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Minutes of Executive Board Meeting 19/103-2

11:40 a.m., December 18, 2019

2. Honduras—First Reviews Under the Stand-By Arrangement and the Arrangement Under the Standby Credit Facility and Request for Modification of Performance Criteria

Documents: EBS/19/114

Staff: Vesperoni, WHD; Corbacho, SPR

Length: 54 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors Alternate Executive Directors

A. Nainda (AE), Temporary
 R. Lopes Varela (AF), Temporary
 J. Corvalan (AG), Temporary
 C. White (AP)
 M. Coronel (BR), Temporary
 Y. Zhao (CC), Temporary
 M. Tabora (CE), Temporary
 J. Weil (CO), Temporary
 S. Benk (EC)
 P. Rozan (FF)
 K. Merk (GR)
 Y. Indraratna (IN)
 F. Spadafora (IT), Temporary
 K. Chikada (JA)
 M. El Qorchi (MD)
 M. Merhi (MI), Temporary
 H. Etkes (NE), Temporary
 M. Bernatavicius (NO)
 L. Palei (RU)
 R. Alkhareif (SA)
 K. Tan (ST)
 R. Makhammadiev (SZ), Temporary
 T. Chrimes (UK), Temporary
 P. Pollard (US), Temporary

H. Al-Atrash, Acting Secretary

S. Maxwell, Summing Up Officer

D. Alcantara, Board Operations Officer

M. McKenzie, Verbatim Reporting Officer

Also Present

Communications Department: Maria Elena Candia Romano. Fiscal Affairs Department: Cristian Emmanuel Alonso. Legal Department: Ivana Maria Rossi, Nataliia Stetsenko. Strategy, Policy, and Review Department: Francisco Jose Arizala Escamilla, Ana Corbacho. World Bank Group: Elena Bondarenko, Stefano Curto. Western Hemisphere Department:

Patricia Alonso-Gamo, Javier Wilfredo Kapsoli Salinas, Catherine Chiew Ming Koh,
Constant Aime Lonkeng Ngouana, Inci Otker, Esteban Rodrigo Vesperoni.

2. HONDURAS—FIRST REVIEWS UNDER THE STAND-BY ARRANGEMENT AND THE ARRANGEMENT UNDER THE STANDBY CREDIT FACILITY AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA

Mr. Villar and Mr. Tabora Munoz submitted the following statement:

Our Honduran authorities are deeply grateful to the staff for the constructive engagement and high-quality policy discussions. They broadly share the staff's assessment of the economic outlook and policy priorities for the upcoming years. It is important to highlight that this is the seventh review since 2014 under two IMF-supported programs, something unprecedented for Honduras. This progress reflects the authorities' steadfast commitment to enhance and consolidate their policy and economic framework. During the 2014-2017 Fund-supported program, Honduras secured macroeconomic stability and institutionalized fiscal responsibility. The new program, approved earlier in 2019, further supports the new economic and institutional reforms to address social needs and governance issues, and to boost investors' confidence.

Authorities intend to continue treating this program as precautionary and build on past gains, supported by technical assistance from the Fund and other multilateral institutions.

Economic Outlook

Economic growth has decelerated due to a number of adverse shocks, and it is projected at slightly below 3 percent in 2019 because of persistently weak terms of trade, a severe drought, and political tensions during the summer of 2019. But it is expected to recover above 3 percent in 2020 led by a more favorable external environment, better business climate and a more stable political context. Inflation expectations at the end of November (3.8 percent y-o-y) continued showing a downward trend after peaking in May and remain below the mid-point of the band (3 to 5 percent), helped by a very low exchange rate depreciation (1.3 percent y-o-y). The revised current account deficit for end-2019 is estimated below 3 percent of GDP and the reserve coverage ratio remains stable at around 5.1 months of imports. Overall balance for 2019 is projected at 1.0 percent of GDP, in line with the program fiscal targets.

Program Performance

Despite the challenging environment and recent adverse shocks, authorities remain fully committed to the program, and aim to maintain

macroeconomic stability, enhance the business climate, strengthening transparency and governance. In that regard, all end-September fiscal and monetary quantitative performance criteria (PC) have been met, including continuous non-accumulation of external arrears. Authorities remain on track to meet the end-year targets. Structural Benchmarks (SB) are progressing in line with expectations, except one that was completed with a delay.

Fiscal Policy

The authorities reiterate that government fiscal policy will continue to be guided by the Fiscal Responsibility Law (FRL). The overall fiscal deficit is in line with the FRL ceiling, despite sluggish growth and faster-than-expected tax revenue losses, which implies a more gradual recovery of public investment while protecting social spending. However, authorities are implementing expenditure relocation, including restraining current spending in central government by about 0.5 percent of GDP to protect investment and the social safety net “Vida Mejor”, and to support short-term growth while securing debt sustainability and upholding the FRL deficit ceiling.

Authorities are strongly committed to revenue mobilization efforts, recognizing that the recovery will be more gradual. They are pursuing streamlining of tax expenditure to reduce distortions in the tax system and broaden the tax base. The 2020 budget just approved is consistent with fiscal targets in the program (including social spending) and incorporates a more detailed report of spending through trust funds.

Authorities have continued enhancing the quality of public expenditure and implementing the recommendations of the Fiscal Transparency Evaluation (FTE) by the Fund. In this line, the Ministry of Finance (SEFIN) recently approved the General Directorate of Trust Funds responsible for the structuring, control and monitoring, and for the registry of each trust fund, all aimed at improving fiscal transparency and observing the public financial management regulations. Moreover, authorities are upgrading statistical standards towards GFSM 2014, also aimed to improve fiscal transparency.

Electricity Sector

Authorities reiterate their full commitment to continue addressing the long-standing challenges in the electric sector, particularly in the electricity public company ENEE. Proper implementation of the General Law of the Electrical Industry (LGIE) constitutes a cornerstone in the current economic program. In that regard, authorities continue strengthening the regulatory

agency (CREE), after having set up its governance structure, supporting its financial autonomy, and implementing the new tariff mechanism to update tariffs on a quarterly basis, based solely on technical considerations. The CREE with the assistance from the World Bank (WB) and Interamerican Development Bank (IDB) continues working on completing the regulatory framework needed to fully implement the LGIE.

The system operator (ODS), responsible for managing the power grid and all spot market transactions, is already functional. ODS is in the final stage of socializing the indicative expansion plans for generation and transmission, which will help guide future energy purchases, especially the bidding processes planned for early 2020. The Ministry of Energy (MoE) is working on streamlining the Power Purchase Agreements (PPA) that do not comply with the LGIE.

With support from IDB, SEFIN will start early in 2020 the audits of ENEE's financial statements and its processes -to value the assets and liabilities of the company- as a critical task to complete the unbundling of the company. Recovering the company's financial independence from the trust funds that manage its cash flows is fundamental to improve the sector's governance and clear arrears. The authorities expect to cancel the trusts early in 2020, using the resources coming from a new 2020 bond placement. All these actions are oriented to establishing a more open, efficient and transparent electricity market.

Authorities recognize that reducing electricity losses is a cornerstone of the electrical sector reform and to secure financial sustainability of the ENEE. In that regard, a new task force to reduce non-technical losses is being established, as well as measures to secure financing to upgrade the transmission grid and reassessing the contract with the distribution operator Empresa Energía Honduras (EEH). Even though a new management team was appointed last July, a comprehensive intervention of ENEE will be pursued in early 2020 to advance the company's structural overhaul.

Monetary Policy

The Central Bank of Honduras (BCH) continues gearing monetary policy towards maintaining price stability and an adequate level of international reserves. BCH also continues the transition towards full-fledged Inflation Targeting (IT), and the work to strengthen the monetary policy framework in order to move gradually to a flexible exchange rate regime. In that regard, BCH's board of directors recently approved further reduction of

20 percent of FX surrender requirements, thus allowing economic agents to sell up to 60 percent of FX inflows to deepen the interbank FX market. Additional technical support from Fund departments will be needed to strengthen BCH capabilities required to develop the new market intervention mechanisms.

BCH authorities, with strong support from the IMF, have completed a draft of the new central bank charter that will be submitted to Congress by end-2019. This new charter is aimed to: (i) clearly define price stability as the primary policy mandate of the BCH; (ii) institute a sound central bank governance structure to clarify operational, oversight and policy decision responsibilities; and (iii) preserve operational autonomy, increase transparency and accountability of the institution.

On November 2019, BCH started the National Household Income Expenditure Survey (NHIES), fundamental tool to improve pricing and economic activity statistics, critical to assess the monetary stance and transition towards full-fledged Inflation Targeting.

Financial Policies

The National Banking and Insurance Commission (CNBS) stays fully committed to the improvement of the regulatory framework and supervisory practices in line with the FSSR recommendations and the Basel III standards, as well as strengthening CNBS capacities in risk-based supervision and stress testing. The CNBS remains attentive to tightening the macro-prudential framework depending on the evolution of credit growth, especially in foreign currency. Non-Performing Loans (NPLs) are low, provision coverage is high, liquidity is plenty, and capital adequacy ratio (CAR) is well above the regulatory minimum. The CNBS continues assessing the investment policy framework of public pension funds, oriented to align the maturity of their assets and liabilities, in line with international best practices.

Consistent with the modernization of the monetary policy framework and aiming towards a full-fledged Inflation Targeting, the CNBS and BCH are drafting the new securities market law to support development of domestic capital markets but also to strengthen the interest rate channel of monetary transmission. The authorities plan to submit the new law to the legislative early in the first quarter of 2020.

Business Environment and Governance

Fostering the conditions for greater private sector activity is critical for the success of the economic program. In that sense, application of the new administrative simplification regulations is ongoing, including developing a plan for the gradual implementation of the electronic signature. Authorities also continue strengthening the fiscal governance to prevent misuse of public resources and limiting fiscal risks. In that regard, the recently-created Public Private Partnership technical unit will work in tandem with the fiscal contingencies unit to improve the PPP framework.

Authorities are reaching full implementation of the enhanced public purchases and contracting platform Honducompras 2.0, ensuring full integration with Treasury IFMIS (SIAFI). As part of this process and following OCDE standards, reforms of the public procurement law to strengthen compliance are planned for late 2020. Additionally, an inter-agency group for transparency and anti-corruption, following the 2018 Lima commitment – “Democratic Governance against Corruption”- was created this year. Along these lines and as part of the Fifth Open Government plan, an outline for the Open Parliament Plan is expected by mid-2020.

The authorities also continue their work on fostering the AML/CFT and anti-corruption framework. In that regard, the court of accounts has decided to issue by-laws to reform the public officials’ asset declaration system and to revise the criteria to determine which officials should report based on their hierarchy and/or risk profile. Moreover, with the help of the Fund, authorities are working on an amendment of the Code of Commerce to create a unified and centralized registry of beneficial ownership.

Climate Change

Honduras remains one of the most vulnerable countries to climate change in the world, as demonstrated by this year’s severe drought that affected dramatically the economic activity and put a toll on the agricultural, cattle and energy sectors. Honduras continues making substantial investments to restore its forests and build climate-resilient infrastructure. The authorities remain committed to create buffers in the national budget for this purpose, but it is critical to secure access to grants and concessional green funds to continue financing adaptation and mitigation measures, and climate change interventions, including water management and food security.

Final Remarks

During the last six years, Honduras has made significant strides in: reducing macroeconomic imbalances, promoting economic stability, strengthening its policy framework and increasing investors' confidence. However, there are still many challenges ahead, so the authorities hope to maintain a continuous and close cooperation with the Fund to successfully complete the program and to solve outstanding problems for the benefit of its population. On behalf of our Honduran authorities, we thank Staff, Management and the Executive Board for the continued support to the country.

Consistent with the commitment to keep the public informed, the authorities consent to the publication of the Letter of Intent, its attachments and the related staff report.

Mr. Fanizza, Ms. Levonian, Mr. Doornbosch, Mr. Etkes, Mr. Spadafora and Mr. Weil submitted the following joint statement:

We thank staff for the informative report and Mr. Villar and Mr. Tabora for the buff statement. Honduras perused a prudent fiscal policy, kept inflation within target band, and met almost all of the program targets for September despite a challenging external environment which yielded low growth. Therefore, we support the completion of the first review and the modification of PC. Specifically, we commend the authorities' proposal for additional conditionality to foster governance, AML/CFT and anti-corruption reforms, which can be instrumental in strengthening the business climate and, ultimately, growth.

The Honduran economy faces significant headwinds including exports decline, a severe drought and social tensions. The recovery slowed down in 2018-19, yet there are some indications of higher growth in 2019-Q3 and the sharp rise in coffee prices in the last two months indicate a somewhat faster growth in the near future. We note that the growth projections in the report predated the recent global slowdown and the monetary easing in the US and wonder how they are expected to affect the Honduran economy?

We commend the authorities for renewing their commitment for the Fiscal Responsibility Law and the deficit ceiling therein. We support their efforts to protect social spending and the use of fiscal space freed up by delays in implementing several large-scale public investment projects to undertake small infrastructure projects with high social impact. We appreciate staff's

view on the appropriate composition of the new spending given the proposed increase in the deficit target to boost growth.

Continued progress on electricity sector reforms will be important to reduce losses in ENEE and create fiscal space for priority spending. We commend the authorities for their progress to date in addressing institutional issues which are fundamental to a well-run electricity sector. It will now be important to address financial and generation issues, including refinancing agreements with creditors and contract renegotiation with distributors.

We encourage the authorities to continue with the transition of the monetary regime towards inflation targeting; the Fund's Capacity Development should effectively support such transition. We are pleased by the Fund's TA to the CHB and wonder about the reasons of the decline in the number of Honduran officials trained in monetary policies in the last two years. We note that this transition is taking place when monetary policy in many countries is accommodative and some central banks use unconventional monetary policies. We wonder whether such expansionary monetary policies affect the transition of the CHB to inflation targeting. Staff comments are welcome.

We commend the authorities for the roadmap to foster governance reform as well as the authorities' proposal to add new benchmarks on governance. These efforts focus on enhancing governance of fiscal regime and strengthening the AML framework. While these are directly linked to the core mandate of the Fund, other phenomena – including the high crime rates in Honduras – might limit the effectiveness of the proposed roadmap. Staff comments are welcome.

Mr. Lopetegui and Mr. Corvalan Mendoza submitted the following statement:

We thank staff for the report and Mr. Villar and Mr. Tabora Munoz for their informative buff statement. Policy reforms served the country well and socio economic indicators showed improvements. Challenges to strengthening institutions responsible for delivering public goods are being tackled with positive results.

We support the completion of the First review under the Stand-By Arrangement. The authorities' commitment to improve the policy framework, with two IMF-supported programs since 2014, are welcome. We concur with the staff assessment and encourage the authorities to continue cementing the modernization process of the economy to safeguard the economy from domestic and external shocks.

Fiscal Responsibility Law (FRL) will guide fiscal policy. We see merit in the authorities' commitments to safeguard this important mechanism and fulfill its well functioning despite sluggish economic growth. FRL compliance at all times is challenging when investments and social demands for financial resources are high. Nevertheless, in order to boost domestic and foreign investors' confidence on the trajectory of the economy, it becomes crucial to strengthen this mechanism. The intention of the authorities to reallocate expenditures to protect investments and the social safety net will send the right signals to the investment community and development partners. At this point the composition of the fiscal adjustment is critical to avoid any action that might lead to fiscal slippages or derail the progress reached so far on this front. On the latter, we take positive note that the General Law of the Electrical Industry is being implemented, which deals among other things with the financial position of the electricity public company ENEE and its independence from the trust funds. Could staff inform us of the potential size of the government bond issuance (as indicated in the buff statement) to cancel these trusts?

We applaud the willingness of the authorities to modernize the monetary framework and to enhance the stability of the financial system. For the former, we are encouraged a new charter for the Central Bank is under way, which will redesign its structure to make it consistent with international best practices. Could staff update us on whether this draft Law was submitted to Congress and what changes it will pass? For the latter, it is important to strengthen the capacity of financial institutions and to pursue the implementation of recommendations of the Fund's Sector Stability Review (FSSR). The agility of the financial system to channel funds for investment and consumption are critical to accelerate economic growth.

We welcome the authorities' roadmap for strengthening governance and fight corruption. Along with other institutional measures to improve governance in policy making, delivering on this agenda will enhance social support for the authorities' program and provide a better climate for efficient private sector investment.

With these comments, we wish the people of Honduras every success in their future endeavors.

Mr. Chikada, Mr. Tan, Mr. White, Mr. Abenoja, Mr. Shin and Mr. Shimada submitted the following joint statement:

We thank staff for their comprehensive report and Mr. Villar and Mr. Tabora Munoz for their informative buff statement. The Honduran economy has continued to face challenging external headwinds and various domestic shocks. Despite the difficult policy environment, it is encouraging that the authorities remain firmly committed to the program with satisfactory performance. Performance criteria, indicative targets and structural benchmarks were mostly met while pending items were subsequently completed or are on track to be met. The requested modifications of the PCs also reflect the use of the small fiscal space allowed by the Fiscal Responsibility Law (FRL) and the better-than-expected external position. We support the completion of the First Review under the Stand-By Arrangement and the Arrangement under the Standby Credit Facility and Request for Modification of Performance Criteria. As we broadly concur with the thrust of the staff appraisal, we will limit our comments to the following points.

Continued fiscal prudence will be needed to free up the space for Honduras' social needs. With still more than 60 percent of the population below the poverty line and the Gini index remaining elevated at 53, fiscal consolidation efforts need to be well balanced against the need to support the growth and the adequate provision of social safety nets. We support a slight increase in the deficit target for this and next year and welcome the authorities' commitment to uphold the FRL deficit ceiling of 1 percent of GDP. It is also encouraging that the authorities are pursuing measures to contain recurrent spending such as wages, while enhancing fiscal governance and PFM. In the medium term, additional efforts should focus on broadening the tax base including by streamlining the large tax expenditures (almost 7 percent of GDP) and improving coordination among revenue-related agencies. We welcome authorities' efforts to reduce electricity losses including through streamlining ENEE's spending and undertaking targeted field assessments of irregular connections even as authorities plan to cautiously proceed with the reassessment of the contract with the distribution system operator. That said, further reform in the electricity sector is vital to improve the efficiency of the sector and create more fiscal space, particularly for investments and social spending. Thus, we encourage the authorities to accelerate multi-faceted reforms in this area, building on recent progress on tariffs. Could staff further elaborate on the effects of these reforms on the most vulnerable?

A transition towards inflation targeting and development of the FX market would help the economy to buffer shocks better. We welcome the

recent progress on monetary operations such as better liquidity management, electronic interbank operations and reduction of FX surrender requirements. We support the broad thrust of the proposed new charter for the central bank to have price stability as the primary mandate and to emphasize the independence, accountability and transparency of the institution. We invite staff to elaborate on the status of the proposed central bank law.

Fostering inclusive growth through ongoing governance reforms is crucial to restore social stability and to enhance the business climate. We welcome the ongoing efforts to strengthen the institutional frameworks of key public institutions, improve public procurement and raise the quality of PPP projects. We encourage the authorities to try to include broader governance issues in their roadmap and expedite the implementation of reform measures. Can staff further elaborate on the absorption of TA activities on these fronts and the priority areas where the Fund's capacity development can be of further support to the authorities? A strong communication strategy should accompany the governance reforms to help garner public trust in government institutions. Stronger rule of law and better governance would be key to attracting FDI and creating quality jobs in the private sector, which would help unlock the growth potential of Honduras, given its significantly high underemployment rate (73.8 percent).

Lastly, besides program performance, we take note that the Indicative Target for the wage bill was wrongly calculated due to a technical error. It is important that staff papers accurately reflect the right context to foster country ownership and policy traction. In this regard, could staff elaborate on the circumstances behind the miscalculation? If the miscalculation is not the authorities' fault, should the comment in the Executive Summary "The IT on the wage bill was missed" be fine-tuned to avoid any miscommunication? Staff comments are welcome.

Mr. Merk and Ms. Koh submitted the following statement:

We thank staff for an informative report and Mr. Villar and Mr. Tabora Munoz for their informative buff statement. Since the onset of the Fund program the Honduran economy has experienced unexpected headwinds from a challenging external environment and domestic shocks to the economy. Against this background, we recognize the authorities' strong program performance and consent to the completion of the first reviews under the SBA and the SCF arrangement, as well as the modifications of the performance criteria. We call on the Honduran government to rigorously work towards improving governance and the rule of law and reducing corruption to

foster more inclusive growth. We encourage the authorities to maintain their reform commitment despite strong headwinds and to treat the SBA and SCF arrangements as precautionary.

In light of recent domestic social tensions, we stress that the social impact of economic reforms as well as the credibility of the authorities' commitment are determining factors for the feasibility of the economic reform agenda. Authorities should ambitiously work towards achieving the program's social benefits and credibly communicate these in line with the program's spirit even outside its immediate reach.

Adverse economic conditions have caused a marked drop in the GDP growth rate and a shortfall in public revenue in 2019 which weighs on public and private investment. In addition, critical social spending such as on education and health has been reduced throughout recent years. At the same time, the economy exhibits a better-than-expected external position and a solid financial system. We take note that staff points to high-frequency indicators suggesting that the bottom of the deceleration process might have been reached in the second quarter of 2019. Could staff provide an update based on more recent high-frequency economic indicators?

We take note of the authorities' intention to reallocate funds towards more short-term investment projects with a high economic and social return while upholding the ceiling set out in the Financial Responsibility Law (FRL). Going forward, more rigorous fiscal discipline, and thus a budget deficit below the 1 percent permitted by the FRL will be needed to scale down public debt while adequately protecting social spending for education and health. As current circumstances prove, a fiscal buffer is helpful to tackle unexpected downturns.

Further efforts to improve governance are of paramount importance to create the economic, political and social preconditions for successful and sustainable reform implementation. More ambitious reforms that reduce corruption, increase the transparency and efficiency of the public sector and improve the business environment are crucial for the credibility of the government's reform agenda towards the Honduran population as well as domestic and foreign investors.

We agree with staff that the authorities' roadmap includes significant measures to improve governance. However, other recent changes [– such as the introduction of a new penal code, “Código Penal” with elements apparently reducing penalties on corruption related cases –] seem to point in a different direction. These developments might be considered as inconsistent

with the authorities' pledge to improve governance. Could staff's please comment on the potentially beneficial impact of extending the mandate of the "International Mission of Support Against Corruption and Impunity in Honduras"(MACCIH), which expires in January 2020. Would this be regarded as a signal of the Honduran government to deliver on their commitment to strengthen the rule of law?

Mr. Benk and Mr. Bukovina submitted the following statement:

We thank staff for the well-focused report, and Messrs. Villar and Tabora Munoz for their informative buff statement. In view of the authorities' commitment to the program and their reform efforts, we support the completion of the first review under the Stand-By Arrangement and Standby Credit Facility, as well as the associated request for modification of performance criteria.

Securing the fiscal position while protecting social spending is consistent with the program's fiscal targets. The authorities continue to maintain prudent macroeconomic policies. Lower-than-expected tax collection, driven by a combination of slower economic activity and higher-than-expected tax revenue losses from previous tax measures, have been offset by restrained public investment, while protecting social spending. We encourage the authorities to streamline tax expenditure, broaden the tax base, and strengthen tax administration. We note the tax revenue losses due to the minimum corporate tax reform in 2018. Could staff elaborate on the efficiency of this reform? Was the minimum corporate tax distortionary for economic activity? Will the reform contribute to improved business conditions over the medium term, or are lower corporate revenues the only effect? The authorities are making progress on the unbundling of the public electricity company ENEE, though further efforts are needed to improve its governance, including reaching agreements with various stakeholders, as well as the implementation of the plan to reduce electricity losses. These reforms should help improve ENEE's financial position as envisaged in the program, opening up fiscal space for investment and social spending.

Monetary policy continues to be geared towards maintaining price stability and an adequate level of international reserves to buffer external shocks. Guided by the recommendations from recent Fund technical assistance, efforts to modernize the monetary policy framework and transition towards a more flexible exchange rate regime are being pursued as planned. In this regard, we welcome the National Household Income Expenditure Survey to collect pricing and economic activity statistics.

The banking system is solid, though pension funds require further improvements to the investment policy framework. Non-performing loans are at low levels, liquidity is sufficient, provision coverage is high, and the capital adequacy ratio exceeds the regulatory minimum. The authorities are strengthening supervisory practices in the financial system in line with Basel III and the Fund's Financial Sector Stability Review. Strengthening internal risk management practices and enhancing transparency in pension funds' investment is fundamental to safeguarding financial sustainability.

A long road lies ahead for Honduras to achieve sustainable and inclusive growth. Inequality is increasing; the poverty and illiteracy rates remain at high levels, especially in rural areas; and the informal sector, one of the largest in Latin America, drags on productivity and competitiveness. On a positive note, the gender gap has decreased, and the authorities have been working on reforms to prevent the misallocation of public resources, enhance the business climate, and reduce significant governance deficiencies. We welcome the authorities' plans to promote climate-resilient forest restoration for the first time, as Honduras suffers from droughts that have a significant impact, particularly on the coffee industry.

Ms. Pollard and Mr. Grohovsky submitted the following statement:

We welcome the first review of the SBA/SCF arrangement for Honduras. Program performance has been solid and we commend the authorities for meeting all performance criteria and all but one indicative target. However, larger challenges and tougher reforms lie ahead, and we encourage the authorities to retain their reform momentum. In particular, significant changes will be needed in the energy sector, including public electricity company ENEE. We support completion of the review and offer the following comments.

We take note of the economic slowdown and hope that the deceleration bottomed out in the second quarter. Nevertheless, we welcome the authorities' flexibility in reallocating expenditures to support near-term growth and their commitment to use available fiscal space. We appreciated the annex on drivers of revenue underperformance, as better revenue mobilization can help provide space for further pro-growth measures. Efforts to streamline high tax exemptions are an important step to improving revenue collection and reducing distortions in the tax code. Could staff elaborate on the prospects for the numerous December structural benchmarks, particularly those related to tax policy?

One of the greatest areas for reform and growth is in the energy sector. We welcome that tariffs continue to be updated on a quarterly basis based on technical considerations, in line with the continuous structural benchmark. We also appreciate the commitments to tackle long-standing challenges in ENEE as laid out in the MEFP, including on management, audits, unbundling, creditor refinancing, and reducing electricity losses. However, we wonder if some of these reforms should be added as structural benchmarks, given their challenging nature and given that the only explicit energy sector benchmark is the aforementioned continuous benchmark on tariffs.

We also welcome the focus of the program and the authorities' ambition on improving governance. The measure to increase fiscal transparency by outlining the activities and transfers to trust funds in a budgetary annex is an important step toward better fiscal governance. Strengthening the AML/CFT and anti-corruption framework should also help improve the business climate and growth. We commend the authorities' proactive efforts to add these measures to the program.

Finally, we welcome the authorities' intention to continue to treat the arrangement as precautionary. Nearly six months on from program approval, we would welcome an update from staff on the conditions in which they see the authorities drawing on the program.

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

We support the authorities' request for the completion of the first review of the Stand-By Arrangement (SBA) and Stand-By Credit Facility (SCF), as well as the associated decisions. Our decision reflects commendable program performance by the Honduran authorities, despite the current slowdown, which is mainly due to exogenous factors. Given lingering effects of volatile commodity prices, a severe drought and remnant social unrest, we believe that this program is essential in maintaining macroeconomic stability and fostering inclusive growth.

The authorities' strong commitment to prudent fiscal policy is commendable and should be sustained. We note that the weaker economic activity necessitated some revenue shortfalls. This notwithstanding, the authorities' restraint within the Fiscal Responsibility Law (FRL), is encouraging as this has anchored improvement in the fiscal position. In line with the reassuring buff Statement by Messrs. Villar and Tabora, we support the authorities' strategies to reduce distortions in the tax system and broaden the tax base. We think that the Treasury's pre-intervention in the public

electricity company (ENEE), which has resulted in savings of about 25 percent of GDP and prevented further accumulation of arrears, is a significantly positive outcome. We look forward to the wide-ranging interventions planned for the coming year that will be necessary in restructuring ENEE and putting an end to the company's strain on public finances. In this context, could staff shed more light on the process of cancelling the contract with Empresa Energia Honduras (EEH) and why the authorities cannot clearly determine the costs involved at this stage? Did the authorities indicate when this assessment would be completed and what the implications are for the program?

We welcome the progress made in the transition towards inflation targeting (IT). The reduction in FX operations and implementation of recommendations from Fund-TA are steps in the right direction. In similar vein, we urge the Central Bank of Honduras (BCH) to deploy additional efforts to strengthen the monetary policy framework and develop the FX market. In modernizing the framework, we are encouraged that the central bank's draft law explicitly outlines key changes regarding operational independence, transparency, accountability and governance. Improving the monetary policy operational framework through better governance of the central bank is critical at this time. Hence, we look forward to the swift passage of the new law by Congress.

Efforts to foster governance reforms are key steps in promoting inclusive growth and managing fiscal risks. We take comfort in the ongoing work to tackle governance issues and improve the business climate. The key measures outlined by the authorities to manage Public-Private Partnerships are steps in the right direction. Once implemented, we believe these would prevent misappropriation of public funds and limit fiscal risks, whilst boosting private sector participation. We are further pleased to note that the authorities will prioritize social spending and continue to provide support and protection for the poor even amidst the push for fiscal consolidation.

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

We thank staff for the report and Mr. Villar and Mr. Tabora for their insightful statement. Honduras has started implementation of its new IMF program on a solid footing. Despite the headwinds and challenges, the country's generally positive outlook is underpinned by strong fundamentals and macroeconomic policies. Consequently, we support the completion of the first review under the 2-year blended Stand-By Arrangement (SBA) and

Standby Credit Facility (SCF). We take note that the authorities continue to treat the arrangement as precautionary.

The IMF program is ambitious, and the authorities have been showing strong ownership and resolve. All quantitative performance criteria have been met for end-September. The indicative targets for the same month have also been met, except for the generally more complex and socially sensitive public wage bill. Nonetheless, we take note that, according to staff, this target is on track to be met in end-December. Such strong initial performance provides a solid momentum to tackle the many challenges going forward, including maintaining fiscal sustainability while protecting social spending, strengthening financial stability, reforming the energy sector and improving governance.

After the buoyant performance in the last few years, real GDP growth has lost some steam in 2019 as a result of compounded adverse shocks. The impact of the slowdown in global trade and activity has hit Honduras hard due to the country's close links to the US economy. Uncertainties associated to social unrest sparked by the education and health reforms presented to Congress earlier in the year and the severe drought contributed to take a toll on the economy's growth. We take note that Honduras is vulnerable to climate-related hazards, including floods, droughts, and hurricanes, and that the authorities plan to tap into the Green Climate Fund to promote climate-resilient projects.

Despite a shortfall in fiscal revenues, the authorities managed to adhere to the Fiscal Responsibility Law (FRL). We commend the authorities for offsetting lower-than-expected tax revenues by reining-in current spending, while still being able to accommodate growth-friendly small infrastructure projects and key social programs. We encourage the authorities to continue strengthening public financial management (PFM) and improving fiscal transparency and reporting. We also welcome the government's initiatives to restructure the state-owned electricity company ENEE, including through periodic review of tariffs, better control of expenses closer monitoring by the Treasury to avoid arrears with providers, and more accountable management.

Strengthening social policies remain key to the program's success. Despite the recent progress in poverty reduction, Honduras still faces high levels of poverty, inequality, outward migration, and insecurity. Therefore, striking the right balance between reform needs and social demands is key for

the program success. Further, calibrating effective social spending will lower the risks of political backlashes and program fatigue.

Mr. Ronicle and Mr. Chrimes submitted the following statement:

We thank staff for the report, and Mr. Villar and Mr. Tabora Munoz for their buff statement. We broadly share staff's assessment on the progress the authorities have made against a challenging backdrop. We also note the authorities' continued intent to treat the arrangements as precautionary. We support completion of the first review and accept the proposed modification of the performance criteria.

The authorities have made good progress against key program objectives, even though the external environment, the drought and the summer's social unrest have all weighed on growth. The authorities' renewed commitment to the Fiscal Responsibility Law (FRL), despite weaker-than-anticipated growth, is prudent. We highlight staff's assessment that overperformance against FRL targets in recent years means there is "moderate space to support growth", and, in the circumstances, we can see the case for a slight expansion in the deficit target for 2019 and 2020.

Looking further ahead, ideally fiscal policy would be anchored by fiscal rules, with monetary policy playing a greater role in managing demand fluctuations. Delivering on commitments to transition to a modernized monetary framework with greater exchange rate flexibility and inflation targeting at its core is a key objective. We recognize that these processes need to be carefully managed. Enhancements in central bank operational independence, transparency, accountability, and governance will help underpin progress. The central bank charter should be a useful step forward. We appreciate the technical support engagement between IMF staff and the Central Bank of Honduras.

We welcome the focus on protecting social spending and public investment. We also note the authorities' intention to prioritize small investment projects with high social impact. Measures to protect the vulnerable remain paramount, given poverty levels and income inequality both remain high. While staff state that social tensions "have lessened", social consensus will continue to be important for the program's success. We encourage staff and the authorities to remain in close contact in this regard.

Pushing ahead with the broader reform agenda proactively, while taking account of distributional concerns, is important to delivering more

sustainable long-run growth. We share the view that progress has been made in reforming the electricity sector but that further efforts are needed, for both fiscal and operational efficiency reasons; this should be a priority for staff and the authorities over the remainder of the program. The roadmap to foster governance reforms and the associated new structural benchmarks proposed by the authorities are encouraging. Finally, we welcome the authorities' interest in climate-resilient forest restoration.

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

We thank staff for the informative report and Mr. Villar and Mr. Tabora Munoz for their informative buff statement. We support completion of the first reviews under the SBA and the SCF arrangements and related decisions. The Fund-supported program has provided a basis for sound macroeconomic policies and structural and institutional reforms. We welcome the robust program performance, despite the adverse shocks. Moreover, we encourage the authorities to keep up the momentum, including on revenue mobilization and energy sector reform. This would create room for much-needed public investment and social spending.

Underperformance in tax collection calls for further revenue measures. While restraining current spending is a necessary near-term measure, broadening the tax base and reducing tax exemptions would be necessary to improve country's overall fiscal position. In this regard, could staff indicate the scale of the reduction in tax expenditures envisaged in the related bill? Adherence to the FRL has entrenched fiscal prudence and should be sustained.

Further progress in restructuring ENEE will be key to preserve fiscal sustainability. We are encouraged by the overhaul of ENEE's governance and its unbundling. That said, it will be critical to reach a workable agreement with EEH to press ahead with reforms in the electricity sector. We note that the expected delay will result in further financial losses by ENEE, and we urge the authorities to avoid protracted negotiations with the distributor. Further improvements in the electricity sector would send a positive signal to investors.

Modernization of the monetary policy framework is welcome. We encourage the authorities to persevere in the transition to inflation targeting and move toward a more flexible exchange rate regime in a timely manner. To deepen the FX market, the remaining surrender requirements should be phased out according to the authorities' plan. We appreciate that the new central bank charter focuses on price stability and strengthens the BCH's

independence and governance structure. Here too, we encourage timely implementation. Could staff comment on indications whether the December benchmarks on the surrender requirements and the BCH Charter will be met?

The authorities should remain vigilant about developments in the financial sector. While we note lower growth in credit provision by pension funds, we urge the authorities to enforce tighter regulation in line with staff's recommendations. Does lending activity of pension funds pose a systemic risk to the financial sector or the economy? The new scheme for financial assistance of heavily-indebted consumers should be subject to scrutiny of the supervisory commission to prevent emergence of financial vulnerabilities.

We support the authorities' structural reform agenda and encourage them to progress in boosting inclusive growth and reducing poverty. We welcome the inclusion of measure to enhance governance and fight corruption as new structural benchmarks under the program. To achieve more inclusive growth, the authorities should also tackle high illiteracy rates, especially in rural areas. This would yield high returns in terms of human capital accumulation in the long term.

Mr. Rozan and Ms. Albert submitted the following statement:

We thank staff for their clear report and Mr. Villar and Mr. Tabora Munoz for their informative buff statement. We commend the authorities for their continuous progress to enhance their policy and economic frameworks. In addition, we very much welcome the incorporation of the authorities' push on governance into the program design through the five new structural benchmarks. The country remains characterized by significant poverty and inequalities levels, and protracted violence. Continued effort regarding these issues will help foster a more inclusive growth as well as a business environment more conducive to higher growth. We support the completion of this first review. We share the thrust of the staff's appraisal and would like to add the following comments:

We commend the authorities for the improvement of the public finances and their efforts to reach the program targets despite the economic slowdown. We welcome the fact that, despite lower revenues than expected, the authorities have reduced their current spending in order to minimize the impact on public investment and protected social spending. We agree that the rationalization of the fiscal exemptions and the broadening of the tax base are key, and we welcome the implementation of the recommendations of the Fiscal Transparency Evaluation (FTE).

The monetary policy framework is improving. We welcome the transition towards a full-fledged inflation targeting and the draft of the new central bank charter which will bring additional credibility to the monetary system. We agree with the importance of moving towards a flexible exchange rate regime, and the development of the domestic capital markets, to strengthen the monetary policy transmission channel.

On the structural front, reforms to reduce poverty and inequalities should be boosted. Poverty has not decreased for more than 20 years, with more than 60 percent of households living below the poverty line. Moreover, informality is one of the largest in Latin America. Social tensions were significant last summer, and criminality remains a key issue which has a negative effect on the business climate. Making progress on these areas appears critical. We welcome the prioritization of the social spending but wonder if more could be done in this field, for example by adding more structural benchmarks. Staff comments on this issue would be welcome.

We also encourage the authorities to continue to restore the sustainability of the energy sector, to foster governance and anti-corruption reforms. We welcome the authorities' commitment to tackle the electricity sector challenges and encourage them to pursue their efforts regarding ENEE's governance and the implementation of the plan to reduce electricity losses, which will help to create fiscal space. Moreover, the improvement of governance and fight against corruption should continue to be a priority, and we look forward to the finalization and the implementation of the public procurement reforms and the Code of Commerce.

Mr. Bhalla and Ms. Indraratna submitted the following statement:

We thank the staff for a comprehensive report and Mr. Villar and Mr. Tabora Munoz for the informative buff statement.

The policies pursued under two Fund-supported arrangements have contributed to macroeconomic stability. Despite a challenging external environment and drought conditions which yielded low growth, the country's economic performance has improved with subdued inflation and the strengthening of the fiscal and external balances. Program performance has been strong, and the authorities have successfully met all quantitative performance criteria and all but one indicative target for end-September 2019. The authorities propose to incorporate new structural benchmarks associated with governance reforms and strengthening of the anti-corruption framework. We commend the authorities for their ownership of the program and the

steadfast commitment to the reform agenda. We support the completion of the first review under SBA and SCF arrangements and endorse the authorities' request for modification of the performance criteria.

We are encouraged that the authorities are committed to upholding the Fiscal Responsibility Law. We note that revenue shortfalls have been adjusted with cuts in recurrent expenditure and that expenditure is being reallocated to protect social spending and support growth in the short-term. We take positive note of the progress in the electricity sector reform which will address long standing challenges in the sector. We welcome the efforts to strengthen the electricity regulatory agency CREE by improving the governance structure and the implementation of a tariff mechanism to update tariffs on a quarterly basis on technical considerations. Can staff elaborate on the nature of this mechanism? We note that the authorities are embarking on governance reforms at ENEE while making progress on unbundling as mandated by the electricity framework law in order to enhance the competitiveness of the electricity market. Improving the financial viability of ENEE will free up fiscal space for investment and social spending.

We welcome the progress made by the authorities in the transition towards an inflation targeting framework. We note the advances made in monetary and foreign exchange operations and endorse the relaxation of the foreign exchange surrender requirement, which will in turn deepen the forex market. We note positively the steps taken towards a more flexible exchange rate regime which will equip the authorities to adjust to external shocks. We encourage the authorities to obtain technical assistance from the Fund for this purpose. We also welcome the preparation of a new central bank act which will make price stability the core mandate of the central bank while improving the governance structure, transparency and autonomy of the bank. When will the authorities adopt the inflation targeting framework? Is financial stability also a core objective under this law?

We commend the authorities for establishing a roadmap to strengthen governance and fight corruption. In this regard, improvements to the public procurement process, reforms to the PPP framework and changes to the public officials' asset declaration system will help in improving the business climate and fostering inclusive growth. The roadmap, together with institutional reforms in the central bank, the Treasury and the public sector, will improve business confidence while strengthening the country's AML/CFT framework.

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

We thank staff for their report and Messrs. Villar and Tabora Munoz for their informative buff statement. In spite of global headwinds and challenging socio-political and economic developments, Honduras' program performance has been strong. The discussions appropriately focused on keeping the program on track, despite sluggish growth, maintaining electricity sector reforms, and further improving governance and anti-corruption reforms. We broadly concur with staff's appraisal, support the proposed decisions, and would like to emphasize the following points.

The authorities have managed to maintain a prudent fiscal stance, despite a revenue shortfall that was partly due to sluggish economic activity. Higher revenues from ENEE's tariff adjustments partially compensated for the lower tax revenue outturn from the non-financial public sector. Demonstrating their commitment to uphold the Fiscal Responsibility Law's deficit ceiling and to protect social spending, the authorities chose to rationalize public investment by prioritizing small infrastructure projects with high social and economic returns. We are reassured that the government intends to streamline tax expenditure to broaden the tax base, rationalize current spending to protect public investment, and enhance governance and public financial management to maintain their prudent fiscal stance and preserve fiscal space.

We commend the authorities on choosing to begin with reforms to strengthen the institutional framework in the electricity sector, including by recovering its financial independence from current trust funds and canceling the trusts in early 2020. Unbundling ENEE into three independent companies to address the generation, transmission, and distribution of electricity will enhance the functioning of the electricity market and attract investment. To that end, we support the mandate to create an independent dispatch center and look forward to finalizing these plans by the end of this year. We also commend the authorities on moving ahead with strengthening the regulatory agency by strengthening the governance structure and adjusting tariffs quarterly based on technical considerations. We note that one objective is to seek a more efficient electricity market through agreements with existing private generation companies. What market share does the private sector currently have in the electricity sector and does the government have a planned target for private sector presence in the sector?

We commend the authorities on their progress in transitioning towards inflation targeting and positively note their commitment to modernizing the

monetary policy framework, with the Fund technical assistance. To that end, we look forward to the submission of the new Central Bank Law to Congress by end-2019, which aims to make price stability as the Central Bank's primary objective and strengthens its institutional, operational, and financial independence. We are also pleased to note that the recently completed Safeguards Assessment finds that the Central Bank has successfully concluded the 2014-18 recapitalization process and strengthened its financial position.

The banking system remains solid, NPLs are low, provision coverage is high, liquidity is abundant, and the capital adequacy ratio is above the regulatory minimum. Credit growth remains strong and FX credit growth, in particular, has gone down to move in line with local currency credit growth. We see merit in strengthening internal risk management practices and the transparency in pension fund investments, which is critical for safeguarding financial sustainability. We also commend the authorities on their plans to strengthen financial sector supervision in line with Basel III and the Fund's FSSR.

We are pleased to note that there are plans to use the Green Climate Fund to promote climate-resilient forest restoration for the first time. Given the climate impact on agriculture in Honduras, we see merit in promoting climate resilient agriculture. We commend the authorities on their commitment to create buffers in the national budget to address the impacts of climate change, and we concur that it is critical to secure access to grants and concessional green funds to continue financing adaptation and mitigation measures, as well as climate change interventions, including water management and food security.

Improving governance and the business climate will further invigorate the private sector to contribute to economic activity and foster inclusive growth. We are thus pleased to see that the authorities have proposed five new structural benchmarks that aim to improve governance and strengthen the anti-corruption framework. We note that the share of informal employment in non-agricultural activity is very high. How does the government intend to address this high incidence of informality?

We wish the authorities continued success moving forward.

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

Honduras has made good progress under the Fund-supported program and the economy continues to grow despite headwinds stemming from a challenging external and domestic environment. Directors have noted the authorities' strong program ownership and agreed on the importance of maintaining a prudent fiscal stance while preserving social spending and growth-friendly public investment, improving the institutional framework of the energy sector, modernizing the monetary policy framework, and strengthening governance, transparency, and the rule of law.

Mr. Tabora made the following concluding statement:

On behalf of my authorities, I would like to thank Directors for their support to our program. Likewise, we want to express our gratitude to the Fund staff for the constructive engagement and the high-quality policy discussions over the last month. I would like to take this opportunity to highlight some important points for my authorities.

First, having had the privilege of leading this economic team for about six years, today I would like to reaffirm the Honduran authorities' steadfast commitment to continue consolidating our policy and economic framework. This is the seventh review since 2014, under two IMF-supported programs, which is unprecedented for Honduras.

For us, securing macroeconomic stability and institutionalized fiscal responsibility is a top priority. Despite the challenging environment and the recent adverse shocks, the authorities remain fully committed to the program, aimed not only to maintain macroeconomic stability but to enhance the business climate, strengthening transparency and governance.

The authorities reiterate that the government's fiscal policy will continue to be guided by the Fiscal Responsibility Law, despite the sluggish growth and faster-than-expected tax revenue losses, which implies a more gradual recovery of public investment. The authorities also will continue the efforts to protect social spending and support short-term growth, while securing debt sustainability and upholding the Fiscal Responsibility Law deficit ceiling.

The authorities are strongly committed to revenue mobilization efforts. They are pursuing a streamlining of tax expenditures to reduce distortions in the tax system and broaden the tax base.

The 2020 budget approved last week is consistent with the fiscal targets in the program, including social spending. The authorities have also continued enhancing the quality of public expenditure, implementing the recommendations of the Fiscal Transparency Evaluation (FTE) by the Fund. The general directorate for trust funds, aimed at improving fiscal transparency and observing the public financial management regulations.

The authorities also reiterate their full commitment to continue addressing the longstanding challenges in the electric sector, particularly in the electricity public company Empresa Nacional de Energía Eléctrica (ENEE). We strongly believe that the plan embedded in this program is the right way to create an open, transparent, efficient, and competitive electricity market.

The proper implementation of the general law of the electrical industry constitutes a cornerstone in the current economic program. In that regard, the authorities continue strengthening the regulatory agency Comisión Reguladora de Energía Eléctrica (CREE) and created the independent dispatch center Objetivos de Desarrollo Sostenible (ODS). The ODS is in the final stage of socializing the indicative expansion plans for generation, transmission which will help guide future energy purchases, especially the bidding process planned for early 2020.

We are deeply grateful to the strategic partners that are helping us with the full implementation of the reform. The recovery of the financial independence of the ENEE is essential to improve the governance of the sector, continuing with the unbundling of the company and clear arrears.

The authorities also recognize that reducing electricity losses is a cornerstone of the electrical sector reform to secure the financial sustainability of the ENEE. In that regard, a new task force to reduce nontechnical losses is being established and reassessing the contract with the distribution operator Empresa Energía Honduras (EEH). Following the due process is a top priority.

The Central Bank of Honduras (BCH) continues gearing monetary policy toward maintaining price stability and an adequate level of international reserves. It also continues the transition toward a full-fledged inflation targeting and will work to strengthen the monetary policy framework in order to gradually move to a flexible exchange rate regime. In that regard, the central bank's board of directors recently approved a further reduction of 20 percent of the foreign exchange (FX) surrender requirements, allowing

economic agents to sell up to 60 percent of their foreign exchange inflows to deepen the interbank foreign exchange market.

The BCH authorities, with strong support from the IMF staff, have just completed a draft of a new central bank charter that will be submitting to congress before the end of this year. This new charter is aimed to clearly define the primary policy mandate of the central bank, institute a sound governance structure, preserve operational autonomy, and increase the transparency and accountability of the institution. The National Banking and Insurance Commission (CNBS), stays fully committed to improving the regulatory framework and supervisory practices, in line with the Financial Sector Stability Review (FSSR) recommendations and the Basel III standards, as well as to strengthening their capacities in risk-based supervision and stress testing. The CNBS remains attentive to tightening the macroprudential framework, depending on the evolution of credit growth, especially in foreign currency.

Consistent with the modernization of the monetary policy framework and aiming toward a full-fledged inflation targeting, the CNBS and the BCH are drafting a new securities market law to support the development of domestic capital markets but also to strengthen the monetary policy transmission mechanism. The authorities plan to submit the new law to the legislature early in the first quarter of 2020.

Fostering the conditions for greater private sector activity is critical to the success of the economic program. In that sense, the application of the new administrative simplification regulations is ongoing, including developing a plan for a gradual implementation of the electronic signature, approving a new procurement law in 2020, and implementing the recently created public-private partnership (PPP) technical unit that will work in tandem with the fiscal contingency unit to improve the PPP framework.

The authorities firmly believe that strengthening overall institutions is the most important task to consolidate the anticorruption framework. In that regard, I would like to thank the many development partners here represented that have been contributing and playing an important role to achieve this goal. Following the 2018 presidential declaration of the Eight Summit of the Americas, held in Lima, called Democratic Governance against Corruption, an interagency group for transparency and anticorruption was created this year. Along these lines, as part of the fifth Open Government Plan, an outline for the Open Parliament Plan is expected to be in 2020.

The authorities also continue their work on fostering the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT). In that regard, it was decided to enhance the public officials' asset declaration system. Moreover, with the help of the Fund, the authorities are working on an amendment to the Code of Commerce to create a unified and centralized registry of beneficial ownership.

Honduras remains one of the most vulnerable countries to climate change in the world. In order to cope with this situation, the government remains committed to making substantial investments to restore its forests, build climate-resilient infrastructure, including water management, and guarantee food security. In this context, securing access to grants and concessional green funds to continue financing adaptation and mitigation measures is critical.

Finally, during the last six years, Honduras has made significant strides in reducing macroeconomic imbalances, promoting economic stability, strengthening its policy framework, and increasing investors' confidence. However, we acknowledge that there are still many challenges ahead, so the authorities hope to maintain a continuous and close cooperation with the Fund to successfully complete the program and to solve outstanding problems for the benefit of the Honduran people.

Once again, on behalf of my Honduran authorities, we thank staff, management, and the Executive Board of Directors for their continued support to the country.

The staff representative from the Western Hemisphere Department (Mr. Vesperoni), in response to questions and comments from Executive Directors, made the following statement:¹

The staff thanks Directors for their gray statements and their support of the policies and reforms in the program.

Despite the challenging external environment, the authorities have shown a firm commitment to the program. The authorities made significant efforts to maintain the prudent fiscal stance and protect social spending. The authorities have also decided to strengthen the governance elements in the

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.

program to increase the effectiveness in public administration and improve the business climate.

Let me address the questions raised in Directors' groups, particularly on electricity sector reform; fiscal issues; governance issues, including the draft central bank law; as well as other program issues.

I will start with the electricity sector reforms. Directors wondered about the progress of these reforms, in particular program design issues, negotiations with the stakeholders, and the impact of tariff adjustments on the poor.

There has been significant progress on electricity sector reforms. The initial reforms focused on the institutional framework. These are not very visible reforms, in the sense that they do not yield immediate results in terms of reductions of costs or electricity losses. However, they are critical to secure open and transparent markets for energy. This is consistent with the overall strategy, to which the authorities are fully committed and which we support.

Given the complexity of these reforms and the multiple stakeholders, our approach is that, as the different elements fall into place, staff will be in the best position to discuss potential new benchmarks on these issues in the next review mission.

Some Directors wondered about the negotiations with EEH. This is not easy because the contract involves a set of complex incentives that are difficult to assess. Losses reduction did not turn as envisaged in the contract. On the other hand, the company argues that the current institutional arrangement prevented them from complying with this. In this context, payments associated with contract cancellations require further discussions. Staff expects negotiations to continue in the first months of 2020. In any case, despite this, the authorities are already implementing the losses reduction plan.

Finally, regarding the impact of tariff adjustments, let me emphasize that reforms were structured to avoid tariff adjustments not associated with the evolution of costs. In line with this, the authorities are following a sound approach. Tariff adjustments are guided by technical criteria, and subsidies to the poor are channeled through the budget. More details on the allocation of subsidies are provided in our technical answers.

Let me now turn to fiscal issues. Directors wondered about the suitability of the fiscal expenditure reallocation and the protection of social spending. Staff believes that the restraint of non-social current spending is appropriate and is aligned with the program's objective of protecting investment and social spending. Moreover, this is not only appropriate to support short-term growth but also to improve the quality of spending, a long-term objective of fiscal policy.

There is strong ownership from the authorities on the protection of social spending, which they have demonstrated by strengthening key programs and protecting them amidst a tight fiscal position. In this context, staff is confident that the prioritization will achieve the objectives of the program and no more conditionality is needed.

I will now turn to our third issue, which is related to governance. Staff believes that the new program elements will foster governance reforms. At this point, reforms in the program cover virtually all major aspects of the recent governance diagnostics. In effect, these measures point to a wide range of issues, such as central bank governance, public finance management, public procurement, governance in tax collection, governance in public enterprises, the elimination of red tape, and the anticorruption framework.

The objective is to help the authorities build domestic institutions. To achieve this, they are working with multiple development partners. Staff recognizes the Mission to Support the Fight against Corruption and Impunity in Honduras's (MACCIH) important role in helping advance anticorruption efforts. The decision to renew MACCIH's mandate lies with the government and their Organization of American States' partners. The president has stated that the decision on the extension of MACCIH mandates will be announced next January. The staff continues to look forward to coordinating and cooperating with the authorities and all development partners.

Let me now close the discussion on governance issues with some remarks on central bank issues, which are part of the program benchmarks for December. Staff is pleased with the excellent cooperation between the authorities and the Fund's Legal Department in the discussion of the new central bank law. The authorities have finalized a draft that is in line with good international practice and aims at basically four main issues. One is strengthening the mandate of price stability. The second one is banning credit to the public sector. The third one is related to strengthening the governance structure through the separation of executive management and oversight. And the last one is improving the process to select and remove board members.

The core objective is price stability, but financial stability is a secondary objective that is exercised by supporting the payment system and by managing macroprudential issues. The draft has been sent to the president for endorsement, and we are confident that it will be sent to congress in the coming days, before the year ends.

Other important steps for end-2019 are those conducive to a more flexible exchange rate regime. In this connection, the central bank has just approved the plan to reduce surrender requirements. Moreover, last week, it has already scheduled a reduction of another 20 percent of the requirements for January, taking them to 40 percent. To prepare for this elimination, the authorities will request technical assistance from the Monetary and Capital Markets Department to refine FX intervention mechanisms. These measures are important steps to move toward inflation targeting. This transition is mainly driven by the ongoing technical work to develop money and FX markets, strengthen local debt markets, refine intervention mechanisms, and revise the national accounts and the CPI basket. The transition should take a few years, as it happened in most regional inflation targets.

Finally, let me now tackle other program issues. Given that progress on structural benchmarks for the second review has been made since the report was written, I will also update the Board on measures not associated with central bank issues.

First, with technical support from FAD, the authorities are finalizing initiatives to strengthen tax revenue administration, with measures related to allowing electronic notification to taxpayers and transferring control of exemptions from the treasury to the tax administration office. They are also finalizing legislation to gradually streamline tax exemptions. We expect this bill to be submitted to congress soon.

Second, the Banking Commission has submitted to the president a proposal to address the financial situation of BANADESA, which will be thereafter submitted to congress. While the full details will be discussed when finalized, this proposal is in line with the principles stated at the initial point of the program and there is no use of budget resources.

Third, with technical support from the World Bank in early December, the authorities are finalizing regulations to set up a centralized wage bargaining process.

Lastly, they are finalizing the plan for the implementation of the electronic signature, which will also be ready by year-end.

Mr. Alkhareif made the following statement:

At the outset, I would like to thank staff for the excellent work and Mr. Villar and Mr. Tabora for the informative buff statement and for Mr. Tabora's helpful remarks. We would like to take this opportunity to support the completion of the first review and the associated decisions.

Despite the challenging environment and adverse shocks, the performance of the program has been strong. We commend the authorities for their strong commitment and ownership of the program and for maintaining prudent macroeconomic policies which will help the country weather the adverse shocks. Indeed, advancing structural reforms will be important to ensure more sustainable and inclusive growth going forward.

Like other Directors, we welcome the authorities' focus on implementing prudent fiscal policies, anchored by the Fiscal Responsibility Law. Like Ms. Pollard in her statement, we welcome the authorities' flexibility in reallocating expenditure and using fiscal space to spur short-term economic growth and protect investment and social spending. Indeed, we are encouraged by the efforts to strengthen debt sustainability under the Fiscal Responsibility Law. We also take positive note that the authorities implemented the FTE recommendations of the Fund. We welcome the efforts to improve fiscal transparency, including through the Government Finance Statistics Manual (GFSM) 2014 standards.

We note the underperformance in tax collection. And we welcome authorities' strong commitment to enhance domestic revenue mobilization. We encourage the authorities to continue their efforts in broadening the tax base, reducing tax exemptions, and strengthening the tax administration. We welcome the progress in reforming the public electricity company. This will help create the fiscal space that can be used to allocate more spending to social and infrastructure needs.

On financial sector issues, we take positive note that the banks are well capitalized and liquid. We also take positive note that non-performing loans remain low. We encourage the authorities to remain vigilant and to step up their efforts in enhancing the AML/CFT and the anticorruption framework. We also look forward to the central bank's charter. We encourage the

authorities to use the new income expenditure survey to help well inform their policy decisions.

On structural reforms, we take positive note of the statements by staff and Mr. Tabora, that the authorities are focusing on enhancing the governance framework, fighting corruption, and improving transparency in the public sector. In our view, the PPP framework will be a step in the right direction to increase the private sector's role in the economy.

Finally, we cannot stress enough the importance of focusing attention on social spending and having constructive discussions with the authorities to better tailor the program and take into account the country-specific circumstances, especially in countries where crime rates and poverty are high. We encourage the staff to focus on these areas going forward.

With these remarks, we wish the authorities continued success.

Mr. Palei made the following statement:

We thank staff for the informative report and Mr. Villar and Mr. Tabora for their well-written buff statement and today's remarks. We commend the strong program performance. Indeed, the authorities have performed well since 2014, so its long track record, and we welcome their commitment to reforms.

The authorities have successfully met all quantitative performance criteria and all but one indicative target for end-September 2019. The last target is on track to be met at end-December. We support the completion of the first review and the authorities' request for a modification of the performance criteria.

We commend the authorities for their adherence to the Fiscal Responsibility Law. This law helped to anchor the fiscal position and will secure the debt sustainability over the medium term.

In the energy sector, the treasury's preintervention in the public electricity company will prevent a further accumulation of arrears. At the same time, a further reform is needed, and assistance from the World Bank should prove helpful in this regard.

With the poverty ratio about 60 percent, Honduras remains one of the poorest countries in the Western Hemisphere. We support staff's

recommendation to increase priority social spending and to improve the transparency of spending. We also welcome the initiative centered around the conditional cash transfers program.

According to staff, the authorities have made progress in transitioning to an inflation-targeting framework. The new central bank charter will improve governance and the monetary policy operational framework. Steps toward a more flexible exchange rate regime will bolster the country's resilience against external shocks. A gradual approach to transition toward a more flexible exchange rate is appropriate, given the lingering risks from balance sheet vulnerabilities and the high exchange rate pass-through.

The authorities and staff agreed to strengthen the focus in the program on governance issues and fight against corruption. We welcome the inclusion of five new benchmarks in this area and welcome today's comments by staff on these matters.

Here, there was a question about this mission on fighting corruption, sponsored by the Organization of American States. I would like to hear more comments about the situation in this area. As I understand it, about four years ago, the authorities and the Organization of American States created a mission to support the fight against corruption and impunity. However, according to the recent media reports, the lawmakers in Honduras have recently voted against renewing the agreement and extending the mandate of this anticorruption body.

We understand this comment, that there are other development partners and that decisions will be made in January. However, now the Fund is very active in this area and have been proposing conditionality related to similar types of agencies in other countries. Given that in Latin America, there is significant experience accumulated with such kinds of agencies, I would like staff to comment on the reasons for the current conflict in the country and whether there are any lessons for other countries in having this approach of creating an agency with responsibilities not included in their domestic institutional structure. Staff could comment on the currently initiatives in the country. Mr. Tabora told us about this new framework, the anticorruption framework that will be discussed in the middle of the year. Are they substitutes? Is it something complementary to the efforts of the Organization of American States? Additional comments would be very welcome so that we can derive lessons for conditionality in other countries.

Mr. Coronel made the following statement:

I would like to start by thanking staff for the report. It was very well put together. We also thank Mr. Vesperoni and Mr. Tabora for their interventions this morning. I believe that between Mr. Vesperoni's comments, Mr. Tabora's intervention, Directors statements, and some of the comments by our colleagues, we seemed to cover all the angles, but sometimes it is those that are beyond our purview that cause trouble and become stumbling blocks on these programs. In addition to the gray statement that we put out, I just wanted to add a couple of points for emphasis.

First is the fact that the program is very sound and well defined and that the economy, as recognized in the staff report and in the gray statements--despite having lost steam in the last year, with respect to the previous years--is still well positioned to meet the challenges ahead. However, the uncertain external and domestic environment poses downside risks to the program and, at the same time, leaves very little scope for complacency. I think the authorities are very clear on that.

The other point is that the social and economic environment in the region has become politically loaded. Society is polarized, whereby, proverbially, any stray spark could start a fire. In this regard, while we strongly encourage the authorities to stay the course, in the face of difficulties, authorities should be cautious and keep a tight grasp on the lessons learned from the previous IMF program, which was very successful and also very thoughtful and very well designed when it came to the measures that were socially sensible. They know very well that it was not easy, but they managed to do it successfully and to also take into account the recent lessons learned from other experiences in the region.

Mr. Merk made the following statement:

We thank staff for the informative report and Mr. Villar and Mr. Tabora for the comprehensive buff statement. We recognize the authorities' strong program performance and encourage the authorities to maintain their commendable reform commitment.

We take note of the authorities' intention to reallocate funds toward short-term investment projects with a high economic and social return, while upholding the ceiling set out in the Fiscal Responsibility Law. Going forward, rigorous fiscal discipline will be needed to scale down public debt while adequately protecting social spending.

More ambitious reforms that reduce corruption, increase the transparency and the efficiency of the public sector, and improve the business environment are crucial for the credibility of the government's reform agenda. And I would support the additional questions raised by Mr. Palei in that context.

Mr. Benk made the following statement:

We thank staff for the answers to our questions. Let me just emphasize a few points.

We commend the authorities for their good performance under the program, building on the gains achieved under the previous Fund program and through technical assistance.

While substantial progress has been made on energy sector reforms, further efforts are needed on management, creditor refinancing, and reducing electricity losses. In this vein, we see scope for some of these reforms to be added as structural benchmarks, given the challenging nature.

We positively note the authorities' work on a road map to foster governance reforms, but we agree with Mr. Merk that the recent introduction of a new penal code with elements reducing penalties on corruption-related cases seems counterproductive.

Finally, given the challenges in delivering inclusive growth, we encourage the authorities to closely cooperate with staff on reform design and a careful communications strategy, as a social consensus is important for a program's success, and some social tensions might be why.

Mr. Rozan made the following statement:

Thanks to staff for the very well-written report and the answers they provided to our technical questions. Just to commend the authorities for their ownership of the program's objectives and the strong program performance that they have achieved so far, despite the slowdown in economic activity. We particularly welcome the fiscal efforts under the Fiscal Responsibility Law. This aspect has overperformed over the last three years. I just wanted to add one comment and ask two questions.

One comment on the governance aspect of the program, I think it is very valuable that we are being asked to approve five new structural benchmarks. This goes in the right direction and is in line with the challenges that the country has to face. We encourage the authorities to strengthen their AML/CFT framework because it is a key aspect of governance and transparency reform.

One question that we raised in our gray statement was on the issue of poverty and the conditionality linked to that. We were saying that poverty has not decreased for more than 20 years. Informality is very strong in the country. We were wondering whether at any point there was a discussion of adapting the conditionality of the program to reflect this, maybe to have an additional benchmark or indicative target on this issue to ensure that the Fund can assist the country to devote more spending and attention to these issues.

The second one was on informality. In your answer, you were explaining that there were several programs designed to enhance the level of formality and ensure that more jobs were going to the formal sector. We were wondering, what was the effectiveness of these policies and if you had a sense whether they were effective in decreasing the level of informality in the country.

The staff representative from the Western Hemisphere Department (Mr. Vesperoni), in response to further questions and comments from Executive Directors, made the following additional statement:

Let me first talk a little bit more about governance and the questions raised by Directors on this. And I will tell you what we know about the process and the decision about MACCIH.

The program has a renewed emphasis on improving the institutional framework in the country. This is very important. The program already had many elements at the inception, and we have added new measures that we believe are very important. One of them is associated with improving the anticorruption framework. The one on the improvement on asset declaration systems for public officials. There are two measures on procurement, which we believe are very important for efficiency in public finance management. There are measures on public spending transparency associated with trust funds. There are governance measures on the central bank, and there are measures that are envisaged to reduce red tape. Going forward, we believe that all of this is very important and critical, mainly for two reasons. One of them is that it will help to improve the framework by which policies are

conducted, especially those measures that are directed to procurement and public spending.

It would also respond to social demands for more transparency and for less corruption. We believe the focus of the program in trying to improve these two things is very important. This is what we are trying to do, to help build domestic institutions, and other development partners are trying to do the same. The important thing is that, in the end, institutions are built within Honduras. Part of the mandate of MACCIH is also trying to help the authorities do that.

There was a question about the decision by congress. This was a statement by congress. Our understanding is that this statement by congress is not legally binding. This is a decision that the president is going to make. At this point, a commission is reviewing what happened over the last four years, what MACCIH has done and what the MACCIH's mandate is. This commission has already issued a report that the president is analyzing, and the president is going to make his decision in January. But this is a joint assessment. It is not only the government of Honduras making an assessment about MACCIH. It is the government of Honduras and staff from the Organization of American States doing a joint assessment. After that assessment, a decision will be made. This is what we know about the process. We understand that the term for MACCIH is ending on January 20, so the decision is going to be made before.

There were also a couple of questions about poverty, conditionality, and informality.

The reason why we believe that the prioritization we already have in the program is going to deliver what we are aiming for is because we see very strong ownership by the authorities on these issues. We have seen this over the last years. The government has made significant progress on social protection since 2015. The government passed the social protection framework in 2015 and developed an effective targeting system which is called El Registro Único de Participantes, managed by the Centro Nacional de Información del Sector Social. The largest financing source of social assistance programs over the past five years has been a trust fund, which is financed by earmarked revenue from the value-added tax. It amounts to almost 1.5 percent of GDP since 2016. Our reading from this situation since 2015 is that there is very strong ownership. We wonder whether trying to get more involved will mean that we are trying to micromanage something on which the authorities have strong ownership.

On the other question, on the programs on informality, there are three programs that have been in place for a while. We do not have a clear assessment of the impact of these programs. We know that they have been there for a few years and that the authorities are putting a strong emphasis on that. Some of these programs are in our prioritization, but we have not been able to perform a clear assessment, and we have not seen literature assessing the impact of these programs. But we take note and hope that during the next mission, we can discuss with the authorities about this.

Mr. Palei made the following statement:

I thank staff for the additional clarifications on the issue of cooperation between the authorities and the Organization of American States.

Just to be clear, we support the structural benchmarks added to the program and the focus of these structural benchmarks. It looks like all of them are in the areas of the Fund's expertise, where the Fund can certainly add value. However, my question was mostly related to this entity which is being proposed in other programs, not in the Western Hemisphere Department but by other country teams and for other countries. There is valuable experience in several countries--Guatemala had similar issues.

My request is, if there is any information, any evaluation of the effectiveness of these entities, staff maybe could provide it to the Board. But we are very much interested in these practices, because the Fund is very active in this area. This is a new area for the Fund. We just want to better understand conditionality and how it works or how it does not work--when it does not work.

The staff representative from the Strategy, Policy, and Review Department (Ms. Corbacho), in response to questions and comments from Executive Directors, made the following statement:

Let me answer with more of a cross-country perspective of the governance work that we are doing here in the Fund.

First, specifically on Honduras, as Mr. Vesperoni has described, the conditionality focuses on the fundamental rebuilding of the legal and institutional framework for anticorruption in Honduras. We see this as a foundation before discussing the institutional or structural modality that would better serve the country. This could be discussed later on in the program, in the sense of understanding whether a domestic, independent institution would

serve better the goals rather than with support from an international organization like the OAS.

The way we approach this is customized for every country. In other programs, the conditionality has been more focused on the specific institutions and has been on creating an anticorruption entity, versus redefining the legal and institutional framework. There are different modes of approaching this, and it corresponds to where we see the largest gaps in the country.

In the case of Honduras, the conditionality that the program is proposing goes to the longstanding challenges that also cut across different sectors. For example, on the registry, it is not only an issue of transparency that helps anticorruption efforts. It is also fundamental for understanding systemic financial risk because it would help banks, for example, to assess better the concentration of risks in a credit portfolio. Therefore, the program has gone for these types of benchmarks before engaging on what type of institution should support the reforms.

In terms of briefing the Board, we are scheduled to come back to the Board on how the new framework on governance is evolving. We will take note on the specific request on how different models of institutional frameworks are working in different regions.

Mr. Palei made the following statement:

Since staff mentioned the work program. In the work program, we had a discussion on this issue and on the format of the upcoming meeting devoted to the stocktaking exercise on conditionality. I think the Managing Director promised to think about it and come back to the Board.

The staff representative from the Strategy, Policy, and Review Department (Ms. Corbacho), in response to further questions and comments from Executive Directors, made the following additional statement:

I apologize if my answer was ambiguous, but that is precisely what I meant; that the staff is taking stock of the request from the Board. We will come back with a proposal on how to engage. But we took note specifically on this request on the institutional structures.

The following summing up was issued:

Executive Directors welcomed Honduras's continued track record of sound macroeconomic management and solid progress in implementing reforms, which have mitigated the economic impact of the challenging global environment. They acknowledged the recent headwinds to growth, including a severe drought and social tensions, and encouraged the authorities to maintain their efforts to pursue policies and reforms to improve the medium-term outlook, paving the way to gradually boost inclusive growth and employment.

Directors commended the authorities' prudent fiscal policies anchored in the Fiscal Responsibility Law. They encouraged preserving revenue mobilization efforts in light of the large spending needs to increase safety nets and support social and infrastructure initiatives. Directors welcomed the decision to protect a set of social interventions that will be critical to reduce poverty and inequality, while maintaining a sustainable fiscal position.

Directors welcomed measures to support growth within the contours of prudent macroeconomic policies. Noting the authorities' efforts to uphold prudent policies over recent years, they supported the decision to provide a moderate stimulus within the limits of the Fiscal Responsibility Law.

Directors noted the authorities' commitment toward price stability, and their efforts to modernize the monetary policy framework. They encouraged the authorities to continue with plans for a more flexible exchange rate regime, which is instrumental in the transition to inflation targeting over the medium term. Proposals to amend the central bank charter will strengthen its operational independence and increase transparency.

Directors urged continued steps to improve the institutional framework in the electricity sector, including restructuring the public electricity company (ENEE). They noted that the strengthening of the regulatory body, the new independent dispatch center, and efforts to improve the operations and governance of ENEE will build a more open and transparent sector. They encouraged the authorities to persist in their efforts to complete the ambitious reform plans, which will create space for infrastructure and social spending.

Directors highlighted the importance of efforts to enhance governance by strengthening the anti-corruption and AML/CFT frameworks. These measures—which tackle a broad set of challenges—will add to the authorities' ongoing work to strengthen the institutional framework in the central bank, the treasury, and public companies. Reforms, including better managing public-private partnerships and improving the public procurement process, have the potential to improve the business climate and foster medium-term growth.

The Executive Board took the following decisions:

Honduras—First Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria

1. Honduras has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for Honduras (EBS/19/62, the “Stand-By Arrangement”) in order to review program implementation.
2. The letter dated November 27, 2019 from the President of the Central Bank of Honduras and the Secretary of the Treasury (the “November 2019 letter”), together with its attached Memorandum of Economic and Financial Policies (the “November 2019 MEFP”) and Technical Memorandum of Understanding (the “November 2019 TMU”), shall be attached to the Stand-By Arrangement and the letter dated June 20, 2019 together with its attachments, shall be read as supplemented and modified by the November 2019 letter and its attachments.
3. Accordingly, the Stand-By Arrangement shall be amended as follows:
 - (a) Paragraph 3(a)(v) of the Stand-By Arrangement shall be amended by the deletion of the words “change in”.
 - (b) The floor for the December 31, 2019, June 30, 2020 and December 31, 2020 performance criterion on the net lending of the nonfinancial public sector of Honduras, the floor for the December 31, 2019, June 30, 2020 and December 31, 2020 performance criterion on the stock of non-borrowed net international reserves of the Central Bank of Honduras, and the ceiling for the December 31, 2019, June 30, 2020 and December 31, 2020 performance criterion on the stock of net domestic assets of the Central Bank of Honduras, referred to in paragraphs 3(a)(i), 3(a)(v) and 3(a)(vi) of the Stand-By Arrangement, respectively, shall be as specified in Table AI.2 to the November 2019 MEFP and as further specified in the November 2019 TMU.
 - (c) The continuous performance criterion set forth in paragraph 3(b)(i) of the Stand-By Arrangement shall be as specified in Table AI.2 to the November 2019 MEFP and as further specified in the November 2019 TMU.
4. The Fund decides that the first review contemplated in paragraph 3(c) of the Stand-By Arrangement is completed and that Honduras may make purchases in accordance with the terms of the Stand-By Arrangement.

5. This Decision shall become effective only upon the adoption of Decision 2 by the Executive Board. (EBS/19/114, 12/04/19)

Decision No. 16621-(19/103), adopted
December 18, 2019

Honduras—First Review Under the Arrangement Under the Standby Credit Facility and Request for Modification of Performance Criteria

1. Honduras has consulted with the Fund in accordance with paragraph 3(b) of the arrangement for Honduras under the Standby Credit Facility (EBS/19/62, the “SCF Arrangement”) in order to review program implementation.
2. The letter dated November 27, 2019 from the President of the Central Bank of Honduras and the Secretary of the Treasury (the “November 2019 letter”), together with its attached Memorandum of Economic and Financial Policies (the “November 2019 MEFP”) and Technical Memorandum of Understanding (the “November 2019 TMU”), shall be attached to the SCF Arrangement and the letter dated June 20, 2019, together with its attachments, shall be read as supplemented and modified by the November 2019 letter and its attachments.
3. Accordingly, the SCF Arrangement shall be amended as follows:
 - (a) Paragraph 3(a)(v) of the SCF Arrangement shall be amended by the deletion of the words “change in”.
 - (b) By replacing the reference in paragraph 3(a) of the SCF Arrangement to “Table AI.2 of the MEFP and as further specified in the TMU” with “Table AI.2 to the November 2019 MEFP and as further specified in the November 2019 TMU”.
 - (c) By replacing the reference in paragraph 4(a) of the SCF Arrangement to “Table AI.2 of the MEFP and as further specified in the TMU” with “Table AI.2 to the November 2019 MEFP and as further specified in the November 2019 TMU”.

4. The Fund decides that the first review contemplated in paragraph 3(b) of the SCF Arrangement is completed and that Honduras may request the second disbursement specified in paragraph 2(b) of the SCF Arrangement. (EBS/19/114, 12/04/19)

Decision No. 16622-(19/103), adopted
December 18, 2019

APPROVAL: May 26, 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:

Outlook and Risks

1. ***We note that the growth projections in the report predated the recent global slowdown and the monetary easing in the US and wonder how they are expected to affect the Honduran economy?***
 - The *World Economic Outlook* in July already incorporated a downward revision of global growth, highlighting that while economic activity was resilient in advanced economies, emerging markets were already experiencing negative surprises. It also emphasized that trends in global trade were negative since the first quarter of 2019, projecting a fall of about 1 percent for the whole year. Staff's growth projections have incorporated these trends into the projections. As monetary policy easing in the US was already expected by late summer, this was factored in the projections. While the revisions in October have cemented these trends, these have been already captured in the projections, especially because after a sharp slowdown in late 2018, global growth tended to stabilize in the first half of 2019, albeit at a weak pace. As explained in the report, other shocks had an impact in activity, such as worsening terms of trade, a large drought, and social unrest. The projections envisage that both easing financial conditions and the gradual recovery in the global economy will aid a pickup in growth; as well as recent developments in the coffee market (see next question).

2. ***We take note that staff points to high-frequency indicators suggesting that the bottom of the deceleration process might have been reached in the second quarter of 2019. Could staff provide an update based on more recent high-frequency economic indicators?***
 - The BCH produces a monthly coincident indicator (IMAE) where information until October is available. While IMAE is not a GDP as it measures production instead of value added, it is usually a good predictor of the GDP. The IMAE point to a recovery in the third quarter, both on an annualized basis or relative to the previous quarterly.²

² Previously IMAE was seasonally adjusted using the ARIMA-X13 method.

IMAE Growth Rates

Year	Quarter	YoY	QoQ
2019	1	3.0	-5.0
2019	2	2.0	-1.0
2019	3	3.1	1.3

Source: Central Bank of Honduras and Fund Staff estimates.

- The recent increase in coffee price—about 25 percent y-o-y—is extremely important, as the new harvest season is about to start.
- A couple of weeks ago, there were announcements about significant forthcoming investments in the *maquila* sector—which already did well in 2019, supported by tariff increases in China’s textile exports to the US. The impact on the economy will depend on the timing of these investments.

Fiscal Policy

3. ***We appreciate staff’s view on the appropriate composition of the new spending given the proposed increase in the deficit target to boost growth.***
 - We consider the authorities’ proposed spending reallocation—restrain in current spending to boost investment and social spending—adequate not only to support growth and employment in the short term, but also from a long-term perspective. This is also consistent with the Fiscal Responsibility law (FRL) which puts a cap on current spending growth.³ The authorities’ decision is also aligned with a pivotal element of the program; improving the quality of public spending.
 - We will make some remarks on fiscal policy at the meeting.
4. ***We note the tax revenue losses due to the minimum corporate tax reform in 2018. Could staff elaborate on the efficiency of this reform? Was the minimum corporate tax distortionary for economic activity? Will the reform contribute to improved business conditions over the medium term, or are lower corporate revenues the only effect?***
 - The minimum corporate income tax (MIT) was introduced in 2014 as part of a comprehensive tax reform. It was designed as a tool to combat tax avoidance or

³ The FRL states that the nominal growth of current spending should be equal to the sum of the 10-year average GDP growth rate and the central bank’s inflation target. Based on historical information this is about 7 percent.

evasion by using a presumptive tax basis—gross income—which is more difficult to manipulate than those forming the basis for accounting records. In the staff’s assessment, it did not impact corporate profits and it was a solid instrument to foster tax compliance. Reported profit rates for all companies affected by the tax rose between 2013 and 2017.

- Using information from household surveys, staff estimates that about 13,500 new formal employments were created between 2019 and the 2017 (before the phase out of the tax started). However, the link between the measure and employment is inconclusive.

5. *While restraining current spending is a necessary near-term measure, broadening the tax base and reducing tax exemptions would be necessary to improve country’s overall fiscal position. In this regard, could staff indicate the scale of the reduction in tax expenditures envisaged in the related bill?*

- The overall fiscal position is projected to be in line with the Fiscal Responsibility Law, and revenue mobilization efforts aim at protecting investment and social spending. The bills on exemptions and tax administration are being finalized in coming days, and the scale of the impact was estimated at around 0.8-0.9 percent of GDP over the program period—some of the measures will have an immediate impact, while others will take more time as exemptions that are not complying with the conditions under which they were granted are revised.

Energy Sector

6. *Could staff inform us of the potential size of the government bond issuance (as indicated in the buff statement) to cancel these trusts?*

- Congress has authorized an issuance of about US\$900 million of which about US\$500 million should be used for budget financing (a previous bond issuance is coming due for this amount) and the remainder would be allocated to financial operations related to electricity reforms.

7. *Further reform in the electricity sector is vital to improve the efficiency of the sector and create more fiscal space, particularly for investments and social spending. Thus, we encourage the authorities to accelerate multi-faceted reforms in this area, building on recent progress on tariffs. Could staff further elaborate on the effects of these reforms on the most vulnerable?*

- Staff does not see a large social impact of the increase in tariffs as they were concentrated in the last part of 2018 and the earlier part of this year. Starting in the second quarter, revisions by the electricity regulatory body has been small given

stable generation costs. Additionally, all consumptions below 75KW are subsidized, and to cushion for the increments on last quarter of 2018 and first quarter of 2019 the authorities granted temporary subsidies.

- We will make more comments during the Board meeting on this.
8. *In this context, could staff shed more light on the process of cancelling the contract with Empresa Energía Honduras (EEH) and why the authorities cannot clearly determine the costs involved at this stage? Did the authorities indicate when this assessment would be completed and what the implications are for the program?*
- Staff will respond to this question during the Board meeting.
9. *We welcome the efforts to strengthen the electricity regulatory agency CREE by improving the governance structure and the implementation of a tariff mechanism to update tariffs on a quarterly basis on technical considerations. Can staff elaborate on the nature of this mechanism?*
- In general, electricity tariff schemes are revised every 4-5 years, and adjustment in between are adjusted based on the evolution of generation costs. The electricity sector regulatory body (CREE) is currently using this temporary scheme, while calculations and regulations on the new tariff scheme approved in June are implemented. The objective is that tariffs are aligned with generation costs. To this end, the adjustment formula considers three components: (i) bunker fuel prices, (ii) exchange rate, and (iii) hydro-thermal power dispatch.

Monetary, Exchange Rate, and Financial Policies

10. **We note that this transition is taking place when monetary policy in many countries is accommodative and some central banks use unconventional monetary policies. We wonder whether such expansionary monetary policies affect the transition of the CHB to inflation targeting. Staff comments are welcome.**
- As noticed in the question, recent monetary policy decisions reflect heightened uncertainty to the global outlook in the near-term. However, given Honduras's limited integration with global financial markets, we do not see risks for this transition to be affected by easy monetary conditions, but rather driven by the needed technical work and reforms on the domestic side. In operational terms, this transition has always been driven by the need to further develop money and FX markets, to improve governance at the BCH, and to revise the national accounts and

the consumer price index—critical to adopt sound monetary policy decisions. This is the why we do not see this happening overnight, but over the next few years, as it happened in most regional inflation targeters.

- We will make some remarks about monetary policy in the Board meeting.
11. ***Could staff update us on whether this draft Law was submitted to Congress and what changes it will pass.***
- Staff will respond to this question during the Board meeting.
12. ***We support the broad thrust of the proposed new charter for the central bank to have price stability as the primary mandate and to emphasize the independence, accountability and transparency of the institution. We invite staff to elaborate on the status of the proposed central bank law.***
- Staff will respond to this question during the Board meeting.
13. ***Could staff comment on indications whether the December benchmarks on the surrender requirements and the BCH Charter will be met?***
- Staff will respond to this question during the Board meeting.
14. ***When will the authorities adopt the inflation targeting framework? Is financial stability also a core objective under this law?***
- Staff will respond to this question during the Board meeting.
15. ***While we note lower growth in credit provision by pension funds, we urge the authorities to enforce tighter regulation in line with staff's recommendations. Does lending activity of pension funds pose a systemic risk to the financial sector or the economy?***
- No, it does not place a systemic risk. There is limited interconnectedness between pensions funds and the private sector (corporates and financial institutions), partly reflecting the dearth of domestic assets—loans to affiliates is an endogenous response to this dearth of domestic assets within the contours of the current regulatory environment on pension funds investment.
 - The main risk would be the loss of accrued pensions by contributors, most of whom have very limited alternative savings or sources of income post-retirement. Additionally, fiscal contingencies could appear as the Treasury will face social pressures to assist contributors in the case of funds' insolvency. For this reason, the

authorities concurred with staff on the need to enforce the regulatory environment of pension funds, including the cap on net loans to affiliates.

Structural Issues

16. *We commend the authorities for the roadmap to foster governance reform as well as the authorities' proposal to add new benchmarks on governance. These efforts focus on enhancing governance of fiscal regime and strengthening the AML framework. While these are directly linked to the core mandate of the Fund, other phenomena – including the high crime rates in Honduras –might limit the effectiveness of the proposed roadmap. Staff comments are welcome.*

- The authorities have embarked in a comprehensive effort to reduce criminality with solid outcomes. Homicide rates have halved—from 85 in 2011 to 40 per 100,000 people in 2018. Certainly, much more needs to be done to reach the Latin America average—about 20 homicides per 100,000 people—but progress has been remarkable and steady. Under this scenario, staff believes that the authorities' proposed roadmap could improve governance and the business climate.

17. *We welcome the ongoing efforts to strengthen the institutional frameworks of key public institutions, improve public procurement and raise the quality of PPP projects. We encourage the authorities to try to include broader governance issues in their roadmap and expedite the implementation of reform measures. Can staff further elaborate on the absorption of TA activities on these fronts and the priority areas where the Fund's capacity development can be of further support to the authorities?*

- In the case of the Treasury, employee turnover is a critical impediment to capacity building. Said that, the Fund—including CAPTAC—has provided several TAs with tangible outcomes which are the backbone of the improvement in the development and implementation of fiscal policy. Some of these outcomes are: the MTFF, the LRF, the implementation of a contingency unit, the development of methodologies to assess the fiscal risk of PPPs, among others.
- Additionally, the recent FTE evaluation has laid out several working lines that point to the priority areas going forward, notably on fiscal risks and fiscal transparency.
- And finally, we expect continued cooperation on governance issues, given the recent diagnostic and the incorporation of conditionality in the program. The legal Department stands ready to help the authorities on these issues.

Program Issues

18. *We are pleased by the Fund's TA to the CHB and wonder about the reasons of the decline in the number of Honduran officials trained in monetary policies in the last two years.*

- As part of the planned transition toward inflation targeting, the central bank has been receiving intensive training and technical assistance from the Fund. After an initial phase of HQ-based training for members of the newly formed team in charge of the monetary policy forecasting and analysis system (FPAS), additional assistance to strengthen the central bank's forecasting capacity was provided through field visits of technical experts in November 2018 and in May 2019. The central bank also received TA in August 2019 to update the central bank's roadmap for the move to IT, covering also operational issues regarding FX interventions and liquidity management to align market interest rates with the policy rate. Additional follow up TA from MCM to set up an FX intervention rule is expected in Q1 next year. STA has also provided intensive TA to the central bank for the update of the CPI base year, another key step for the move to IT. Therefore, the reduction in HQ-based training is due to the increase in capacity building provided directly in Tegucigalpa.

19. *In this regard, could staff elaborate on the circumstances behind the miscalculation? If the miscalculation is not the authorities' fault, should the comment in the Executive Summary "The IT on the wage bill was missed" be fine-tuned to avoid any miscommunication? Staff comments are welcome.*

- We believe that the staff report is candid about the mistake, but we do agree that the executive summary should be clearer. Hence, we agree with your comment on avoiding miscommunication, and we have expanded the language in the executive summary to note that this is related to a staff mistake.
- In the budget process, there are usually non recurrent wage expenditures that are related to labor debt associated with hiring in previous exercises (unbudgeted hiring). This requires adjustments in the seasonal patterns of the wage bill to reflect these payments, which may happen at different quarters within the fiscal year. In doing these adjustments, the staff miscalculated the seasonal coefficients, which gave place to the mistake mentioned in the staff report.

20. *Could staff's please comment on the potentially beneficial impact of extending the mandate of the "International Mission of Support Against Corruption and Impunity in Honduras"(MACCIH), which expires in January 2020. Would this be regarded as a signal of the Honduran government to deliver on their commitment to strengthen the rule of law?*

- Staff will respond to this question during the Board meeting.
21. *Could staff elaborate on the prospects for the numerous December structural benchmarks, particularly those related to tax policy?*
- Staff will respond to this question during the Board meeting.
22. *On the structural front, reforms to reduce poverty and inequalities should be boosted. Poverty has not decreased for more than 20 years, with more than 60 percent of households living below the poverty line. Moreover, informality is one of the largest in Latin America. Social tensions were significant last summer, and criminality remains a key issue which has a negative effect on the business climate. Making progress on these areas appears critical. We welcome the prioritization of the social spending but wonder if more could be done in this field, for example by adding more structural benchmarks. Staff comments on this issue would be welcome.*
- Staff will respond to this question during the Board meeting.
23. *Nearly six months on from program approval, we would welcome an update from staff on the conditions in which they see the authorities drawing on the program.*
- As discussed at the time of program approval, the choice of a precautionary arrangement responds to the fact that while we do not expect a disbursement in the baseline scenario in Honduras, we do see a set of external risks—trade tensions, migration policies, volatile terms of trade and tightening financial conditions—that is particularly relevant for the economy and could open a BOP gap.
 - Staff considers that the disbursement scenario previously prepared is still valid. That scenario envisions a disbursement only in the case of a significant terms of trade shock happens—for example, an increase in oil prices, given that Honduras is an oil-importer.
 - Mr. Tabora and Mr. Villar’s BUFF reiterates the authorities’ commitment to keep the program as precautionary, which is consistent with the fact that the external position in Honduras has strengthened during the year.

Other

24. *What market share does the private sector currently have in the electricity sector and does the government have a planned target for private sector presence in the sector?*

- In generation, the private sector participation is at about 80 percent. There is no private participation in transmission and distribution.
- There is no target for private sector presence in the electricity market.

25. *How does the government intend to address this high incidence of informality?*

- Based on the 2019 household survey, the informality rate in Honduras is about 57 percent and it is mostly located in rural areas (63 percent). In terms of age profile, 49 percent of informal workers are below 34 years old.
- The authorities have been implementing several policies to reduce informality, with the main interventions being:
- *Con Chamba Vivis Mejor*. A program to create temporary jobs mainly targeting young adults.
- *Apoyo a las Microempresas Productivas*. Provides funding and technical assistance for the creation of small enterprises, mainly on the bakery sector.
- *Crédito Solidario*. Funds entrepreneurship at low interest rates in agrobusiness and SMEs.