FOR AGENDA

SM/83/224

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November 1, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Honduras - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Honduras, which will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Elson, ext. 74328.

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INTERNATIONAL MONETARY FUND

HONDURAS

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the
1983 Article IV Consultation with Honduras

Approved by S.T. Beza and Manuel Guitian

November 1, 1983

I. *Introduction*

The 1983 Article IV consultation discussions with Honduras 1/ were conducted in Tegucigalpa during the period of September 1-9, 1983 and were continued in Washington, D.C. during the Annual Meetings. The representatives of Honduras in these discussions included the President of the Central Bank, the Ministers of Finance, Economy and Labor, the Executive Secretary of the National Planning Council, and senior officials of various ministries, the Central Bank, and several state enterprises. The staff representatives were R. A. Elson (Head-WHD), A. Antonaya (FAD), L. Cardemil, M. Figuerola (both WHD), G. Oliveros (EP-WHD), and T. Puri (Secretary-WHD).

The last Article IV consultation with Honduras was concluded by the Executive Board on November 5, 1982 (EBM/82/142), at the same time that requests for a stand-by arrangement (EBS/82/179) and a purchase under the compensatory financing facility (EBS/82/184) were approved.

II. Recent Developments and Performance Under the Current Stand-By Arrangement

During the period 1980-82, the economic and financial position of Honduras deteriorated sharply. Political instability in the Central American region eroded private sector confidence with adverse effects on investment, trade, and domestic savings. At the same time, the external terms of trade declined significantly as a result of the second oil price shock and a fall in the world prices of Honduras' major commodity exports (coffee, bananas, sugar, and certain minerals). As a consequence, the rate of growth in real GDP, which had averaged 8 1/2 percent in the late 1970s, fell to less than 3 percent in 1980 and became negative in 1981-82.

1/ Honduras has accepted the obligations of Article VIII, Sections 2, 3, and 4.

Financial developments reflected not only the negative impact of these external forces, but also expansionary fiscal and monetary policies. During 1980 and 1981, the overall deficit of the nonfinancial public sector rose to an average of 9 percent of GDP, compared with an average of 6 percent in the previous three years. This deterioration, which reflected primarily a weakening in tax administration and a rapid growth in current expenditures at the central government level, was financed mainly by increased borrowing from the Central Bank. In addition, the net domestic assets of the Central Bank expanded rapidly because of heavy credit demands on the part of the official financial institutions, reflecting an increase in nonrecoverable loans, and legal reserve deficiencies of various commercial banks.

As a result of these problems, Honduras' performance under the EFF arrangement approved in June 1979 was poor. Honduras observed the main quantitative performance criteria during the first 12-month period of the arrangement, but its performance departed significantly from program targets thereafter. Consequently, Honduras was able to make only one purchase during the final two years of the EFF arrangement.1/

Against this background, the Administration that took office in early 1982 sought to redirect economic policy toward the achievement of fiscal and balance of payments equilibrium.2/ During the course of 1982, a stabilization program was developed, including a number of prior actions in the fiscal area, which was supported by a 14-month stand-by arrangement approved in November 1982 for an amount of SDR 76.5 million (150 percent of quota). Under this arrangement, which expires on December 31, 1983, Honduras has purchased SDR 61.2 million. The main objective of the program was the strengthening of fiscal performance through a combination of revenue and expenditure measures which was to facilitate a sharp reduction in the domestic financing requirements of the public sector. The targeted deficit for 1983 was around 7 percent of GDP, compared with 9 percent in 1981, which was to be financed mainly with long-term external loans on concessional terms.

The fiscal adjustment was intended to facilitate the achievement of approximate balance of payments equilibrium in 1983 (including the elimination of payments arrears) after three years of substantial deficits. The balance of payments adjustment process was to be reflected in a reduction in the current account deficit, attendant upon an export recovery and a compression in private sector demand for imports of goods and services, while net capital inflows would be bolstered from larger disbursements of development aid, special assistance under the U.S. Caribbean Basin Initiative, and debt relief on commercial foreign borrowing.

1/ Honduras' performance under the EFF arrangement was reviewed in SM/82/151.

2/ In November 1981 presidential elections were held for the first time in ten years, thus completing the transition from military to civilian rule which began with the election of a Constitutional Assembly in April 1980.

1. Results of the program in 1982 1/

In view of the lagged effect of the measures taken during 1982 and the underlying weakness of the economy, significant results from the program had not been expected during 1982. Nevertheless, Honduras' financial performance departed significantly from the objectives of the stand-by program last year, in part because the decline in the level of economic activity and foreign trade was much more pronounced than had been assumed.

The main departure from the program occurred in the central government finances. The overall government deficit turned out to be around L 560 million (10 percent of GDP), compared with a program target of L 440 million (7 1/2 percent of GDP). Most of this deviation was reflected in higher domestic financing of the Government, and therefore the ceiling on net credit of the banking system to the public sector was exceeded by L 79 million (Table 1).

Revenue performance in 1982 was much weaker than had been projected, especially in view of the tax increases enacted by the new Government. These included an increase in the sales tax rate from 3 percent to 5 percent, the introduction of income tax surcharges and selective consumption duties, and the temporary imposition of an import duty surcharge pending the entry into effect of a comprehensive customs tariff reform. Despite these measures, central government revenues grew by only 4 percent in 1982 and fell from 14.1 percent of GDP in 1981 to 13.7 percent of GDP in 1982, compared with a program target of 14.3 percent (Table 2). Most of the shortfall in revenues would appear to be explained by conjunctural factors, as mentioned above, but deficiencies in tax administration also appear to have played a role.

There were also deviations with respect to the program on the expenditure side; current expenditure was higher than projected, as was net lending to the rest of the public sector to cover interest payments on foreign commercial borrowing in default. As a result, the target for government expenditure was exceeded by the end of the year.

The ceiling on the net domestic assets of the Central Bank was exceeded at the end of 1982, but by less than the ceiling on net credit to the public sector, as net Central Bank credit to the rest of the banking system was significantly lower than projected in the program (Table 3). This result reflected a large buildup of liquidity in the commercial banks, which may have been related to the quantitative import restrictions introduced in mid-1982, and relatively low demand for bank credit from the private sector. Mainly because of the fiscal problems described above, the rate of overall credit expansion in 1982 was 23 percent in 1982, instead of the program target of 17 percent, and

1/ Although the stand-by arrangement was approved in late 1982 and covered only two months of that year, the policies and targets for last year had been set by midyear.

Table 1. Honduras: Performance Under Stand-By Arrangement

(In millions of lempiras)

Quantitative Performance Criteria/End of Quarter	1982 December	1983 March	1983 June	1983 September
1. Net domestic assets of Central Bank				
Ceiling	510	505	490	505
Actual	557	479	440	479
Margin/excess (-)	-47	26	50	26
2. Net banking system credit to public sector				
Ceiling	725	730	735	755
Actual	804	756 1/	825 1/	818
Margin/excess (-)	-79	-26	-90	-63
3. Commercial payments arrears				
Limit	--	--	--	--
Actual	--	--	--	...
4. Foreign commercial indebtedness				
Limit	75	75	75	100
Actual	-6	23 2/	18 2/	14 2/
Margin/excess (-)	81	52	57	86
5. Central government expenditure 3/				
Target	1,022	1,249	1,516	1,826
Actual	1,054	1,294	1,537	...
Margin/excess (-)	-32	-45	-21	...

Sources: EBS/82/179; and Central Bank of Honduras.

1/ These figures represent revisions to the data originally reported to the Fund staff at the time compliance with the program was tested for making purchases under the arrangement. These revisions were necessary because of the misclassification of certain accounts in the Central Bank's balance sheet related to government operations.

2/ Includes conversion of a short-term foreign liability of the Central Bank (US$30 million) into a medium-term maturity.

3/ Not a performance criterion. Defined as total expenditure minus foreign borrowing, measured on a cumulative basis from January 1, 1982.

Table 2. Honduras: Central Government Operations

(In millions of lempiras)

	1981	1982 SBA	1982 Actual	1983 SBA	1983 Projection
Revenue	741	832	770	980	758
Tax revenue	695	786	717	939	703
Nontax revenue	34	27	36	23	42
Transfers	12	19	17	18	13
Expenditure	1,152	1,272	1,326	1,370	1,420
Current	792	825	858	873	956
Capital and net lending	360	447	468	497	464
Capital	(209)	(242)	(256)	(312)	(261)
Net lending	(151)	(205)	(212)	(185)	(203)
of which: interest 1/	/14/	/83/	/93/	/55/	/76/
Savings	-63	-12	-105	89	-211
Overall deficit	-411	-440	-556	-390	-662
External (net)	226	250	274	300	393
Domestic (net)	185	190	282	90	269
Banks	(156)	(150)	(236)	(50)	(150)
Bonds	(34)	(40)	(54)	(40)	(119)
Other	(-5)	(--)	(-8)	(--)	(--)

Sources: EBS/82/179; Ministry of Finance; Central Bank of Honduras; and Fund staff estimates.

1/ Loans to the rest of the public sector to cover interest payments on foreign commercial indebtdness.

Table 3. Honduras: Summary Central Bank Accounts

(In millions of lempiras)

	Dec. 1981	December 1982		December 1983	
		SBA	Actual	SBA	Projection
Net international reserves	21	-173	-214	-193	-290
Net domestic assets	312	506	557	546	660
Public sector (net)	572	722	804	772	955
Central Government 1/	(502)	(652)	(738)	(702)	(890)
Rest of public sector	(70)	(70)	(65)	(70)	(65)
Banks (net)1/	32	97	-30	127	-5
Credit	(265)	(...)	(354)	(...)	(390)
Deposits (-)	(-234)	(...)	(-385)	(...)	(-395)
Medium- and long-term foreign liabilities	-311	-358	-343	-417	-420
Other	19	45	126	64	130
Currency issue	333	333	343	353	370

Sources: EBS/82/179; Central Bank of Honduras; and Fund staff estimates.

1/ Government bonds held by the rest of the banking system are included in the Central Bank's net credit to the Central Government and in net claims by banks on the Central Bank.

the loss in net official international reserves was larger than envisaged in the program. In addition, there was an accumulation of external debt arrears amounting to US$47 million, as a rescheduling of commercial debt maturities was not finalized as expected before the end of the year.1/

The larger than programed deficit in the overall balance of payments occurred despite the sharp reduction in the current account deficit that resulted from a substantial contraction in imports. In view of the significant decline in the pace of domestic economic activity and the authorities' reliance on import restrictions, imports declined by nearly 25 percent last year compared with a program estimate of 8 percent. As a result, the current payments deficit was reduced from around US$300 million (11 1/2 percent of GDP) in 1981 to US$230 million (8 percent of GDP) in 1982 (Table 4). However, the capital account position was much weaker than projected in the program. Net capital inflows to the official sectors were lower than expected last year, while there was an apparent net outflow of private capital, instead of a small inflow assumed in the program.

2. Performance under the program in 1983

In 1983 the Government has attempted to reduce the 1982 departures from the stand-by program through a variety of compensatory measures. In the fiscal area, the Government was able to reduce its net position with the banking system during the first few months of the year mainly as a result of a temporary improvement in revenue performance arising from a change in the timing of income tax payments and an increase in the net placement of bonds with the rest of the public sector and the nonfinancial private sector. At the same time, the Government delayed payments for its domestic currency obligations which resulted in an increase in arrears. The reduced need for bank credit early in 1983 also meant an improved performance by the Central Bank with respect to the ceiling on its net domestic assets. The position of the Central Bank under its overall credit ceiling and implicit balance of payments target was also affected by the conversion of a short-term foreign commercial liability of US$30 million into a medium-term foreign liability as of March 1983. In addition, the excess reserves of the banking system in the Central Bank have remained at a high level during 1983, as the authorities have continued to license imports restrictively, even though such restrictions do not appear to have been intensified.

Despite the partial correction of program deviations during the first half of the year, Honduras' financial performance in 1983 is likely to continue to depart from the program's objectives as the underlying trend of the economy has remained weak. In the absence of the recovery in exports and domestic economic activity which was hoped for under the

1/ In the expectation that the external debt arrears would be rescheduled before the end of 1982, such arrears were not included in the arrears test of the program shown in Table 1 which refers only to commercial payments arrears.

Table 4. Honduras: Summary Balance of Payments

(In millions of U.S. dollars)

	1981	1982 SBA	1982 Actual	1983 SBA	1983 Projection
Current account	-304	-329	-230	-312	-253
Trade balance	-192	-188	-62	-157	-82
Exports, f.o.b.	(784)	(710)	(677)	(781)	(690)
Imports, c.i.f.	(-976)	(-898)	(-739)	(-938)	(-772)
Net factor payments	-154	-188	-204	-210	-216
Other	42	47	36	55	45
Capital account	184	232	66	302	218
Private 1/	25	9	-98	30	-47
Nonfinancial public sector	167	152	135	195	206
of which: Central Government	(131)	(125)	(135)	(150)	(197)
Financial sector 2/	-9	27	29	34	21
of which: Central Bank	(3)	(23)	(16)	(30)	(39)
Debt relief	--	44	--	43	38
Overall balance	-120	-97	-164	-10	-35
Net international reserves (increase -)	107	87	117	10	...
External debt arrears	13	--	47	-54	-60
Rescheduling	--	--	--	54	60
Commercial arrears	--	10	--	--	...

Sources: EBS/82/179; Central Bank of Honduras; and Fund staff estimates.

1/ Includes net errors and omissions.
2/ Includes SDR allocation.

program, the underlying fiscal performance has continued to be poor, especially on the revenue side. Receipts from taxes on foreign trade transactions and domestic sales have shown no growth in 1983, compared with an increase of 19 percent projected under the program. In the area of import taxes, the combination of declining economic growth and quantitative import restrictions (mainly on consumer goods) has adversely affected the yield from customs duties which are an important component of government revenues. This outturn has also reflected the failure of the Government to obtain passage of the comprehensive customs reform that was submitted to the Legislative Assembly in late October 1982 as part of the stand-by program. That reform called for the replacement of the existing NAUCA nomenclature with one based on the Brussels classification, the substitution of ad valorem for specific rates and an overall increase in average import duties.

In order to minimize the effect of the revenue shortfall on domestic bank credit expansion, the Government, as mentioned above, has delayed payments for purchases of goods and services, with a corresponding rise in arrears, and has increased sharply its bond sales in the domestic nonbank market. The build up in arrears has reflected not only the revenue shortfall, but also a further excess in current government expenditures over the program projection. The latter has been related mainly to unanticipated increases in interest payments on government bonds and in defense expenditures. As regards the domestic financing of the government deficit, the program assumed net bond placements of L 40 million in 1983, the same as in 1982, but this target was already exceeded in the first half of the year. Such sales have been facilitated by the large growth of private financial savings in relation to the demand for private sector credit due to the combination of import restrictions and a recession in domestic economic activity. All in all, it is estimated that the overall government deficit (including arrears) will remain this year at roughly the same level in relation to GDP as last year (i.e. 10-11 percent), compared with a program target of 6 percent.

III. Report on Discussions

In view of the problems experienced in the implementation of the 1982-83 stand-by program, the consultation discussions focused primarily on issues related to short-run stabilization policy. In this connection, it was pointed out that, although the overall credit and balance of payments objectives of the program might be achieved (or nearly achieved) in 1983, this result was only possible because of reliance upon import restrictions as an instrument of adjustment rather than fiscal policy. As a result, the authorities acknowledged that the problem of achieving internal and external balance was perhaps more difficult than before, as not only corrective fiscal action was required, but also policies to correct the distortions created by import restrictions.

Moreover, in charting the future path of adjustment policy, possibly to be supported by a new stand-by arrangement after the present one expires, both the Honduran authorities and the Fund staff representatives were more cautious than in the past in evaluating the prospects for economic recovery. It was generally agreed that, given the continuing political uncertainties and weak economic conditions in the rest of the Central American region, the pace of domestic economic activity would be sluggish at best. In particular, the view was that growth in the value of exports would depend to a large extent upon a recovery of international prices and the development of new markets to offset the effect of quota arrangements in the markets for Honduras' traditional exports (coffee, sugar and meat) and the breakdown of the Central American regional trading arrangements which had supported heretofore the growth of Honduras' nontraditional exports.

1. Fiscal policy

The Honduran authorities recognized that the country's adjustment effort would have to focus on a strengthening of the fiscal position. As regards 1983 as a whole, it was estimated that the Government was running an overall deficit which required domestic financing on the order of 5 percent of GDP, compared with a target of about 1-1/2 percent of GDP under the program, the expansionary impact of which was reflected in a large increase in domestic liquidity. The outlook for 1984 suggested a continuation of this trend. In these circumstances, it was agreed that substantial action was needed to reduce sharply the overall government deficit, although all the means to achieve this end have not yet been fully defined.

The authorities pointed to efforts under way to bolster central government revenues. In spite of the delays experienced to date in the enactment of the customs tariff reform, the authorities expressed their intention to continue to press for legislative approval. However, in view of the political resistance to some of the tariff proposals affecting the commercial and industrial sectors of the economy, they indicated that the reform might have to be implemented in two stages, involving first the change in nomenclature and elimination of specific duty rates, and later the modification and simplification of the structure of protection. It was noted that the first stage of the customs tariff reform was in accord with proposals already advanced within the Central American Common Market. A delay in the second phase of the reform, however, would involve a loss of potential revenues which would have to be compensated by other measures.

Accordingly, the authorities are considering further modifications in domestic taxes, which would affect sales and income tax collections. In the area of sales taxation, a significant increase in revenue is expected to be derived from extending the base of the tax to include services (for example, public utilities). At the same time, consideration is being given to the idea of eliminating the exemptions now enjoyed

by public enterprises for sales (and import) taxation. These efforts are being supplemented by programs of technical assistance to improve the administration of the sales and income taxes.

On the expenditure side, the authorities noted that the 1984 budget which was presented to the Legislative Assembly in September 1983 included the same level of expenditures to be financed with domestic resources that had been authorized for 1983, i.e., L 1,180 million. However, this figure did not include the transfers (in the form of net lending) which the Government would have to make to cover interest payments on foreign commercial indebtedness of certain public entities, mainly the National Investment Corporation (CONADI). In the absence of compensatory measures by these entities to accommodate such interest payments, the potential burden on the Central Government next year would be on the order of L 80 million (nearly 1 percent of GDP), which is similar to the amount to be paid this year.

The authorities also pointed to certain pressures which might result in additional budgetary authorizations in the next fiscal year, mainly in the defense and salary fields. Increased outlays for defense had already been a factor behind this year's deviation from the program. The pressure for higher salaries came mainly from the union of public school teachers whose salaries have been frozen for the last three years. The authorities recognized the difficulty of accommodating the full demands of the teachers union in view of the existing budget constraint and the possible negative demonstration effect on wage adjustments in the rest of the economy, but noted that some increase in teacher salaries was inevitable.

As regards the rest of the nonfinancial public sector, the authorities were satisfied that the performance of the public enterprises was basically in line with the program in 1983 as reflected in their use of domestic bank credit. Also, they pointed to programs of tariff adjustments under way in the case of the Electricity Authority (ENEE) and the Water and Sewerage Authority (SANAA). In the case of the Port Authority (ENP), tariff adjustments established late last year had been sufficient to allow that enterprise to cover interest payments on its foreign commercial debt this year without recourse to central government resources as was the case in 1982. But the authorities recognized that further tariff adjustments in the enterprise sector would be needed to increase the share of the sector's investment to be financed by own resources and to re-establish a situation whereby certain enterprises, such as the National Forestry Corporation (COHDEFOR) and the National Telecommunications Enterprise (HONDUTEL), could transfer a share of their profits to the Central Administration.

2. Monetary policy

In the present economic circumstances, the main task for monetary policy was seen to be that of minimizing the impact of the large domestic financing needs of the budget on domestic prices or the net international

reserves of the Central Bank. The authorities recognized that the present policy of financing the government budget deficit with domestic bond sales was only a temporary solution to the fiscal problem in that such a policy merely delayed the time when fundamental action on revenues and/or expenditure would need to be taken. They also believed that the domestic rate of inflation (around 9 percent), although higher than the rate of external price increases, could have been much higher in the present circumstances, had it not been for several special factors. First, demand for private sector credit was low because of the prevailing recession in domestic economic activity; second, cost pressures on domestic prices had been dampened by the absence of large private sector wage demands in the face of high unemployment and by the adequate domestic supply of basic grains which figure prominently in the popular diet and consumer price index; and third, banking system liquidity was concentrated primarily in the hands of the industrial sector which was investing its excess supply of funds in domestic financial assets at a time when a foreign exchange shortage and import rationing reduced their supplies of raw materials and intermediate goods.

In these conditions, the authorities believed that domestic interest rate policy had a crucial role to play, especially in encouraging the retention of private liquidity in domestic financial instruments and in dampening the demand for private sector credit. The primary mechanism for maintaining interest rates on bank deposits at levels which were positive in real terms has been the sale of government bonds in the domestic market at rates which ranged from 10 percent in the case of sight bonds sold from the Central Bank's own portfolio up to 13 percent for new bond issues carrying a maturity of 18 months. In the present circumstances, the authorities had decided not to change the prevailing ceiling on banking system interest rates, as the present level (19 percent) was considered high enough to allow for sufficient interest rate flexibility.

Notwithstanding the arguments given for why the rate of inflation had not been larger than it was, the authorities recognized that excess liquidity in the banking system was a threat to monetary stability not only insofar as domestic prices were concerned, but also as regards the value of the lempira in the unrecognized parallel exchange market. For this reason, they were considering the possibility of sterilizing a large part of this excess liquidity in the Central Bank by an increase in the basic legal reserve requirements or by establishing marginal reserve requirements. In this connection, the authorities noted that the strong growth in domestic liquidity since late 1982 had allowed for a significant easing of the chronic legal reserve deficiencies which certain banks with a large portion of loans in default had been experiencing prior to that date. These banks had entered into special arrangements with the Central Bank's Superintendency of Banks in order to improve their loan recovery activity and to restore their legal reserve position with the Central Bank.1/

1/ Since 1980 the Superintendency of Banks has been receiving technical assistance from a CBD panel expert.

The authorities also reported that the reorganization of official banks was going forward, although not as quickly as had been hoped for. In the case of CONADI, the Government of Honduras signed a letter of understanding late last year with the World Bank, in the context of the Fund stand-by program, which outlined the plan for a significant restructuring of that institution. In view of the large arrears on direct and guaranteed foreign commercial borrowing which CONADI began to accumulate as of early 1982, its lending and investing operations were suspended indefinitely, while a detailed study of its portfolio was carried out. With technical assistance from the World Bank, a survey of CONADI's investments was undertaken and a program of recovery was established involving the rehabilitation of certain enterprises and the selection of others for liquidation or sale to private (domestic or foreign) investors. To date, the effect of these actions has been to reduce CONADI's reliance on transfers from the Central Administration in 1983 by an estimated L 20 million.

3. External sector policies

The Honduran authorities characterized their reliance on quantitative import restrictions as a necessary response to the shortfall in foreign exchange earnings under the program and the failure to achieve the intended reduction in the overall fiscal deficit. Since May 1982, the Central Bank has been granting import licenses according to a list of priorities. Licenses for certain essential imports are granted automatically, but requests for many consumer good imports are delayed for periods ranging up to six months. During the year the authorities have attempted to operate the system flexibly and with a view toward minimizing the time delay in approving licenses for essential imports. Accordingly, in August 1983 the system was revised whereby maximum time periods for the approval of licenses were predetermined for each category of imports.

The authorities viewed the import licensing system as a temporary measure which they intended to eliminate as the balance of payments situation of the country improved. They also recognized the distortions which import restrictions involved and the adverse consequences of the system for the revival of exports and economic recovery in general.

The reliance on import restrictions and the poor performance of exports also raised questions in the discussions about the adequacy of the existing parity of the Honduran lempira (L 2 = US$1). These doubts about the viability of the exchange rate were reinforced by the evidence of an erosion of about 25 percent since 1978 in Honduras' competitiveness, measured by changes in the effective value of the lempira adjusted for relative movements in consumer prices (Chart 1).1/ The Honduran authorities were skeptical about the effectiveness of an exchange rate adjustment at the present time, in part because they felt that a significant

1/ This degree of overvaluation is also reflected in the value of the lempira in the illegal parallel market which has been fluctuating around L 2.50 per U.S. dollar.

share of their exports (for example coffee, meat, and sugar) were determined mainly by quota arrangements in international or country-specific markets. They also believed that in an open economy such as Honduras an exchange rate adjustment might not have a lasting effect on domestic relative prices and could have a destabilizing effect on wages.

The case for an exchange rate adjustment was also viewed from the perspective of the medium-term balance of payments outlook. The growing burden of service payments on Honduras' external public debt makes clear that nontraditional exports, which might be most sensitive to an exchange rate adjustment, need to grow substantially in the next few years if the country is to maintain a manageable external debt position. Traditionally, Honduras' external debt profile was very favorable because of the large amounts of concessional foreign assistance available to it, but this advantage had been eroded by the end of 1982 by heavy recourse to foreign commercial borrowing, especially in connection with CONADI's investment program. In view of the deterioration in CONADI's financial position and the failure of a number of local businesses whose foreign borrowing it had guaranteed, the Government of Honduras has been forced to engage in a restructuring exercise with its foreign commercial creditors. Rescheduling or debt relief on the order of US$130 million in respect of maturities owed in 1982-84 has been sought, along with a commitment from the banks to establish a medium-term trade financing facility. The authorities indicated that the negotiations on rescheduling have proceeded satisfactorily, although these had been temporarily suspended recently because of a change in the chairmanship of the banks' steering committee.1/

On the assumption that a rescheduling agreement is finalized before the end of 1983, Honduras' debt service ratio, which rose from 12 percent of exports of goods and services in 1978 to 26 percent in 1982, would decline somewhat in 1983-84 and then return to its 1982 value over the next four years. This projection is valid, however, only on the assumption that exports of goods and services recover to their 1980 peak by 1985 and then grow by nearly 20 percent a year through 1988 (Table 5).

IV. Staff Appraisal

The economic and financial situation of Honduras has continued to deteriorate. Weak external demand for Honduras' exports, reflecting not only the world recession but also the regional economic and political crisis, together with sluggish domestic investment, has led to a substantial decline in the growth of real GDP. These developments have

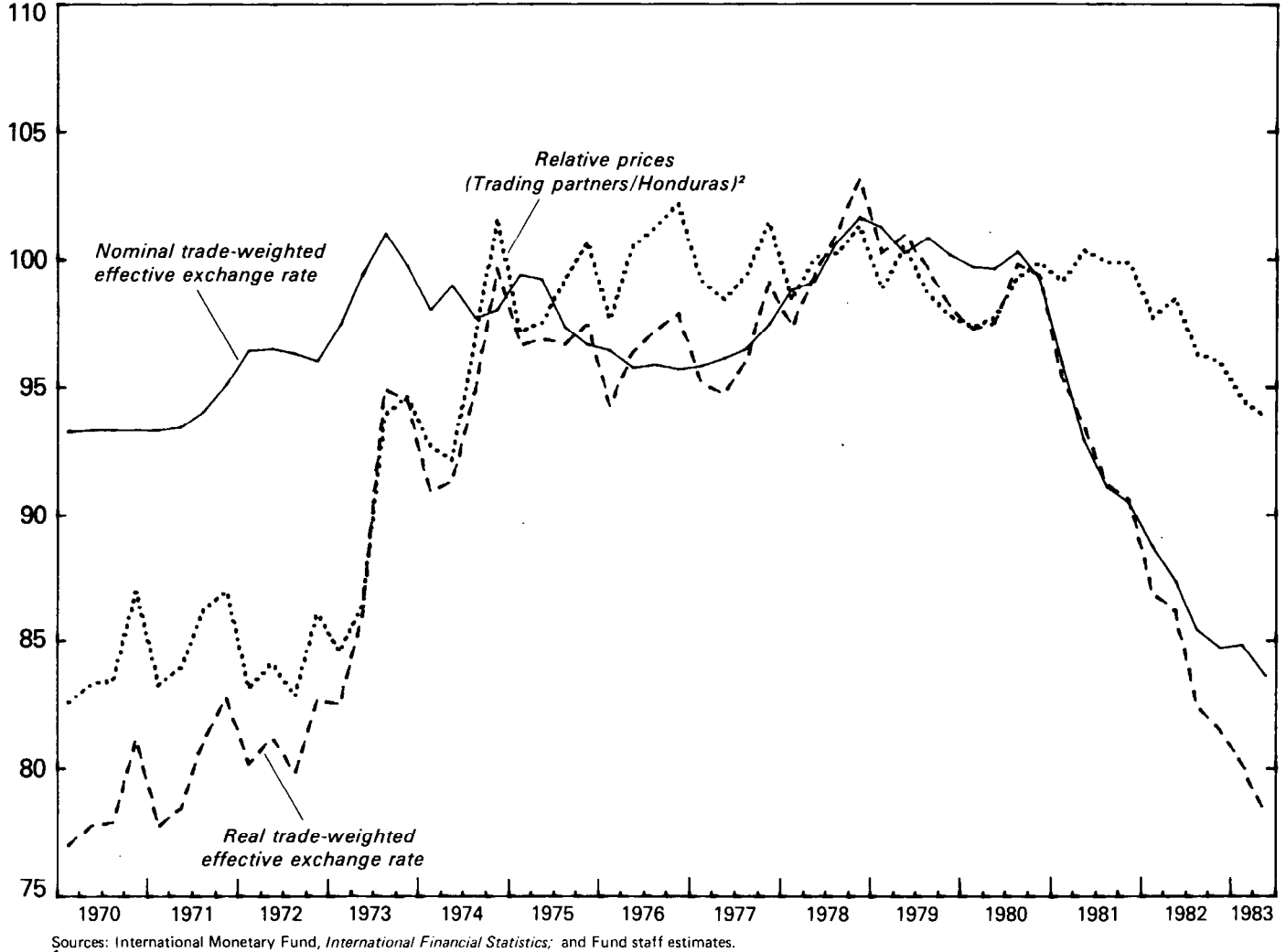
1/ The delays in finalizing an agreement with the banks have given rise to payments arrears in respect of external debt service obligations estimated at US$79 million as of end September 1983. No other restrictions on payments and transfers for current international transactions exist in Honduras' exchange system.

CHART 1

HONDURAS

EFFECTIVE EXCHANGE RATE INDICES, 1970-83[1]

(1978=100)



Sources: International Monetary Fund, *International Financial Statistics;* and Fund staff estimates.

[1]In Honduran lempira per unit of foreign exchange. The weights were based on the average distribution of export and import trade in 1978-79. Over 90 percent of trade with other partner countries is covered by these weights.

[2]Relative price levels were mesured by wholesale price indices, and where not available, consumer price indices.

Table 5. Honduras: Medium-Term Outlook

	Actual	Projected					
	1982	1983	1984	1985	1986	1987	1988
	(In millions of U.S. dollars)						
Balance of payments							
Current account	-230	-253	-238	-310	-335	-362	-392
Exports of goods and services	784	790	849	976	1,122	1,347	1,617
Imports of goods and services	1,044	1,075	1,122	1,326	1,502	1,759	2,064
Tranfers (net)	30	32	35	40	45	50	55
Current account deficit/GDP	8.2	8.4	7.4	9.0	9.0	9.0	9.0
	(In percent)						
External debt							
Outstanding public debt/GDP							
Total	56.9	63.0	68.6	72.9	76.5	79.4	82.2
Total excluding IMF	53.2	58.2	61.8	67.0	72.3	77.2	81.4
Net drawings/GDP 1/							
Total	8.1	9.9	9.8	8.8	9.1	8.7	8.8
Total excluding IMF	5.7	8.5	7.5	9.3	10.3	10.3	10.0
Debt service/exports of goods and services							
With rescheduling 2/							
Total	26.5	22.0	26.5	27.9	31.9	31.3	28.7
Total excluding IMF	26.0	20.8	24.1	24.4	26.5	25.7	25.1
Without rescheduling							
Total	26.5	26.8	27.6	26.0	29.1	28.0	25.7
Total excluding IMF	26.0	25.6	25.2	22.5	23.7	22.3	22.1
Other macroeconomic indicators							
Real growth rate/GDP	-1.2	-0.3	1.0	2.0	3.0	3.0	3.0
Nominal growth in exports of goods and services	-13.3	0.8	7.5	15.0	15.0	20.0	20.0

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

1/ Gross disbursements on the stock of debt contracted before December 1982 are projected according to actual contractual data. Disbursements on debt contracted after December 1982 are consistent with the rescheduling of arrears, debt relief to be received over 1983-84, and the public investment program. It is assumed that Honduras would enter future debt commitments so as to maintain the same lender composition prevailing as of December 1982 on the total stock of outstanding debt, with the exception of new commitments contracted during 1983-84 when a larger share of commercial bank lending is expected in accordance with the conditions stipulated in the rescheduling agreement.

2/ The rescheduling agreement currently under negotiation includes US$60 million in arrears accumulated over 1981-82 and US$70 million in debt relief over 1983-84, as well as US$40 million in additional financing for trade operations. Loans are to be repaid over a five-year period starting on the first quarter of the year following their due date in the original contract. Interest rate is LIBOR plus 2 1/4 or the U.S. prime rate plus 2 1/2, in addition to extension, conversion, and servicing lender fees.

had adverse effects on central government revenue, which in the face of continued growth in total expenditure has resulted in a substantial widening of the overall fiscal deficit financed with domestic resources. Honduras' performance with respect to the fiscal objectives of the current stand-by arrangement has been poor, as clearly shown by the most recent data gathered by the staff, and the overall credit and balance of payments targets have been met mainly because of the existence of quantitative import restrictions.

To re-establish internal and external balance without recourse to import restrictions, a fundamental correction in financial policies is required. In the fiscal area, efforts are needed to strengthen the Government's revenue performance and to make it less sensitive to the behavior of foreign trade. This will require further administrative improvements, a shift in the burden of taxation toward domestic transactions and tax increases in selected areas. On the expenditure side, more flexibility is needed to ensure that overall budgetary commitments can be brought into line with available revenue. In the last few years, current expenditures of the Government have tended to exceed targeted levels, even as a shortfall developed in revenues.

The management of the central government finances also has been complicated by the burden of foreign interest obligations which other public entities cannot meet because of their own weakened financial position. The most important of these entities is CONADI. Progress has been made in restructuring that institution, but much more needs to be done in order for CONADI to become self-supporting. Efforts also should be made to strengthen the savings performance of public enterprises so that they may finance a larger share of their investment programs or contribute a larger proportion of their profits to the Government.

In the monetary sphere, the authorities have been able to limit the impact of the Government's domestic deficit on central bank credit by selling bonds to the nonbank private sector, and because of the rise in commercial bank reserves occasioned by the weak private demand for credit. As more normal conditions return, however, the pressures for credit will increase, which makes it incumbent upon the authorities to take certain precautionary action such as sterilizing in a more permanent way the excess reserves now in the Central Bank. Also, the authorities should limit the sale of Government bonds, which can be redeemed at sight, and encourage the sale of Government bonds with longer maturities carrying higher interest yields. The task of managing excess liquidity in the financial system and encouraging the private placement of Government bonds makes clear the need to maintain domestic interest rates at levels which are significantly positive in real terms.

In view of the domestic financial problems which have emerged in recent years, the authorities have found it necessary to resort to quantitative import restrictions to manage the balance of payments. The staff would caution the authorities that this policy course is at best

a palliative and that it is self-defeating as it will introduce distortions in resource allocation which may in due course damage export growth and recovery of the economy. Therefore, the staff believes that the authorities need to consider the potential benefits of adopting a more flexible stance on exchange rate policy in the context of a comprehensive adjustment program.

Honduras maintains a restriction on payments and transfers for current international transactions in the form of arrears on external debt payments. The staff encourages the authorities to eliminate these as quickly as possible and to undertake adjustment policies that would prevent their re-emergence without recourse to import restrictions. In the meantime, approval for the retention of this restriction is not proposed.

Fund Relations with Honduras
(As of September 30, 1983)

Status:	Article VIII
Quota:	SDR 51 million. (Honduras has consented to the increase in its quota to SDR 67.8 million under the Eighth General Review.)

Fund holdings of Honduran lempiras:

	Millions of SDRs	Percent of Quota
Total	191.0	374.5
Of which:		
Credit tranches	(37.7)	(73.9)
EFF	(19.6)	(38.5)
CFF	(46.4)	(91.0)
EAR	(36.3)	(71.1)

SDR Department:	Holdings - SDR 52,050 or 0.27 percent of net cumulative allocation of SDR 19.1 million.
Trust Fund (second period):	Disbursed - SDR 14.1 million
Gold distribution:	21,396 fine ounces
Direct distribution of profits from gold sales:	US$4.0 million
Exchange rate:	US$0.50 per lempira
Last Article IV consultation:	April-May and August 1982, discussed by the Executive Board on November 5, 1982 (EBM/82/142).
Technical assistance:	In August 1983 a staff member from the Fiscal Affairs Department visited Honduras at the request of the Honduran authorities to design a technical assistance program on tax policy. Since September 1982 an expert from the Fund's Central Banking panel has been assigned as an advisor to the Central Bank of Honduras in the area of bank supervision.

BASIC DATA

Area and population	
Area	112,088 sq. kilometers
Population (mid-1983)	4.0 million
Annual rate of population increase (1979-83)	2.8 percent
GDP (1982)	SDR 2,538 million
	US$2,802 million
	L 5,603 million
GDP per capita (1982)	SDR 635

	1980	1981	Prel. 1982
		(percent)	
Origin of GDP			
Agriculture and mining	31	30	30
Manufacturing	16	16	16
Construction	6	6	5
Transport, communications, and utilities	10	10	10
Commerce and banking services	18	18	18
Other	19	20	21
Ratios to GDP			
Exports of goods and nonfactor services	37.9	33.6	27.4
Imports of goods and nonfactor services	45.3	40.4	29.5
Current account of the balance of payments	-12.7	-11.5	-8.2
Central government revenues	15.3	14.1	13.7
Central government expenditures	23.1	21.9	23.8
Central government savings	0.1	-1.2	-2.0
Central government overall surplus or deficit (-)	-7.8	-7.8	-10.1
External public and government guaranteed debt (end of year) 1/	44.9	51.9	56.9
Gross national savings	13.5	11.6	9.9
Gross domestic investment	26.2	23.1	18.1
Money and quasi-money (end of year)	27.4	28.3	31.2
Annual rates of change in selected economic indicators			
Real GDP per capita	--	-2.3	-3.9
Real GDP	2.8	0.5	-1.2
GDP at current prices	13.7	5.8	6.4
Domestic expenditure (at current prices)	17.2	5.1	1.7
Gross domestic investment	(19.2)	(-6.5)	(-16.7)
Consumption	(16.5)	(8.9)	(6.8)
GDP deflator	10.5	5.3	7.7
Consumer prices (annual averages)	18.1	9.4	9.4
Central government revenues	20.3	-2.5	3.9
Central government expenditures	41.2	0.4	15.9
Money and quasi-money	6.6	9.4	17.1
Money	(10.9)	(4.5)	(10.6)
Quasi-money	(3.5)	(13.3)	(21.8)
Domestic bank credit 2/	17.9	21.9	31.9
Credit to public sector (net)	(11.4)	(8.4)	(13.1)
Credit to private sector 3/	(7.3)	(8.0)	(10.8)
Merchandise exports (f.o.b., in U.S. dollars)	12.4	-7.8	-13.7
Merchandise imports (c.i.f., in U.S. dollars)	22.0	-6.2	-24.3

Central government finances	1980	1981	Prel. 1982
	(millions of lempiras)		
Revenues	760	741	770
Expenditures	1,148	1,153	1,336
Current account surplus	6	-63	-114
Overall deficit (-)	-388	-412	-566
External financing (net)	252	263	269
Internal financing (net)	136	149	297
Balance of payments	(millions of U.S. dollars)		
Merchandise exports (f.o.b.)	850	784	677
Merchandise imports (c.i.f.)	-1,039	-976	-739
Investment income (net)	-154	-153	-204
Other services and transfers (net)	26	42	36
Balance on current and transfer accounts	-317	-303	-230
Official capital (net)	144	168	135
Financial system capital (net)4/	23	-9	29
Private capital (net)5/	85	25	-98
Overall balance	-65	-119	-164
Net official international reserves (increase -)	65	107	117
External debt arrears	--	13	47

International reserve position	Dec.31 1981	June 30 1982	Dec. 31 1982
	(millions of SDRs)		
Central Bank (gross)	101.9	93.9	125.8
Central Bank (net)	8.9	-59.3	-97.6
Rest of banking system (net)	-16.8	-35.7	-20.7

1/ Includes obligations to IMF. Excludes short-term debt.

2/ In relation to the banking system's liabilities to the private sector at the beginning of the period.

3/ Includes credit to the nonbank financial intermediaries.

4/ Includes transactions with nonmonetary international agencies and allocation of SDRs.

5/ Includes net errors and omissions.