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Statement by Mr. Schwartz and Mr. Peraza on Honduras
Executive Board Meeting
March 28, 2005

Key Points

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

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

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

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

Background

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

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

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

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

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

Macroeconomic policies and structural reforms

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

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

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

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

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

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

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

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