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August 4, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Honduras - Staff Report for the 1989 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1989 Article IV consultation with Honduras, which will be brought to the agenda for discussion on a date to be announced.

Mr. Linde (ext. 8500) or Mr. Berengaut (ext. 8503) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

HONDURAS

Staff Report for the 1989 Article IV Consultation

Prepared by the Western Hemisphere Department

(In consultation with the Exchange and Trade Relations,
Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by S. T. Beza and Thomas Leddy

August 2, 1989

<u>Contents</u>	<u>Page</u>
I. Introduction	1
II. Background and Recent Developments	2
III. Summary of Policy Discussions	10
1. Fiscal policy	11
2. Monetary policy	13
3. External sector policies	14
4. Medium-term projection	16
IV. Staff Appraisal	18
 <u>Text Tables</u>	
1. Main Economic Indicators	3
2. Consolidated Operations of the Nonfinancial Public Sector	4
3. Banking System Operations	6
4. Balance of Payments	8
5. Central Government Operations	12
6. Medium-Term Outlook	17
 <u>Appendices</u>	
I. Fund Relations	21
II. Basic Data	24
III. Statistical Issues	26
IV. Relations with the World Bank	28
 <u>Chart</u>	
1. Effective Exchange Rate Indices, 1978-89	8a

I. Introduction

The 1989 Article IV consultation discussions with Honduras took place in Tegucigalpa on April 29-May 12, 1989 and were continued during a visit by the authorities to Fund headquarters on July 12-13. ^{1/} Staff representatives met with the President of the Central Bank, the Ministers of Finance, Economy, Labor, and Agriculture, the Executive Secretary of the National Planning Office, and officials of various ministries, agencies, and enterprises. The mission also met with the President of the Republic. Ms. Napky, Advisor to the Executive Director for Honduras, participated in some of the policy discussions.

The previous Article IV consultation discussions with Honduras were held in January 1988 and the staff report was discussed at EBM/88/83 on May 23, 1988. In concluding the consultation, Executive Directors viewed the continuation of moderate economic expansion and the maintenance of a low rate of inflation as positive developments. However, they noted with concern the weak savings performance of the public sector and the deterioration of the external position, including the emergence in the second half of 1987 of a serious problem of arrears on external payments. Directors emphasized the need to strengthen efforts to bring about a sustained improvement in the external position and to lay a basis for sound economic growth. Directors recommended a strengthening of tax policies, better control over current expenditures, and improvement of the operations of public enterprises. Directors stressed the need to restrain credit to ease pressures on domestic prices and official net international reserves. Directors called for the dismantling of the complicated system of fiscal and exchange incentives and, noting the overvaluation of the official exchange rate, they encouraged the authorities to accelerate the transfer of transactions to the parallel market as a transitional arrangement toward an early unification of the exchange system.

In late 1987 Honduras began incurring arrears to the Fund. These rose to SDR 19 million in August 1988, but were cleared in early November 1988. Since then, obligations amounting to SDR 13.5 million have fallen due through end-July 1989 of which SDR 12.7 million are yet to be cleared. A report and a complaint under rule K-1 and notice of failure to settle Trust Fund Obligations (EBS/89/08) related to these arrears were discussed by the Executive Board on May 31, 1989. The decision called for the next review to be completed by August 31, 1989. Further details on Honduras' relations with the Fund are shown in Appendix I. Relations with the World Bank are presented in Appendix IV.

^{1/} These discussions were part of a series held with Honduras on ways to settle the arrears to the Fund and on a package of policy measures that could serve as a basis for the use of Fund resources once Honduras became current with the Fund; earlier missions visited Tegucigalpa on February 15-25, March 7-10, and March 26-April 7. The staff members participating in these discussions were Mr. Linde (Head), Mr. Berengaut, Ms. Sumar (all WHD), Ms. Xafa (ETR), and Ms. Bustillo and Ms. Ulmschneider (Secretaries-WHD).

Honduras has incurred arrears to other multilateral institutions. The arrears to the World Bank amounted to US\$70.1 million as of end-July 1989; disbursements have been suspended since December 1988 and Honduras was placed on a nonaccrual status on April 1, 1989. The arrears to the Inter-American Development Bank amounted to US\$15.8 million at the end of July 1989.

Honduras has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement.

II. Background and Recent Developments

Honduras experienced a downturn in economic activity in the early 1980s. Growth resumed in 1984, but until 1987-88 the rate of growth of output was, at about 3 percent, barely above the population growth rate (Table 1). In the past two years output growth accelerated to an average of 4 1/2 percent a year; nevertheless, real GDP per capita in 1988 was more than 10 percent below the peak in 1980. Throughout the period labor force growth has been rapid, thus contributing to a high rate of open unemployment. Measured inflation has generally been low throughout the recovery period; however, there was an acceleration of prices in 1988 and the first half of 1989 that was attributed to shortages in basic grain production and a depreciation of the lempira in the parallel exchange market following the exhaustion of usable reserves because of domestic fiscal imbalances. By mid-1989, the annual rate of change of consumer prices was about 9 1/2 percent. ^{1/}

The overall deficit of the nonfinancial public sector declined from about 11 percent of GDP in 1984 and 8 1/2 percent of GDP in 1985 to a range of 6 - 6 1/2 percent in the period 1986-88 (Table 2). The reduction reflected a sharp drop in capital expenditure in the aftermath of the completion of the externally financed El Cajon hydropower plant in 1985. Current outlays rose from about 19 percent of GDP in 1984 to about 21 percent of GDP in 1988, owing to a rise in spending on wages and salaries and military outlays.

The domestic financing requirement remained small through 1985 but increased subsequently as foreign financing fell by more than capital outlays. Foreign assistance and external financing covered 85 to 90 percent of the financing requirement in 1984-85; this share declined to 15 percent in 1987, but rose to nearly 40 percent in 1988 with the disbursement of the World Bank SAL and a sectoral loan. The share financed by the domestic banking system rose from roughly 10 percent in 1984-85 to about one third in 1987-88. Payments arrears emerged in 1987, covering 40 percent of the overall deficit that year and around 25 percent in 1988.

^{1/} Price developments discussed in this report are based on official price statistics. Owing to extensive price controls and the unavailability of many items at the controlled prices, the official data underestimate actual inflation.

Table 1. Honduras: Main Economic Indicators

	1984	1985	1986	1987	Prel. 1988
<u>(Annual percentage change)</u>					
Real GDP	3.0	3.2	3.1	4.9	4.0
<u>Consumer prices</u>					
Average annual	4.7	3.4	4.4	2.4	4.5
End of period	3.6	4.2	4.1	2.0	6.7
<u>Banking system 1/</u>					
Net domestic assets	12.9	12.2	13.7	18.0	9.4
Credit to public sector	4.5	1.4	2.7	4.9	5.4
Credit to private sector	9.5	10.4	7.7	14.1	3.1
Liabilities to private sector	8.5	6.1	10.3	16.4	10.6
<u>(As percent of GDP)</u>					
<u>Nonfinancial public sector</u>					
Total revenue	20.6	21.8	21.4	21.3	21.1
Total expenditure and net lending	31.7	30.3	27.6	27.4	27.3
Current account balance	1.7	1.5	1.4	0.4	-0.1
Overall surplus or deficit (-)	-11.2	-8.5	-6.2	-6.1	-6.2
<u>External sector</u>					
Exports f.o.b.	22.2	22.0	23.0	20.4	20.5
Imports c.i.f.	-27.8	-26.0	-24.4	-23.6	-23.2
External current account	-10.5	-8.8	-6.5	-8.1	-7.8
Overall balance of payments	-1.6	-1.8	-0.3	-2.7	-2.4

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

1/ With respect to the stock of liabilities to the private sector at the beginning of the period.

Table 2. Honduras: Consolidated Operations of the Nonfinancial Public Sector

	1984	1985	1986	1987	Est. 1988
(In millions of lempiras)					
Total revenue	1,329	1,522	1,619	1,730	1,856
Tax revenue	1,021	1,134	1,137	1,253	1,369
Nontax revenue	276	326	440	358	376
Central Government	51	59	138	159	179
Rest of general government	126	150	169	199	197
Public enterprises 1/2/	99	117	133	92	84
Current transfers	19	18	2	1	1
Capital revenue	12	44	40	26	27
Total expenditure and net lending	2,052	2,115	2,091	2,238	2,405
Current expenditure 2/	1,209	1,375	1,476	1,675	1,840
Capital expenditure	749	685	548	512	474
Fixed capital formation	739	638	475	470	452
Capital transfers	1	2	58	22	3
Other capital expenditure	9	45	16	20	19
Net lending	94	55	67	51	91
Current account balance	108	104	102	23	-11
Overall surplus or deficit (-) accrual basis	-723	-592	-472	-508	-549
Interest payments arrears	--	--	--	109	55
Central government	--	--	--	100	37
Rest of public sector	--	--	--	9	18
Overall surplus or deficit (-) cash basis	-723	-592	-472	-399	-494
External financing (net)	574	397	173	-9	10
Foreign assistance 3/	68	111	137	81	205
Domestic financing (net)	81	84	162	223	199
Banking system (net)	87	40	74	152	179
Other	-6	44	88	71	20
External amortization arrears	--	--	--	103	80
(As percent of GDP)					
Total revenue	20.6	21.8	21.4	21.4	21.1
Tax revenue	15.8	16.2	15.0	15.3	15.6
Nontax revenue	4.2	4.7	5.9	5.6	5.2
Central Government	0.8	0.9	1.8	2.0	2.0
Rest of general government	1.9	2.1	2.2	2.5	2.2
Public enterprises 1/2/	1.5	1.7	1.7	1.1	1.0
Current transfers	0.3	0.3	--	--	--
Capital revenue	0.2	0.6	0.5	0.3	0.3
Total expenditure and net lending	31.7	30.3	27.6	27.5	27.3
Current expenditure 2/	18.7	19.7	19.5	20.7	20.9
Capital expenditure	11.6	9.8	7.2	6.1	5.4
Fixed capital formation	11.4	9.1	6.3	5.6	5.1
Capital transfers	--	--	0.8	0.3	--
Other capital expenditure	0.1	0.6	0.2	0.3	0.2
Net lending	1.5	0.8	0.9	0.6	1.0
Current account balance	1.7	1.5	1.4	0.4	-0.1
Overall surplus or deficit (-) accrual basis	-11.2	-8.5	-6.2	-6.1	-6.2
Interest payments arrears	--	--	--	1.2	0.6
Overall surplus or deficit (-) cash basis	-11.2	-8.5	-6.2	-4.9	-5.6
External financing (net)	8.9	5.7	2.3	-0.1	0.1
Foreign assistance 3/	1.1	1.6	1.8	1.0	2.3
Domestic financing (net)	1.3	1.2	2.1	2.8	2.3
Banking system (net)	1.3	0.6	1.0	1.9	2.0
Other	--	0.6	1.1	0.9	0.3
External amortization arrears	--	--	--	1.4	0.9
Memorandum item					
GDP (millions of lempiras)	6,462	6,977	7,600	8,109	8,799

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

1/ Operating surplus net of interest.

2/ Includes all contractual interest (paid and unpaid).

3/ Mainly special U.S. assistance for budgetary support.

In 1988 the overall deficit of the nonfinancial public sector remained unchanged at slightly above 6 percent of GDP, instead of declining to 5 1/2 percent of GDP as targeted. Plans to raise revenues through improved tax administration and to restrain expenditures were not implemented. The ratio of total revenues of the nonfinancial public sector to GDP declined marginally because of lower nontax revenue from the rest of the general government and a decline in the operating surplus of public enterprise, owing to the lack of adjustment of prices and tariffs. Total expenditure and net lending decreased slightly; although current expenditure continued to rise, there was a further decline in capital outlays that reflected shortfalls in local counterpart financing and reduced lending from multilateral agencies. As a result, the current account balance of the nonfinancial public sector, which had become negligible in 1987, turned negative in 1988.

In the period 1984-87, bank credit expanded more rapidly than the banking system's liabilities to the private sector (Table 3). External financing and foreign assistance as well as the use of international reserves covered the difference. Since the mid-1980s the share of foreign medium- and long-term financing of credit expansion has declined markedly, falling from 45 percent of total credit in 1985 to virtually nil in 1988. The acceleration of bank credit in 1986-87, due in part to the increased reliance on domestic financing of the fiscal deficit, placed strong pressure on domestic resources and led to a growing loss of reserves.

In 1988 steps were taken with the aim of tightening credit policy. From February to April 1988, legal reserve requirements were raised from 32 percent to 35 percent. However, the increase in reserve requirements had only limited effects on the credit operations of the banking system, as banks reduced their excess reserves or incurred deficiencies with respect to the legal reserve requirements. ^{1/} In the last three months of 1988, the Central Bank moved to restrict credit financed through rediscounts that subsidize various economic activities. The net domestic assets of the banking system increased by 9 1/2 percent during 1988 (with respect to the stock of liabilities to the private sector at the beginning of the period), compared with an increase of 18 percent in 1987 (Table 3). However, owing to the substantial domestic financing requirements of the public sector, banking system credit to the private sector rose by only 3 percent in 1988, compared with 14 percent in 1987. ^{2/}

^{1/} Excess reserves of the banking system fell from about 4 1/2 percent of liabilities to the private sector at end-1987 to 1/2 percent at end-1988.

^{2/} The comparison is affected by a writedown of nonperforming loans that took place in 1988; excluding the effects of the writedown, the banking system credit to the private sector grew by about 6 percent in 1988.

Table 3. Honduras: Banking System Operations

	1984	1985	1986	1987	Prel. 1988	May 1988	May 1989
(In millions of lempiras)							
I. Banking System							
<u>Net international reserves 1/</u>	-277.4	-291.1	-283.6	-264.4	-212.1	-235.2	-203.8
<u>Net domestic assets</u>	3,513.8	3,808.0	4,158.2	4,665.5	4,974.6	4,831.3	5,029.6
Credit to public sector (net)	1,055.2	1,088.4	1,157.4	1,296.6	1,475.5	1,324.1	1,435.2
Central Government	1,052.6	1,165.6	1,344.6	1,502.4	1,706.4	1,506.7	1,758.3
Rest of public sector	2.6	-77.2	-187.2	-205.8	-230.9	-182.6	-323.1
Credit to private sector	2,177.9	2,429.8	2,627.4	3,024.7	3,125.6	3,032.0	3,197.6
Other	280.7	289.8	373.4	344.2	373.5	475.2	396.8
<u>Medium and long-term foreign liabilities 1/ 2/</u>	824.0	956.5	1,050.7	1,113.7	1,125.0	1,168.8	1,166.9
<u>Liabilities to private sector</u>	2,412.4	2,560.4	2,823.9	3,287.4	3,637.5	3,427.3	3,658.9
II. Monetary Authority							
<u>Net international reserves 1/</u>	-232.1	-233.2	-226.9	-149.1	-118.1	-129.9	-117.6
<u>Net domestic assets</u>	656.4	687.8	703.9	690.1	740.0	619.3	684.3
Credit to public sector (net)	662.1	702.8	662.5	782.7	994.1	745.9	982.3
Central Government	582.7	616.2	626.8	763.9	968.8	711.5	1,004.7
Rest of public sector	79.4	86.6	35.7	18.8	25.3	34.4	-22.4
Arrears deposits	-55.5	-55.3	-20.5	-36.3	-97.7	-38.3	-99.8
Banks (net)	567.7	726.2	841.4	865.7	852.1	860.5	862.2
Medium- and long-term foreign liabilities 1/ 2/	586.7	715.2	814.3	880.1	911.6	932.8	957.3
Other	68.8	29.3	34.8	-41.9	-96.9	-16.0	-103.1
<u>Currency issue</u>	424.3	454.6	477.0	541.0	621.9	489.4	566.7
(In percent of GDP)							
Banking system							
Net domestic assets	54.4	54.6	54.7	57.5	56.5	...	...
Credit to public sector	16.3	15.6	15.2	16.0	16.8	...	...
Credit to private sector	33.7	34.8	34.6	37.3	35.5	...	...
Liabilities to private sector	37.3	36.7	37.2	40.5	41.3	...	...
(Changes in percent) 3/							
Banking system							
Net domestic assets	12.9	12.2	13.7	18.0	9.4	16.2	5.8
Credit to public sector	4.5	1.4	2.7	4.9	5.4	3.0	3.2
Credit to private sector	9.5	10.4	7.7	14.1	3.1	12.2	4.8
Liabilities to private sector	8.5	6.1	10.3	16.4	10.6	15.6	6.8

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

1/ Included in medium- and long-term foreign liabilities are the following short-term loans that were converted into medium term liabilities: in 1985, a US\$31 million (L 62 million) loan; in 1986, a US\$4.4 million (L 8.8 million) loan; in 1987, a US\$32.2 million (L 64.4 million) loan; and in 1988, a US\$23.2 million (L 46.4 million) loan.

2/ Includes SDR allocations and valuation adjustment.

3/ With respect to the stock of liabilities to the private sector at the beginning of the period.

Interest rates on lending operations have been subject to ceilings set by the Central Bank. Deposit interest rates have not been subject to ceilings but have been influenced by the yields set on government bonds. The level of nominal interest rates has remained broadly unchanged in recent years, and with the acceleration of inflation in 1988, real interest rates declined. By mid-1989, real interest rates on time and savings deposits turned negative.

Honduras' balance of payments performance has weakened markedly in the 1980s as domestic demand growth has been high in the light of the slow growth of export volume, declines in the terms of trade, and decreased external financing. Export volumes of all products, with the exception of bananas, stagnated. Exports declined as a share of GDP and the share of nontraditional exports in total exports fell as well. The volume of imports remained broadly unchanged in the period 1984-88. The current account deficit averaged about 8 percent of GDP over the same period (Table 4). In the early years of the 1980s the deficit on the current account was financed mainly through project loans from multilateral institutions and bilateral balance of payments support. In more recent years inflows of official capital have fallen and despite a pick up in private capital inflows since 1986 reflecting in part debt-equity swaps, net capital inflows have declined. The growing overall balance of payments deficit has been financed by an accumulation of arrears. The stock of external arrears rose from US\$217 million at the end of 1986 to US\$432 million by end-1988 (equivalent to 45 percent of exports of goods and nonfactor services); US\$278 million was owed to commercial banks, US\$112 million to official bilateral creditors, and US\$42 million to multilateral institutions. 1/

The policy of pegging the lempira to the U.S. dollar resulted in a strong appreciation of the real effective exchange rate in the first half of the 1980s (Chart 1). In early 1985 the real exchange rate was 40 percent above its 1980 level. As a result of the movement of the U.S. dollar vis-à-vis other major currencies, the lempira depreciated in real terms from mid-1985 to end-1987, but then resumed appreciating through early 1989. Currently, the lempira is 27 percent higher in real

1/ In 1988, out of total debt service actually paid of US\$233 million, repurchases and payments of charges to the Fund amounted to US\$42 million.

Table 4. Honduras: Balance of Payments

	1984	1985	1986	1987	Prel. 1988
(In millions of U.S. dollars)					
<u>Current account</u>	<u>-352.9</u>	<u>-315.2</u>	<u>-246.2</u>	<u>-328.8</u>	<u>-341.2</u>
Trade balance	-187.7	-141.8	-51.9	-128.2	-117.4
Exports f.o.b.	745.7	786.0	870.2	830.7	893.0
Imports c.i.f.	-933.4	-927.8	-922.0	-959.0	-1010.5
Factor payments (net)	-179.4	-190.2	-211.2	-222.7	-240.5
Other services and private transfers (net)	14.2	16.8	16.9	22.1	16.7
<u>Capital account</u>	<u>298.0</u>	<u>249.0</u>	<u>234.4</u>	<u>217.5</u>	<u>192.7</u>
Official transfers	79.9	133.1	145.4	115.3	115.0
of which: U.S. AID <u>1/</u>	68.0	111.0	107.5	81.3	80.0
Official capital	287.2	198.4	86.6	5.5	30.0
Financial intermediaries	6.5	5.2	-0.3	29.1	-10.4
Private capital and other (net) <u>2/</u>	-75.6	-102.1	2.7	57.6	58.1
<u>Balance of payments support</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>45.0</u>
<u>Overall balance</u>	<u>-54.9</u>	<u>-66.2</u>	<u>-11.8</u>	<u>-111.3</u>	<u>-103.5</u>
Change in net official reserves (- increase) <u>3/</u>	18.5	-13.8	-13.2	-48.3	-13.7
of which: IMF (net)	-1.7	-15.0	-48.6	-51.7	-25.7
Net change in arrears	36.4	49.0	20.6	127.4	94.0
Conversion of short-term to medium-term debt	--	31.0	4.4	32.2	23.2
(In percent of GDP)					
<u>Current account</u>	<u>-10.5</u>	<u>-8.8</u>	<u>-6.5</u>	<u>-8.1</u>	<u>-7.8</u>
Trade balance	-5.6	-4.0	-1.4	-3.2	-2.7
Exports f.o.b.	22.2	22.0	23.0	20.4	20.5
Imports c.i.f.	-27.8	-26.0	-24.4	-23.6	-23.2
Factor payments (net)	-5.3	-5.3	-5.6	-5.5	-5.5
Other services and transfers (net)	0.4	0.5	0.4	0.5	0.4
<u>Capital account</u>	<u>8.9</u>	<u>7.0</u>	<u>6.2</u>	<u>5.4</u>	<u>4.4</u>
Official transfers	2.4	3.7	3.8	2.8	2.6
of which: U.S. AID	2.0	3.1	2.8	2.0	1.8
Official capital	8.6	5.6	2.3	0.1	0.7
Financial intermediaries	0.2	0.1	--	0.7	-0.2
Private capital and other (net)	-2.3	-2.9	0.1	1.7	1.3
<u>Balance of payments support</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>1.0</u>
<u>Overall balance</u>	<u>-1.6</u>	<u>-1.8</u>	<u>-0.3</u>	<u>-2.7</u>	<u>-2.4</u>
Change in net official reserves (- increase)	0.6	-0.4	-0.3	-1.2	-0.3
of which: IMF (net)	-0.1	-0.4	-1.3	-1.3	-0.6
Net change in arrears	1.1	1.4	0.5	3.1	2.2
Conversion of short-term to medium-term debt	--	0.9	0.1	0.8	0.5
<u>Memorandum item:</u>					
Stock of external arrears					
In millions of U.S. dollars	147.7	196.7	217.3	344.6	432.0
In percent of GDP	4.4	5.5	5.8	8.5	9.9

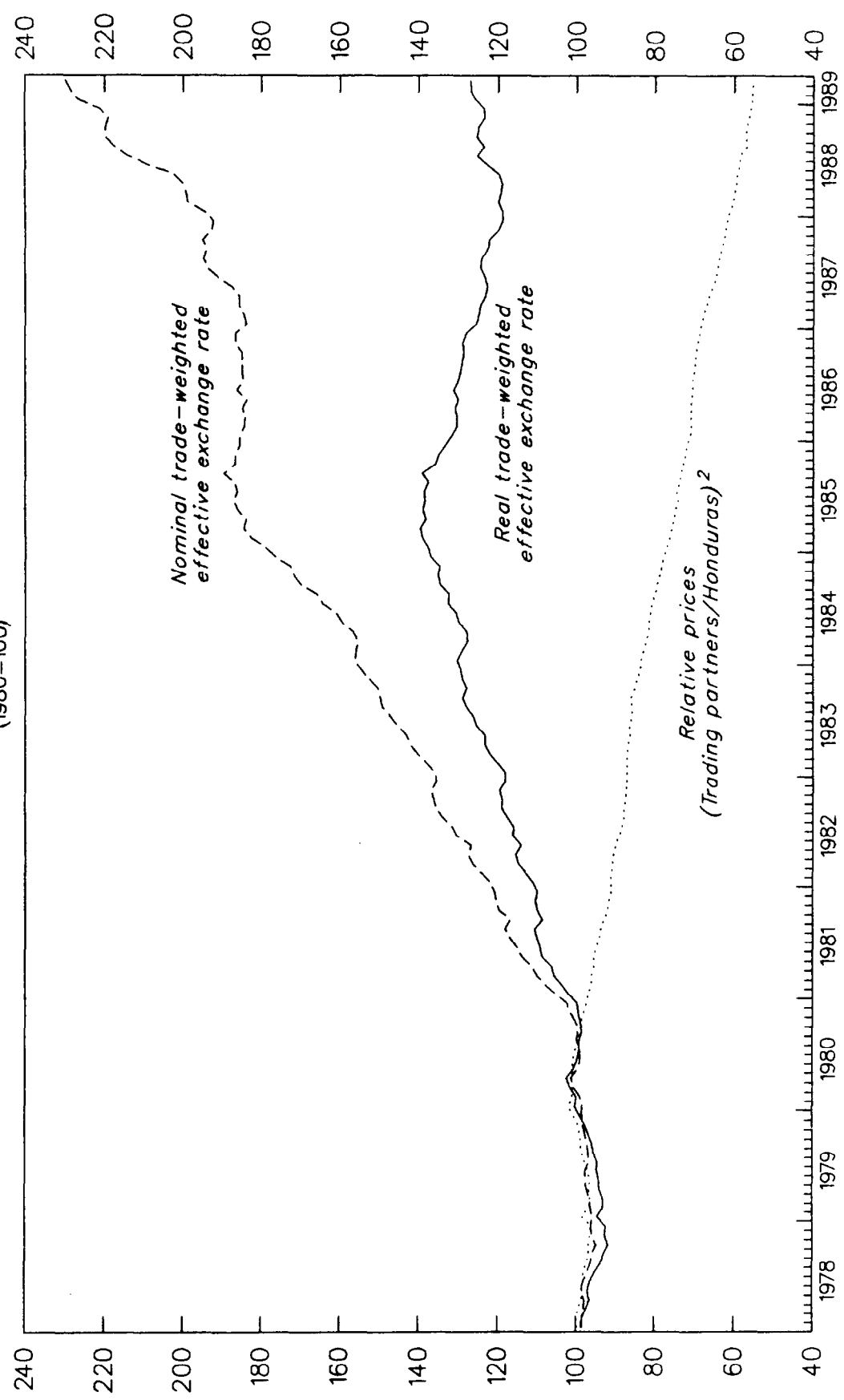
Sources: Central Bank of Honduras; and Fund staff estimates.

1/ Includes ESF disbursements to the public and private sectors.

2/ Includes net errors and omissions.

3/ Net of valuation changes.

CHART 1.
HONDURAS
EFFECTIVE EXCHANGE RATE INDICES, 1978-1989¹
(1980=100)



Sources: International Monetary Fund, *International Financial Statistics*; and Fund staff estimates.
¹ In Honduras lempira per unit of foreign exchange, therefore a decline in the index indicates a depreciation of the domestic currency. The weights are based on the average distribution of export trade in 1980 (excluding oil).
² Relative price levels are measured by consumer price indices.

effective value than it was in 1980. 1/ A sizable spread between the official and parallel exchange rates has emerged as the external accounts have deteriorated. By the end of 1987 the spread was 32 percent; it rose to 50 percent by the end of 1988 and to 70 percent in the spring of 1989. Gross reserves have declined markedly in the past two years and were down to the equivalent of one month's imports at the end of 1988; liquid reserves were equivalent to 1 1/2 weeks of imports.

The authorities have made use of fiscal and exchange incentives to promote exports and ease the pressure on net international reserves stemming from the misalignment of the official exchange rate. Export taxes on bananas and coffee were reduced, but without compensating fiscal measures, and tax incentives were extended for investment in the export sector. In addition, a rising share of trade transactions has been shifted to the unofficial parallel market. The export surrender requirement (i.e., the proportion of export receipts that exporters are required by law to sell to the Central Bank at the official exchange rate) has been relaxed progressively since 1985 to permit certain exporters to retain a portion of their export earnings to pay for their own imports (self-financed imports). 2/

The practice of self-financed imports was supplemented by a Transferable Certificate of Foreign Exchange (CETRA) scheme that came into effect in February 1988. 3/ The scheme, originally restricted to a small number of nontraditional exports, was extended to all nontraditional exports in June 1988 and to all exports in August 1988. Moreover, the proportion of export receipts against which CETRAs were issued--in effect equal to the proportion of exports channeled through

1/ These calculations, based on the indicator used in the Fund's Information Notice System, are subject to two offsetting biases: on the one hand, they understate the extent of the real appreciation insofar as they are based on the officially published price data (see footnote 1 on page 3); on the other hand, they overstate the real appreciation insofar as they are based on the official exchange rate at which a decreasing share of trade transactions occurs. Estimates based on a weighted average of the official and parallel rates relative to the U.S. dollar indicate that, as of April 1989, the bilateral exchange rate has depreciated by 10 percent in real terms since end-1987 using the official inflation index, but only by 3 percent using estimates of the inflation rate including uncontrolled prices (such estimates are not available for the period prior to 1987).

2/ Recent developments in the exchange system are reviewed in Appendix I of the recent economic developments paper.

3/ The scheme provides exporters with a transferable certificate amounting to a specified portion of their export earnings surrendered to the banking system. CETRAs provide the holder with preferential access to the foreign exchange market at the official rate, and thus trade at a premium that is about equal to the parallel market premium. Since September 1988 commercial banks have been permitted to intermediate the sale of CETRAs.

the parallel market--was gradually raised to a level of 50 percent. The combination of CETRA transactions and export receipts retained to self-finance imports have resulted in about 65 percent of all export proceeds being channeled through the parallel market as of mid-1989.

Regulations governing imports also changed frequently during 1988-89, depending mainly on market conditions. The waiting period for granting authorizations for self-financed and CETRA-financed imports was raised in November 1988 in response to a rise in the parallel market premium, reduced in February 1989 during the seasonal inflow of export receipts, and raised again in April 1989 in response to a surge of imports. In June 1989 the authorities issued a reduced list of products whose importers were eligible for access to foreign exchange at the official rate; as a result, an estimated two thirds of imports would now be financed through the parallel market, compared with 50 percent in 1988 and 30 percent in 1987.

With regard to nontrade balance of payments transactions, the majority of nonfactor services were transferred to the parallel exchange market over the past two years; private capital transactions also are effected through the parallel market.

In the area of structural reforms, a program of divesting CONADI (National Investment Council) subsidiaries was initiated in 1985 and began receiving financial support from U.S. AID in 1986. Seven enterprises have been privatized to date, with twenty more scheduled to be divested in the rest of 1989. In the external sector, export documentation has been streamlined and a new ad valorem tariff system with Brussels nomenclature was adopted. However, the level and dispersion of tariffs has remained high owing in part to the introduction of numerous surcharges to offset revenue losses stemming from selective tariff exemptions and the overvaluation of the official exchange rate.

III. Summary of Policy Discussions

The authorities viewed the large and entrenched deficit of the nonfinancial public sector as the central problem affecting the economy, limiting their room for maneuver and handicapping the effectiveness of credit and exchange rate policy. The authorities continued to oppose outright devaluation of the lempira, and emphasized the shortcomings of exchange rate policy in the absence of fiscal action. However, as the fiscal deficit has remained high, a progressive widening of the discount in the parallel market has resulted. Under market pressure, the share of trade and services transactions conducted in the parallel market has been enlarged and has contributed to adjustment.

The authorities recognized that a greater adjustment effort had to be undertaken if progress was to be made toward re-establishing sustained growth and external viability, and that such an effort would require a comprehensive package of mutually reinforcing policy measures.

Although their policy choices in the remainder of 1989 were constrained by the elections in November, the authorities remained interested in a stand-by arrangement from the Fund. Discussions continued on a policy package that would serve as a basis for eventual negotiations on the use of Fund resources once Honduras became current in its obligations to the Fund.

1. Fiscal policy

The key fiscal objective of the authorities was to reduce the overall deficit of the nonfinancial public sector to a level that could be financed largely with foreign concessional resources--an estimated 4 1/2 percent of GDP. In their view, substantial progress toward the targeted reduction in the fiscal deficit could be achieved in 1989 by improving tax administration, cutting expenditure, and raising the operating efficiency of public enterprises.

On the revenue side, the authorities remained reluctant to introduce new taxes or raise tax rates, and emphasized that considerable scope existed for improving tax administration. In 1988 for example, two new initiatives aiming at expanding the tax base had been implemented: a lottery system designed to encourage retail and wholesale establishments to utilize invoices which facilitated the administration of sales taxes; and a requirement of presenting tax clearance certificates when requesting foreign exchange at the official rate from the Central Bank. Preliminary data on central government revenues in the period January-May 1989 showed an increase of about 9 percent over the corresponding period in 1988 (Table 5).

On the expenditure side, the authorities' fiscal plan for 1989 comprising the original central government budget approved by the National Assembly together with an estimate of supplementary outlays pointed to an increase in spending of about 2 percent compared with the actual estimated outcome in 1988. To attain the needed degree of restraint, the wage and employment freeze for the public sector instituted in February 1988 was to be maintained in effect throughout 1989. Indeed, central government expenditures in the period January-May 1989 were slightly lower in absolute terms than in the corresponding period of 1988. However, in the first half of 1989, the National Assembly continued to authorize additional budgetary requests. These involved mainly outlays for wage increases (teachers, military personnel, and municipal workers), pension benefits, national security, and transfers to the rest of the public sector (e.g., universities, and municipalities). If all authorizations were fully utilized, total expenditures in 1989 could increase by about 7-8 percent over 1988. However, the authorities thought that by close monitoring of all outlays with a view to slowing down spending in low-priority categories, the rise in total outlays could be kept within the range of 4-5 percent, permitting a reduction in the overall deficit of the nonfinancial public sector to a little over 5 percent of GDP in 1989 (from a little over 6 percent in 1988).

Table 5. Honduras: Central Government Operations

	1986	1987	1988	Revised Budget 1989	January-May	
					1988	1989
<hr/>						
(In millions of lempiras)						
<u>Total revenue</u>	<u>1,179.8</u>	<u>1,321.0</u>	<u>1,430.0</u>	<u>1,557.5</u>	<u>547.8</u>	<u>597.2</u>
<u>Total expenditure and net lending 1/</u>	<u>1,763.2</u>	<u>1,912.1</u>	<u>2,076.2</u>	<u>2,166.5</u>	<u>709.6</u>	<u>704.3</u>
Current expenditure	1,353.2	1,517.0	1,635.2	1,785.5	584.1	613.5
Capital expenditure and net lending	410.0	395.1	441.0	381.0	125.5	90.8
<u>Overall deficit</u>	<u>-583.4</u>	<u>-591.1</u>	<u>-646.2</u>	<u>-609.0</u>	<u>-161.8</u>	<u>-107.1</u>
 (As percent of GDP)						
Overall surplus/deficit (-)						
Central government	-7.7	-7.3	-7.4	-6.3	...	...
 Memorandum items:						
Overall surplus/deficit (-)						
Rest of the public sector	1.5	1.2	1.2	1.0	...	...
Nonfinancial public sector	-6.2	-6.1	-6.2	-5.3	...	...

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

1/ Includes extrabudgetary appropriations.

While the fiscal performance in the first five months of 1989 had been encouraging, the staff noted that determined efforts would be needed to extend this performance through the remainder of the year. In its view, in the absence of additional measures, the overall fiscal deficit in relation to GDP in 1989 was likely to be close to the outcome in 1988. To reduce the deficit, the staff supported the authorities' efforts to reduce fiscal evasion, but noted that administrative improvements alone might not prove sufficient to strengthen revenue performance significantly. The staff put forward other options for strengthening revenue performance, including an increase in the value-added tax from 5 percent to 8 percent and a shift in the valuation of imports for tariff purposes from the official to the parallel exchange rate (the potential yield of the valuation shift was estimated at about 1 1/4 percent of GDP). On the expenditure side, it was agreed that priority needed to be given to avoiding further approvals of extrabudgetary expenditures and limiting outlays of extrabudgetary expenditures already approved. Given the sharp decline in capital expenditures and expansion in current expenditures since 1984, the staff noted there also was a need to protect investment outlays from bearing the brunt of fiscal adjustment.

In the rest of the public sector, the Social Security Institute needed to be placed on a sound actuarial footing (its overall position turned negative in 1988 for the first time since 1984). Studies were being undertaken on the means of improving the Institute's position; in this context, the authorities were considering the resumption of making employer's contributions to the Institute on behalf of government employees; they were also reviewing the investment activities of the Social Security funds, particularly the social housing program and lending to the private sector. The authorities noted that the Electricity Authority (ENEE)--the largest public enterprise, with a large foreign indebtedness--faced a problem of excess capacity owing to the poor prospects of exports to neighboring countries. The authorities thought that ENEE's problems could be addressed, at least partially, through a review of its operating expenditures, especially the level of employment, and by restructuring its external debt. There also was the possibility of reviewing the level of electricity tariffs which have not been adjusted since 1985 (between 1985 and 1988, ENEE's current revenue declined by about 1/3 percent of GDP).

2. Monetary policy

The authorities noted that the rate of growth of the monetary aggregates had declined substantially in 1988. In the absence of fiscal adjustment, however, the policy followed had resulted in a squeeze of credit to the private sector. Given the inflationary pressures that existed and the need to facilitate external adjustment, the authorities said that the policy of overall credit restraint would be continued, and relief for the private sector would come only with fiscal adjustment.

The conduct of monetary policy has been complicated by the approach employed to finance the public sector deficit. The deficit financed internally has been covered in the first instance through overdrafts with the Central Bank (yielding 4 percent a year) and government notes (yielding 2 percent a year). On an irregular basis and subject to legislative approval, the overdrafts and notes have been converted into government bonds with guaranteed redemption at par on demand, and these bonds have been placed in the market where their "sight" characteristics have made them close substitutes for monetary assets. Thus, the first effects of monetary restraint by the Central Bank have been a move on the part of the banks to redeem bonds rather than reduce their credit operations. The authorities attempted in 1987-88 to issue bonds without redemption guarantees but were unsuccessful, owing primarily to unattractive yields. In the discussions, ways were examined whereby interest rates would be made more flexible, perhaps through the development of an interbank market and auctions of government bonds. This would allow the government to place its bonds directly with the private sector and enable the Central Bank to concentrate more directly on its role in managing credit.

In recent years the Central Bank has become heavily involved in the process of financial intermediation through its operation of subsidized credit lines and autonomous trust funds. In addition to complicating the Central Bank's management of credit policy, these operations have resulted in distortions because the dispersion in the structure of interest rates has increased and credit markets have become more separate. The staff recommended that the Central Bank reduce its involvement in the intermediation operations and rely to a greater extent on market-determined interest rates in its rediscount operations.

With regard to the operations of the various official banks, especially the National Investment Corporation (CONADI) and National Bank for Agricultural Development (BANADESA), the authorities noted that efforts have been made to improve their financial position. The divestment of seven CONADI subsidiaries was seen as a positive step; further divestments were expected to take place in the near future. In BANADESA, steps were being taken to reduce the scope of its operations by encouraging commercial banks to become more involved in crop financing (especially coffee and basic grains). The authorities also were preparing a program to improve BANADESA's asset portfolio through additional capitalization and debt-equity swaps.

3. External sector policies

Because of the sharp decline of international reserves and the build up of arrears, the authorities have resorted to restrictive exchange and trade practices as a means of protecting the external position of the Central Bank. These practices have reduced the transparency and increased the complexity of the exchange and trade system, giving rise to distortions in resource allocation and to a high budgetary cost. In addition to the direct cost of export subsidies, the

practice of valuing imports at the official exchange rate for the purpose of assessing import duties--including those financed at the parallel rate--has meant that a significant amount of revenue has been foregone. Moreover, the frequent changes in regulations have increased uncertainty in production and investment decisions. Delays in import authorizations to reduce pressures on official reserves have caused disruptions in production, added to pressures on domestic prices, and worsened the investment climate.

The staff emphasized that, in the absence of a change in the official exchange rate, an accelerated transfer of transactions to the parallel exchange market coupled with action to liberalize the trade and exchange system was needed. This was a matter of urgency, given the magnitude of the external imbalance and the outlook for exports. The authorities agreed, and they noted that as a result of recent actions about two thirds of all trade transactions already were being conducted in the parallel market and that further transfers were under consideration. The mission stressed that the transfer of trade transactions to the parallel market should be viewed as a step toward an early and complete unification of the exchange system. In the meantime, the transfers of import and export transactions needed to be effected in a manner that would facilitate the unification of the markets.

Honduras' exchange system involves the following restrictions and multiple currency practices subject to the Fund's approval under Article VIII of the Fund agreement: (a) an exchange restriction arising from limitations on the authorization of official foreign exchange for import payments; (b) a restrictive and discriminatory multiple currency practice arising from special exchange rates with Central American countries; (c) a multiple currency practice arising primarily from the foreign exchange certificate scheme (CETRA) referred to above; and (d) a restriction evidenced by the existence of payments arrears on external debt obligations and certain invisibles.

Honduras' external debt including interest in arrears amounted to US\$3.1 billion or 70 percent of GDP at end-1988. About one half of the debt is due to multilateral institutions and therefore is not subject to rescheduling. The debt-service ratio increased from 22 percent of exports in 1984 to 31 percent in 1988 because of an increase in repurchase obligations from the Fund and the expiration of grace periods on the El Cajon loans.

Honduras has made no principal payments to commercial bank creditors since 1982 and has not concluded any debt rescheduling agreements with either commercial banks or official creditors since the beginning of the decade. Partial payments of interest to banks were made intermittently until November 1987 and have since ceased. Following lengthy negotiations, the advisory committee representing Honduras' commercial banks creditors made a comprehensive debt rescheduling proposal, including partial interest capitalization, in December 1988. However, the advisory committee disbanded in February 1989, citing slow progress in

the negotiations and the decision of some banks to settle their claims bilaterally through debt-equity conversions and other means. ^{1/} About 10 percent of Honduras' bank debt, estimated at US\$260 million at end-1988, was extinguished through debt-equity swaps in 1987-88. ^{2/}

4. Medium-term projection

The medium-term projections prepared by the staff assume that the adjustment program discussed with the authorities will be implemented in early 1990. The program is expected to lead to a resumption of new lending, including balance of payments support loans from both multi-lateral and bilateral sources. A medium-term scenario through 1992 consistent with these assumptions and with the most recent WEO projections of the external economic environment is presented in Table 6.

Specifically, the scenario assumes that the share of trade transactions conducted in the parallel market will continue to increase in 1989, and that the exchange rate system will be unified in early 1990, with the unification supported by a tightening of fiscal and credit policies. The key assumption made was that the overall fiscal deficit will decline to 4 percent of GDP in 1990, a level which could be financed through available external resources, and further to 2 1/2 percent of GDP by 1992. The implementation of structural reforms, including a competitive interest rate and exchange rate stance, as well as restrained wage policy, would be expected to boost private sector saving and investment and to contribute to per capita income growth averaging 2 percent a year in 1990-92. The WEO projections imply a further small decline in the terms of trade in 1990 with no change thereafter.

On the basis of these assumptions, the external current account deficit is projected to decline from about 7 1/2 percent of GDP in 1988-89 to 4 1/2 percent in 1992. The real depreciation implied by the shift of additional transactions to the parallel market and the unification of the exchange rate can be expected to boost exports, in part through redirecting them to formal channels, and provide incentives for export diversification. Export volume is projected to grow at an average annual rate of 6 1/4 percent in 1990-92, with the share of nontraditional exports in total exports rising from an average of 14 percent in 1986-88 to 17 percent by 1992. Import volume is expected to decline in 1990 as the stocks of imported goods accumulated in the first half of 1989 are drawn down, and to grow by an average of 2 3/4 percent in 1991-92. In addition to its dampening effect on the demand for imports, the unification of the exchange rate is expected to reduce capital flight in part by eliminating incentives for officially financed imports to be re-exported through informal channels to other countries in the region.

^{1/} It should be noted that relatively few (i.e., four) banks hold the bulk of commercial banks' claims in Honduras.

^{2/} For details of the debt-equity swap program, see Appendix II of the recent economics developments paper.

Table 6. Honduras: Medium-Term Outlook

	Prel. 1988	Projection			
		1989	1990	1991	1992
(In millions of U.S. dollars)					
<u>Current account</u>	-341.2	-349.9	-311.6	-287.0	-269.0
Trade balance	-117.4	-121.5	-75.0	-44.5	-20.3
Export f.o.b.	893.0	949.6	1,057.2	1,155.6	1,256.5
Imports c.i.f.	-1,010.5	-1,071.1	-1,132.1	-1,200.1	-1,276.9
Factor payments (net)	-240.5	-248.0	-262.2	-271.0	-281.0
Other services and private transfers (net)	16.7	19.6	25.6	28.5	32.3
<u>Capital account</u>	192.7	71.0	254.0	193.0	204.0
Official transfers	115.0	45.0	182.0	130.0	130.0
Of which: USAID	80.0	10.0	140.0	80.0	80.0
Official capital	30.0	-1.0	22.0	28.0	39.0
Financial intermediaries	-10.4	--	--	--	--
Private capital and other (net) ^{1/}	58.1	27.0	50.0	35.0	35.0
<u>Balance of payments support</u>	45.0	22.0	150.0	50.0	25.0
<u>Overall balance</u>	-103.5	-256.9	92.4	-44.0	-40.0
Financing	103.5	256.9	-172.4	-30.0	-30.0
Change in net official reserves (-increase)	-13.7	17.0	-20.0	-10.0	-10.0
Of which: IMF (net)	-25.7	-17.6	-9.1	-1.8	-1.6
Net change in arrears	94.0	239.9	-152.4 ^{2/}	-20.0	-20.0
Conversion of short-term to medium-term debt	23.2	--	--	--	--
<u>Financing gap</u>	--	--	-80.0	-74.0	-70.0
(In percent of GDP)					
<u>Current account</u>	-7.8	-7.4	-6.0	-5.2	-4.4
Trade balance	-2.7	-2.6	-1.5	-0.8	-0.3
Export f.o.b.	20.5	20.1	20.5	20.9	21.2
Imports c.i.f.	-23.2	-22.7	-22.0	-21.7	-21.5
<u>Capital account</u>	4.4	1.5	4.9	3.5	3.4
Official transfers	2.6	1.0	3.5	2.4	2.2
<u>Balance of payments support</u>	1.0	0.5	2.9	0.9	0.4
<u>Overall balance</u>	-2.4	-5.4	1.8	-0.8	-0.7
<u>Financing gap</u>	--	--	-1.6	-1.3	-1.2
Memorandum items:					
External debt ^{3/}					
In millions of U.S. dollars	3,069.0	3,329.9	3,429.5	3,561.5	3,675.5
In percent of GDP	70.3	70.4	66.6	64.4	61.9
Change in terms of trade (in percent)	4.5	-2.7	-0.4	--	--
Gross reserves (in months of imports)	1.0	0.7	0.9	1.0	1.0
Nominal GDP (in millions of U.S. dollars)	4,363.0	4,728.0	5,153.0	5,530.0	5,936.0
GDP growth (in percent)	4.0	3.5	3.8	4.0	4.0
Debt service ratio	30.8	29.0	27.2	25.0	23.5
Interest	16.5	16.2	16.2	15.4	14.6
Amortization	14.3	12.8	11.0	9.6	8.9
Price of coffee (U.S. cents per kg)	112.7	113.8	117.8	121.3	125.0

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

^{1/} Includes errors and omissions and capital gains from the conversion of debt for equity below par.

^{2/} Includes reduction through cash payments; the remaining outstanding arrears are assumed to be rescheduled or converted to equity.

^{3/} Includes interest in arrears in 1988-89, assumed to be cleared in 1990 through rescheduling or cash payments. Assumes that debt-equity swaps and other debt-reducing techniques will extinguish US\$20 million per year in 1989-92 of debt in arrears due to commercial banks.

The net inflow of capital is expected to show another large decline in 1989, as virtually no new loans from multilateral institutions have been approved while disbursements from the existing pipeline are dwindling. Implementation of an adjustment program in 1990 would be expected to release a significant amount of undisbursed grants budgeted for previous years, as well as an estimated US\$150 million in balance of payments support loans from multilateral institutions and cofinancing from Japan. In addition, the European Community's recent initiative to increase its financial support for Central America is expected to raise official grants from non-U.S. sources over the projection period. While this inflow would permit full repayment of nonrefinanceable arrears in 1990, the external imbalance would nevertheless remain above sustainable levels during the projection period, giving rise to an unfinanced gap averaging US\$75 million in 1990-92 (equivalent to slightly over 1 percent of GDP). These gaps could be closed with comprehensive debt relief from both official creditors and commercial banks.

In line with the bilateral approach agreed among commercial bank creditors to regularize Honduras' payments situation, the projections assume that bank debt in arrears is reduced by US\$20 million a year in 1989-92 (just under 1/2 percent of total external debt per year) through debt-equity swaps and other means. Total bank debt, estimated at US\$260 million at end-1988, would thus be nearly halved over a five-year period. The projections assume that one third of the interest due on outstanding bank debt will be paid in full. External debt (including interest in arrears) is projected to decline gradually from an estimated 70 percent of GDP in 1988 to 62 percent in 1992. The debt service ratio would decline from about 31 percent in 1988 to 23 1/2 percent in 1992.

The medium term outlook is quite sensitive to changes in the external economic environment. For example, if the price of coffee were 10 percent lower in 1990-92 than in the baseline scenario, by 1992 the current account deficit would be 1/2 percent of GDP higher, and the financing gap would rise by an average of US\$27 million a year, before any additional interest payments are taken into account. To offset the shortfall in export receipts, the rate of growth of nontraditional exports in U.S. dollar terms would have to rise to 16 percent a year compared with 10 1/2 percent under the baseline scenario.

IV. Staff Appraisal

Honduras has experienced moderate output growth since 1984 with relatively low inflation, but unemployment has remained high and per capita income has stagnated. Large fiscal deficits in recent years have been financed increasingly with domestic bank credit, which has resulted in a crowding out of the private sector and balance of payments strains. The maintenance of the present exchange rate parity, albeit for a decreasing proportion of transactions, has encouraged imports and held back the growth of exports, and has contributed to a major deterioration in the net official international reserve position. A complicated

system of fiscal and exchange incentives introduced to compensate for the erosion in external competitiveness has created distortions in the economy and has involved substantial fiscal costs.

Economic growth remained moderate in 1988, although inflation accelerated owing to shortfalls in basic grain production and a depreciation of the lempira in the parallel exchange market as international reserves continued to be drawn down. Net capital inflows declined further in 1988 and the overall balance of payments deficit was financed by a further accumulation of arrears. Arrears continued to accumulate in the first half of 1989 because of heavy debt service obligations to multilateral agencies. At the end of July 1989, arrears to the World Bank were US\$70.1 million, to the Inter-American Development Bank they were US\$15.8 million, and to the Fund they were SDR 12.7 million.

To address the internal and external imbalances faced by the economy, the Government's policies in 1989 were aimed at reducing the overall deficit of the nonfinancial public sector through a combination of expenditure restraint, improvements in tax administration, and increasing the operating efficiency of the public sector enterprises. The staff agrees with the direction of these policies, and welcomes the strong fiscal performance in the first five months of the year. However, in light of the likely intensification of budgetary pressures in the second half of the year, it questions whether the policies now in place will be enough to achieve the reduction in the deficit which the authorities envisage.

To deal effectively with the fiscal problem, the staff has suggested an increase in the value-added tax rate or a shift in the valuation of imports from the official to the parallel exchange rate to raise customs revenue. On the side of expenditure, while restraint was maintained through the first five months of the year, the sizable extra-budgetary expenditures that have been authorized point to an increased rate of spending in the remainder of 1989. The staff welcomes the authorities' intentions to monitor spending closely with a view to slowing the rate of execution in low-priority areas. However, if a contribution to deficit reduction is to be made from the spending side it will be necessary to keep extrabudgetary outlays well below the authorized level.

In the rest of the public sector, efforts to improve the financial position of the public enterprises and decentralized agencies need to be strengthened. In particular, the tariffs of public enterprises, which have not been adjusted since 1985, should be reviewed and controls over the operations of the enterprises, especially wage and employment practices, need to be tightened. The continued implementation of the divestment legislation also would be appropriate.

A reduction in the rate of increase of domestic bank credit to the public sector would assist external adjustment and would allow for increased lending to the private sector to support economic recovery.

To enable the Central Bank to improve its control over credit policy it is important to reduce subsidized credit operations, increase the flexibility of interest rates, and simplify legal reserve requirements and rediscount policies. Further progress in the lengthening of the maturities of government bonds and the gradual elimination of their "sight" characteristics would be appropriate.

Any policy reform designed to deal with the large external imbalances and distortions in relative prices would need to address the current exchange system. The overvalued official exchange rate, the large discount in the parallel market, and the quantitative import restrictions give rise to the underinvoicing of exports, increase demand for officially financed imports, and have adverse effects on the climate for investment.

The most effective way to deal with these problems would be to modify directly the official parity of the lempira. While the authorities remain reluctant to take this step, they have been expanding the scope of the parallel market. As of mid-1989 some 65 percent of trade transactions were being conducted in the parallel market and a further enlargement of the parallel market is anticipated. The staff welcomes the progressive enlargement of the parallel market as a temporary measure. However, the magnitude of the external imbalance and the wide spread between the exchange rates in the official and parallel markets highlight the need to complete the unification process without delay.

The fiscal policy and exchange system actions outlined above would facilitate the elimination of multiple currency practices and exchange restrictions, including those evidenced by external payments arrears which are damaging to Honduras' international creditworthiness. High priority needs to be given to the clearing of arrears to the Fund. Since the policies now in place do not ensure that recourse to the restrictions and multiple currency practices will be temporary, their approval is not recommended at this time.

It is proposed that the next Article IV consultation take place on the regular 12-month cycle.

Honduras - Fund Relations
(As of July 31, 1989)

I. Membership Status

- (a) Date of membership: December 1945
- (b) Honduras accepted the obligations of Article VIII, Sections 2, 3, and 4 (July 1950).

A. Financial Relations

II. <u>General Department</u>	<u>Millions of SDRs</u>	<u>Percent of Quota</u>
(a) Quota	67.8	
(b) Fund currency holdings	91.44	134.86
(c) Fund credit	23.64	34.86
From Fund Resources:	7.95	11.72
Extended Fund	7.95	11.72
From Enlarged Access	15.69	23.14
(d) Reserve tranche position	--	--

III. Stand-by or Extended Arrangements and Special Facilities in the Last Ten Years

(a) Extended Arrangement:

- (i) Duration: From June 1979 to June 1982
- (ii) Amount: SDR 47.6 million (140 percent of quota)
- (iii) Purchases: February 1980 - SDR 16.0 million
August 1981 - SDR 7.9 million
- (iv) Undrawn balance: SDR 23.7 million

(b) Stand-by arrangement:

- (i) Duration: From November 1982 to December 1983
- (ii) Amount: SDR 76.5 million (150 percent of quota)
- (iii) Purchases: November 1982 - SDR 15.3 million
April 1983 - SDR 15.3 million
May 1983 - SDR 15.3 million
August 1983 - SDR 15.3 million
- (iv) Undrawn balance: SDR 15.3 million

(c) Special Facilities:

(i) Compensatory Financing Facility:

Approved: January 8, 1982

Amount: SDR 23.3 million

(ii) Compensatory Financing Facility:

Approved: November 5, 1982

Amount: SDR 23.10 million

IV. <u>SDR Department</u>	Millions of SDRs	Percent of <u>Allocation</u>
(a) Net cumulative allocation	19.06	
(b) Holdings	--	--
(c) Current Designation Plan	None	--
V. <u>Administered Accounts (Trust Fund loans)</u>		
(a) Disbursed	14.07	
(b) Outstanding	3.65	

VI. Financial Obligations due to the Fund

	Overdue Financial Obligations (7/31/89)	<u>Principal and Interest Due</u>			
		1989 1/	1990	1991	1992
		(In millions SDRs)			
<u>Total</u>	<u>12.7</u>	<u>8.9</u>	<u>10.2</u>	<u>3.0</u>	<u>1.6</u>
Principal	10.7	7.6	7.6	1.4	--
Repurchases	9.0	6.5	6.8	1.3	--
Trust Fund	1.7	1.1	0.8	0.1	--
Charges and Interest including SDR and TF (provisional)	2.0	1.3	2.6	1.6	1.6

1/ August 1 - December 31, 1989.

B. Nonfinancial Relations

VII. Exchange Rate Arrangements

The currency of Honduras is the lempira, which is pegged to the U.S. dollar at L 2 = US\$1. A special exchange arrangement exists whereby transactions with certain Central American countries are permitted to be negotiated through a parallel foreign exchange market, in which the exchange rate is freely determined. There are no taxes or subsidies on purchases or sales of foreign exchange. Payments for imports with foreign exchange at the official exchange rate are restricted. Certain export proceeds may be sold in the parallel market. Honduras' exchange restrictions and multiple currency practices are not approved by the Fund.

VIII. Last Article IV Consultation

The last Article IV Consultation with Honduras was concluded by the Executive Board on May 20, 1988 (EBM/88/83).

IX. Technical Assistance

CBD. From September 1982 to February 1986 the Central Banking Department provided technical assistance to the Central Bank of Honduras in the area of bank supervision.

FAD. Since August 1987, an expert has been assigned to the Planning Ministry to help develop new public sector budgeting and accounting procedures.

STA. Staff members from the Bureau of Statistics visited Honduras in September 1988 (money and banking statistics) and January 1989 (balance of payments statistics).

Honduras: Basic Data

<u>Area and population</u>	
Area	112,088 sq. km.
Population density	81.7 per sq. km.
Population (mid-1988)	4.2 million
Rate of population growth (1984-88)	2.9 percent
Life expectancy at birth	60.6 yrs.
Infant mortality rate	76.8 per thousand
Child death rate	7.1 per thousand
Population per hospital bed	900
Population with access to safe water	44.0 percent
Calorie intake as percent of requirements	94.5 percent
Unemployment rate (estimated)	13-22 percent
<u>GDP (1988)</u>	
	SDR 3,273.6 million
	US\$4,399.5 million
	L 8,799.0 million
<u>GDP per capita (1988)</u>	
	SDR 785.4

<u>Origin of GDP</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>Est. 1988</u>
		(percent)		
Agriculture and mining	31.0	30.3	30.6	30.4
Manufacturing	14.9	14.7	15.3	15.4
Construction	5.8	5.1	4.0	4.1
Transport, communications, and utilities	9.6	10.8	10.9	11.0
Commerce and banking services	18.0	18.1	18.0	17.8
Other	20.7	21.0	21.2	21.3
<u>Ratios to GDP</u>				
Exports of goods and nonfactor services	25.1	25.9	23.1	21.9
Imports of goods and nonfactor services	-30.4	-28.0	-26.9	-25.7
Current account of the balance of payments	-8.8	-6.5	-8.1	-7.8
Central government revenues	15.7	15.6	16.3	16.3
Central government expenditures	24.7	23.3	23.8	23.6
Central government current account deficit (-)	-2.1	-2.3	-2.4	-2.3
Central government overall surplus or deficit (-)	-9.0	-7.7	-7.5	-7.3
External public and government-guaranteed debt (end of year) <u>1/</u>	73.7	72.9	72.3	70.3
Gross national savings	9.1	7.7	6.6	5.6
Gross domestic investment	18.1	14.1	14.7	13.3
Money and quasi-money (end of year)	35.0	36.2	39.8	40.6
<u>Annual changes in selected economic indicators</u>				
Real GDP per capita	0.3	0.2	1.9	1.0
Real GDP	3.2	3.1	4.9	4.0
GDP at current prices	8.0	8.9	6.7	8.5
Domestic expenditure (at current prices)	6.0	5.6	8.5	8.4
Gross domestic investment	2.6	-15.0	11.1	-1.8
Consumption	6.8	9.9	8.1	10.1
GDP deflator	4.7	5.6	1.8	4.4
Consumer prices (annual averages)	3.4	4.4	2.4	4.5
Central government revenues	11.9	7.8	12.0	8.3
Central government expenditures	0.6	2.2	9.5	7.5
Money and quasi-money	4.9	10.9	17.3	10.7
Money	3.1	7.2	17.6	11.6
Quasi-money	7.4	16.8	15.9	10.9
Domestic bank credit <u>2/</u>	11.8	10.4	19.0	8.5
Credit to public sector (net)	1.4	2.7	4.9	5.4
Credit to private sector <u>3/</u>	10.4	7.7	14.1	3.1
Merchandise exports (f.o.b., in U.S. dollars)	5.4	10.7	-4.5	7.5
Merchandise imports (c.i.f., in U.S. dollars)	-0.6	-0.6	4.0	5.4

<u>Central government finances</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>Est.</u> <u>1988</u>
		<u>(millions of lempiras)</u>		
Revenues	1,094	1,180	1,321	1,430
Expenditures	1,725	1,763	1,931	2,076
Current account deficit (-)	-150	-173	-196	-205
Overall deficit (-)	-631	-583	-610	-646
External financing (net) <u>4/</u>	437	338	74	217
Domestic financing (net)	194	245	333	312
Arrears	--	--	203	117
<u>Balance of payments</u>		<u>(In millions of U.S. dollars)</u>		
Merchandise exports (f.o.b.)	786.0	870.2	830.7	893.0
Merchandise imports (c.i.f.)	-927.8	-922.0	-959.0	-1,010.5
Investment income (net)	-58.0	-67.5	-70.0	-78.1
Other service and transfers (net)	-115.4	-126.9	-130.5	-145.6
Balance on current and transfer accounts	-315.2	-246.2	-328.8	-341.2
Official transfers <u>4</u>	133.1	145.4	115.3	115.0
Official capital (net)	198.4	86.6	5.5	30.0
Financial system capital (net) <u>5/</u>	5.2	-0.3	29.1	-10.4
Private capital (net) <u>6/</u>	-102.1	2.7	57.6	58.1
Overall balance (deficit -)	-66.2	-11.8	-111.3	-103.5
Net official international reserves (increase -)	-13.8	-13.2	-48.3	-13.7
External payments arrears	49.0	20.6	127.4	94.0
Conversion of short-term debt to medium-term liabilities	31.0	4.4	32.2	23.2
<u>International reserve position (end of year)</u>		<u>(In millions of SDRs)</u>		
Central Bank (gross)	89.9	88.0	68.9	59.6
Central Bank (net)	-106.2	-92.8	-52.6	-43.9
Rest of banking system (net)	-27.9	-24.8	-42.1	-36.6

1/ Includes obligations to IMF, and interest in arrears. 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 special assistance from the U.S. Government.

5/ Includes transactions with nonmonetary international agencies, allocations of SDRs, and valuation adjustments.

6/ Includes net errors and omissions.

Honduras: Statistical Issues

1. Outstanding statistical issues

a. Real sector

The coverage and currentness of data on real sector developments remain weak.

b. Government finance

GFS data remain incomplete and uncurrent. The 1988 issue of the GFS Yearbook covers budgetary central government data through 1981, and extrabudgetary accounts through 1976. Summarized data for the local governments are available only through 1976. There are no data for the Social Security Funds.

c. Monetary accounts

The Honduran authorities are presently engaged in a program aimed at the modernization of the accounting systems of the Central Bank, deposit money banks (DMBs), and other banking institutions (OBIs) of Honduras. This task is being undertaken within the framework of Bureau technical assistance to the Central American Monetary Council (CAMC) and its member countries, with the idea of producing and presenting monetary data for CAMC members based on standard and consistent analytical principles.

d. Balance of payments

A two-day visit to Honduras was made by a Bureau Staff member in January 1989, as part of the technical assistance provided to the CAMC. The purpose of the mission was to assess the possibility of compiling quarterly balance of payments statements. The mission found that an overall improvement was needed in balance of payments compilation in Honduras, particularly in the timeliness of trade data and the coverage of the services accounts.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Honduras in the July 1989 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Honduras, which during the past year, have been provided on an irregular basis.

Status of IFS Data

		<u>Latest Data in July 1989 IFS</u>
Real Sector	- National Accounts	1987 <u>1/</u>
	- Prices: CPI	February 1989
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	Q2 1988
	- Financing	Q2 1988
	- Debt	Q2 1988
Monetary Accounts	- Monetary Authorities	March 1989
	- Deposit Money Banks	March 1989
	- Other Financial Institutions	March 1989
Interest rates	- Discount Rate	March 1989
	- Bank Lending/Deposit Rates	December 1988
	- Bond Yields	December 1987
External Sector	- Merchandise Trade:	
	Values	Q4 1987
	Unit values	Q4 1987
	Prices: bananas	June 1989
	- Balance of Payments	1987
	- International Reserves	June 1989
	- Exchange Rates	June 1989

1/ Data for GDP at 1985 prices provided through 1987.

Honduras: Relations with the World Bank

Honduras' financial relations with the World Bank Group are summarized in the table below. As of December 31, 1988, total loans committed from the Bank amounted to US\$696.7 million, of which US\$76.0 million remained to be disbursed. The power sector has been the most important recipient of Bank credits (34 percent), reflecting the Bank's involvement in the financing of the El Cajon hydroelectric project (US\$125 million). The agricultural, transport, and industrial sectors have been the other major beneficiaries of Bank lending.

After reaching a peak of US\$56 million in FY 1984, net loan disbursements from the World Bank Group declined steadily during FY 1985-88. This decline came about as a result of a slowing down of new loan activity and rising repayments on loans for the El Cajon project. There have been five loans approved in the last three years; one for urban development (US\$6.9 million); another to support industrial financing (US\$37.4 million) through the National Fund of Industrial Development (FONDEI); and a third for education (US\$4.4 million). A Structural Adjustment Loan (US\$50 million) and a Fourth Agricultural Credit (US\$25 million) were approved in September 1988. Debt service payments in calendar year 1988 were US\$81.4 million and are projected at US\$88 million for 1989. As of December 31, 1988, Honduras had overdue payments to the World Bank in the amount of US\$21.3 million.

The Bank's strategy for Honduras emphasizes medium-term structural adjustment. In view of the urgent need to reverse the negative capital flows that occurred in 1987-88, however, the Bank's strategy also focused on balance of payments support loans. Examples of this strategy include the amendment to the Third Industrial Credit Loan approved in April 1988 which reallocated US\$20 million to finance general imports and the Structural Adjustment Loan which is to support the Government's structural adjustment efforts to be carried through the medium term. Conditions for disbursements are: (a) a revision of the 1988-89 public sector investment program in line with available resources and economic efficiency criteria; (b) measures to generate additional public savings in 1988; (c) a divestiture program for public enterprises; and (d) measures to improve the country's imbalance of payments viability over the medium term, including trade reform and the legalization of the parallel exchange market and eventual unification of the exchange rate system. The first tranche of US\$25 million was disbursed in December 1988. The Bank plans to continue its support for the adjustment process through a second SAL, and a series of sector adjustment operations in public enterprise management, power, agriculture, finance and trade policy to correct the structural imbalances in the respective sector.

Honduras: Financial Relations with the World Bank Group

(In millions of U.S. dollars)

Financial relations

A. IBRD/IDA/IFC Operations

(as of December 31, 1988) 1/

<u>IBRD/IDA Loans</u>	<u>Disbursed</u>	<u>Undisbursed</u>
Agriculture	103.7	25.0
Education	11.7	3.7
Industry	74.8	4.4
Ports	30.5	--
Power	237.0	--
Municipal development	1.8	5.1
Transport	113.1	--
Tourism	12.7	0.8
Petroleum exploration	2.8	--
Water supply	7.6	12.0
SAL	25.0	25.0
<u>Total</u>	<u>620.7</u>	<u>76.0</u>
IDA	85.0	--
IBRD	535.7	76.0
Of which:		
Outstanding <u>2/</u>	474.7	--
Repaid	146.0	--
IBRD	140.2	
IDA	5.8	

IFC investments

B. IBRD/IDA Loan Disbursements 3/

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u> <u>4/</u>	<u>1988</u> <u>4/</u>	<u>1989</u> <u>4/</u>
Net disbursements	47.5	56.3	35.7	27.2	3.7	7.7	7.0
Gross disbursements	54.7	65.6	48.4	42.2	32.4	34.5	28.0
Accrued amortization	7.2	9.3	12.7	15.0	28.7	26.8	21.0
Total arrears	--	--	-	--	--	38.2	65.4

Source: IBRD.

1/ Net of cancellations.

2/ Net of loans sold to a third party.

3/ By IBRD fiscal year: July 1 to June 30.

4/ Includes exchange adjustment for amortization.