agree that authorities should build on the past success of implementing the Financial Action Task Force of Latin America's report and develop a national AML/CFT strategy. Reform in this area is crucial and could stimulate foreign investment by enhancing the business environment and improve fiscal indicators. We ask staff whether they will recommend the renewal of the mandate for the Mission to Support the Fight against Corruption and Impunity in Honduras (MACCIH) after January 2020, to

continue its positive impact on corruption levels in Honduras, alongside measures set out in as part of this program?

We also note high external risks, such as the high levels of remittance from the US, with 7 percent of the Honduran population living there. There are high and increasing levels of remittances from these migrants, making up around 20 percent of GDP in 2018, which have significant effects on the balance of payments. Could staff please explain the potential long-term effects of these emigration rates on the economy in Honduras? How would a change in US immigration policy effect economic activity in Honduras?

Mr. Rosen and Mr. Grohovsky submitted the following statement:

The Honduran authorities made strong progress to stabilize the economy during the previous IMF arrangement. Under headwinds from commodity prices, fiscal restraint, and prudent monetary policy have broadly contained pressures to public debt and inflation. On the back of this performance, we support the authorities' request for the Stand-By Arrangement and arrangement under the Standby Credit Facility to maintain their commitment to key structural reforms, and we welcome the authorities' intention to treat the program as precautionary. During the course of this new arrangement, we urge further progress on securing financial stability of the public electricity company (ENEE), increasing the quality of fiscal policy and governance, transitioning toward inflation targeting and exchange rate flexibility, and improving the business climate. Tackling these issues will create fiscal space, build buffers, increase confidence, and bolster growth. Noting that the authorities intend to treat the arrangement as precautionary, can staff elaborate on the conditions in which they envision the authorities would draw on the arrangement?

ENEE's financial situation continues to deteriorate and remains one of the main challenges in Honduras. We welcome the three prior actions that focused on approving a new tariff scheme, creating a financial sustainability plan, and presenting a plan to secure a reduction in electricity losses. Reform to energy subsidies has proven exceptionally difficult for many countries, including Honduras, not least because of deep vested interests in maintaining the status quo. As the Selected Issues paper on international experiences notes, it is also critical to provide support for the poor during the reform period. We welcome that there are programs already in place in Honduras to maintain the electricity subsidy for those consuming less than 75kwh per month and to provide transitory budgetary transfers for low-consumption households. Honduras has made strong progress to improve the financial

condition of the sector, including with the support of its previous Fund arrangement, but a clear work program remains. The commitment by the authorities to the structural reform of the sector is critical, not only for the fiscal savings that are needed to pursue Honduras' development objectives, but also for the signal such reform should send to domestic interests and foreign investors that the business climate is improving. We strongly support the close engagement of the IMF and Honduras' development partners to keep these and other critical reforms under close review. Could staff opine on recent political developments and how they may impact the authorities' ability to implement reform in this space, as well as to the overall program?

We welcome the authorities' commitment to maintaining non-financial public sector deficits below the Fiscal Responsibility Law's ceiling. Fiscal gains from improvements in the energy sector, complemented by reducing tax exemptions and building on revenue mobilization efforts, can create the fiscal space needed for infrastructure and social spending. Improving on areas identified in the recent Fiscal Transparency Evaluation would also help enhance governance and transparency in public financial management.

On monetary policy, we are encouraged by the authorities' commitment to build on recent progress toward inflation targeting, as well as improving the monetary policy operational framework through governance reforms at the central bank. We also agree with staff that the new monetary policy regime's ability to buffer shocks would be complemented by a transition toward a more flexible exchange rate regime. We particularly appreciated Box 3 and the Selected Issues paper highlighting the buffering role of exchange rate flexibility. While the authorities continue this transition, they maintain foreign exchange surrender requirements and two multiple currency practices. We welcome the authorities' commitment to phase these practices out and we support the temporary approval of the MCP, recognizing the goal of eliminating these shortly as liberalization measures are implemented.

While undertaking all of these reforms, the authorities could boost growth and foreign investment by improving the business climate and enhancing anti-corruption efforts. We thought the report did a good job of highlighting these macro-critical issues but could benefit from additional discussion on how the authorities can leverage increased investment spending and coordinate with multilateral institutions to further increase potential growth and reduce dependence on agriculture. We also welcome the authorities' strategy to improve female labor participation rates and entrepreneurship.

Mr. Just and Mr. Harvan submitted the following statement:

We thank staff for the candid report, and Mr. Villar and Mrs. Suazo for their insightful buff statement. Since successfully completing the Stand-by Arrangement (SBA) in 2018, Honduras has continued to make progress on fiscal policy, including an adjustment in electricity tariffs. The macroeconomic performance remains broadly on track, although the current account has declined and financial risks have increased. Corruption, gang violence and rampant inequality will need to be addressed more decisively to improve economic prospects and social outcomes in Honduras.

We support the request for the SBA and Standby Credit Facility arrangements, which the authorities intend to treat as precautionary, and would argue for more ambitious conditionality in structural policies.

Maintaining a prudent fiscal stance is essential and the focus on ENEE, the public electricity company, is well-justified and should, over time, create fiscal room for investment and social spending. We take note of the well-targeted prior actions set for ENEE as well as the ceiling on the accumulation of domestic arrears, and would argue for redirecting resources from inefficient electricity subsidies to targeted social programs. Given the size of the accumulated liabilities, significant network losses, and signs of mismanagement, what steps are being taken to ensure a better corporate governance of ENEE? How do electricity generation costs compare with neighboring countries? Further actions are required for improving the composition of the budget, mobilizing domestic revenues, and implementing public financial management reforms. We deem such actions as critical to increase the quality and effectiveness of public spending, in particular for social spending. In this context, prompt and credible measures are needed to phase out the existing tax exemptions, improve custom and tax administration, and enhance the effectiveness and targeting of social assistance schemes. Could staff comment on the specific sources of tax gaps as estimated in the Selected Issues Paper and the impact of recent changes in the legal framework weakening the tax authority's coercive powers? Building on the recent Fiscal Transparency Evaluation, we welcome the structural actions to bring trust funds under the budgetary framework from 2020, and highlight the need to monitor fiscal risks of these funds and state-owned enterprises.

We support the planned steps to strengthen the central bank's operational autonomy and governance with a view to transition towards inflation-targeting and greater exchange rate flexibility. We welcome the plans to reform the central bank law by adopting a new charter to enhance its

governance framework, improve its operational independence, and specify a clear price stability mandate. In this context, it will also be important to engineer the transition to inflation-targeting carefully and well communicated. Although the banking sector is assessed as robust to a broad range of shocks, we agree with staff that the fast-increasing corporate FX debt warrants careful monitoring. We also appreciate the authorities' commitment to strengthening the AML/CFT framework in line with the GAFILAT's recommendations and making compliance more effective. Staff's comments would be appreciated whether the FSSR recommendations that have not been implemented to date will be a part of the program.

Achieving sustainable and inclusive growth will require tackling the root causes of gang-related violence, combatting corruption and addressing rampant social inequality. We welcome the additional information provided by Mr. Villar and Mrs. Suazo in their buff statement on the progress in improving the business environment and streamlining regulation. We highlight the overbearing importance of taking credible steps to improve governance, increase transparency and accountability, and to follow through with anti-corruption initiatives. as well as ensuring the rule of law to address violent crime. Given the importance of coffee exports, the high share of small- and medium-sized producers, and the global oversupply, how does staff assess the prospects of the industry and the risks for the economy? As climate change appears to reduce agricultural prospects in Honduras, we would be interested if this topic will be taken up by staff in forthcoming surveillance with Honduras.

Mr. Raghani and Mr. N'Sonde submitted the following statement:

We thank staff for a well-written report and Mr. Villar and Mrs. Suazo for their insightful buff statement.

The Honduran authorities should be commended for the sound macroeconomic performance in 2018 but vigilance is required to contain fiscal and external vulnerabilities. The economy has continued to grow close to potential. Unemployment has decreased on the back of favorable labor markets. Inflation remains within the central bank's target band. The public sector deficit remains below the targeted ceiling and the external position remains broadly in line with fundamentals. We note however that the current account is highly vulnerable to adverse terms of trade. The financial sector which is liquid, well-capitalized and stable, nevertheless faces the challenge of highly dollarized and concentrated credit. Looking forward, it will be critical for the authorities to step up reforms, with the view to strengthen public

finances, build buffers against shocks and sustain growth. We also stress the importance of advancing governance and transparency reforms.

We broadly agree with staff's assessment and policy advice under the proposed program and support the authorities' request for a Stand-By arrangement (SBA) and an arrangement under the Stand-By Credit Facility (SCF) on a precautionary basis. The proposed program is rightly focused on policies and reforms to meet these challenges and lay the ground for stronger and more inclusive growth. Steadfast implementation of the policy and reform agenda will be indispensable, particularly in light of the significant downside risks stemming notably from trade tensions and tightening global financial conditions. Fund support is warranted by the country's potential financial needs that could arise from the materialization of external risks.

We encourage the authorities to effectively implement their fiscal program which encompasses domestic revenue mobilization efforts and the strengthening of public expenditure management. They should implement strong measures to broaden the revenue base as recent generous tax policy have negatively affected tax revenues. We see merit in tackling the elevated tax expenditures, streamlining special tax treatments, and increasing tax compliance controls. We welcome the planned improvements in tax and customs administrations and the modernization of tax procedures. Preserving and properly allocating social spending will be necessary to tackle informality and reduce the gender gap. We urge the authorities to follow through with their reform agenda in these areas and to draw on technical assistance from the Fund and other partners to achieve their objectives. We would welcome staff's view on the capacity to swiftly implement these important reforms, including by overcoming resistance from possible vested interests.

It will be essential to step up the reform of the electricity sector. Significant fiscal risks arise from losses incurred by the national electricity company, ENEE, and represent a drag on public investment and growth. We are encouraged with the specific measures to reduce the ENEE's imbalances and separate the different functions of the company into subsidiaries to improve transparency and efficiency. We also note the plan to protect the poor from the adverse effects of this reform. However, measures already put in place in this vein include allocating the electricity subsidy on the basis of consumption rather than income levels. Secondary residences for instance are likely to consume lesser electricity but seldom belong to the poor. Staff elaboration on the justification of such subsidy will be appreciated.

We commend the authorities for their program to strengthen monetary policy institutions and framework, and further enhance financial sector stability. Envisaged actions to transition toward inflation targeting, enhance governance at the central bank and gradually shift toward a more flexible exchange rate to better absorb external shocks and safeguard international reserves are appropriate. We welcome the elimination of one multiple currency practice (MPC) under Fund jurisdiction related to rules applicable to the foreign exchange auction and look forward to that of a new MPC created by the use of previous days' official exchange rates in some FX transactions. We encourage the authorities to address the financial situation of the agricultural development bank BANADESA and align the investment policy framework of public pension funds with international standards.

Ongoing efforts to buttress inclusive growth are commendable while continued strengthening of the AML/CFT framework should help combat illicit finance and improve the business climate. We appreciate the authorities' commitment to expand social safety nets and support women participation in labor markets and entrepreneurship. We note its significant impact of emigration on Honduras' demographics as well as the potential fiscal burden that a return of migrants may imply. Can staff elaborate on the plan, if any, to enhance the FOSMH fund in support of such returning migrants? What would be the social and poverty implications considering the importance of remittances from migrants?

With these remarks, we wish the Honduran authorities every success in their endeavors.

Mr. Saito and Mr. Shimada submitted the following statement:

We thank staff for their comprehensive report and Mr. Villar and Mrs. Suazo for their insightful statement. We commend the authorities for significant progress in strengthening its policy framework under a three-year IMF supported program between 2014 to 2017. However, poverty is still high and challenges that hinder medium-term growth remain. We support the authorities' request for a Stand-By Arrangement (SBA) and an Arrangement under the Standby Credit Facility (SCF). We encourage the authorities to achieve institutionalizing fiscal prudence, stabilizing public debt, and introducing elements of a modern monetary policy framework and reducing poverty under the new program. As we broadly concur with the staff's appraisal, we will limit our comments to the following points.

Fiscal policy

While we commend the authorities for the continued commitment to the Fiscal Responsibility Law, the public electricity company (ENEE)'s deteriorating financial situation need to be addressed. As explained in Box2, the current severe situation of ENEE is explained by many factors, such as poor management of tariffs, several decrees exempting, electricity losses and higher oil prices. The authorities' reform plans cover necessary and sufficient elements, and are well-phased, but further efforts are needed to complete the reform. We encourage staff to continue providing detailed advices along with the reform phase. In this regard, we would like to know the major impediments to complete the ENEE reform.

Monetary and exchange rate Policy

We welcome that the BCH's plan to shift the monetary policy framework to inflation targeting. To this end, improving the monetary policy operational framework through better governance of the central bank is imperative. We welcome that the authorities plan to submit a new law to the Congress, aiming at safeguarding operational autonomy and increasing transparency and accountability of the central bank. We also positively take note that after some progress such as introducing the transaction with collateralized securities in the interbank market, the gap between policy rate and interbank rate has reduced. We encourage the BCH to push the modernization of monetary policy framework going forward. In this regard, we would like to know the planned timeframe to shift its monetary policy framework to inflation targeting.

We take note that the authorities have eliminated one multiple currency practice (MCP) by amending the rules on the foreign exchange auction, but an additional MCP arises. We concur with staff that the MCP does not materially impede Honduras's balance of payments adjustment and do not harm the interests of other members. We therefore support the approval of the MCPs. In connection to that, we would like to know whether the additional MCP along with existing MCPs would be regarded as the MCPs under the new MCP policy.

Financial Sector

While we welcome that the banking system is broadly resilient to most shocks, FX credit growth is needed to be monitored carefully. In addition, we also take note that an agricultural development bank (BANADESA) is under

severe financial stress. We concur with staff that BANADESA does not pose systemic risk given its size, but it is important to resolve the banks smoothly. In this regard, we would like staff to elaborate more on the resolution process of BANADESA, and potential risk on that process.

The Acting Chair (Mr. Furusawa) made the following statement:

Honduras has made significant progress in stabilizing its economy and improving confidence, thanks to sound policies with the support of the previous Fund-supported program. However, Honduras continues to face significant challenges with a poverty rate of 60 percent, high inequality, and problems with governance and violence. To address these issues, Honduras needs to maintain macroeconomic stability and follow through with structural reforms to improve institutional quality and foster inclusive growth. In this regard, Directors' gray statements recommended increasing fiscal transparency, reforming the electricity sector, safeguarding investment and priority social spending, improving the business climate, and enhancing female labor force participation. A new Fund-supported program could provide an adequate framework to support the implementation of those measures.

Ms. Suazo made the following statement:

We thank the Board for its support on the Standby Credit Facility (SCF) and Stand-By Arrangement (SBA) programs, the recognition of the advances gained up to now, and for their very helpful comments and recommendations. Aided by a three-year Fund program that expired in 2017, Honduras made great strides in reducing macroeconomic imbalances, improving confidence, institutionalizing fiscal prudence, and strengthening its policy framework. To build on previous achievements and make progress in solving longstanding issues, the authorities have requested a new precautionary Fund program as an anchor to support reforms and address remaining vulnerabilities and risks such as a deteriorating financial situation of Empresa Nacional de Energia Electrica (ENEE), the public electricity company, and the continuing need to strengthen the macroeconomic policy framework, reduce poverty, and improve governance and the business environment.

The authorities are committed to resolve the longstanding issues of the energy sector. Since it is a complex process that includes various stakeholders, all of them signed a commitment at the national level to implement reforms in the electricity sector through market-friendly agreements. These reforms will

in turn put ENEE's financial position on a sustainable path. So far, all prior actions have been met, and the reform plan is advancing in institutionalizing the electricity regulatory body and working toward the launch and expansion of the system operator.

It is very important to recognize the commitment of the Honduran government in its fight against corruption, in strengthening national institutions, including with the support of the international community, which is why strengthening governance is one of the main objectives of this program.

The agreement the Mission to Support the Fight Against Corruption and Impunity in Honduras (MACCIH) is in the process of being reviewed by the Organization of American States (OAS) and the government of Honduras, where the interest of the mission continues to support not only the country's research capacity, but also encourages the country to cooperate on other issues in the agreement that have not yet been addressed, such as strengthening the police force presence and transparency.

The Honduran government considers it imperative to continue to expand programs that have been proven successful in reducing the unacceptably high poverty rate, such as its cash transfer flag program, *Bono Vida Mejor*, and to foster initiatives to reduce gender inequality.

As mentioned in the staff report, foreign exchange credit was growing in double-digits year-on-year in 2018, which has since decelerated to single-digit and is being closely monitored by authorities, who stand ready to take policy action if necessary.

Finally, it is very important to recognize the great effort and collaboration of the Fund teams that have been accompanying us throughout these years, highlighting the performance of Mr. Vesperoni and Mr. Garcia Saltos and their teams, including country representatives, who have worked hand in hand with the authorities. Also, Fund technical assistance (TA), including through the Regional Technical Assistance Center for Central America, Panama, and the Dominican Republic (CAPTAC-DR), has been extremely valuable and has resulted in complete and tangible public policy results, such as strengthening tax and custom administration, resulting in better revenue mobilization.

The staff representative from the Western Hemisphere Department (Mr. Vesperoni) made the following statement:¹

The staff is grateful for Directors' gray statements and their support for policies and reforms the program. Honduras has made significant efforts to reduce macroeconomic imbalances and strengthen the macroeconomic framework over the last years. We believe that the authorities' programs for the next year propose significant steps to tackle remaining challenges, fostering growth in a context of macroeconomic stability, better governance, and protection of the most vulnerable. The authorities have met all the prior actions agreed in the program.

Let me now take a few minutes to address some questions raised in the Directors' gray statements, from which we have identified four themes. The first theme is the potential impact of the political situation on the authorities' plan. Then there is another theme on fiscal policy and the importance of revenue mobilization efforts. The third issue is electricity sector reform, and finally, there were some questions about program design issues. I will tackle each of these themes in turn.

On political issues, Directors wonder whether the political situation may compromise the authorities' ability to implement reforms and overcome persistence of possible vested interests. The political situation is complex. There have been protests over the last weeks, mainly associated with tensions over electoral reforms and sectoral demands, especially in the education and health care sectors. Left-leaning political groups took advantage of the political climate to mobilize their bases. The authorities continue to work to reach agreement on electoral reforms, and the congress's decrees on reforms on the education and health sectors, which had been seen as laying the ground for massive dismissals, have been repealed.

I would like to make two points about this. One is a reflection on the past, and the other is a reflection on the future. As for the past, Honduras has already experienced complex political environments, notably in early 2018. However, the authorities have consistently shown commitment to maintain the course of prudent policies. They overperformed the fiscal responsibility law ceilings both through the 2017 electoral process and in 2018, and they kept a prudent monetary policy stance. The economy has been growing in a stable macroeconomic environment despite negative terms-of-trade shocks.

¹ Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

As for my thoughts about the future, let me start by considering what are the core challenges that lie behind potential social discontent, which are the impediments in the Honduran economy to achieve stronger growth and employment opportunities to reduce poverty and raise living standards. These are precisely the issues that the authorities' program is trying to address, making the economy strong and stable while protecting the most vulnerable. It has basically three elements. Fiscal and electricity sector reforms will secure the fiscal position and at the same time maintain room for much-needed investment and social spending. Reforms to the monetary policy framework will help ensure that Honduras will be in a good position to buffer external shocks in the future. The focus on governance and transparency will help improve the business environment, including by fostering efforts in the fight against corruption.

It is true that these reforms require more than maintaining the course, and they will affect vested interests. However, on top of the authorities' firm ownership and commitment, we also see broad social consensus about the need to take up the main elements of the program, the revision of tax exemptions, the reform of an ailing electricity sector, and better governance.

Turning to fiscal issues, Directors wonder about the recent measures that tended to undermine revenue mobilization efforts over the last year. We have given a detailed explanation of these issues in our technical answers, but let me take a moment to provide a big picture overview of the rationale of the program on this issue.

There is certainly a debate in Honduras about tax pressure on the economy, which is in part triggered by the fact that Hondurans tend to collect more than regional peers and certainly more than many Latin American economies in terms of GDP. Hence, the authorities are trying to balance the need to protect tax revenue and the need to foster investment and employment. In light of this, the program acknowledges that reforms pointing to a creation of new taxes or the revision of existing tax rates—which are in line with regional peers—may not offer the best way forward and may also face strong social resistance. What is not in line with regional peers in Honduras is the level of tax expenditures. These are high and oftentimes related to long-dated special regimes that do not seem to be yielding benefits for the economy and also create distortions that are difficult to justify. The objective of the program then is to keep tax collection at the level achieved by 2018, which is a record high for the Honduran economy by broadening the tax base and strengthening tax administration.

A third issue that was raised is electricity reform. Directors raised some questions on sequencing tariffs on subsidies. We have offered detailed explanations of these issues in our technical answers, but I would like to take a moment to emphasize a few issues now. To understand this reform, one has to understand that the key underlying principle is that challenges in the sector cannot be just addressed by a hike in tariffs. The authorities have made a significant effort before submitting this program to the Board, increasing tariffs by about 30 percent for residential consumers and a similar amount for commercial consumers over the last three quarters. These adjustments and the approval of a tariff scheme and a sound institutional framework that bases tariff decisions on technical principles is laying the ground for keeping tariffs in line with the evolution of costs. Social and competitiveness issues, as well as governance issues, advise against ad hoc tariff adjustments.

The reform involves deep institutional changes, and a compromise from all stakeholders to define good strategic plans, enhance governance, build a solid payment system in the production chain of energy that avoids arrears, and eliminate inefficiencies. The plan includes support to the poor, which although it could be better targeted, will be nonetheless instrumental to the reform agenda, as indicated by international experience.

This is a complex reform that will take time and commitment. Besides institutional changes, a key challenge is that they will involve difficult negotiations in the context of the burden-sharing exercise that involves multiple stakeholders with different interests. However, we believe that the current situation also offers a window of opportunity, basically because of two reasons. First, because the legal framework for the electricity sector is in line with good international practice, and it has already been approved by congress, which is a particularly important step forward, and second, because there is broad social consensus that as it is, the situation in the electricity sector is not sustainable.

Finally, let me turn to the last theme that I have raised, which is program design issues. Directors wonder about the choice of a precautionary instrument vis-à-vis a Policy Support Instrument (PSI), conditions that will trigger a disbursement, governance reforms, and the staff's position regarding the renewal of the MACCIH.

The choice of a precautionary arrangement responds to the fact that while we do not expect disbursements in the baseline scenario in Honduras, we do see a constellation of external global shocks associated with trade tensions, migration policies, volatile terms of trade, and tightening financial

conditions, that is particularly relevant for the economy and could open a balance of payments gap. We envision a disbursement scenario in the event of significant terms-of-trade shocks—for example, an increase in oil prices, given that Honduras is an oil importer. Staff simulations based on higher oil prices than the ones assumed in the program show that the deterioration of the terms-of-trade will translate into lower GDP growth, higher current account deficits, and slightly higher public debt. It may also open a balance of payments gap.

A third issue on this theme is governance vulnerabilities. The diagnostics on governance vulnerabilities is taking place through technical assistance (TA) from our Fiscal Affairs Department (FAD) and the Legal Department (LEG), which has also benefitted from collaboration with the World Bank on certain issues. The Fund team has already visited Tegucigalpa, and the report with the specific recommendations will be finalized before the first review, in time to inform program design. A decision to publish the TA report lies as usual on the authorities.

Finally, on the MACCIH, the staff recognized the MACCIH's important role in advancing anti-corruption efforts in Honduras. The decision to renew MACCIH mandates lies with the governments and their OAS partners; and as said in the previous statement, this is something that is in the works. The staff as usual will continue to look forward to coordinating and cooperating with the authorities and all their development partners on governance issues.

Mr. Rawah made the following statement:

We thank staff for the well-focused set of records and Mr. Villar and Ms. Suazo for their buff statement and Ms. Suazo for the opening remarks. We did not issue a gray statement since we are in broad agreement with staff's analysis and policy recommendations. We would limit our remarks to a few issues.

First, like other Directors, we support the authorities' request for an SBA and an arrangement under the SCF. This will build on the satisfactory economic performance, underpinned by the authorities' prudent policies and the progress under the previous Fund program. Indeed, we support the authorities' bold reform agenda to address the remaining structural impediments and foster inclusive growth while maintaining macroeconomic stability. We also welcome the focus in the program on protecting the most vulnerable.

Second, we take positive note of the fiscal prudence pursued to ensure debt sustainability anchored by the authorities' strong commitment to the fiscal responsibility law. However, to further improve the fiscal position, we encourage the authorities to continue their revenue mobilization efforts, including the broadening of the tax base and the reduction of tax exemptions, and to ensure the financial sustainability of the public electricity company, as highlighted by other Directors.

Third, these efforts need to be complemented by continued measures to strengthen the social safety net, especially in light of the current high poverty rate and gender gap. Furthermore, enhancing governance, fighting corruption, improving transparency in public finance management, and enhancing the business environment are also important priorities.

Finally, we welcome the authorities' efforts to improve the monetary policy operational framework and encourage the authorities to further strengthen the AML/CFT framework.

Mr. Rosen made the following statement:

We welcome this discussion, and we support the approval of the SBA SCF program along with the authorities' intention to treat the program as precautionary. This program should serve as a good anchor to undertake further reforms. The two most pressing economic issues in Honduras are electricity sector reform and public financial management. We noted in our statement that although some changes have been made, clear work remains to make the electricity sector more competitive, financially stable, and market oriented. At the same time, we agree with the gray statement by Mr. de Villeroché that the sequencing of the tariffs and support for the most vulnerable are critical, particularly given the challenging social and political context.

As we have seen in other countries, these types of reforms can be difficult to implement, and I am reassured by the staff's that despite the challenging political situation in Honduras, there does seem to be a consensus of support for the program. We found staff's responses to questions on the electricity sector reform sequencing to be helpful, particularly where they laid out the timeline of all the reforms that need to take place. The length of that list underscores the challenge the authorities face but also the need for their strong reform commitment and ownership. Reforming the electricity sector will also help improve risks to public finances by reducing the support needed from the treasury. We also welcome the authorities' strong commitment to

maintaining non-financial public sector deficits below the ceiling of the fiscal responsibility law, and we echo our call that reduced tax exemptions should help create fiscal space for infrastructure and social spending. With that we wish the authorities all the best in their efforts for a successful program.

Mr. Just made the following statement:

We thank staff for the technical answers and the intervention today and for presenting a well thought through program proposal, which has our full support.

Honduras is one of those countries where we need to think hard on how to engage effectively, as we are dealing with a post-conflict situation, extreme inequality, where the state monopoly on violence is contested, and with significant government deficiencies.

In addition, Honduras is already dealing with the effects of climate change, and we may need to adapt program design to capture risks from climate change in a more forward-looking manner. The Fund has done a good job in helping the authorities with macro stabilization. Progress on fiscal adjustment has been commendable, but given extreme social inequality and gang violence, it would be particularly important that the fiscal space created with the program is used to increase both the level as well as the quality of social expenditure. This will obviously require collaboration and coordination with the World Bank and the Inter-American Development Bank (IDB).

As the effects of change are already felt in Honduras, the impact on agriculture and particularly on coffee is significant, with the resulting poverty and food insecurity as reasons for migration, we would see a clear need to design the program with climate change in mind. Given its impact on Honduras, adaptation and resilience will be key.

Mr. Castets made the following statement:

I thank the staff for the quality of the report and the answers to our technical question, as well as for the elaboration. It was very helpful. I thank Mr. Villar and Ms. Suazo for their very insightful buff statement and very helpful intervention.

We are very happy to support this precautionary program since we believe it will help the government to deepen its own reform program, and Ms. Suazo recalled that some progress has already been made. But the country

still needs to tackle some longstanding challenges, and Mr. Just recalled some of them, and we would insist on reforms in the field of governance and also in the fight against poverty.

Building on our gray statement, I would like to make four comments. The first one is to commend the authorities for their significant effort to raise additional revenues. The mission chief recalled that Honduras is one of the countries of the region where public revenue is quite elevated. But still we would encourage the authorities to move forward on tax exemptions, where there is still room for improvement, as well as on fiscal transparency and public financial management.

Second, on the energy sector reform, Mr. Rosen recalled that in our gray statement we agreed with staff on the need for caution and sequencing. On this issue, very often our view is that the best can be the enemy of the good if during the transition we do not have the social safety nets in place to fully compensate. We tend to see a need to be pragmatic and to use the instruments we have while working intensively on improving the targeting of the social safety nets moving forward. On that issue, we would also encourage the authorities to communicate to the population to underline the welfare impact of such a reform and how over the medium term it will benefit the whole population.

Third, on governance reform and the fight against corruption, this is of paramount importance, and the governance diagnostic that will be done by the Fund could be a cornerstone to help the authorities in improving the institutions, so we urge the authorities to seize the opportunity and to fully coordinate with the Fund on that issue.

Finally, it is reassuring to hear from Ms. Suazo that the TA provided by the Fund is very effective, and we fully associate ourselves with the call of Mr. Just to fully integrate the climate change dimension into the program design moving forward.

Ms. Suazo, in a brief concluding statement, thanked the Board for its support to Honduras.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended Honduras' ambitious reform efforts in the last few years that resulted in macroeconomic stability, fiscal deficit reductions, strengthened

institutional and policy frameworks, and improved investor confidence. Notwithstanding these achievements, Directors noted that high poverty and inequality, corruption, weak rule of law, and widespread violence remain major challenges. Addressing these challenges will support Honduras' pursuit of strong, sustainable, inclusive and pro-poor growth. In this context, Directors welcomed the authorities' economic reform program, which focuses on maintaining macroeconomic stability, while implementing reforms to foster inclusive growth and improve social conditions.

Directors commended the authorities' commitment to fiscal prudence— institutionalized by the Fiscal Responsibility Law—while protecting investment and social spending. They called for continued efforts at revenue mobilization—including through a revision of tax exemptions—and stronger tax administration and compliance. Together with measures to control expenditure over the medium term, Directors encouraged improved transparency and governance, including for trust funds, and sound public financial management. In that context, Directors positively noted the completion of the Fiscal Transparency Evaluation and the authorities' commitment to implement its recommendations.

Directors welcomed the authorities' recent reforms in the electricity sector, including a tariff adjustment with subsidies to protect the very poor. Noting that reducing financial imbalances would create space for much needed infrastructure and social spending, they encouraged further efforts to improve the sector's institutional framework and put the finances of the national electricity company (ENEE) on a sustainable path.

Directors commended the recent measures to modernize the monetary policy framework and make the exchange rate regime more flexible—notably by reducing foreign exchange surrender requirements. Moving forward, they encouraged a gradual transition to exchange rate flexibility and continued efforts in strengthening the central bank's operational² autonomy and governance with a view to gradually transition toward inflation-targeting. Directors, thus, welcomed the authorities' plan to submit a new Central Bank Charter to Congress by year-end.

Directors noted that the financial system remains broadly stable, liquid, well-capitalized, and with NPLs at historic lows. Notwithstanding these developments, they encouraged its careful monitoring given foreign exchange credit growth and encouraged the authorities to continue to address the financial situation of the non-systemic agricultural development bank, BANADESA. Directors also appreciated the authorities' commitment to

strengthening the AML/CFT framework in line with the Financial Action Task Force of Latin America's (GAFILAT) recommendations and called for more effective compliance.

Directors welcomed the authorities' focus on structural reforms to improve governance and the business climate, primarily by reducing the scope for corruption and strengthening the rule of law. Noting that such reforms would help foster medium-term inclusive growth, they welcomed programs to improve gender equality and female labor force participation rates and encouraged the authorities to strengthen these efforts.

It is expected that the next Article IV consultation with Honduras will be held in accordance with the Executive Board decision on consultation cycles for members with Fund arrangements.

The Executive Board took the following decisions:

Honduras—Multiple Currency Practices Subject to Approval Under Article VIII, Section 3

1. Honduras maintains two multiple currency practices subject to Fund approval under Article VIII, Section 3. These arise (i) from the lack of a mechanism to prevent spreads in excess of 2 percent between the official exchange rate (TCR) of the day and the exchange rates at which foreign exchange is sold at the foreign exchange auction on that day; and (ii) from the use of previous days' official exchange rates (TCR) in certain FX transactions, which rates may differ by more than two percent from the TCR in force and the interbank market rate on a given day.
2. In the circumstances of Honduras, the Fund grants approval for the retention of the multiple currency practices until July 1, 2020 or the conclusion of the next Article IV consultation with Honduras, whichever is earlier. (EBS/19/62, 6/25/19)

Decision No. 16581-(19/64), adopted
July 15, 2019

Honduras—Request for a Stand-By Arrangement

1. Honduras has requested a Stand-By Arrangement in an amount equivalent to SDR 149.880 million for a period of twenty-four (24) months from the effective date of this decision.

2. The Fund approves the Stand-By Arrangement for Honduras set forth in EBS/19/62 and decides that purchases may be made under the arrangement, on the condition that the information provided by Honduras on the implementation of the measures specified as prior actions in Table AI.1 to the Memorandum of Economic and Financial Policies attached to the letter from the Chief of the Economic Cabinet, President of the Central Bank of Honduras, and Secretary of the Treasury, dated June 20, 2019 is accurate.

3. This Decision shall become effective only upon the adoption of Decision No. 16561 (19/64) below by the Executive Board. (EBS/19/62, 6/25/19)

Decision No. 16560-(19/64), adopted
July 15, 2019

Honduras—Request for an Arrangement Under the Standby Credit Facility

1. Honduras has requested an arrangement under the Standby Credit Facility (SCF) for a period of twenty-four (24) months in an amount equivalent to SDR 74.940 million.

2. The Fund approves the SCF arrangement for Honduras set forth in EBS/19/62 and decides that Honduras may request the first disbursement under the arrangement, on the condition that the information provided by Honduras on the implementation of the measures specified as prior actions in Table AI.1 to the Memorandum of Economic and Financial Policies attached to the letter from the Chief of the Economic Cabinet, President of the Central Bank of Honduras and Secretary of the Treasury, dated June 20, 2019 is accurate. (EBS/19/62, 6/25/19).

Decision No. 16561-(19/64), adopted
July 15, 2019

APPROVAL: May 29, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Fiscal Policy

1. *The Selected Issues Paper (SIP) indicates that the threshold for companies liable to minimum Corporate Income Tax (CIT) is set to double from \$12 million in 2018 to \$24 million in 2019 and further to \$40 million by 2020. Could staff comment on the rationale behind, and impact of, these somewhat sharp increases in the threshold?*
 - As discussed in the 2018 Article IV, the minimum income tax was largely disputed—including several lawsuits—with the argument that the tax burden in Honduras was above regional peers, discouraging private investment. In this scenario, the authorities decided to gradually increase these thresholds. Staff estimates that—when fully phase out—the fiscal cost would be around ½ percent of GDP. According to the main business association (COHEP) the removal of the tax would create 65,000 formal jobs during the 2018-2020 period.

Minimum Income Tax-Phase in Schedule

| | 2017 | 2018 | 2019 | 2020 |
|---|------|------|------|------|
| Gross revenue threshold (in US\$ million) | 0.4 | 12.0 | 24.0 | 40.0 |
| Rate (percent of gross revenue) | 1.5 | 1.5 | 1.0 | 1.0 |

2. *A very useful analysis in the selected issues paper shows, that if tax inefficiencies were removed, Honduras could increase tax collection by about 4 percentage points of GDP. In addition to this, some elements in the current tax policy, such as large and periodically extended tax amnesty, and a 5 percent CIT surtax to the most profitable companies, could create negative economic incentives. Staff comments would be welcome.*
 - Staff considers critical for Honduras to maintain its revenue mobilization efforts; which would provide fiscal space to invest in much needed infrastructure and social spending. Honduras has made commendable progress on revenue mobilization over the past 5 years, leading to a high tax to GDP ratio when compared to other Latin-American countries. Indeed, as found in the benchmarking exercise in the selected issues paper, the distance to the efficiency frontier for Honduras is much lower than the average for the region. Thus, staff does not argue for raising the tax revenue to GDP ratio in the short run, but see these efficiency gains as a long-term objective. However, staff welcomes the authorities' commitment to streamline tax exemptions to promote transparency and equity in the tax system and make up for tax revenue losses from recent policy measures. In addition, strengthening tax enforcement will be key to maintain revenue mobilization. To that end, new tax

amnesties must be avoided, which is a commitment in the authorities' plan. While the 5 percent CIT surcharge may be distortionary, the combined marginal rate for the top firms is broadly in line with the statutory rate in the region, so staff does not recommend any changes at this stage.

3. ***We note that a new tax code may tend to weaken institutions, incentives to pay, and thus tax collection and, in this regard, we would like a further elaboration from staff on the reasons of these tax policy measures.***
 - As discussed in the 2018 Article IV, the tax reform was heavily disputed, mainly based on the argument tax burden in Honduras was above regional competitors. The new tax code reflects the balance of the objectives of protecting tax revenues and fostering private investment and competitiveness. While it contains some positive elements such as the regulation of customs, it also includes elements that have weakened the coercive power of the tax authority. The program aims at correcting some of these elements, with measures such as returning the control of tax expenditures to the tax authority and facilitating the notification of tax procedures.

4. ***Could staff comment on the specific sources of tax gaps as estimated in the Selected Issues Paper and the impact of recent changes in the legal framework weakening the tax authority's coercive powers?***
 - Efficiency gaps in the benchmarking exercise prepared for the SIP were estimated at the general government level, therefore the revenue coverage included in the analysis comprises taxes and social contributions (health and pensions). This exercise suggests that the gap is mainly explained by informality—about 75 percent—which weakens the collection of social contributions and the very large level of tax expenditures. As explained in the SIP, countries are benchmarked against “best performers”. Given this methodology, the large level of tax expenditures—well-above Honduras' comparators—heavily weighs on the efficiency gap.
 - While it is difficult to estimate the impact of changes in the legal framework quantitatively, they could certainly have a negative impact on revenue mobilization, particularly in the long run, through reduced compliance. Tax amnesties have yielded one-off revenues, but at the cost of weakening incentives to pay taxes properly. Weakening the framework to control exemptions in a context of large tax expenditures, as it is the case in Honduras, could lead to abuses of the different regimes.

Energy Reform

5. ***While we support the roadmap established by the program to reform the electricity sector, we urge staff and the authorities to carefully sequence the phasing in of the new electricity tariff and the strengthening of the social safety net for the most vulnerable. Given the difficult social climate and complex political context, it is of***

the utmost importance that the authorities, and by extension the IMF through this program, carefully implement these difficult reforms without neglecting their social impact. As highlighted during the recent discussion on the Fund strategy for social spending, communication will be key. Could staff elaborate on the concrete timing of these reform and provide more details about the incidence of the tariff reforms (in terms of disposable income and by revenue deciles) as well as of the one of the compensation measures?

- The electricity sector reform is indeed a complex process that will require time and continued commitment, and while the timing and sequencing of the different elements are likely going to be subject to reassessment during the process, the framework envisages that the key measures are going to be pursued as follows:
 - *Strengthening of the electricity regulatory body (CREE):* second quarter of 2019
 - *Creation of the System Operator (dispatch center, ODS):* second quarter of 2019
 - *Implementation of transitional arrangement between ENEE and ODS:* second quarter of 2019 to end-2019
 - *Preparation of Emergency Plan by ODS:* third quarter of 2019
 - *Development of generation expansion plans by ODS:* Third quarter of 2019 to end-2019
 - *Approval of the new tariff scheme:* June 2019
 - *Development of tariff regulations based on new tariff scheme:* third quarter of 2019 to end-2019
 - *Adjustment to regulations based on new tariff scheme:* a continuous process starting in the third quarter of 2019
 - *Unbundling of ENEE:* third quarter of 2019 to first quarter of 2020
 - *Operational reforms in the unbundled companies:* third quarter of 2019 to end-2020
 - *Unbundling of ENEE trust fund (regaining control of company cash flow):* third quarter of 2019 to end-2019
 - *Revision of generation contracts that have not been implemented:* third quarter of 2019 to end-2019
 - *Negotiation over current generation contracts:* third quarter of 2019 to end-2019
 - *Implementation of new payment system of ENEE providers:* third quarter of 2019 to end-2019
 - *Refinancing agreement with ENEE's creditors:* third quarter of 2019 to end-2019
 - *Negotiation of arrears with generators:* third quarter of 2019 to end-2019
 - *Renegotiation of contracts with EEH:* third quarter 2019 to end-2019
 - *Revamping of losses reduction plan:* third quarter of 2019
 - *New Enforcement Task Force:* third quarter of 2019
 - *Development of strategic investment plan for losses reduction:* third quarter of 2019 to end-2019
 - *Implementation of losses reduction plan:* continuous process until end-2021

- The tariff adjustments during the implementation of reforms will be guided by the legal framework recently developed. This does not allow for *ad-hoc* adjustments, and most of the update for previous lack of timely tuning was made up over the last three quarters ending in June 2019. During this period, in line with international practices during energy sector reforms, the authorities have granted subsidies to pay electricity bills—although the targeting has room for improvement (see below).

6. *Given the size of the accumulated liabilities, significant network losses, and signs of mismanagement, what steps are being taken to ensure a better corporate governance of ENEE? How do electricity generation costs compare with neighboring countries?*

- Better governance—both in the sector and in ENEE—will be pursued by:
 - Strengthening of the CREE.
 - Creating a system operator (ODS) that will be independent from ENEE.
 - Eliminating ENEE’s trust funds, allowing the company to manage its cash flow.
 - Unbundling of ENEE, with three independent management teams for the different stages in the energy production process: generation, transmission, and distribution.
 - Implementing the new tariff scheme, which will be established the different components of electricity tariffs (this will also support the process of ENEE’s unbundling).
 - Creating of a new payment mechanism for ENEE’s providers.
 - Revision of generation contracts that have not been implemented to allow the ODS to strategically plan for expansion of energy supply, enhancing governance in ENEE transmission and distribution
- Generations cost are broadly comparable for certain sources of generation, but they are higher for some renewable generation projects that were implemented through long-term Energy Purchases Agreements (PPA) that were signed at a time in which generation costs for this source of energy were much higher (prices for some sources of renewable energy have fallen significantly over the last five years).

7. *We encourage staff to continue providing detailed advices along with the reform phase. In this regard, we would like to know the major impediments to complete the ENEE reform.*

- Staff will respond to this question during the Board meeting.

8. *Given the significant adjustment in electricity tariffs of last October, we ask staff to share their views on the scope for further increases, which will very likely face political and social resistance.*

- A key reform implemented during the 2014-2017 program was the creation of an independent regulatory body (CREE), which mandate is to set tariffs based on

technical considerations. Under the current legal framework, the CREE is quarterly updating tariffs based on changes in generation costs—mainly bunker price and the evolution of the exchange rate. This framework does not necessarily imply further adjustments. As a prior action for the approval of the program, the CREE has approved a new tariff scheme that would be fully implemented in the coming months. It aims at recovering transparently all costs of electricity generation, transmission, and distribution. To protect the poor, the government has introduced temporary subsidies to ensure that higher tariffs are only gradually transferred to households' bills.

- Staff will add comments on the electricity sector reform during the Board meeting.
9. *We also note the plan to protect the poor from the adverse effects of this reform. However, measures already put in place in this vein include allocating the electricity subsidy on the basis of consumption rather than income levels. Secondary residences for instance are likely to consume lesser electricity but seldom belong to the poor. Staff elaboration on the justification of such subsidy will be appreciated.*
10. *We are not fully convinced that maintaining price subsidies for low-consumption households is an adequate way to support the poor. Referencing the subsidy to electricity consumption per month runs the risk of both benefiting better-off households using electricity sparingly and missing poor households with many members and therefore higher consumption. Protecting affected vulnerable households by targeted compensatory measures embedded in the social safety net would thus seem preferable. Staff comments would be welcome. In addition, we would be interested in whether the reform package also foresees repealing the decrees exempting various entities from paying their electricity bill, as mentioned in Box 2?*
- For questions 9 and 10.
 - Certainly, a targeted mechanism is usually a better option, and as a general policy, the instruments preferred by the government in terms of social support are the conditional cash transfers programs. However, while a better target mechanism could not be developed to grant subsidies on electricity consumption, the authorities acknowledged that a critical factor for the success of electricity reforms is to grant subsidies during the reform process; and given the fact that poverty is widespread, the regressive impact of an across-the-board subsidy could be limited. Also, note that only the subsidy for consumption below 75KW per month is permanent. Other subsidies are designed to cushion the impact of the recent large adjustment due to the initial wedge between the actual and the cost-recovery tariff—which was significant in late 2018—and are temporary by nature.

- Staff will add comments on the electricity sector reforms during the Board meeting.
- 11. *In addition, we would be interested in whether the reform package also foresees repealing the decrees exempting various entities from paying their electricity bill, as mentioned in Box 2?***
- Regarding repealing decrees granting free energy for the set of institutions outlined in Box 2, while the program does not envisage this in the short-term, it does include this spending transparently in the budget. The budget process itself will define the scope and extension of these subsidies over the medium term.

Monetary and exchange rate policies

- 12. *We note that the previous safeguard assessment flagged the need for adopting International Financing Reporting Standards (IFRS) but its implementation has been significantly delayed. Could staff explain the main obstacles faced by the Central Bank of Honduras (BCH) in implementing IFRS, and whether the authorities are requesting Fund TA in this regard?***
- The BCH's previous plans to implement IFRS were impacted by capacity constraints and limited resolve to move forward. IMF TA on IFRS implementation was provided during 2011–12 and in 2018, and the authorities intend to request further assistance. The June 2019 safeguards assessment mission found a renewed commitment to advance the BCH's adoption of IFRS and the authorities have developed a roadmap for implementation. The current plans discussed with the BCH envisage implementation by FY 2021.
- 13. *We note the staff's comments in Box 3 that empirical evidence suggests that Honduras could benefit from exchange rate flexibility, but, at the same time the staff poses a right dose of caution by alerting that risks from balance sheet vulnerabilities and a high exchange rate pass call for a gradual approach. Therefore, the authorities' approach, liberalizing 30 percent of the foreign exchange market, leaving to remove the rest by the end of the year, seems to be headed in the right direction. In any case, is it strictly necessary to eliminate surrender requirements to achieve exchange rate flexibility? Staff comments will be welcome.***
- Eliminating the surrender requirement is critical to deepen the still shallow interbank FX market, which is important to strengthen the market's FX price discovery process and avoid volatility going forward. Concurrently, this is instrumental to reduce the large exchange rate pass-through in the Honduran economy, critical for a credible inflation targeting regime that would reduce the sacrifice ratio of monetary policy in buffering external shocks. Conditionality calls for the adoption by end-2019 of a plan to gradually phase out the remaining 70 percent FX surrender requirement. The gradual approach to eliminating surrender requirements is particularly important, as it

allows market participants and regulators to build the regulations, market infrastructure, and skills needed for effective and safe functioning of a liberalized FX market. Further development of domestic currency and debt markets to strengthen the interest rate channel of monetary policy transmission is the other key component of the plan to transition to IT and a flexible exchange rate system.

14. *We would like to know the planned timeframe to shift its monetary policy framework to inflation targeting.*

- The Fund has emphasized in its TA that the implementation of IT and associated modernization of the FX system should proceed gradually. Past TA from MCM has recommended that the BCH should monitor and observe market reactions to developments in the interbank FX market, while also developing its own expertise in interacting with the FX market. Specific timing and actions need to adapt to evolving conditions, with the BCH carefully assessing at each stage the capacity of the economy and the financial system to handle the new step without creating pressures for a policy reversal that could undermine credibility of the reform. An upcoming MCM mission to assess the status of the reform process will likely provide a better idea of the expected timeframe for the shift to a fully-fledged IT framework.

Financial Policies

15. *The authorities plan to address the financial situation of BANADESA, the agricultural development bank, which is currently under severe financial distress. How will the bank's resolution plans affect the agricultural sector and the economy?*

- BANADESA's assets represents only about one percent of GDP—compared with about 100 percent of GDP for the whole private banking system. In addition, it has very limited relationships with the rest of the banking system, so its resolution does not pose a systemic risk to either the banking system or the economy. While BANADESA accounts for a significant share of total credit from the banking system to agricultural sector (about 10 percent), alternative mechanisms could be used to funnel financial resources for small and medium sized agricultural producers, e.g. using other public banks such as Banhprovi.

16. *We would like staff to elaborate more on the resolution process of BANADESA, and potential risk on that process.*

- The authorities are still in the process of finalizing the resolution plan for BANADESA, and it is up to the Congress to decide if to close the bank. In any case, the authorities envisage zero budgetary costs of the resolution of BANADESA.

17. *Staff's comments would be appreciated whether the FSSR recommendations that have not been implemented to date will be a part of the program.*

- The authorities have completed more than half of the FSSR recommendations, including important areas such as the identification and more intensive supervision of systemically important banks and enhanced reporting requirements on cross-border activities of conglomerates. As noted in the MEFP, the authorities are strongly committed to completing the implementation of remaining FSSR recommendations, including further strengthening the capacity for risk-based supervision, further developing stress testing capacities, completing the regulatory framework on market and liquidity risk, and developing new methodologies to assess operational risks. The staff will assess the need to introduce explicit structural conditionality on the implementation of these recommendations in future program reviews.

Social Policies

18. *We agree with staff that there should be an increase in social and infrastructure spending, but considering the scale of the challenge, we ask staff how progress will be measured in this area and whether a floor priority social spending will do enough to ensure improvement?*

- As indicated in the question, the size of the challenge matters. Given solid evidence on the positive long-term impact of social interventions based on strengthen human capital, staff firmly believes that the set of prioritized interventions selected for the social spending floor will improve the social situation in Honduras. However, given widespread and persistent poverty levels, a more sustained and persistent budgetary effort would be needed to ensure a large reduction in poverty. One of the key objectives of the program is that the budget lines including social spending are not affected by the existing challenges.

Corruption/Institutions

19. *We ask staff whether they will recommend the renewal of the mandate for the Mission to Support the Fight against Corruption and Impunity in Honduras (MACCIH) after January 2020, to continue its positive impact on corruption levels in Honduras, alongside measures set out in as part of this program?*

- Staff will respond to this question during the Board meeting.

Program Issues

20. *While economic performance is close to potential, reserve adequacy is around 110 percent of the Fund's Reserve Adequacy Metric. It is also noteworthy that the authorities intend to treat this arrangement as precautionary. Against this backdrop, could staff elaborate on why SBA/SCF agreements have an advantage over the Fund's non-financial Policy Support Instrument?*

- Staff will respond to this question during the Board meeting.
21. *Noting that the authorities intend to treat the arrangement as precautionary, can staff elaborate on the conditions in which they envision the authorities would draw on the arrangement?*
- Staff will respond to this question during the Board meeting.
22. *Fostering inclusive growth through ambitious governance reforms is crucial to bring back social stability. Current political polarization indeed stems from a widespread perception of corrupted institutions and misuse of public money. We are encouraged by the authorities' willingness to address these issues and we welcome the commitment to conduct a governance diagnostic with the Fund before the 1st review. Could staff detail how this diagnostic will be realized and under what form it will be reported?*
- Staff will respond to this question during the Board meeting.

Other topics

23. *We would appreciate it if staff could elaborate on the track record of Honduras' access to international financial market (e.g. borrower, size, frequency, spreads etc.) and staff's view on its future condition of market accessibility.*
- Honduras had three bond placements in international financial markets during the last years. The table below summarizes the main characteristics of these placements.

| Issuance Date | Coupon | Amount (US\$ million) | Spread (bp) | Maturity Date |
|---------------|--------|-----------------------|-------------|---------------|
| 3/12/2013 | 7.50 | 500 | 237.7 | 3/15/2024 |
| 12/11/2013 | 8.75 | 500 | 112.3 | 12/16/2020 |
| 12/1/2017 | 6.25 | 700 | 280.5 | 1/19/2027 |

- The staff believes that a solid track record of prudent macroeconomic policies and good program implementation would allow Honduras to continue accessing international capital markets.
24. *Could staff opine on recent political developments and how they may impact the authorities' ability to implement reform in this space, as well as to the overall program?*
- Staff will respond to this question during the Board meeting.
25. *We see merit in tackling the elevated tax expenditures, streamlining special tax treatments, and increasing tax compliance controls. We welcome the planned improvements in tax and customs administrations and the modernization of tax procedures. Preserving and properly allocating social spending will be necessary to tackle informality and reduce the gender gap. We urge the authorities to follow*

through with their reform agenda in these areas and to draw on technical assistance from the Fund and other partners to achieve their objectives. We would welcome staff's view on the capacity to swiftly implement these important reforms, including by overcoming resistance from possible vested interests.

- Staff will respond to this question during the Board meeting.
26. *We would like to know whether the additional MCP along with existing MCPs would be regarded as the MCPs under the new MCP policy.*
- Given that a new MCP policy has not yet been adopted by the Executive Board, staff has not yet tested existing MCPs against a new policy, including in relation to monitoring exchange rates arising from official action against market exchanges rates. That being said, in the case of Honduras's two MCPs, it should be noted that these MCPs are based on the potential for spreads in excess of two percent to arise. The Board has already indicated that potentiality should not form part of a new MCP policy.

Outlook/Risks

27. *There are high and increasing levels of remittances from migrants, making up around 20 percent of GDP in 2018, which have significant effects on the balance of payments. Could staff please explain the potential long-term effects of these emigration rates on the economy in Honduras? How would a change in US immigration policy effect economic activity in Honduras?*
- Let us emphasize that the core elements of the authorities' program aim at fostering inclusive growth through macroeconomic stability, better quality of fiscal policy, better governance, and enhanced transparency in public investment. These policies and reforms have the potential to create incentives for the Honduran population to remain in the country.
 - The impact of higher emigration rates is ambiguous, and it may depend on the horizon being considered. In the short-term, remittances associated with migrants (who may not have the opportunity to enter labor markets) may foster economic activity. In the long-term though, the loss of human capital may compromise growth. In line with this, evidence from a WHD study on the impact of migration and remittances in LAC (WP/17/144) concludes that the impact of emigration and remittances on real per capita GDP growth in the LAC region appears to have been small and ambiguous, with these effects varying across subregions likely reflecting the different characteristics of migrants. While the joint or net effect of migration and remittances has likely been negative for the Caribbean and South America, with the former experiencing large emigrant outflows and both characterized by brain drain and relatively smaller remittance receipts, the net impact appears small and possibly positive for CAPDR countries, which receive much higher remittances. The impact of

a change in US migration policies would depend on how it affects the population already living in the US; and how it affects the behavior of prospective migrants.

28. *We would be interested to what extent the tightening of migration policies in major host countries is having an impact on remittances?*

- What seems to be having an impact on remittances in Honduras is the uncertainty about future migration policies. Remittances have been very high over the last years—increased by 12 percent in 2017, 11 percent in 2018, and 9 percent over the January-June period of 2019. This is in line with empirical evidence suggesting that migrants suffering fear of deportation are likely to increase precautionary savings, thus sending more remittances to their home countries (about 35 percent above the average).

29. *Given the importance of coffee exports, the high share of small- and medium-sized producers, and the global oversupply, how does staff assess the prospects of the industry and the risks for the economy? As climate change appears to reduce agricultural prospects in Honduras, we would be interested if this topic will be taken up by staff in forthcoming surveillance with Honduras.*

- Certainly, developments in the coffee market—a critical commodity for Honduras—have been negative particularly due to record-low prices mainly caused by oversupply from largest producers. However, demand prospects are positive due to expected consumption increases in China and prices are recovering. Therefore, while recognizing that risks exist, staff expects positive developments in the coffee sector for Honduras in 2020 and thereafter. Regarding climate change, it was a topic discussed during the 2018 Article IV. Staff recommended fostering the production of value-added goods rather than agricultural goods and taking due notice of fiscal contingencies that could stem from global warming. Certainly, the topic could be reassessed in the next Article IV.

30. *Can staff elaborate on the plan, if any, to enhance the FOSMIH fund in support of such returning migrants? What would be the social and poverty implications considering the importance of remittances from migrants?*

- Staff is not aware of expansion plans for the FOSMIH. Regarding the impact of a reduction in remittances, this will likely have a negative impact on poverty conditions in Honduras. According to a recent IADB study 17 percent of Honduran households receive remittances amounting 38 percent of their monthly income. Of the families receiving remittances, 44 percent are poor (income less than US\$4 per day) and 40 percent are vulnerable (income less than US\$10 but higher than US\$4 per day).²

² Interamerican Development Bank (2016) “Remittances Recipients in Honduras: A Socioeconomic Profile”.