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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/43

12:00 noon, March 11, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	J. A. K. Munthali, Temporary
	Song G., Temporary
	M. Lundsager, Temporary
J. de Groote	
A. Donoso	
	S. K. Fayyad, Temporary
	A. Bertuch-Samuels, Temporary
J. E. Ismael	
	J. R. N. Almeida, Temporary
	D. A. Woodward, Temporary
	I. Puro, Temporary
	D. McCormack
	J.-C. Obame, Temporary
	A. R. Al-Abdullatif, Temporary
G. Ortiz	L. Filardo
	G. Pineau, Temporary
	G. Schurr, Temporary
	I. Sliper, Temporary
G. Salehkhou	
A. K. Sengupta	A. Vasudevan, Temporary
	T. Morita, Temporary
	S. Rebecchini, Temporary

L. Van Houtven, Secretary
J. K. Bungay, Assistant

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Also Present

IBRD: C. Sepeda, Latin America and the Caribbean Regional Office. Exchange and Trade Relations Department: M. Guitián, Deputy Director; N. E. Weerasinghe. IMF Institute: R. Duarte, Participant. Legal Department: J. V. Surr. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, R. A. Elson, J. Ferrán, A. Wolfe. Advisors to Executive Directors: R. Morales. Assistants to Executive Directors: H. S. Binay, V. K. Malhotra, C. Noriega, L. M. Piantini.

1. HONDURAS - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Honduras (SM/87/45, 2/18/87). They also had before them a background paper on recent economic developments in Honduras (SM/87/52, 2/25/87).

Mr. Ortiz made the following statement:

A steep decline in prices of primary commodities in world markets, the fall in private investment associated with the erosion of confidence brought about by the political and social tensions in the Central American region, and the contraction of economic activity in the area severely affected the Honduran economy during the first years of this decade. However, following two consecutive years of negative growth, the economy began to recover in 1984, mainly as a consequence of an acceleration in public investment, the relaxation of import restrictions, and the expansion of credit to the private sector. Consecutive increases in real GDP of about 3 percent during the next three years were accompanied by a significant slowdown in the rate of inflation. In fact, after the price increases that averaged 8.5 percent during the recession years, the rate of inflation was halved and remained at about 4 percent during the recovery period, 1984-86.

In an atmosphere of decelerating inflation, preliminary data for 1986 show positive real growth for all sectors of the economy except construction. Furthermore, an increase in the ratio of private savings to GDP, which may have reflected the improvement in the external terms of trade during 1986, reversed the decline observed in 1985. Thus, while public savings have averaged about 1 percent of GDP during the past five years, the ratio of private savings to GDP has more than doubled in the same period, reaching 7.5 percent in 1986. This favorable behavior of domestic savings, coupled with moderate increases in domestic current expenditures during the same period and reinforced by a significant reduction in public investment in 1985/86, brought about a sharp reduction in the financing gap. This gap declined from an average of 10 percent of GDP during the previous four years to less than 7 percent of GDP in 1986.

The rate of domestic price increases, which rose rapidly in the early 1980s, decelerated sharply in 1984--to almost half the rate in 1983--and has remained stable since then. Although several exogenous factors contributed to this deceleration, such as the lower inflation rates among Honduras's major trading partners in the context of a fixed exchange rate regime, of major importance were the relaxation of import restrictions in 1984, the reduction of the fiscal deficit, and cautious monetary management. Production of basic grains, which had increased

even during the recession period, has been abundant in recent years. Although the Government has for many years attempted to influence prices of certain essential goods with a view to avoiding speculative movements, beginning in 1984 it decided to reduce the scope of its intervention through its most important marketing agency. To this end, concessions to private retailers are replacing the Government's retail outlets.

With regard to public sector finances, both the Central Government and the rest of the public sector performed satisfactorily in 1986. While the Central Government's ratio of total expenditure to GDP remained at about the same level of the recession years, about 24 percent, current revenues have increased significantly, from about 13 percent of GDP in 1982/83 to just over 16 percent in 1986. As a result, the ratio of overall deficit to GDP has come down almost 4 percentage points during the past two years. The improvement in public finances is even more significant when considering the consolidated public sector; the ratio of the overall public sector deficit to GDP declined from a peak of about 12 1/2 percent in 1983 to 7 percent in 1986. The improvement in central government finances was induced both by better tax revenue performance and a steady reduction in total expenditure as a percent of GDP throughout the recovery period.

In accordance with the objective of reducing the fiscal deficit and lowering inflation, the Honduran authorities have followed a cautious monetary policy during the past three years. While restricting the public sector's access to credit from the banking system, private sector activity--which led to the reactivation of the economy--was strongly supported. As a result, the proportion of credit to the public sector within total credit has come down quite drastically from 67 percent in 1983 to about 10 percent in 1986. The authorities have suspended the financial operations of the National Investment Corporation (CONADI), which was financially overburdened by its lending operations to loss-making subsidiaries. With a view to strengthening the Corporation's financial position, legislation has been approved for the divestment of CONADI's subsidiaries beginning in early 1987.

Developments in the Honduran external position in 1986 were favorable. The significant improvement in the terms of trade, stemming from higher coffee prices and the decline in petroleum prices, resulted in a reduction of the trade deficit to only one third of the level observed in 1985. Export earnings in 1986 increased about 12 percent, while imports remained unchanged. Concomitantly, the current account deficit in 1986 declined to 7 percent of GDP, from an average of about 10 percent during the previous four years. Furthermore, the overall balance of payments deficit continued falling, reaching $25 million in 1986, compared

with $165 million in 1982. While in previous years this was explained by increased disbursements of development loans to the nonfinancial public sector (1982) and important disbursements from multilateral sources to the Central Bank (1983-85), in 1986 the main underlying factor was official transfers in the form of balance of payments support.

The authorities emphasize that during 1986, Honduras fulfilled all its financial commitments with international financial institutions and maintained interest payments current on its external debt, including the portion corresponding to rescheduling agreements. Bearing in mind the favorable performance in the current account of the balance of payments and the cautious monetary and fiscal policies being pursued--which have contributed to the current low rate of inflation--the authorities are of the view that a modification of the lempira's exchange rate would not be advisable at this time. However, the authorities are aware that in order to sustain Honduras's economic recovery on a lasting basis and strengthen the country's external position, they must combine adjusting public sector finances while maintaining monetary discipline, and implement policies to foster export growth.

In the fiscal area, the authorities are committed to reducing further the deficit of the nonfinancial public sector, not only through divestment of some public sector enterprises and improvement in the efficiency of those that remain in the public sector, but also through changes in the tax structure, and further restraint in expenditure. A revision of income tax withholdings, sales tax invoicing, and customs procedures is under way and is expected to improve revenue yields in the very near future. In addition, in an effort to reduce dependency on foreign trade taxes, the authorities are planning to revise the base of taxation on domestic transactions. The expected improvement in tax collections, coupled with the Government's decision to limit growth in current expenditure to the annual rate of inflation, should bring about a further reduction in the overall central government deficit as a proportion of GDP. For those enterprises that will remain in the hands of the Government, the authorities plan to change drastically the current budgetary and expenditure control procedures.

The authorities intend to conduct credit and financial policies in accordance with their balance of payments objectives, and consistent with the maintenance of the current level of inflation. They believe that a further reduction in domestic financing to the public sector would free resources for the financing of private sector activity. In this connection, the Central Bank is studying the possibility of introducing more flexibility and reducing the dispersion in the current interest rate structure.

The authorities are of the view that the design and implementation of policies aimed at promoting and diversifying exports is essential to attain external equilibrium. From that perspective, they have designed a scheme of tax incentives that covers: (a) the revision of the drawback scheme; (b) the revision of the corporate income tax; (c) the establishment of industrial export zones; and (d) the revision of the existing system of negotiable tax credit certificates. Furthermore, they are also about to implement a program of trade reform, which includes the changeover of the tariff nomenclature to the Brussels classification, the conversion of specific tariff rates to an ad-valorem one, and changes in customs administration and valuation procedures. The authorities aim at unifying the various import surcharges and fees into a uniform customs tariff.

The authorities remain skeptical about the alleged benefits of exchange depreciation for Honduras, embodied in the medium-term scenarios prepared by the staff. They point out that Honduras's main export products are not likely to respond to exchange rate depreciation--for well-known reasons--and that the potential benefits to be derived from the stimulus to other export products may be outweighed by ensuing inflationary pressures, with all the adverse consequences on expectations, wage negotiations, and the overall investment climate. Given the openness of the Honduran economy, domestic prices are very sensitive to exchange rate movements; a rekindling of inflation would provoke a wage-price spiral and possibly social and political unrest.

In fact, it seems that the cautious monetary and fiscal policies pursued by the authorities in 1986--which consolidated the progress made in reducing inflation--together with some measures aimed at liberalizing the exchange operations, such as the expansion of the parallel exchange market for trade transactions with the rest of Central America, and the increase in the retention of exporters' proceeds to finance their own imports, explain the significant decline in the rate of exchange in the parallel exchange market from L 2.7 per U.S. dollar at the end of 1985 to about L 2.2 at the beginning of 1987. This element should, in turn, contribute to a more stable environment in 1987.

Mr. Sengupta made the following statement:

The developments in the Honduran economy in 1986 demonstrate a continuation of the recovery that began in 1984. Real GDP grew in 1986 for the third successive year. The rate of inflation was slightly over 4 percent in 1986, equivalent to the average rate of inflation in the years 1984 through 1986. These three years were characterized by higher investment--particularly in the private sector--as a proportion of GDP, and by a higher private

savings ratio. The public sector fiscal deficit, as a percentage of GDP, declined to 7.1 percent in 1986, from 9.3 percent in 1985 and 11.5 percent in 1984. Monetary expansion decelerated during these three years. The total credit of the banking system rose by 13 percent in 1986, compared with increases of 15 percent in 1985 and 18 percent in 1984. It is significant that credit expansion to the public sector fell sharply, from about 11 percent in 1983 to slightly over 1 percent in 1986. The external current account deficit as a percent of GDP declined to about 7 percent in 1986 from about 11 percent in 1984, with the trade deficit share of GDP also showing corresponding declines over this period. However, with net inflows on the capital account, the overall balance of payments deficit has been between 1 percent and 2 percent in the past four years; in the light of the recent experience of many countries, these data reflect one of the successful economic performances.

The authorities want a sustained, durable economic recovery and a strengthened external position. In this context, Mr. Ortiz has pointed out his authorities' awareness that they have to maintain fiscal and monetary discipline and implement policies to stimulate export growth.

A few differences between the staff and the authorities have emerged from the policy discussions, but I think that they are not serious and are reconcilable. The authorities' commitment to reduce the fiscal deficit further is commendable. I am struck by their view that public investment should be maintained or increased moderately, since it has been cut severely in the past two years; public investment as a proportion of GDP fell from 11.7 percent in 1984 to 7 percent in 1986, whereas the ratio of private investment to GDP remained stable at 8.2 percent. In the absence of enough buoyancy in private investment, public investment must rise in order to maintain the growth rate. I am also struck by the authorities' determination to raise tax revenues and restrain expenditures on wages and salaries, current transfers, and nonmilitary purchases. It is possible to achieve this goal, for the tax revenues of the Central Government increased substantially--by 39 percent between 1983 and 1986--and were higher than the 35 percent increase in current expenditure over the same period. The staff favors broadening taxes on domestic transactions and shifting the burden away from taxes on foreign trade. There is some merit in the staff position, but it must be recognized that revenues from taxes on goods and services are already high, accounting for more than one third of total tax revenues.

As for monetary policy, the authorities appear to favor conducting credit operations in a manner that supports private sector activity, and introducing a flexible interest rate structure. The experiments to phase out the sight characteristic of

government bonds, the yields of which have often served as a floor to deposit rates, should prove helpful in bringing about some flexibility in the interest rate structure.

With respect to external sector policies, both the authorities and the staff recognize the critical importance of increasing exports. The authorities prefer to promote exports through fiscal incentives rather than through exchange rate action. The staff report has outlined the fiscal incentives and argued that the approach of the authorities will entail a fiscal burden and a distortion of resource allocation. However, the staff noted that the competitiveness of the lempira, which had eroded since 1980, has been restored in the past two years. From February 1985 to October 1986, the lempira depreciated in real effective terms by about 17 percent, largely as a result of the depreciation of the U.S. dollar--to which the lempira is pegged--vis-à-vis other major currencies. To support the authorities' position, Mr. Ortiz has rightly pointed to the sensitivity of domestic prices to exchange rate movements in economies that are as open as that of Honduras. I agree with Mr. Ortiz that a rekindling of inflation could well provoke a wage-price spiral, and still worse, could lead to social and political unrest. Moreover, as the staff paper on primary commodity prices (EB/CW/DC/87/2, 2/25/87) has shown, the prospects of recovery in these prices are not good, and it is highly doubtful that export receipts will rise as a result of exchange rate depreciation.

The external public debt of Honduras has increased in recent years, but because of the concessional nature of much of that debt, the debt service payments have not grown as fast as total indebtedness has. Concessional financing flows would facilitate greatly the country's adjustment efforts, which clearly are in the right direction and are supported by the authorities' strong commitment. These considerations should be taken into account in any Fund and World Bank approach to future requests of Honduras for financial support.

Mr. Almeida made the following statement:

Some progress has been made in improving the external economic situation of Honduras. There has been a substantial reduction of almost 3 percentage points of GDP in the balance of payments current account deficit, as exports have grown quickly and the terms of trade have improved. However, real GDP per capita has not increased, and domestic investment has declined.

The public sector deficit was reduced moderately in 1986, in large part because of a cutback in public investment that might affect future growth. The authorities have been energetic in

divesting public enterprises in accordance with a medium-term plan that has yielded good results, and the financial burden of the public sector has been alleviated.

The authorities are well aware of the need to improve the tax administration; I wonder whether any technical assistance has been sought from the Fund. I also wonder whether the authorities intend to involve the World Bank, through its sectoral programs, in helping to reorganize the public sector--particularly the Social Security Institute, which is currently facing serious financial difficulties.

I am particularly happy to see that of the two substantively differentiated medium-term scenarios, the staff is more inclined toward the growth scenario that would imply a more gradual reduction in the current account deficit than toward the scenario based on both low real growth and low export growth. However, as Mr. Ortiz has emphasized, it is by no means necessary for an export growth policy to be coupled with an exchange depreciation, the benefits of which--if any--would be more than outweighed by an increase in inflationary forces that could exert a downward pressure on real growth. In fact, with a population growth rate of 2.9 percent, Honduras has no other option than to embark on a high-growth policy, despite all the risks involved.

We are encouraged by the efforts that the authorities are making to improve the trade system, and we hope that the trade reform can be effected soon. With respect to the negotiations with commercial banks on a multiyear rescheduling arrangement, we would appreciate staff comment on the status of those negotiations.

Ms. Lundsager made the following statement:

In many respects, the Honduran economy is performing much better than just a few years ago: positive real economic growth has been restored, the rate of inflation has dropped significantly, and the overall balance of payments deficit has been reduced. While these favorable trends are welcome, in some other respects, performance appears to have been less satisfactory and perhaps not up to the potential of the economy. A number of important structural reforms are now in process, but we have reservations about whether these reforms will be fully adequate to restore a long-lasting domestic and external equilibrium in the context of high growth. Additional supportive measures could assist the authorities in attaining their broad aims of promoting domestic investment, reducing fiscal deficits, maintaining monetary restraint, and promoting exports.

A welcome reduction in the fiscal deficit has occurred over the past years and has helped to support the reduction in the balance of payments deficit. Nonetheless, we are concerned that a sustained reduction may not be possible without some wider-ranging measures. A reduction in the dependence of the Honduran budget on trade-related taxes, especially export taxes, would appear appropriate, and thus a more ambitious effort at tax reform should be considered in the near future--to alleviate the fluctuations in revenues that follow the swings in world coffee markets, to cite one example. A broader, more elastic revenue base could ease the burden placed on expenditure containment and assist the authorities in maintaining investment spending. In the interim, however, the implication is that a more determined effort to contain current expenditures will be required. The indication that public sector wages will be frozen this year is reassuring, but it seems that controls on other expenditures will be necessary to attain the authorities' goals, and at the least, to prevent a widening of the deficit. On this last point, the increasing utilization of domestic bond sales to finance public sector operations, while perhaps not inflationary, does serve to limit the availability of domestic savings for private sector use.

The public enterprises have been subject to increasing scrutiny, and the divestment of the commercially oriented entities, as well as the subsidiaries of CONADI, is most welcome. This effort is tying in nicely with efforts to stimulate more investment, both domestic and foreign, through the initiation of Honduran-type debt/equity swaps. Those entities remaining in the public sphere should continue to make efforts to improve performance, including tariff adjustments as necessary to cover operating costs, at a minimum, with the ideal being some coverage of investment expenditures as well.

Monetary policy has aimed recently at a tight credit stance, with high interest rates, in order to support the payments position and maintain the low rates of inflation. While this stance may be appropriate to the attainment of those goals, it does hamper domestic investment, and domestic entities have turned to some extent to foreign financing. While this may reflect repatriation of funds held abroad, it could also represent private sector foreign borrowing, which could eventually contribute to raising the national debt servicing burden; however, we recognize that at present this may not be a pressing problem. It also appears that the Central Bank has become overly involved in sectoral credit decisions through the establishment of various rediscount facilities for different sectors. We would be more comfortable with an emphasis on generalized monetary policies, without efforts to subsidize various sectors through preferential credit arrangements.

Policies relating to the external sector are evolving, and the tariff reform that is now before the legislature will be a constructive initial move toward rationalizing the tariff structure. However, we would have welcomed a concrete indication of the authorities' plans to make the tariff system more uniform, since that step will be central to enhancing the role of world market forces in directing resource allocation in Honduras.

With respect to the exchange rate, the reasons provided by the authorities for their reluctance to change the official parity are understandable, although evidence suggests that the institution of a more flexible system could prove useful. In particular, this evidence includes the subsidization of some exports--meat and cotton--to promote sales, and the formulation of a detailed system of tax-related incentives to export. In addition, overall payments imbalances have continued to occur, and although reduced, they have still resulted in the accumulation of arrears and the recourse to exchange restrictions. Finally, a parallel foreign exchange market does exist, with a more depreciated rate, and while it is not extensive, it provides an indication of the market perception that the lempira is overvalued. Mr. Ortiz has noted the recent expansion of the parallel market, and we agree that this does help to improve the payments prospects. Further expansion of this market could alleviate the need for some of the measures that I mentioned earlier, such as the fiscal incentives. However, this could contribute further to the restrained availability of foreign exchange to the official market, depending on what types of transactions are transferred.

These various factors lend weight to the view that broader exchange rate actions should be considered, a view that is further supported by the medium-term scenarios. These scenarios indicate that exchange rate adjustment can support faster export--and thus faster domestic--growth, and keep Honduras from lagging behind those other countries in the region that have adopted more flexibility in their exchange systems. We urge the authorities to consider these beneficial effects of exchange rate actions when they evaluate their current policies.

Mr. Donoso made the following statement:

For the third consecutive year, the Honduran economy has continued to perform relatively well. Economic growth, although moderate, has remained positive and close to 3 percent; the rate of inflation has been kept at about half its 1983 level; the deficit in the current account of the balance of payments has narrowed to less than 7 percent of GDP, from almost 11 percent in 1983, while the nonfinancial public sector deficit has continued to decline in line with the economic program objectives.

However, these achievements have not prevented the economy from remaining weak and vulnerable to unfavorable external developments. To a large extent, the improvement in the external accounts of the economy through 1986 reflected a significant improvement in the terms of trade, the sustainability of which cannot be ensured in the medium and long term. Recent trends in the prices of coffee and oil may well reverse the gains attained in 1986, and they underscore the need for reinforcing the overall competitiveness of the economy, in the context of a major diversification effort, and for making direct attempts to lower production costs. The medium-term prospects emphasize those needs, and will, inter alia, require the authorities to continue their current prudent monetary policy stance, to make further efforts to reduce the fiscal imbalances, and to undertake a major liberalization of the external sector.

As for fiscal policy, we welcome the commitment of the authorities to reduce further the deficit of the nonfinancial public sector, and we concur fully with the measures that are contemplated in connection with that goal. We welcome in particular the envisaged reforms aimed at improving the structure and the yield of existing taxes. Such reforms, coupled with a program of rationalization in the public sector enterprises, should result in a more balanced fiscal position, and thereby in a reduced level of financial requirements.

In turn, an improved fiscal performance will allow major access to credit for the private sector without endangering the goals of monetary policy, and will be consistent with the balance of payments objectives. Furthermore, if fiscal balance is achieved, it would become an alternative way of reaching a better-balanced current account, thus diminishing the urgency of implementing a more active exchange rate policy. We understand the authorities' arguments in favor of retaining the current level of the exchange rate, and we believe that this policy can be sustainable if fiscal developments show strong improvements, provided that the external environment remains favorable. Fiscal difficulties or weaknesses of the external sector, however, should lead the authorities to a more flexible view on exchange rate policies.

The staff representative from the Western Hemisphere Department commented that the authorities had requested the Fund to consider providing technical assistance in the fiscal area, and in that connection a staff member from the Fiscal Affairs Department was scheduled to visit Honduras the following week. The authorities had mentioned a particular interest in experimenting with zero-based budgeting for a selected group of public sector entities. Another area of special interest included the accounting and monitoring procedures as applied to the Superintendency of Decentralized Institutions, which was intended to be the control point

for the Central Government's supervision of the public enterprises. The staff was not aware of any request from the authorities to the World Bank for technical assistance in the fiscal area.

The staff understood that the authorities had reached agreement in principle with the banks on most of the points under discussion regarding a limited multiyear rescheduling arrangement, the staff representative indicated. The main issue outstanding appeared to be what the amount of spread over LIBOR would be. It was expected that the final agreement would be reached during the first half of 1987.

While it was true that the erosion of the competitiveness of the lempira had been reversed in the past two years, largely as a result of the depreciation of the U.S. dollar to which the lempira was pegged, it was useful to compare the behavior of the real effective exchange rate of the lempira with that of other regional currencies, the staff representative observed. The staff had been experimenting with alternative calculations, one of which was related to the exercise undertaken by the Research Department for the Information Notice System. According to calculations for the regional currencies, the lempira had appreciated by about 50 percent in real terms with respect to the base year of 1980 and vis-à-vis the weighted average value of the colón in Costa Rica, the quetzal in Guatemala, and the colón in El Salvador.

In the Information Notice System, an attempt was being made to incorporate a greater emphasis on competitive producers in evaluating the performance of the currency, as distinct from the simple weighting of trade partners that was the base for the index in the staff report, the staff representative from the Western Hemisphere Department went on. The latter index was affected significantly by the performance of the córdoba of Nicaragua, which still carried an important weight because of traditional trade patterns. Under the alternative system, the lempira at end-1986 was still appreciated by about 22-25 percent with respect to the base period of 1979/80, compared with the estimate of 10 percent derived from the index used in the staff report.

The Deputy Director of the Exchange and Trade Relations Department commented that the broad issues that arose concerning the role and effects of the exchange rate mechanism in an open economy extended beyond the example of Honduras. Two inferences could be drawn from such openness in an economy: one, as Mr. Ortiz had pointed out, was the sensitivity of domestic prices to exchange rate movements, and the concomitant possibility of upward domestic price pressures following a devaluation; the other was that openness seriously constrained policymaking and permitted the authorities only a limited degree of freedom. Once an imbalance developed, the question arose of what policy mix should be used in such an open economy. The staff appraisal had suggested that the flexible exchange rate mechanism might be a better element in the policy mix than the solution preferred by the authorities, namely, the use of import restrictions and fiscal incentives for exports. The staff view was that the real exchange rate should be restored to a realistic and sustainable position. From

that standpoint, the less willing the authorities were to use the exchange rate mechanism, the more constraints they imposed on the scope for other policy actions.

Mr. Ortiz indicated that the authorities recognized that the magnitude of Honduras's imbalances was still considerable, despite their success in recent years in reducing those imbalances. The authorities had taken significant steps toward the correction of the fiscal imbalances, and had had some success in reducing the overall balance of payments deficit--in part because of bilateral flows, but also because of the growth of some nontraditional exports such as seafood. It appeared that the staff agreed with the main thrust of the authorities' medium-term investment program. Directors had broadly endorsed the Government's aims of streamlining the public sector and strengthening public finances. The authorities' strategy essentially was to maintain current expenditures at their present levels while increasing public investment moderately, but their emphasis was on the revenue side, namely, to improve the yields of existing taxes and gradually to shift the base of taxation toward more domestic taxes. The authorities agreed with Ms. Lundsager that it would be appropriate for such a shift to occur. Nevertheless, export taxes--accounting for about 10 percent of the total tax base--were a considerable, but not huge, proportion of Honduras's tax base.

The authorities' skepticism about the effectiveness of exchange rate actions stemmed from the experience of other Central American countries, Mr. Ortiz remarked. The exchange rate actions taken by other countries in the region had led not so much to better export performance, but instead to the instability of internal prices. Honduras's rate of inflation had fallen substantially over the past few years in response to improvements in fiscal and monetary management, and the authorities were keen to maintain domestic price stability. The fact that the authorities had maintained the exchange rate at its current level--and that the parallel rate had recently fallen from 2.7 lempiras to 2.2 lempiras per U.S. dollar--had to be attributed to the stability of prices. Apart from the direct effects of exchange rate movements and the price index, the authorities were worried about the effect on expectations; rightly or wrongly, they felt that after they had maintained a system of fixed exchange rates for such a long time, an exchange rate action would be extremely damaging in terms of expectations and confidence. The authorities agreed with the staff, of course, that if they did not take exchange rate action, then they would have to depend more heavily on other policy instruments in order to achieve the goals of internal and external stability.

The Acting Chairman made the following summing up:

> Executive Directors noted that in 1986, Honduras's economic recovery and low rate of inflation had continued, and that the external account and overall fiscal deficits had diminished as well. Reference was also made to higher private investment and the higher private savings ratio. However, Directors observed that, although the country's payments difficulties had been

eased temporarily by an improvement in the terms of trade in 1986 as well as by some substantial inflows of bilateral aid, Honduras needed to strengthen further its effort to bring about a lasting improvement in its external position over the medium term and to lay the basis for sustained economic growth.

Directors welcomed the significant reduction in the fiscal deficit that had taken place in recent years. However, that reduction had reflected mainly a cutback in investment outlays, and thus Directors stressed the need for the authorities to increase public savings in order to reduce further the fiscal imbalance while maintaining an appropriate level of public investment. In that regard, Directors emphasized the importance of measures to strengthen tax administration and to shift the burden of taxation toward domestic transactions, thus reducing the dependence of the tax system on foreign trade transactions. Directors also saw the need for a closer monitoring of current government outlays. With respect to the performance of the rest of the public sector, Directors urged the authorities to strengthen control over the public enterprises in order to improve their efficiency and to accelerate the process of divestiture approved in 1985 by the National Assembly.

Directors recognized Honduras's record of positive real interest rates, but considered that efforts should be made to increase interest rate flexibility. In that regard, they noted the authorities' experiments in phasing out the sight redemption clause for government bonds, and possible plans to auction government bonds at market determined rates. Directors pointed to the desirability of streamlining the instruments of monetary policy, noting that the Central Bank's sectoral rediscount facilities, with varying interest rates, had proliferated in recent years. Directors also called on the monetary authorities to strengthen the role of the banking system in the financing of private sector activity.

Directors noted the effective appreciation of the currency over the past several years, but they recognized that the authorities were reluctant to take direct action to reverse that movement, given their concerns that the exchange rate depreciation would rekindle inflation. At the same time, however, it was stressed that exchange rate flexibility was important to maintain competitiveness and to avoid having to resort to ad hoc policies to stimulate exports, as well as to facilitate the orderly elimination of external payments arrears. In any event, it was observed that exchange rate stability would require a continued tight monetary policy and continued fiscal adjustment.

It is expected that the next Article IV consultation with Honduras will be held on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/42 (3/9/87) and EBM/87/43 (3/11/87).

2. COST OF LIVING ALLOWANCE - STAFF OF OFFICES IN EUROPE AND GENEVA

The Managing Director is authorized to establish for staff members assigned to the Office in Europe and the Office in Geneva whose salaries are denominated in U.S. dollars, a system for a cost of living differential, to be effective January 1, 1986, which shall be devised, and may be amended from time to time, in accordance with the principles set forth in Section III of EBAP/87/39 (3/2/87). This differential shall be applied to the installation allowance and disposable salary paid to such staff members.

Adopted March 9, 1987

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/101 through 86/103 are approved. (EBD/87/68, 3/3/87)

Adopted March 9, 1987

4. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAP/87/46 (3/10/87) is approved.

APPROVED: October 7, 1987

LEO VAN HOUTVEN
Secretary