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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/48-1

10:00 a.m., May 30, 2018

1. Honduras—2018 Article IV Consultation

Documents: SM/18/114, and Supplement 1, and Supplement 2, and Supplement 3; and Supplement 4; and Supplement 5,

Staff: Garcia-Saltos, WHD; Corbacho, SPR

Length: 25 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	D. Mahlinza (AE)
	H. Razafindramanana (AF)
	E. Rojas Ulo (AG), Temporary
	C. Barron (AP)
	B. Saraiva (BR)
	H. Ma (CC), Temporary
	J. Suazo (CE), Temporary
	N. Feerick (CO), Temporary
	C. Just (EC)
	A. Castets (FF)
	K. Merk (GR)
S. Gokarn (IN)	
A. Leipold (IT)	
	Y. Naruse (JA), Temporary
	P. Abradu-Otoo (MD), Temporary
	F. Al-Kohlany (MI), Temporary
	V. Rashkovan (NE)
	K. Virolainen (NO)
	P. Snisorenko (RU), Temporary
	F. Rawah (SA), Temporary
	E. Villa (ST)
M. Panek (SZ)	
	O. Haydon (UK), Temporary
M. Claver-Carone (US)	

C. McDonald, Acting Secretary
S. Kalra, Summing Up Officer
D. Jiang, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Legal Department: Y. Esquivel Soto. Western Hemisphere Department: R. Garcia-Saltos. Strategy, Policy, and Review Department: A.Corbacho. Executive Director: C. Hurtado (CE). Senior Advisors to Executive Directors: A. Del Cid-Bonilla (CE), O. Odonye (AE). Advisors to Executive Directors: A. Arevalo Arroyo (CE), K. Carvalho da Silveira (AF), L. Cerami

(IT), M. Coronel (BR), F. Dogan (EC), T. Gade (NO), G. Khurelbaatar (AP), A. Nainda (AE), L. Rauqeuqe (ST), C. Rebillard (FF), P. Trabinski (SZ), J. Montero (CE).

1. HONDURAS—2018 ARTICLE IV CONSULTATION

Mr. Hurtado and Mrs. Suazo submitted the following statement:

The Honduran authorities want to thank the IMF team for their well-informed policy advice as well as for a very constructive and candid dialogue.

In the last four years, supported by a Fund program, the Honduran authorities have made immense strides in stabilizing the economy and reducing criminality while at the same time fostering poverty reduction policies. It is important to remember where Honduras stood four years ago, with wide fiscal and external imbalances (non-financial public sector deficit of 7.5 percent of GDP and a current account deficit of 9.5 percent) and a very challenging security situation ranking as the country with the highest homicide rate in the world.

Now, economic fundamentals are strong with an economic growth rate in 2017 of 4.8 percent, the highest in a decade, non-financial public sector (NFPS) deficit of 0.8 percent of GDP, below the Fiscal Responsibility Law (FRL) ceiling of 1.5 percent of GDP and historically low for an election year. In the external sector, a combination of export growth and increased inflows of remittances narrowed the current account deficit to 1.7 percent of GDP and international reserves are equivalent to more than 5.3 months of non-maquila imports cover. Furthermore, a remarkable decline in violence was reached by more than 50 points with respect to 2013, a trend which has continued to date. The authorities' vast reform agenda and the resulting stabilization of the economy have helped boost investor confidence, which gave rise to the historic improvement of Honduras' international debt credit rating.

The government remains committed to safeguard the advances achieved and retain fiscal discipline while continue working at a gradual and timely pace, towards placing Honduras on a higher-potential growth path. To this end, our authorities will seek a new program with the Fund, cognizant of the valuable role the IMF has played and recognizing that there is still more to be done as well as challenges ahead due in part to the less favorable external conditions.

For the next four years, the government is optimistic that it will achieve ambitious goals on economic growth, employment creation and poverty reduction. These goals will require progress on seven strategic priorities: boosting innovation, deepening financial inclusion, enhancing the country's role as Central America's logistics hub, improving education and health (including investing in bilingual English-Spanish public education), strengthening security, preserving macroeconomic stability, and reducing corruption. To make progress on these areas, and with the U.N. support, the government has initiated a national dialogue with all political parties.

Governance and Transparency

One of the first outcomes of the national dialogue is the creation of a new framework to enhance government transparency. The new framework includes the recent creation of the Inter-Institutional Table for Transparency, comprised by the heads of the three branches of government—civil society, comptrollers and municipalities—which were installed recently, as well as electoral reforms including a new ID (last updated 20 years ago) with modern technology which will result in the added benefits of enhanced security and aid in doing business. Additionally, the government has reaffirmed its backing of the special anti-corruption[1] entity, created with the support of the Organization of American States (OAS), per the country's request in 2016. Through this alliance and as a key component towards achieving transparency, a special anticorruption unit within the public prosecutor's office was created in October 2017, backed by the MACCIH, which has generated the prosecution of high profile cases in 2018.

As highlighted in the staff's report, Honduras has greatly improved budget transparency since 2008, as evidenced in the survey-based Open Budget Index[2] which has improved from 12 in 2008 to 54 in 2017. Also, in the last four years, the country has improved the transparency indicator in the execution of public infrastructure from 74 percent in 2014, to 85 percent in 2017.

Moreover, a few days ago the SISOCS-APP—an integral framework for the disclosure of public-private partnership projects—was launched, Honduras thus becoming the first country in the world to implement a project of its kind. We also remain the only country in the world whose government signed with Transparency International an agreement to work to improve transparency in a pilot project of five ministries of state. It is important to

[1] Misión de Apoyo Contra La Corrupción y Impunidad en Honduras (MACCIH)

[2] Measures the amount and timeliness of publicly available standard budget information

emphasize the valuable support of the Fund's technical assistance in these attainments.

To further enhance transparency, authorities have agreed to undergo a Fiscal Transparency Evaluation, led by FAD, which will assess the country's compliance with the basic requirements for fiscal risk disclosure under the new IMF Fiscal Transparency Code.

Monetary and Exchange Rate Policy

Throughout the duration of the program and in 2018, inflation remained within target reaching 4.2 percent in April 2018[3] (similar to the 4.1 percent of the year before). Based on assessment of external and domestic economic conditions, the central bank will stand ready to take the necessary measures to keep inflation within target.

According to the Central Bank of Honduras (BCH)'s strategic plan to modernize monetary policy and adopt an inflation-forecast targeting framework, approved in October 2016, new regulations for the interbank money market and FX market were approved in 2017, which have contributed to bolstering the monetary transmission mechanism and supporting de-dollarization. Furthermore, the monetary authority updated its organizational structure and strengthened its staffs' macroeconomic modeling capacity with the aid of technical assistance from the Fund.

In January 2018, an additional 10 percent of FX surrender requirements were decreased (for a total reduction of 20 percent) with the goal of creating a more dynamic FX market and, going forward, gradually increasing exchange rate flexibility to strengthen the country's capacity to absorb economic shocks. BCH is committed to making further advances in the planned transition to full inflation targeting, including the development of the secondary securities market, backed by the adoption of a new securities market law as well as enacting a central bank law with a clear mandate to control inflation. To accomplish these, they have requested a follow up TA to aid in the transition process.

Fiscal Policy

The Honduran government has pledged to maintain the NFPS deficit unchanged from last year (expenditures have been cut back to counteract the

[3] 4±1 percent tolerance range

revision in the minimum income tax reform) and to sustain a prudent fiscal stance, with main spending priorities being in social spending, infrastructure and security. It is also committed to containing the wage bill. The authorities are receiving valuable technical assistance from the World Bank in civil service reform and from the Fund in performance-based budgeting, which will contribute to the above-mentioned goals.

The customs authority has achieved concrete progress in improving revenue collection and in generating efficiency throughout the customs clearance process. The advances achieved have contributed significantly to reduce costs for the private sector and to foster a positive investment environment. The transition to a fully independent and functioning customs authority is expected by August 2018.

Statistics

The current reference year for the Honduran National Accounts and Consumer Price Index (CPI) is based on the 1998-99 survey. Conscious of the importance of these in the economic and social policy decision process, as well as their significance in the transition to an inflation targeting regime, the authorities of the BCH and the National Institute of Statistics, signed recently in May 14, 2018 an inter-institutional technical cooperation agreement for the planning, formulation and execution of a new household survey. The new survey will consider the statistical and technical requirements necessary for updating the basket of goods and services and their weight for a new CPI database and will strengthen household estimates for the National Accounts. This project is planned to be finalized in the first quarter of 2021.

Energy Company (ENEE)

In the last four years, authorities reached significant progress in solidifying ENEE’s financial position. The ongoing actions toward that end have included reductions in non-technical losses, a rightsizing program which attained a 60 percent reduction in the workforce, quarterly tariffs adjustments based on a cost-recovery formula, and the creation of a new Secretary of Energy to support the implementation of the electricity sector’s reform.

Going forward, the authorities are committed to ensuring ENEE’s financial sustainability by implementing a holistic plan and assessing a scope of wide-ranging actions including faster reduction in non-technical electricity losses as well as generating income through the charge for ancillary services to electricity generators.

Results of the Social Welfare Programs

Alleviating poverty has been and remains a key priority for the Honduran authorities. To that end, social spending was safeguarded and increased, even throughout the challenging fiscal consolidation process. Social spending has consisted mainly of social benefits such as conditional cash transfers. Results indicate that these programs have been effective in improving education, health and nutrition indicators, widely accepted as mechanisms to break the intergenerational transmission of poverty.

Structural Reforms

The country's medium-term development strives to attain inclusive export-led growth of the tourism, textiles, intermediate-goods, back office support, and agro-industrial sectors. The achievements in macroeconomic stability, crime reduction, coupled with ongoing efforts to enhance the country's internal and regional connectivity and ease of doing business will help the continued expansion of the tourism sector.

The afore-mentioned reduction of cargo backlog by the customs authority increased corporate sector profitability and will provide incentives for private sector investment. The customs union signed in June 2017 with Guatemala has enhanced trade, and the addition of El Salvador—later this year—will further boost growth in the region. Trade and tourism will also be enhanced by the construction of a bigger airport (projected to be finalized at the end of 2019).

Authorities have agreed to the publication of the staff report for the 2018 Article IV consultation.

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

We thank staff for the report and Mr. Hurtado and Mrs. Suazo for their comprehensive statement.

In the aftermath of last year's elections, economic conditions in Honduras initially deteriorated, but the situation has since stabilized and economic activity has regained momentum. The three-year Stand-By Arrangement, which expired in December, brought about sustained fiscal discipline, lower inflation, well-balanced credit expansion, improved social conditions, and more stable economic growth. Following the last presidential elections in November, economic conditions have deteriorated due to the political unrest, however, the situation seems to have evolved towards stabilization. Though still vulnerable to unfavorable political developments, the economy has proven resilient and continues to perform strongly.

While last year's growth surprised on the upside, staff reduced the 2018 growth projections, reflecting the adverse confidence effect of the post-electoral political crisis and the worsening of the external conditions. Growth in 2017 was broad-based and higher than expected, despite the slowdown of economic activity during the last two months of the year, when the political turmoil took place. As for 2018, the projected slowdown seems consistent with the current output gap and potential growth. In the medium-term, staff expects potential growth to remain at around 3.75 percent, yet we wonder how it would be reconciled with an anticipated deceleration of the U.S. economy, to which Honduras holds strong linkages through trade and worker's remittances. The staff's comments in this regard would be appreciated.

Despite a challenging political environment, the authorities' efforts remain focused on preserving macroeconomic stability and the hard-won stronger fiscal position. In 2017, the thrust of Honduras's strong export-driven growth momentum, together with higher remittances, and the effects of a well-executed fiscal reform over the last few years, has resulted in a more resilient economic environment. Thus far in 2018, even amidst a disruptive political atmosphere, the authorities have managed to keep a tight grasp on fiscal policy in line with the Fiscal Responsibility Law, reflecting their continued commitment to fiscal discipline and debt sustainability.

As oil prices creep-up and demand side pressures increase, the Central Bank of Honduras (BCH) may need to tighten monetary policy going forward. Even with an accommodative monetary policy stance, inflation has eased and been kept at around 4 percent, within the target range. However, recent inflationary pressures are likely to increase over time prompting a shift towards a tighter stance. We welcome the fact that the BCH has continued to strengthen the monetary policy framework to support the transition towards a more flexible exchange rate regime and place the economy in a better position to successfully absorb external shocks. In this context, we support the authorities' request to retain the two transitory multi-currency practices (MCP), as they meet all conditions for an Art VIII, Section 3 temporary waiver.

Honduras' external position has improved over the last few years and remains stable, albeit not without risks. Despite a moderate increase in the trade deficit, in 2017, the current account deficit narrowed to just -1.7 percent of GDP due to a record high worker's remittances flow from the United States. Reserves are expected to keep rising, supported by growing FDI and mining sector investment spurred by the recently approved mining reform law. By the end of 2018, the current account deficit is expected to widen to about 4 percent of GDP, as oil prices rise and remittances normalize.

We welcome the authorities' efforts focused on strengthening the country's institutional framework to enhance the rule of law and the fight against corruption. Continued reform in this area should improve the transparency and effectiveness of the country's financial management framework, with positive impacts to the investment climate. We welcome the creation of the National Economic Council that will oversee the progress on the implementation of structural reforms to increase efficiency of social spending and ensure the financial soundness of the country's SOE's, including the National Electricity Company (ENEE). Other long-standing structural challenges include closing the gap in infrastructure and education, and keeping poverty reduction programs in place until the very high poverty rates diminish substantially. Despite recent progress, the risks associated with Honduras's endemic high crime rates continue to impinge on the business climate and discourage local and foreign investment. This issue needs to be addressed forcefully. Alongside the efforts to strengthen institutional capacity, we encourage the authorities to update the country's National Accounts and the CPI, as suggested by staff.

Mr. Rashkovan submitted the following statement:

We thank staff for a comprehensive paper and Mr. Hurtado and Mrs. Suazo for an informative buff statement. Economic fundamentals in Honduras seem strong now, thanks to an impressive fiscal consolidation, a stabilized debt trajectory, an improved external position. The 2014-2017 Fund-supported program has become instrumental in restoring investor confidence and reducing macroeconomic imbalances. We commend the government for remaining committed to safeguard the fiscal discipline and urge them to maintain a prudent fiscal stance and gradually reverse the supportive monetary policy stance. We share the views of staff, support the proposed decision and offer the following point for emphasis.

High poverty and weak institutions remain key constraints to growth in Honduras. We are encouraged by the new anti-corruption initiatives and appreciate the launch of the national dialogue to create a new framework to enhance government transparency, and we urge the authorities to take this issue seriously. We hope that the special anti-corruption entity, created with the support of the Organization of American States and a special anticorruption unit within the public prosecutor's office backed by the MACCIH will generate the prosecution of high profile cases to create conditions for a more inviting business climate.

With these remarks, we wish the authorities success in their future endeavors.

Mr. Merk and Mr. Rosenberger submitted the following statement:

We thank staff for their informative set of reports and Mr. Hurtado and Mrs. Suazo for their insightful buff statement. We broadly concur with the thrust of the staff's appraisal.

Sound policies under the Fund-supported program helped to stabilize the economy, which continues to expand—although at a slower pace— in 2018. The outlook for the medium term is broadly positive. However, notwithstanding recent improvements, external and domestic downside risks prevail. Therefore, an ongoing commitment to reduce fiscal vulnerabilities, fostering credibility of monetary policy and a sound financial sector, and continuing reform efforts to address structural challenges will be essential to retain macroeconomic stability, sustainable growth and poverty reduction.

We welcome the authorities' commitment to maintain a prudent fiscal stance, that can act as an anchor for macroeconomic stability, will help to contain vulnerabilities and to ensure future adequate funding for social programs. In this regard, it is important to further improving revenue mobilization, rationalising tax expenditure, removing tax exemptions and ensuring the sustainability of state owned enterprises. Furthermore, we welcome the continuing reforms on public financial management and the authorities' commitment on the need to increase the transparency of public spending. In this regard, we acknowledge the authorities' agreement to undergo a Fiscal Transparency Evaluation.

Regarding monetary policy, we agree with staff to gradually reverse the supportive monetary stance to curb inflationary pressures and anchor expectations. Furthermore, we strongly encourage authorities to implement the recommended legal reforms to enhance the autonomy and governance structures of the central bank. We welcome the authorities' commitment to monetary policy modernization and the requested TA to help with the transition process. Moreover, we agree with staff that updated statistics

(National Accounts and CPI) is one element to ensure a smooth transition to an inflation targeting regime. We acknowledge the planned household survey.

On the financial sector, we take positive note that the banking system remains resilient to standardized shocks. However, we encourage the authorities to adequately address the remaining vulnerabilities in the financial sector. In this regard, could staff please elaborate more on the build-up of household debt and the possible macro-financial risk.

On structural reforms, we encourage the authorities to continue their reform efforts to improve the business environment by enhancing the rule of law, continuing the fight against corruption and improving the social and education outcomes.

Ms. McKiernan and Mr. Feerick submitted the following statement:

We thank staff for their report and Mr. Hurtado and Ms. Suazo for their helpful buff statement. Policy implementation through the recent program was strong and there were some tangible indications that the authorities had intended to continue on this path. However, the overarching of any macroeconomic policy framework creates a continued political uncertainty that could jeopardize the reform momentum. We note that the authorities are in broad agreement with staff's recommendations. We agree with the thrust of the staff assessment and offer the following comments for emphasis.

While the near-term growth outlook is positive, there is a clear need to bolster the potential growth rate of the economy to facilitate an improvement in living standards. Notwithstanding recent growth momentum, over sixty percent of the population still lives in poverty. In terms of productivity, the ultimate driver of living standards over the longer term, there is an urgent need to address the weak business environment, low human capital and high crime. We welcome the establishment of the National Economic Council and its role in identifying needed structural reforms. Can staff elaborate on the extent to which the NEC recommendations are binding? Are they a "comply or explain model"?

In order to effectively address the above obstacles to growth, the authorities need to find ways to generate fiscal space. High levels of informality, at 75 percent, limit the tax policy choices afforded to the government. As such, sequencing of reforms should be considered closely, as any substantial changes to rates, in the absence of bringing more workers into the tax net, could negatively impact on taxpayer compliance. The staff usefully identify tax expenditures, which at 7 percent of GDP are amongst the highest in the region, as potential sources of revenue. Moreover, at the very least, any new tax exemptions should be subject to rigorous Cost Benefit Analysis and appropriate sunset clauses. In terms of fiscal architecture, the prevalence of extra-budgetary funds, which are outside normal expenditure controls, should be reviewed to consider their efficacy. Finally, on fiscal transparency generally, we would like to acknowledge the good work of the authorities in their intended publication of contingent liabilities, which is expected to accompany next-year's budget.

We welcome that the banking system is assessed as sound. NPLs are low, liquidity is ample, profitability is high and dollarization is on a downward trend. As would be expected given the above, stress tests on the banking sector show that it is resilient to a broad range of shocks. Saying that, rising household debt and growth in public bank operations merit close attention going forward.

Ms. Barron and Mr. Khurelbaatar submitted the following statement:

We thank the staff for the report and Mr. Hurtado and Mrs. Suazo for their informative buff statement. The successful completion of the Fund program and continued prudent macroeconomic policies has reduced macroeconomic imbalances. With nearly 60 percent of the population living in poverty and 40 percent in extreme poverty, it is important to maintain macroeconomic stability while also creating the conditions for inclusive growth. We agree with the thrust of staff's recommendations and make the following comments.

We commend the authorities' effort in reducing the crime rate and we welcome further efforts to reduce violence. We call on the authorities to further tackle corruption in the country to restore rule of law and build an effective and accountable government. Greater fiscal transparency and improving the public financial management should enable the country to proceed with more efficient macroeconomic reforms.

Structural reforms in the fiscal area are required. Honduras faces difficult challenges in reducing poverty, addressing the social problems and providing an adequate education and health services for the population. Continued prudent fiscal policies will not be enough alone and fundamental reforms are required to achieve the fiscal space to address the country's needs. As tax exemptions are reaching almost 7 percent of GDP, the country is losing an important source of fiscal revenue. We agree with staff that tax exemptions should be reduced and ideally tax exemptions should be targeted in line with the country's growth strategies. Taking control of the wage bill and resolving the energy producer ENEE's finances will be important steps to achieve medium term fiscal sustainability.

Tax revenues are projected to fall partly caused by the introduction of a new tax code which weakened the collection and enforcement of the tax authority. Also, the tax code would allow excuse from criminal charges related to tax fraud. We strongly urge the authorities to restore criminality to tax fraud and take other measures necessary to improve tax compliance.

The authorities introduced a lending program for housing that consists of interest rate subsidies and reduction in reserve requirement. The staff estimates that this could result in monetary expansion over the next three years equivalent to 10.5 percent of end 2017 currency issue. Could staff explain what are the implications for the medium term fiscal balance and monetary policy? What could be an alternative solution to the housing program?

Finally, we recommend Honduras to urgently update the base year and methodology of national account and CPI. Relevant and accurate data will be a basis for an effective macroeconomic policy planning and implementation.

Mr. Claver-Carone and Mr. Rudolph submitted the following statement:

With the recently concluded IMF-supported program having successfully stabilized the macroeconomic outlook, the Honduran government should prioritize macro-critical structural reforms such as anti-corruption, improvements to the investment environment, and rationalizing taxation and spending. We welcome the authorities' decision to seek a new program to address these challenges and safeguard the stabilization, as stated in Mr. Hurtado and Mrs. Suazo's buff statement. We support staff's fiscal and monetary policy advice and focus our comments on structural reforms.

We strongly agree with staff that sustained anti-corruption efforts are needed to enhance the rule of law. Judicial independence in Honduras is weak and worsening, and the recently passed law aimed at limiting the powers of the Attorney General to prosecute embezzlement cases is a significant step backward in the fight against corruption. As the rule of law is rightly one of the macro-critical channels identified in the Fund's new governance and corruption framework, we fully expect staff to treat this as an essential issue in the Fund's future work with Honduras.

Though Honduras compares favorably to its regional peers in terms of revenue generation, it remains important that the country continue to improve its ability to finance its own development. We note that the lingering effects of tax amnesties in recent years are weakening the collection and enforcement powers of the tax authority, and we urge the authorities to take up the recommendations outlined by in the staff report. Simplifying the tax code, reducing exemptions, and closing loopholes would complement reforms to the tax registry and risk management procedures.

We welcome the progress Honduras has made in reforming the state energy company (ENEE) in recent years, recognizing that high energy costs continue to weigh on competitiveness and growth.

We concur with staff's recommendation to temporarily allow two multiple currency practices. However, continued vigilance in monitoring the increase in credit dollarization seen late last year will remain important, and we support the authorities' plans to gradually increase exchange rate liberalization. We also support efforts to modernize the central bank including the adoption of an inflation targeting regime. Can staff provide an update on the authorities' plans to establish a well-funded lender of last resort facility?

We welcome the authorities' development of a new supervisory manual with methodologies for risk-based supervision, improved training programs, and new AML/CFT rules. Further information sharing between law enforcement and the financial intelligence unit may improve the effectiveness of Honduras' AML/CFT regime, in part by leading to more money laundering cases and convictions. We urge the authorities to enhance supervision of designated non-financial businesses and professions (DNFBPs), and continue to share information within their interagency and countries in the region.

We appreciate the detailed assessment of the external sector in the staff report. The staff note that political uncertainty will affect consumer confidence and indicate that the authorities downplay staff's assessment of political uncertainty on private investment. We note that while in the external sector assessment for Thailand the current account gap is adjusted significantly for political uncertainty, no adjustment is made in the case of Honduras.

Mr. Mahlinza and Mr. Razafindramanana submitted the following joint statement:

We thank staff for their well-written set of papers and Mr. Hurtado and Mrs. Suazo for their informative buff statement. We broadly concur with the thrust of staff's assessment and policy recommendations, and would like to make the following comments for emphasis.

The Honduran authorities have successfully completed a 3-year Fund supported program that has largely set the stage for a sustained economic recovery, including adoption of institutional reforms to entrench macroeconomic stability and engender higher growth. The economic outlook remains positive with growth expected to moderate at around 4 percent driven by private demand. However, domestic and external challenges, including political uncertainty and changes to immigration policies in the United States, could weigh on the country's economic prospects. Going forward, we encourage the authorities to proceed with the swift implementation of their reform agenda to address structural bottlenecks, boost competitiveness and further strengthen macroeconomic stability, including inclusive growth.

We commend the authorities for demonstrating fiscal prudence, particularly during the election cycle, and maintaining the public deficit below the ceiling in the Fiscal Responsibility Law. Maintaining this stance and pursuing further fiscal reforms, notably to improve domestic revenue mobilization, will be essential to build fiscal buffers given the projected loss of tax revenues from lower customs duties and high tax exemptions. With Honduras' tax expenditures ranking among the highest in the world, reducing exemptions and rationalizing tax expenditures remains a crucial fiscal policy lever. That said, we note that the state-owned National Electricity Company (ENEE) continues to be a drag on the overall fiscal position and its financial position has continued to deteriorate despite central government support. Could staff provide an update on the state of readiness by the authorities to undertake comprehensive reforms in the electricity sector and the prospects of the new measures to resolve the situation?

We support staff's recommendation to strengthen the institutional foundation for inflation targeting (IT). In this regard, reforming the central bank law is a crucial step for ensuring that IT framework contributes to driving lower real interest rates, anchoring inflation expectations and providing greater predictability of policies. In addition, we encourage the authorities to take further steps to accelerate the development of the money and FX markets in order to support greater exchange rate flexibility, while protecting against emerging external shocks. We take note of the authorities' commitment to monetary policy modernization and urge staff to provide the necessary TA support. That said, we wonder how the authorities plan to balance the reversal of the current supportive monetary policy stance with the monetary expansion implicit in the new lending program for housing promised by the government. Comments are welcome. Concerning the large concentration of personal loans in the public pension funds' portfolio, we note that the authorities see this is as a consequence of the minimum profit requirements and limited investment opportunities. The staff's comments on the risk associated with this and its impact on the banking sector are welcome. Nevertheless, we encourage the authorities to continue to monitor this credit concentration, including the growth of household debt in the financial system.

Finally, with over sixty percent of the population living below the poverty line, aggressive implementation of structural reforms to bolster inclusive growth is crucial. In this respect, we commend the authorities for the successful implementation of the CCTs program and reducing child malnutrition, as well as the significant progress achieved in the reduction of crime over the years. Looking ahead, efforts should aim towards enhancing competitiveness, improving social protection, job creation as well as updating the relevance and accuracy of national statistics. In addition, given the country's vulnerability to natural disasters with extreme climate variability, strengthening climate-related actions is vital to facilitate long-term growth and sustainability.

Mr. Just and Mr. Mehmedi submitted the following statement:

We thank staff for the candid report and Mr. Hurtado and Mrs. Suazo for their insightful buff statement. We commend the authorities for successfully completing the recent Stand-by-Arrangement; however, the post-election political tensions, the recent approval of several unproductive spending initiatives, and the termination of the Temporary Protection Status (TPS) by the United States risk jeopardizing these recent program successes and have clouded the medium-term outlook. We call on the authorities to increase the resilience of the economy, strengthen institutions also to rein in corruption and more forcefully combat rampant poverty. We broadly share staff's assessment and policy advice, and would like to provide the following comments for emphasis.

Maintaining a prudent fiscal stance by improving the composition of the budget, mobilizing domestic revenues, and implementing public financial management reforms continue to be essential. In this context, prompt and credible measures are needed to phase out the existing tax exemptions, improving custom and tax administration, implementing the civil service reform to contain the increase in the wage bill, and increasing the effectiveness and targeting of social assistance schemes. Enhancing fiscal transparency by bringing trust funds under the budgetary framework remains also essential and we welcome the authorities' plans to undergo a Fiscal Transparency Evaluation. The staff's comments on whether the authorities are considering reinstating the criminality of tax fraud in order to improve tax compliance are welcome.

The current supportive monetary policy stance should be gradually reversed to rein in the inflationary pressures while policy actions are required to improve the inflation-targeting regime. The authorities should stand ready to tighten monetary policy in view of increasing domestic price pressures as well as less supportive global monetary conditions. This will help anchor inflationary expectations. In addition, we encourage the authorities to promptly reform the central bank law to enhance its governance framework and improve its operational independence. Similarly, we echo staff's call for accelerating the development of the money and FX market infrastructure and allowing for greater exchange rate flexibility. We note that the authorities maintain two multiple currency practices, which are subject to Fund jurisdiction under Article VIII, Section 3, and wonder whether the authorities' planned reform to the monetary policy framework will eliminate these measures?

Financial sector reforms should be aimed at enhancing the regulatory and supervisory frameworks. We note that the banking sector remains well-capitalized, liquid, and profitable and take note of the authorities' efforts in implementing the main recommendations of the Financial Sector Stability Review. Going forward, the policy priorities should be on moving to a full risk-based supervision, enhancing the AML/CFT framework, and further reducing the dollarization rates. While there is scope to increase access to finance for small and medium-size enterprises to boost investment and growth, we caution against the expansion of lending programs by the public development bank and pension funds as this entails financial and macroeconomic risks.

Tackling poverty and improving governance are essential components for achieving more sustainable and broad-based growth. We take positive note that the authorities have started a national dialogue on creating a new framework to enhance governance and transparency but caution that its success will rest on the pace of its implementation. Efforts to enhance the business environment and improve the labor and product markets should continue with the aim of boosting investment and growth. This would be reinforced by increasing domestic security, which is also essential for the

Honduras 20/20 development plan to bear fruit on the much necessary poverty reduction.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for their well-written reports and Mr. Hurtado and Mrs. Suazo for their informative buff statement.

The Honduras economy continues to perform strongly. Economic growth has accelerated, while inflation remains within the tolerance band. Public finances have been sound with moderate debt distress. The current account deficit and foreign exchange reserves have improved. The outlook remains broadly positive. Strong commitment of the authorities and structural reforms implemented under the recently concluded SBA program have been instrumental in achieving this progress, which has led to continued upgrading of credit rating as well. Going forward, preserving macroeconomic stability is essential while strengthening the institutional framework and creating a suitable environment to place the country on a higher growth path to reduce high poverty as reflected by over 60 percent of the population which lives below the poverty line. While noting the multiple currency practices maintained by Honduras, we support the granting of approval for the retention of these practices with the expectation that corrective actions will be taken to introduce a single currency mechanism within the specified period. We broadly agree with the staff's assessment and would like to make the following remarks for emphasis.

On the fiscal policy front, continuation of fiscal prudence is essential. It is commendable that fiscal discipline has been maintained during the election cycle as reflected by a deficit below the ceiling under the Fiscal Responsibility Law (FRL) in 2017, which needs to be continued. The staff's comments on the implementation progress of FRL, adopted in 2016, are welcome. On the revenue side, the rationalization and phasing out of tax expenditures, which is one of the highest in the region, supported by strengthening tax administration in line with the medium-term fiscal framework (MTFF), are among the key priorities. The staff's comments on the strategy and the progress in reducing tax expenditures are welcome. We take positive note on the ongoing measures to improve budget execution and public procurement and support the measures to further improve public spending to ensure greater accountability. The achievements in the budget transparency over the years are appreciated. We encourage the authorities to improve the efficiency of the public spending also while containing wage growth and undertaking civil service reforms to generate fiscal space to support public investments and channel sufficient resources to social spending. We agree with the staff on the need for a comprehensive plan to address the issues in ENEE to restore its financial sustainability.

Given the closing output gap, mild overheating conditions, emerging inflationary pressures and need for maintain vigilance on monetary policy, the central bank's readiness, indicated in buff statement, to take necessary measures to keep inflation within target is reassuring. We support the planned measures, including the new central bank law, which will provide a clear mandate to maintain price stability and ensure BCH's autonomy and independence, towards establishing a credible inflation targeting framework and enhancing monetary policy credibility. Acceleration of the development of money and forex markets infrastructure to increase exchange rate flexibility to absorb external shocks and enhancement of the communication strategy are also critical in moving to a successful inflation targeting framework.

With banking system remained sound and NPLs remain historically low, further efforts are required to strengthen financial system stability. In this context, we encourage the authorities to continue the implementation of the recent FSSR recommendations to contain financial risks. We see the importance of careful monitoring of the developments in household debt and NPLs to ensure financial system resilience.

Deeper institutional reforms are critical to remove bottlenecks to boost economic growth while safeguarding the macroeconomic stability. Despite the recent achievements in doing business environment, further progress could be achieved by making product and labor markets competitive while reducing red tapes. We commend the impressive reduction of violence due to continuous efforts which should be supplemented by the reduction of homicides. Expanding the achievements so far made in continuing anti-corruption efforts to enhance the rule of law is vital to attract investments from both domestic and foreign sources. We welcome the creation of a new framework to enhance government transparency which will also contribute to improve governance. The announced creation of National Economic Council to coordinate and ensure effective implementation of the structural reforms is a commendable initiative. We would welcome staff comments on the progress of implementing "Honduras 20/20 Plan" aimed at generating jobs and reducing poverty.

With these remarks, we wish the Honduras authorities all success in their future endeavors.

Ms. Villa and Ms. Rauqeuqe submitted the following statement:

We thank staff for the insightful set of reports and Mr. Hurtado and Mrs. Suazo for their informative buff statement.

The Honduran authorities' sound macroeconomic management is commendable. Increased public investment, robust private consumption and improved harvests underpinned the solid GDP outcomes in the recent past. Equally important, maintaining fiscal discipline through an election cycle, addressing corruption, reducing criminality and strengthening security have also helped improve business and international investor confidence. Nevertheless, structural poverty and weak institutions weigh on the country's economic and social prospects. As such, we broadly agree with staff views on the needed policy mix to safeguard macroeconomic stability.

Strengthening tax administration, revenue mobilization and expenditure efficiency are key for fiscal sustainability. Containment of the wage bill and improvements to date to budget transparency are welcome. However, like staff, we encourage the authorities to phase out tax exemptions, right-size the public-sector wage bill, strengthen the collection and enforcement powers of the tax authority and ensure the financial sustainability of ENEE to further consolidate the fiscal position and support social spending. The recent introduction of measures that may prevent the prosecution of embezzlement cases underscores the need for fiscal prudence to be ably supported by improved transparency, accountability and the appropriate institutional framework.

Building inflationary pressures underpin the call for less accommodative monetary policy. Both demand and supply factors have accounted for the recent uptick in inflation. Outside of a policy rate hike, the authorities also have the option of raising banks' reserve requirements (RR). Could staff clarify how feasible it would be to raise RRs, given government's recently introduced lending program for housing. Otherwise, we note positively the relaxation of FX surrender requirements and strengthening of the institutional foundation for inflation targeting. These signal the authorities' commitment to reforms and should bolster economy-wide confidence. Given the latest global financial market volatility, we wonder about the potential impact on Honduran banking sector liquidity. The staff's comments are welcome.

The structural reform agenda should continue to prioritize strengthening the business environment and increasing resilience. The authorities have worked on reducing bureaucratic red tape and introduced notable anti-corruption measures as part of efforts to remove structural impediments to doing business. Even so, improving both social outcomes and employment prospects to ensure inclusive growth, require increased investments in health and education. Also, given the sizeable informality in the country, improving sources of income especially for those in rural Honduras should be prioritized to put a dent in stubbornly high poverty. The frequency of natural disasters presents an additional source of risk for the authorities, highlighting the need to further increase the country's resilience.

Mr. Alogeel and Mr. Rawah submitted the following statement:

We thank staff for a well-focused report and Mr. Hurtado and Mrs. Suazo for their helpful buff statement. We take positive note of the improvement in macroeconomic conditions with the successful completion of Fund-supported program (2014-17), which helped in restoring confidence and reducing macroeconomic imbalances. Indeed, the economy continues to expand and the medium-term prospects are broadly positive. Nonetheless, stagnant productivity, institutional weaknesses, and high poverty remain among the key growth impediments. Going forward, capitalizing on the recent momentum by implementing key structural reforms to address remaining vulnerabilities and put the economy on a higher growth path is critical. We are in broad agreement with the staff's analysis and policy recommendations and would limit our remarks to a few issues.

The fiscal outlook is broadly favorable as the deficit is projected to remain below 1 percent over the medium-term and the debt distress is moderate, as assessed in the DSA. Nonetheless, further revenue mobilization efforts, improving spending efficiency, and actions to address the state-owned enterprises issues are essential to ensure fiscal sustainability. This could be achieved through improving the tax administration and pursuing a gradual phasing out of tax exemptions, especially in light of the limited capacity to increase tax rates as noted by staff. Also, the objective of curbing government spending could benefit significantly from containing the wage bill growth in a sustainable manner.

It is reassuring to note that poverty alleviation remains a key priority for the authorities, as noted in the buff statement. It is also encouraging to note that social spending has been increasing with evidence of enhanced effectiveness of the social programs as reflected in improved education and health outcomes. In this connection, we encourage the authorities to continue their efforts to further improve the coverage of the social safety net.

Finally, it is encouraging to note that the banking system remains sound with NPL at historic low, ample liquidity and adequate buffers. Here, we join staff in encouraging the authorities to continue the implementation of the recommendations of the recent FSSR. Also, the authorities' strategic plans to develop a secondary securities market backed by new laws are welcome.

With these remarks, we wish the authorities further success.

Mr. Leipold and Ms. Cerami submitted the following statement:

The productive interchange between staff and the authorities attested in both the detailed staff report and in Mr. Hurtado and Mrs. Suazo's informative buff statement is appreciated and welcome.

The positive post-program momentum provides the opportunity for Honduras to adopt the institutional reforms necessary to ensure stable and inclusive growth and accelerate economic development. The staff report draws a broadly positive picture of the Honduran economy and prospects and conveys a clear message on the required policy priorities, which we fully share. Having successfully completed the IMF-supported program and enjoyed stronger than expected growth in 2017, the resulting gains now need to be safeguarded and entrenched.

The buff states that authorities intend to request a new Fund program. This seems appropriate and we would be interested to know what is being envisaged in this regard.

High poverty and weak institutions remain key constraints to growth. We encourage the authorities to swiftly adopt well-targeted measures to address these priority issues in an effective and fiscally responsible manner. With respect to poverty, we note that despite the increase in social spending and solid evidence of effectiveness of the conditional cash transfers program, structural poverty remains unacceptably high.

We thus reiterate our call for expanding social spending, leveraging on the expected revenues from the reduction of tax exemptions and improved tax compliance, as recommended by staff. The gradual reduction in the minimum corporate tax starting from the current fiscal year provides the authorities with a political economy argument for broadening the tax base. Against this background, the recent introduction of new tax exemptions (for tourism and agriculture) and the weakening of the collection and enforcement powers of the tax authority are deeply regrettable. We advise an early reversal of these measures, particularly the decriminalization of tax fraud, and the phasing-out of the most inequitable tax exemptions and distortions, as recommended by staff.

The weakening of the tax collection framework is of particular concern given the broader institutional weaknesses. The new justice law that—according to the report—may prevent the prosecution of embezzlement cases is another source of concern. These setbacks in the fight against corruption risk undermining the credibility of the authorities' commitment as well as the remarkable progress achieved in reducing crime. Renewed efforts in fighting corruption and continued progress in the implementation of the AML/CFT framework are in order.

We commend the adoption of and the adherence to the Fiscal Responsibility Law, which sets a deficit ceiling of 1.5 percent of GDP, limiting the fallout from insufficient progress on revenue mobilization. Also welcome are the progress made on the accounting of contingent liabilities and the intention to issue the first report on contingent liabilities as part of the 2019 budget. However, further progress is also required on the spending side, bringing trust funds under the budgetary framework, enhancing fiscal transparency, incorporating performance-based indicators in the medium-term fiscal framework, improving the quality of health and education spending, containing public wage growth, and ensuring the financial sustainability of the public electricity company, ENEE. According to the report, the authorities are designing a new general policy for civil service compensation, an area where the country received technical assistance from the World Bank and the Fund. To what extent is the upcoming reform reflecting inputs from the TA? The authorities also indicated their intention to develop a comprehensive reform of the electricity sector, including measures such as charging generators for ancillary services and allowing the purchase of electricity at minimum available cost. Could staff update on any progress on this front?

We emphasize the importance of strengthening the independence of the central bank and the inflation targeting framework. The staff presents such strengthening as a medium-term target, while in our view it deserves earlier action. As staff point out, the 2016 staff report had already recommended introducing legislation to ensure the institutional and operational independence of the central bank, set a clear mandate to control inflation, and adopt a robust accountability mechanism, aligned with the International Financial Reporting Standards (IFRS). We note that staff recommend that the central bank should avoid direct financing of the public development bank, BANPROVI—allowed under the current legal framework—but fall short of suggesting that the new central bank law should repeal such direct financing. The staff's comments are welcome.

We support the authorities' request for temporary approval of the two multiple currency practices subject to Fund jurisdiction under Article VIII, Section 3, on the understanding that the authorities will continue with the ongoing FX liberalization so as to "ultimately" eliminate these measures. Considering that these practices have been in place for quite some time, could staff provide their estimate for a feasible phase-out timeline?

Finally, we support staff's recommendation to update the base year and methodology of National Accounts and CPI, to better inform economic policies and strengthen the credibility of the inflation targeting framework. We take positive note from the buff that the competent authorities are developing a new household survey to collect the data required to update the statistical framework. We support such work and look forward to the completion of the project as soon as feasible.

Mr. Panek and Mr. Trabinski submitted the following statement:

The Honduran economy continues to improve, driven by increasing investment, higher private consumption, and good harvests. The recent successful completion of a Fund-supported program has stabilized the economy further. The authorities have maintained fiscal discipline within the thresholds set by the Fiscal Responsibility Law (FRL), despite the 2017 elections. The financial sector is broadly resilient and profitable, non-financial public-sector debt was reduced further, and inflation should remain within the tolerance band. While the outlook is positive, Honduras is vulnerable to certain external shocks and domestic instability stemming from corruption, political polarization, and relatively weak institutions. It will be important for the authorities to maintain the achievements of the Fund-supported program and increase reform efforts, with a view to reducing the high level of poverty and providing more inclusive growth.

The authorities' prudent fiscal stance is key to safeguarding macroeconomic stability. We share the staff's assessment regarding the need for a cautious and coordinated policy response to mitigate risks. Strengthening revenue mobilization, tackling the deteriorating condition of ENEE, and curtailing tax exemptions are of vital importance for further fiscal consolidation. We commend the authorities for their efforts to enhance transparency and public information, and we encourage them to conduct a

Fiscal Transparency Evaluation. We also support the redesign of the tax registry and further work on the risk management framework.

Corruption and impediments to doing business limit economic growth. We call on the authorities to redouble their efforts in fighting corruption. While we welcome the authorities' efforts to back the special anti-corruption unit (MACCIH), we agree that the recently introduced law that transfers investigative powers to the court of accounts is a step backward. Although Honduras is improving in facilitating business, there is still much to be done regarding reduction of bureaucracy and red tape. We would like to encourage the authorities to focus their efforts on limiting informality, which remains a key obstacle to the reduction of structural poverty. Well-designed educational and labor market reforms would certainly help toward that end.

More should be done to contain existing and potential financial risks. We commend the authorities for the implementation of several FSSR recommendations. However, rising household debt and the accumulation of personal loans by the pension funds call for robust supervision and monitoring. We also encourage the authorities to strengthen supervisory capacity in order to be able to introduce Basel III standards.

We encourage efforts to improve economic statistics. We welcome the recent cooperation between the BCH and the National Institute of Statistics in undertaking the survey necessary for the introduction of new CPI database, as described by Mr. Hurtado and Mrs. Suazo in their candid buff.

Mr. Virolainen and Mr. Gade submitted the following statement:

We thank staff for the report and Mr. Hurtado and Mrs. Suazo for their informative buff statement. The completion of the Fund program, which ended 2017, succeeded in reducing macroeconomic imbalances. It is essential to build on the achievements from recent years, and adopt the necessary institutional and structural reforms to sustain macroeconomic stability, and to continue strengthening governance, reduce informality, and increase inclusion. We broadly agree with the staff appraisal and make the following comments for emphasis.

Reforming the central bank law to strengthen the independence of monetary policy implementation should enhance the credibility of the inflation targeting regime. We support staff's recommendation and policy priorities for reforming the central bank law and accelerating the development of money and FX market infrastructure. Given the slight overheating potential at the current stage of the cycle, credibility of monetary policy and adequate anchoring of inflation expectations is essential. We welcome the authorities' commitment to monetary policy modernization and the request for technical assistance to support in the transition process.

Tackling the longer-standing fiscal issues remains critical to ensure transparency and efficiency of public revenue and expenditure management. We support staff's appraisal and more specific recommendations in this respect, including reducing tax exemptions, modernizing the wage policy for public employees, enhancing fiscal transparency, and improving the efficiency of social spending. In this process, consideration should be given to greater progressivity and inclusion. We note with some concern the unresolved issues with the public electricity company ENEE's financials and, consequently, additional pressures to public expenditure. We welcome progress in recent years, and note the authorities' commitment to ensuring ENEE's financial sustainability, but would appreciate staff's concrete commentary on the outlook for a comprehensive plan to tackle this issue.

We encourage the authorities to urgently update the base year and methodology of national account and CPI statistics. Accurate statistics are a pre-requisite for prescribing and assessing policy needs and policy actions. The staff recommends such an update to maintain relevance and accuracy, and staff's comments on current accuracy would be appreciated.

Finally, we take note of the authorities' intention to seek a new program with the Fund, cognizant of the valuable role the IMF has played and recognizing that there is still more to be done, as well as the challenges ahead due in part to the less favourable external conditions. We think the current report correctly highlights a need for institutional and structural reforms, the need to reduce external vulnerabilities, facilitate inclusive growth, reduce poverty, strengthen governance, and for continued anti-corruption efforts.

Mr. Lopetegui and Mr. Rojas Ulo submitted the following statement:

We thank staff for a clear and candid report and Mr. Hurtado and Ms. Suazo for their helpful buff statement.

Honduras's economy shows a sustained recovery and the outlook should remain challenging with a vast structural reform agenda. After the successfully completed Fund-supported program, the country has made significant social and macroeconomic progress implementing corrective actions but the emergence of political events has increased the risk to the pace of the reform momentum. Economic growth is projected to slow down from 4.8 percent in 2017 to 3.75 percent in 2018 and stabilize at 3.75 percent in the medium term, generating a positive but moderate growth rate. We concur with the staff's recommendation on the implementation of policies focused on strengthening and preserving macroeconomic stability to increase resilience to consolidate the improvements achieved in the last period.

The target to maintain fiscal discipline to contain macroeconomics vulnerabilities and support sustainable growth is important. In recent years, the fiscal deficit decreased notably due to the impact of sustained fiscal discipline and is expected to remain at 0.8 percent of GDP in the medium term, a value below the ceiling established by the Fiscal Responsibility Law. Recent efforts to limit the fiscal deficit should continue, along with the reforms to strengthen revenue mobilization, rationalize tax expenditures, and improve the efficiency of spending. In this context, we support policies to contain wage growth, improve the efficiency of social spending, enhance tax and customs revenue administration, develop public fiscal management capacity, and strengthen fiscal transparency by timely access to economic and fiscal data.

We welcome the authorities' efforts to control the increase in public debt and the development of fiscal capacity in public debt management. The Debt Sustainability Analysis (DSA) indicates that the public debt trajectory suggests a favorable outlook and the risk assessment of external debt distress is moderate. As the staff suggests, we concur that stronger fiscal consolidation by structural fiscal reforms and reducing the current account deficit will strengthen the resilience capacity of the economy. We support the implementation of policies to prioritize expenditures, ensure the sustainability of ENEE, strengthen the risk management framework, and develop the secondary market for Lempiras-denominated bonds.

The banking system's soundness indicators have improved but efforts are needed to deepen reforms in the financial sector. The banking sector has been an adequate balance sheet buffer and remains resilient to most standardized shocks. The authorities should continue monitoring the private sector credit, especially in foreign currency, as well as growth in public bank operations and maintain the trend achieve to non-performing loans (NPLs). We support the implementation of the recommendations of the FSSR to strengthen bank supervision, adopting international standards in the framework of the Basel III. The progress made in AML/CFT legislation is remarkable.

The monetary policy stance will gradually reverse and modernizing the legal framework is necessary to support macroeconomic stability. Inflation has picked up but remains within the range established by the Central Bank of Honduras (CBH) which reflects a recovery in domestic demand, increasing international oil prices affecting the expansionary monetary policy stance. The authorities should continue monitoring liquidity and inflation developments and anchor expectations within the target band. We support the staff's recommendation for the CBH to gradually reverse the currently supportive monetary policy stance, accelerating the pace of the reduction in FX surrender requirements, and for a credible inflation-targeting regime, enacting a central bank law to modernize monetary policy.

We support the implementation of structural reforms which promote inclusive growth and improve the business climate. Honduras' economy has particular characteristics and, in the long term, it is susceptible to climate change. Additionally, reducing poverty rates as well as strengthening institutions and governance are critical factors to promote sustainable growth. The World Bank's Doing Business Indicators show that the country could implement policies and measures to reduce red-tape and ease the business climate. We encourage the authorities to continue their efforts in the implementation of structural reforms to promote the production of higher-value goods, strengthen labor market institutions, improve social and education outcomes, and ensure coordination among government agencies.

With these comments, we wish Honduras and its people success in their future endeavors.

Mr. de Villeroché and Mr. Rebillard submitted the following statement:

We thank staff for an informative set of reports, as well as Mr. Hurtado and Mrs. Suazo for their useful buff statement. We commend the authorities for the successful completion of the Fund-supported program, which significantly reduced Honduras' macroeconomic imbalances. While the ongoing recovery is welcome, additional efforts are needed to further entrench macroeconomic stability, boost potential growth and address long-term challenges such as poverty. We broadly share the thrust of the staff's appraisal, and would like to add the following comments:

Fiscal Policy

The fiscal consolidation effort under the IMF program, amounting to 6¾ percent of GDP over the past four years, has been impressive. We take positive note that fiscal discipline was maintained during the recent election cycle. Despite an increase in public spending in the context of post-election political tensions, the non-financial public sector deficit is expected to remain moderate, at 0.8 percent of GDP this year. Going forward, further efforts are needed to build the necessary fiscal space to address high social and infrastructure needs. On the expenditure side, like staff we see merit in containing the public wage bill. Nonetheless, we see more scope for additional revenue given the very high level of tax expenditures (7 percent of GDP); we strongly agree with staff and encourage the authorities to rationalize tax expenditures and streamline tax exemptions.

Monetary and Exchange Rate Policies

Given the recent pick-up in inflation expectations and the slightly positive output gap, we support staff's recommendation to gradually reverse the supportive monetary policy stance. Over the medium-term, reforming the Central Bank Law will be key to strengthen the credibility of the new inflation targeting framework. The Fund should stand ready to provide Technical Assistance along the transition, as requested by the authorities. We emphasize the need to progressively allow for greater exchange rate flexibility, as a crucial step to foster de-dollarization and the efficiency of the inflation targeting regime.

Structural Reforms

Addressing high poverty will require sustained medium-term growth, a strengthening of institutions and improving the business climate. We take positive note of the effectiveness of the Bono Vida Mejor conditional cash transfer; emphasis should now be put on reducing the still high coverage gap. We commend the authorities for the progress achieved in reducing crime over the past few years, as detailed in Box 1. Further efforts are needed in the fight against corruption; in this regard, the approval in January of a law that potentially prevents the criminal prosecution of embezzlement cases, is a matter of concern. We take positive note of the advances made in AML/CFT legislation and encourage further progress regarding the implementation of GAFILAT recommendations. Finally, we welcome the authorities' intention to update national accounts through a revision of the methodology and rebasing of GDP, the 1998-99 household survey being likely significantly updated; accurate statistics are indeed crucial to provide appropriate guidance for macroeconomic policies.

Ms. Suazo made the following statement:

On behalf of the Honduran authorities, I thank the staff for the valuable and timely recommendations and Directors for their gray statements.

The Honduran authorities have expressed their intention to formally request a new Fund program. The authorities are currently working on the contents of their economic program, for which the issues raised in the Article IV will be an important input. The authorities are considering the elements of the comprehensive reform of the electricity sector and steps to create fiscal space by reducing tax exemptions to reduce poverty further. Once the authorities complete this process, they will request that Fund staff begin negotiations.

As highlighted in the staff report, impressive progress has been achieved in macroeconomic stabilization. The Honduran authorities have also continued making progress in reducing poverty. On this last point, the Inter-American Development Bank (IDB) published on Monday an impact evaluation of the flagship social program *Vida Mejor*, which broadly consists of conditional cash transfers. The study's results are positive and point out that a total of 30,000 households left extreme poverty, with a reduction of 12.12 percentage points in the poverty rates of the sectors that received those transfers. The results were also positive in nutrition and health indicators.

The Honduran Government also ratifies the commitment to create the National Economic Council as an instrument of coordination of economic policy. The current legal framework is being reviewed to accommodate the council in ways that fulfills its function appropriately.

Mr. Claver-Carone made the following statement:

We issued a gray statement, but I want to underscore that we welcomed the indication in the buff statement by Mr. Hurtado and Ms. Suazo that the authorities will seek a new Fund program aimed at safeguarding the macro stabilization achieved by the prior program and placing Honduras on a higher potential growth path.

Lifting potential growth will require prioritizing macro-critical structural reforms, such as rationalizing taxation and spending, reforming the state energy company, and improving the investment environment. For this, the rule of law and the fight against corruption are important and key. I know the authorities have been working on many of these macro-structural reforms, and we applaud them for deciding to use a new Fund program to sustain and expand that momentum.

Mr. Leipold agreed with Mr. Claver-Carone's remarks. Mr. Leipold noted that the staff report included no selected issues papers, whereas the last staff report included four selected issues papers. He remarked that it demonstrated that area departments had the flexibility to decide whether a selected issues paper was necessary given their budget constraints.

Mr. Saraiva made the following statement:

> We also issued a gray statement, and I want to highlight three aspects that deserve some praise.
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> First, the performance of the Honduran economy was impressive last year, with 4.8 percent growth in spite of the turmoil at the end of the year. It shows how the program has been successful in laying the groundwork for a sound economy in Honduras. We welcome the authorities' intention to continue on the successful track established by the previous program.
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> Second, it is remarkable how successful the policy on crime and security has been. It is an impressive success in terms of reducing the rate of homicides. There is much to be done in this area, but the success is encouraging. The effort will also benefit from progress on poverty reduction and on creating job opportunities for the youth.
>
> Finally, we should underscore the efforts that have been made to increase transparency, especially in public financial management. Based on that, Honduras is pursuing a sound track, and it is encouraging that they are envisaging further work with the Fund to continue along those lines.

The staff representative from the Western Hemisphere Department (Mr. Garcia-Saltos), in response to questions and comments from Executive Directors, made the following statement:[4]

> I thank Directors for the thoughtful discussion presented in the gray statements. I plan to cover two issues: first, the outlook for the reforms on the tax exemption regimes; and second, our view on the reform of the electricity sector broadly and the electricity company, in particular.
>
> On the tax exemptions, I would like to go back to 2014, in which there was an approval of the social protection framework law that mandated the

[4] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

expansion of coverage in health care and the expansion of the retirement system. These two broad principles of the social protection framework law implied a sizeable amount of revenues to finance these operations.

During the previous program, the government committed to implement this law gradually and to start designing a reduction of the tax exemptions to finance the implementation of this law. The framework called for a reduction in exemptions to finance between 2 and 3 percentage points of GDP, which is what the implementation of the social protection framework law will cost.

In our discussions during the Article IV mission, the authorities reiterated their intentions to advance the reduction of the tax exemptions. The question is: What, when, and how much will they be?

We can discuss the "what." The easy ones to start reducing are the VAT exemptions to products that are harmful to health—for instance, sodas. Moving to the difficult ones in terms of the political constraints, there are a number of special regimes in the corporate income tax. Then there is room for reducing tax exemptions and it was presented in the previous staff report, the one that we presented in the last review of the program in October last year. On the corporate income tax, there is a number of special regimes that can be subject to be phased out. Broadly speaking, these two sources cover about half of the total universe of tax exemptions.

Now, on "when," the timing for implementation is part of the discussion on the design of the economic program that is currently taking place.

Our assessments of "how much" would be required is presented in the staff report. Over the next three years, a reduction in tax exemptions yielding a minimum of 1.5 percent of GDP in new revenues will be adequate.

I will now turn to the second topic, which is the situation of *Empresa Nacional de Energía Eléctrica* (ENEE) and the measures to start implementing the reforms.

I would like to start by describing the situation of the electricity company in 2013. It started with a deficit of about 2 percent of GDP in 2013. In 2016, the deficit went down by 0.3 percent of GDP. Over the past two years, the reduction in the deficit of the electricity company has been 1.2 percent of GDP. To put this in context, during the previous four years of the program, the fiscal consolidation was close to 7 percent of GDP. The reduction in the deficit from ENEE covered about 20 percent of the fiscal consolidation.

Two measures were taken to improve the financial situation of ENEE: raised electricity tariffs, and the rationalized wage bill. Going forward, our projection for 2018 includes an increase in the deficit of ENEE. This is worrisome.

What are the measures that, on a preliminary basis, have to be included? We have to start with principles. The main principle is that the reform must be comprehensive. It has to have a strategic plan that includes not only ENEE but also reforms of the electricity sector. This will need to include on the revenue side a sizeable reduction in the electricity losses. It probably has to include an adjustment on tariffs, although we have to be mindful that, for competitive reasons, there will be a limit on the increase in tariffs in order to remain competitive in the region.

It has to include a charge to private generators for ancillary services that the electricity company currently provides for free. It has to include a rationalization of the energy purchases by adopting the basic principle of purchase of energy at the minimum cost.

These measures will have to part of a strategic plan for the electricity company. The plan must define what parts of the transmission, distribution, and generation will be open to private investors. In our discussions with the government, the agreement was to have a short-term plan anchored in a strategic plan for the medium term for the reform of the energy sector.

As Ms. Suazo indicated, the authorities are in the process of designing these reforms, and the creation of the National Economic Council, which will coordinate the reforms in the economic sector, is a welcome step.

Mr. Claver-Carone asked if the staff had assessed the impact on the Honduran economy if the country was able to import electricity from Mexico and other countries. He noted that there had been some hindrances, but they are able to do so mainly because of Guatemala and others.

The staff representative from the Western Hemisphere Department (Mr. Garcia-Saltos) responded that there was an initiative with the Northern Triangle countries of El Salvador, Guatemala, and Honduras that was aimed at finding more efficient ways to provide energy at the minimum cost. The United States and IDB supported those efforts, but he remarked that it would take more time than was required to design a strategic plan for ENEE.

Ms. Suazo made the following concluding statement:

I wanted to conclude by verifying the commitment of the Honduran authorities to advance the fight against corruption and to strengthen government institutions. The authorities fully support the Mission to Support the Fight Against Corruption and Impunity in Honduras within the framework of our constitution—by supporting our institutions but not replacing them.

On the subject of ENEE, as Mr. Garcia-Saltos noted, the government is working with the donors and multilaterals to present a comprehensive program to address the problem, which will be part of the negotiations of the new program. This plan includes in a precise manner the revision of the law's reduction targets, the evaluation of the electricity market, the update of the tariff framework, and the adoption of measures to solve the administrative and operational problems of the energy company.

We also ratified the government's commitment to maintain macroeconomic discipline.

It is important to underline that, as a country, we have made significant progress in the last four years, as shown by the figures and institutional advancement. However, we recognize that we still have a long way to go, and that is why it is in the interest of our authorities to continue their relationship with the Fund and continue moving forward.

We hope to continue counting on the support of the institution and its Board of Directors so that the new program is successful and allows us to continue building the Honduras that we all want.

The following summing up was issued:

Executive Directors broadly agreed with the thrust of the staff appraisal. They commended the authorities for the successful completion of the Fund-supported program. Directors noted the reduction in macroeconomic imbalances and the institutional enhancements, particularly the Fiscal Responsibility Law (FRL), under the program. These gains are critical factors for a favorable medium-term outlook. Looking forward, Directors underscored the need for deeper reforms to entrench macroeconomic stability and place Honduras on a higher, more inclusive growth path.

Directors supported the authorities' near-term policy mix. A more prudent fiscal stance than required under the FRL will send an important signal of the commitment to maintain macroeconomic stability. Directors also welcomed the readiness to unwind the supportive monetary policy stance, if needed, to further anchor inflation expectations and contain inflationary pressures. These policies are particularly important in the context of downside risks from tightening global financial conditions, worsening terms of trade, and uncertainties related to overseas immigration policies.

Directors stressed the need for continued ambitious fiscal reforms and revenue mobilization efforts to boost potential growth, further expand the social safety net and reduce poverty. They noted the positive results of the conditional cash transfers program and its envisaged expansion within the ceilings of the FRL. A comprehensive review of large tax expenditures, and rationalization of expenditures is called for. Directors cautioned against the adverse effects of repeated tax amnesties on compliance and revenue mobilization efforts. Stronger efforts to resolve the financial situation of the state electricity company, right-size the wage bill, and enhance the transparency and efficiency of public expenditure will also be critical.

Directors welcomed the progress made toward the modernization of monetary policy, including the reductions in surrender requirements and the introduction of collateralized transactions in the interbank market. Directors recommended speeding up the adoption of the new central bank law to enshrine the primacy of inflation as a monetary policy target. They also recommended efforts to deepen the money and foreign exchange markets to support the development of domestic capital markets, as well as more exchange rate flexibility that will provide a cushion against external shocks.

Directors welcomed the stability of the banking system and commended the progress made toward adopting Basel III standards. They recommended sustained implementation of the Financial Sector Stability Review recommendations. Relatedly, Directors called for careful monitoring of household debt, the concentration of consumer loans in public pensions fund portfolios, and the expansion of development banks toward first-tier operations. They also underscored the need for a further strengthening of the AML/CFT framework.

Directors underscored the need to implement supply-side reforms to boost competitiveness, growth, and job creation. They noted that strengthening the rule of law is critical to improve the business environment. Directors acknowledged the ongoing progress in fighting corruption in collaboration with international agencies and recommended enhancing the transparency of the current asset disclosure regime for public officials. Directors underscored the need for continued efforts to reduce red tape and increase the ease of doing business.

Directors emphasized the need to update national statistics for effective policy formulation and welcomed the progress made by the authorities.

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

APPROVAL: April 17, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***In the medium-term, staff expects potential growth to remain at around 3.75 percent, yet we wonder how it would be reconciled with an anticipated deceleration of the U.S. economy, to which Honduras holds strong linkages through trade and worker's remittances. The staff's comments in this regard would be appreciated.***

- The recent increase and later deceleration of the U.S. economic growth is unlikely to affect Honduras' exports and growth significantly given the composition of Honduras' exports, less geared toward investment goods and higher-end consumer products that are expected to fluctuate more during the medium term as a result of the fiscal reforms that are a key factor in the U.S. growth outlook. The baseline medium term scenario assumes no significant changes in the composition of labor conditions of Latinos in the United States, therefore remittances are unlikely to be significantly affected by the projected changes in the U.S. growth.

Fiscal Policy and Debt Sustainability

2. ***Could staff provide an update on the state of readiness by the authorities to undertake comprehensive reforms in the electricity sector and the prospects of the new measures to resolve the situation?***

- The staff will address this question orally.

3. ***The authorities also indicated their intention to develop a comprehensive reform of the electricity sector, including measures such as charging generators for ancillary services and allowing the purchase of electricity at minimum available cost. Could staff update on any progress on this front?***

- The staff will address this question orally.

4. ***We note with some concern the unresolved issues with the public electricity company ENEE's financials and, consequently, additional pressures to public expenditure. We welcome progress in recent years, and note the authorities' commitment to ensuring ENEE's financial sustainability, but would appreciate***

staff' concrete commentary on the outlook for a comprehensive plan to tackle this issue.

- The staff will address this question orally.

5. ***The staff's comments on whether the authorities are considering reinstating the criminality of tax fraud in order to improve tax compliance are welcome.***

- The authorities have indicated their support to reinstate the criminality of tax fraud and staff expects the new criminal code, still to be enacted, to include tax fraud as punishable crime.

6. ***The staff's comments on the implementation progress of FRL, adopted in 2016, are welcome.***

- So far implementation of the FRL has been positive. Both fiscal rules, on the NPFS deficit and current spending growth, where fulfilled in 2016 and 2017. Additionally, the law has catalyzed a series of important reforms on budgeting and financing procedures such as: the implementation of medium-term fiscal framework; the creation of fiscal contingency unit; the adoption of accounting rules for PPP operations in line with international standards; and the standardization of domestic debt contracts.

7. ***The staff's comments on the strategy and the progress in reducing tax expenditures are welcome.***

- The staff will address this question orally.

8. ***According to the report, the authorities are designing a new general policy for civil service compensation, an area where the country received technical assistance from the World Bank and the Fund. To what extent is the upcoming reform reflecting inputs from the TA?***

- The reform is at a design stage. The main objective is to bring greater standardization in remuneration policies across the public administration, with equal pay for equal work within the public sector. The authorities are working with the IDB on a pilot project covering 12 public institutions from different levels of government, with the intention of extending reforms to the entire public sector based on learnings from the pilot.

Financial Sector, Monetary and Exchange Rate Policies

9. ***We encourage the authorities on adequately address the remaining vulnerabilities in the financial sector. Could staff elaborate more on the build-up of household debt and the possible macro-financial risk.***

- From a macro-financial standpoint, the ratio of household debt relative to disposable income remains moderate at 22¼ percent in 2017 (20¼ percent in 2013). The staff's recommendation of monitoring household debt, including from pension funds, aims at preventing the debt buildup in low-income earners that recently received financial assistance from pension funds to consolidate debts.

10. ***Concerning the large concentration of personal loans in the public pension funds' portfolio, we note that the authorities see this is as a consequence of the minimum profit requirements and limited investment opportunities. The staff's comments on the risk associated with this and its impact on the banking sector are welcome.***

- The concentration of consumer loans in pension funds' portfolio entails several risks. Specifically, fiscal contingencies stemming from possible non-performing loans affecting future pensions. The authorities point to virtually non-existent NPLs at the moment due to automatic payroll deduction. However, possible over-indebtedness resulting from continued extension of loans could result in high debt service leaving insufficient resources for living expenses, prompting need for future bailout to maintain the integrity of the pension system. The authorities' analysis of repayment capacity shows that debt-service to income ratios are still at reasonable levels; hence staff advice is to continue monitoring trends closely to prevent excessive debt build-up. While not an issue at the moment, credit quality of the banking sector would also be affected if current practices of pension funds resulted in excessive build-up of debt by borrowers also exposed to the banking sector.

11. ***The authorities introduced a lending program for housing that consists of interest rate subsidies and reduction in reserve requirement. The staff estimates that this could result in monetary expansion over the next three years equivalent to 10.5 percent of end 2017currency issue. Could staff explain what are the implications for the medium-term fiscal balance and monetary policy? What could be an alternative solution to the housing program?***

- The program is limited to about 2,000 beneficiaries per year. The restriction on beneficiaries is given by the allotted resources to pay the interest rate subsidy (less than US$ 10 million in 2018). Assuming the program is implemented under these restrictions and the liquidity expansion is sterilized, staff does not envisage any major impact in the monetary or fiscal balances. However, as staff pointed out during the mission, the current housing gap is around half a million units, therefore, the program introduces a potential risk of social pressures to expand the program beyond the above-mentioned limits.

12. ***We wonder how the authorities plan to balance the reversal of the current supportive monetary policy stance with the monetary expansion implicit in the new lending program for housing promised by the government. Comments are welcome.***

- If signs of inflationary pressures were to emerge or inflationary expectations become unanchored because of rapid implementation or further expansion of the lending program for housing, a monetary tightening, possibly including through an increase in reserve requirements, will be needed.

13. ***Outside of a policy rate hike, the authorities also have the option to raise reserve requirements (RR). Could staff clarify how feasible it would be to raise RRs, given government's recently introduced lending program for housing.***

- See response to question # 12

14. ***Can staff provide an update on the authorities' plans to establish a well-funded lender of last resort facility?***

- This question was clarified bilaterally with the Executive Director.

15. ***We note that the authorities maintain two multiple currency practices, which are subject to Fund jurisdiction under Article VIII, Section 3, and wonder whether the authorities' planned reform to the monetary policy framework will eliminate these measures?***

- Yes, it will, as the official exchange rate will be eliminated once the transition towards inflation targeting is completed.

16. ***We support the authorities' request for temporary approval of the two multiple currency practices subject to Fund jurisdiction under Article VIII, Section 3, on the understanding that the authorities will continue with the ongoing FX liberalization so as to "ultimately" eliminate these measures. Considering that these practices have been in place for quite some time, could staff provide their estimate for a feasible phase-out timeline?***

- See response to question # 12.

17. ***Given the latest global financial market volatility, we wonder about the potential impact on Honduran banking sector liquidity. The staff's comments are welcome.***

- The staff does not expect strong impacts from global financial market volatility. One of the banking system's strengths is its reliance on domestic funding sources (78.4 percent of funding comes from local depositors, and 7.6 percent from domestic issuances) which keeps the system relatively insulated from external shocks. As a reference, during the Global Financial Crisis, the impact on the Honduran banking system was minimal.

18. ***We note that staff recommend that the central bank should avoid direct financing of the public development bank, BANHPROVI—allowed under the current legal framework—but fall short of suggesting that the new central bank law should repeal such direct financing. The staff's comments are welcome.***

- The Lempiras 13bn limit for BCH financing to development banks under current legislation has already been reached. In staff's view the new central bank law should ban direct financing to any public entity, including development banks.

Structural Reforms

19. ***Can staff elaborate on the extent to which the National Economic Council recommendations are binding? Are they a "comply or explain model"?***

- Our understanding is that the National Economic Council role would be to articulate short-term economic policy decisions with the medium-term growth agenda.

20. ***We would welcome staff comments on the progress of implementing "Honduras 20/20 Plan" aimed at generating jobs and reducing poverty.***

- Honduras 20/20 is a strategic development partnership between private and public sectors. It targets the creation of 600,000 jobs in the following sectors:

    - Tourism
    - Textile
    - Light manufacturing
    - Outsourcing services
    - Housing
    - Agribusiness

- So far, the most significant result of the Honduras 20/20 is a new tourism framework law, which introduced new tax incentives for investment in the tourism sector. The program's sponsors have noted that Honduras 20/20 program has created around 50,000 new jobs, counting jobs created by the maquila and service offshoring sectors.

21. ***We encourage the authorities to urgently update the base year and methodology of national account and CPI statistics. Accurate statistics are a pre-requisite for prescribing and assessing policy needs and policy actions. The staff recommends such an update to maintain relevance and accuracy, and staff's comments on current accuracy would be appreciated.***

- The authorities have adopted a plan to upgrade the CPI consumer basket which is currently based on a survey conducted in 1999, implying likely distortions due to changes in consumption patterns. The authorities' plans to update the methodology and base year of national accounts statistics are also critical to more accurately capture GDP growth according to the current sectoral structure of the economy.

Program Issues

22. ***The buff states that authorities intend to request a new Fund program. This seems appropriate and we would be interested to know what is being envisaged in this regard.***

- The staff will address this question orally.