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FOR AGENDA

SM/09/92

April 14, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Honduras—Staff Report for the 2009 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2009 Article IV consultation with Honduras, which is tentatively scheduled for discussion on **Wednesday, April 29, 2009**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Honduras indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Lopez-Mejia (ext. 34334) and Mr. Bannister (ext. 35979) in WHD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Wednesday, April 22, 2009; and to the European Commission, the European Investment Bank, and the Inter-American Development Bank, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

HONDURAS

Staff Report for the 2009 Article IV Consultation

Prepared by the Western Hemisphere Department
(in consultation with other departments)

Approved by Miguel A. Savastano and Michele Shannon

April 14, 2009

- **Background**. Performance since the last Article IV consultation has been mixed. Output growth has been above trend and the fiscal deficit has been low following debt relief. However, inflation has increased, the external position has weakened, and financial sector vulnerabilities are higher.
- **Outlook**. A large external current account deficit, combined with a sharp decline in net capital inflows (due to global and domestic factors) could result in a balance of payments deficit of close to US$300 million in 2009 (11 percent of gross reserves at end-2008). On current policies, reserves could reach critically low levels by 2010–11. The growth slowdown also poses a threat to the financial system.
- **Political context and authorities' views**. Presidential elections are scheduled for November 2009 and re-election is not allowed. The authorities' priority is to support domestic demand to mitigate the effect of the global shock on economic activity. They see maintaining the fixed exchange rate system and loose liquidity conditions as key elements of their policy response, including because lower oil prices have eased the need for rapid policy correction to protect the balance of payments.
- **Staff recommendations**. With significant downside risks to the outlook, the policy priority should be to reduce the risks of a disorderly adjustment in the balance of payments in order to preserve macroeconomic stability and sustain growth over the medium term. The mission recommended:
  - *Correcting macro imbalances.* By avoiding a large fiscal expansion in 2009, strengthening monetary policy, and reinstating the crawling exchange rate band.
  - *Increasing the resilience of the banking system*. By enhancing the monitoring of liquidity, preparing contingency plans to address potential bank problems, improving compliance with provisioning norms, and continue implementing risk-based supervision.
  - *Building consensus with the main presidential candidates on policies for sustainable growth and poverty reduction.* Reforms identified in the 2004 PRGF arrangement have not been completed and remain relevant, including strengthening governance and macroeconomic institutions.
- **Fund relations**. The last Article IV consultation was concluded on February 21, 2007. A 12-month Stand-By Arrangement (SBA) expired on March 30, 2009; no purchase was made and no review was completed due to large deviations in monetary and exchange rate policies.
- **Mission**. Discussions took place during February 23–March 5, 2009. The team comprised A. López-Mejía (Head), G. Bannister and G. Callegari (all WHD), S. Maziad (SPR) and F. Bornhorst (FAD). C. Medeiros (MCM) also joined the mission. M. Garza, the Fund's Resident Representative assisted the mission. A. Umaña (OED) participated in the final meeting.

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I. Background

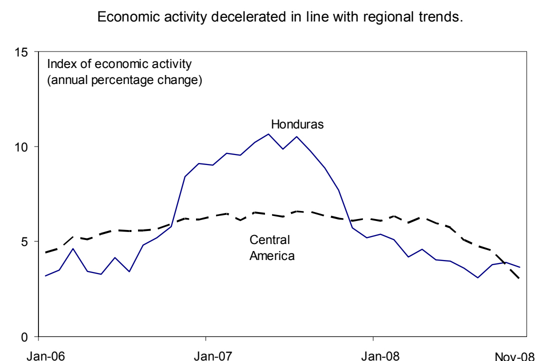
1. ***In early 2008 the Fund approved a 12-month Stand-By Arrangement with Honduras aimed at correcting the macroeconomic imbalances identified as risks during the 2006 Article IV consultation***.[1] One year ago, the economy was growing above trend, inflation was creeping up, the external current account deficit had exceeded 10 percent of GDP, and foreign reserves were falling (Figure 1). The SBA was to provide a bridge to an arrangement under the Poverty Reduction and Growth Facility (PRGF) that would help Honduras to address its structural challenges. Among these, weak institutions and governance were seen as critical, including because of their role in the interruption of a previous PRGF arrangement in 2006 (when substantial concessions were granted on wages for teachers and other public sector workers).

2. ***The main objective of the 2008 SBA was to maintain macroeconomic stability and strengthen the foundations for sustained growth***. To this end, economic policies aimed at reorienting the fiscal stance towards priority spending, containing inflation, strengthening the balance of payments, and addressing weaknesses in the energy sector. In the event, external conditions (especially prices of food and oil imports) were more adverse than envisaged and policies were not in line with those agreed under the SBA (Box 1). Despite a rapid weakening of the balance of payments position, monetary policy remained expansionary and the exchange rate was kept fixed (Figures 2 and 3). Fiscal performance was mixed. The deficit target in the program (1½ percent of GDP) was missed by a small margin (0.2 percent of GDP) as overruns in current expenditure and net lending by pension funds (mostly to teachers) were partly offset by lower capital expenditure. While the finances of the electricity company were strengthened, current spending (mainly untargeted subsidies) increased as the government tried to mitigate the impact of higher oil prices on personal income (Figure 4).

3. ***Weak policy implementation and an adverse global environment affected economic performance during 2008***.

- ***Output and inflation***. Growth is estimated to have slowed to 4 percent (down from an average of 6¼ percent during 2004–07), reflecting binding capacity constraints, higher oil and food prices through September 2008, and a slowdown in remittances and exports (Figures 1, 3). Headline inflation (12-month rate) mirrored developments in world fuel and food prices, reaching

Economic activity decelerated in line with regional trends.



[1] Honduras—Staff Report for the 2006 Article IV consultation, SM/07/53 (2/7/07).

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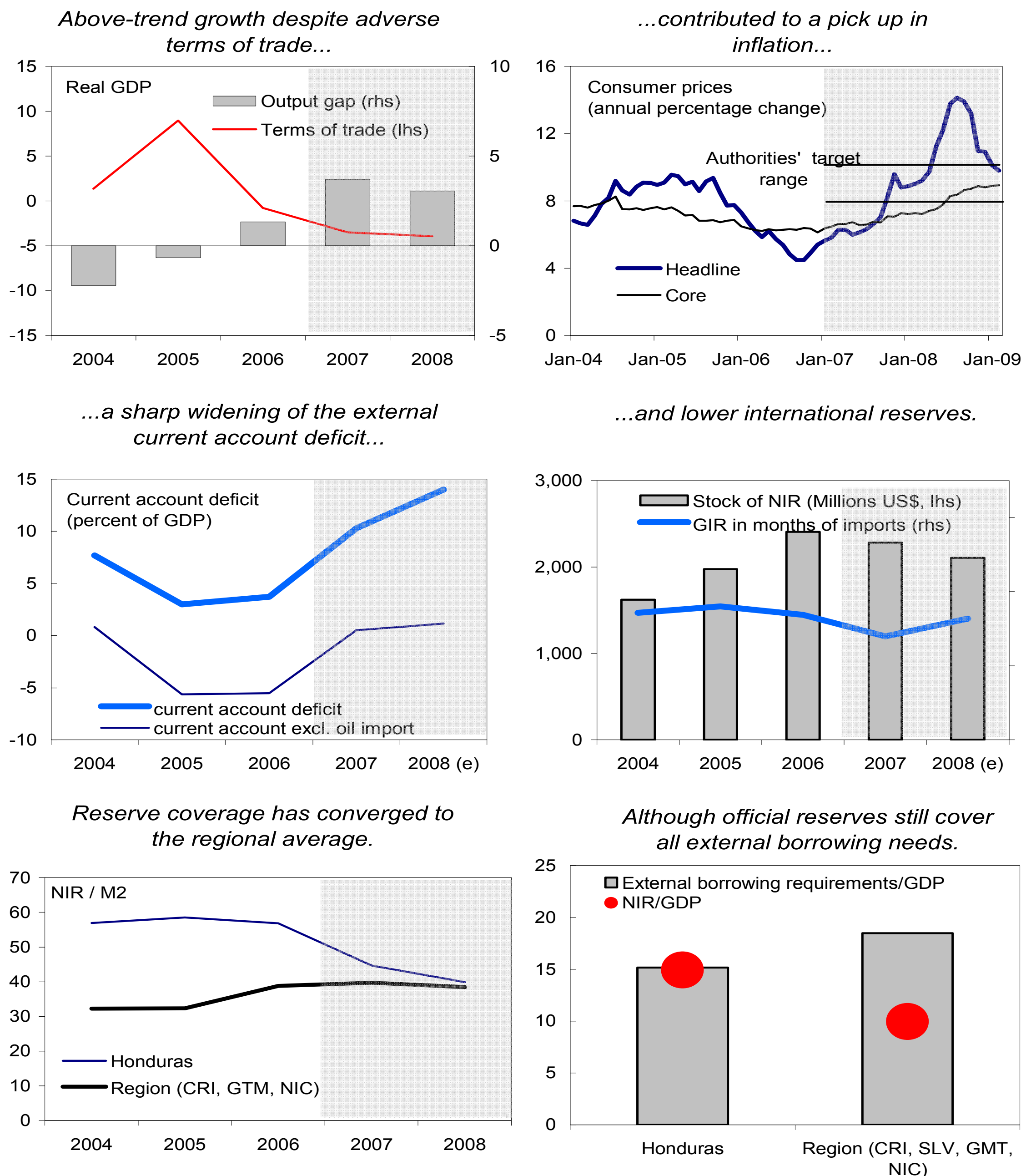
Figure 1. Honduras: Recent Macroeconomic Developments



Sources: Central Bank of Honduras and Fund staff calculations.
Note: CRI=Costa Rica, GTM=Guatemala, NIC=Nicaragua, and SLV=El Salvador.

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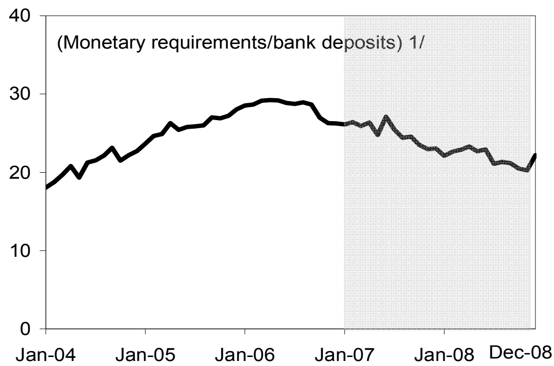
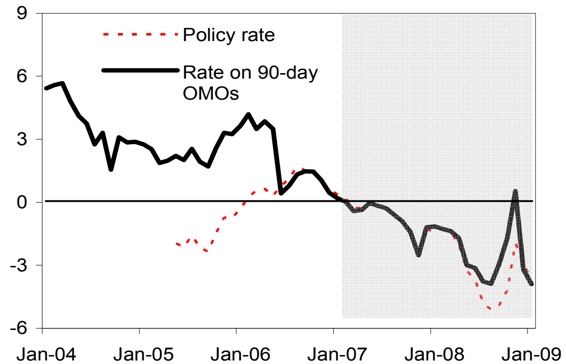
Figure 2. Honduras: Monetary Developments

Expansionary monetary policy fueled domestic demand growth and increased external imbalances.

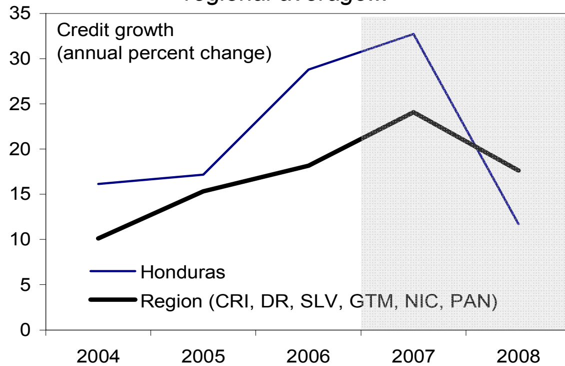
Since 2006, lower monetary requirements...



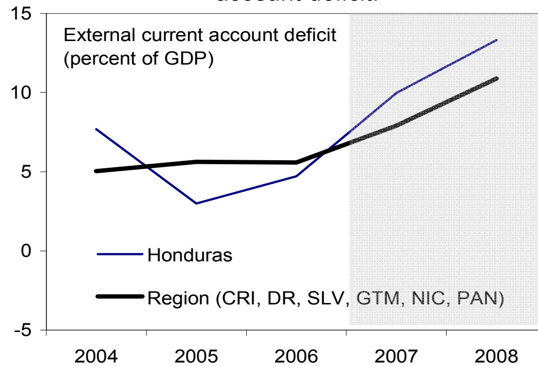
...and a policy rate negative in real terms...



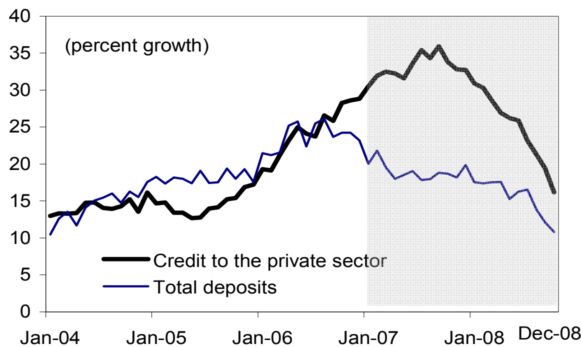
...pushed credit growth above the regional average...



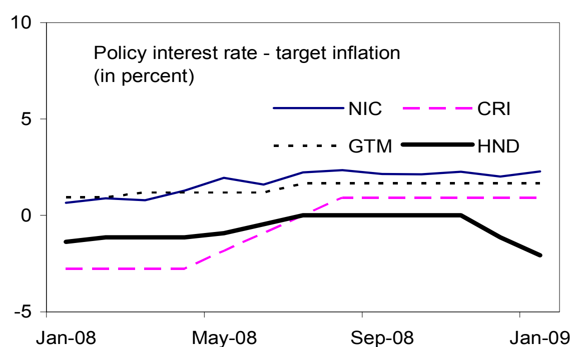
...and contributed to widen the current account deficit.



The gap between credit growth and deposit growth has narrowed in recent months...



...even though the policy interest rate has become more negative.



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

1/ Monetary requirements comprise reserve requirements, obligatory investments, and open-market bills; bank deposits include demand and time deposits held by depository institutions.

Note: CRI=Costa Rica, DR=Dominican Republic, SLV=El Salvador, GTM=Guatemala, NIC=Nicaragua, and PAN=Panama.

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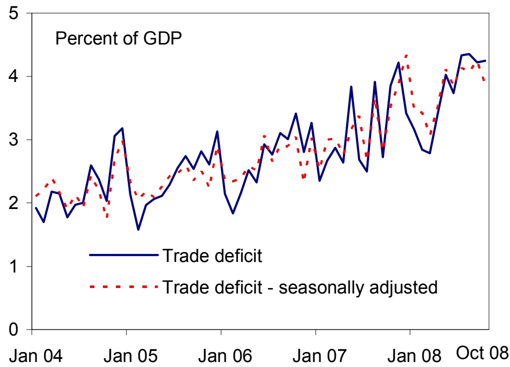
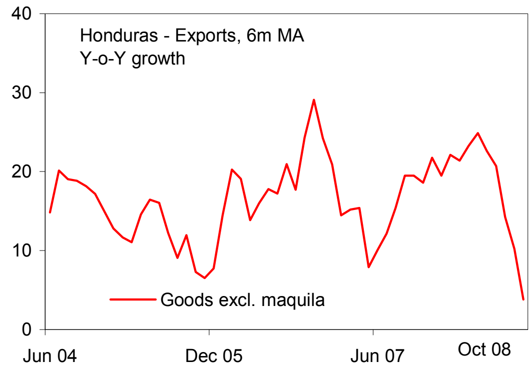
Figure 3. Honduras: External Sector Developments

Growing trade imbalances and stagnant remittances widened the current account deficit, while the real exchange rate appreciated.

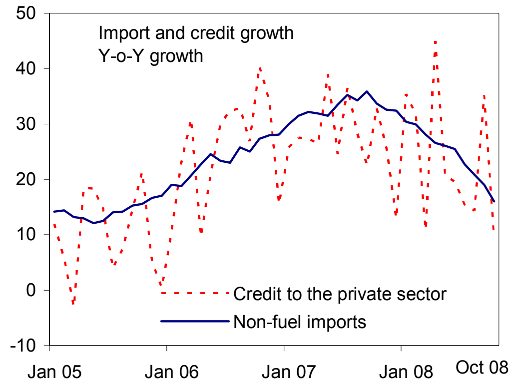
The trade deficit has been rising since 2006.



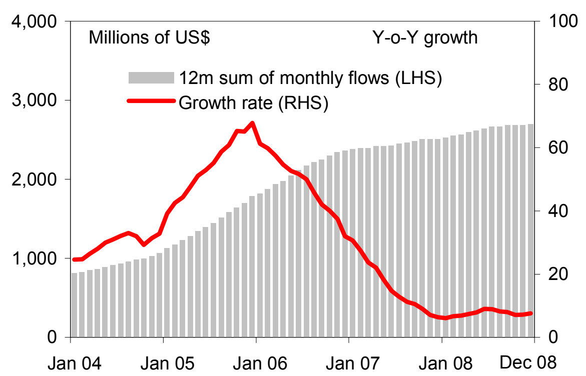
Although export growth averaged 18%...



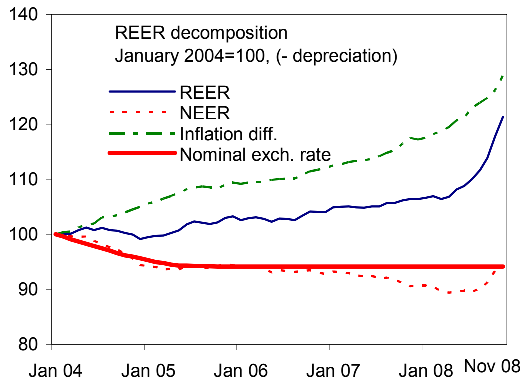
…non-oil import growth was much higher.



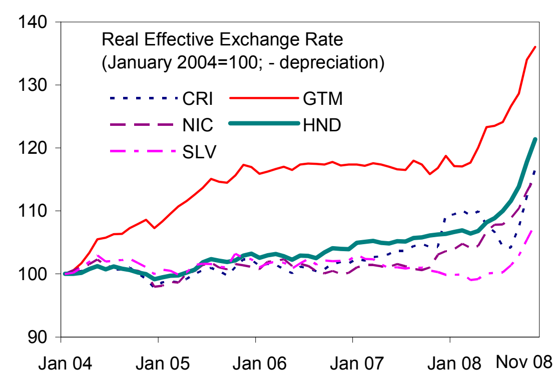
The growth of remittances fell sharply.



A fixed exchange rate and a large inflation differential...



…has led to a steady appreciation of the lempira.



Sources: BCH and Fund staff calculations.

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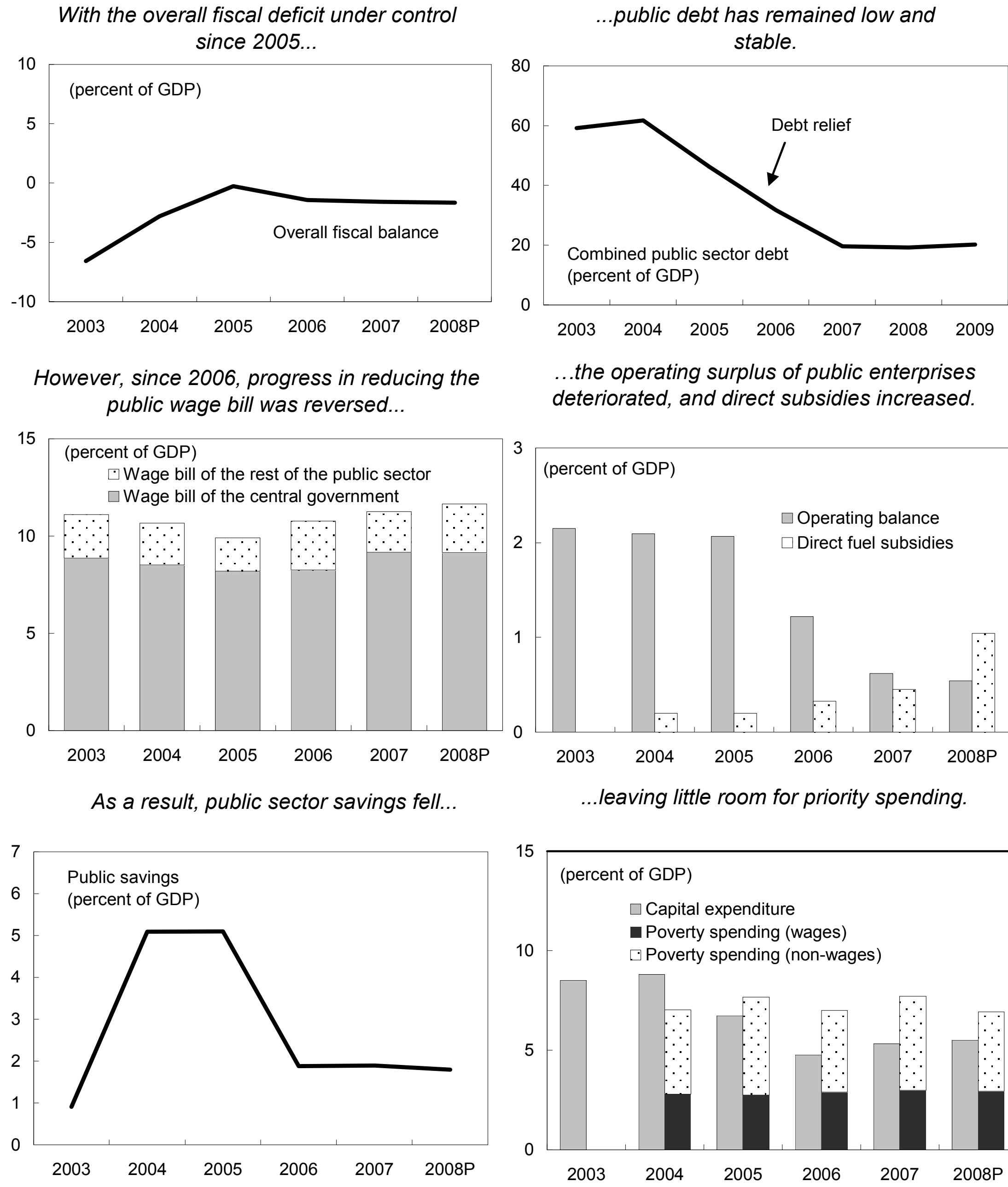
Figure 4. Honduras: Fiscal Developments

Following debt relief, public debt has remained low and stable, but the quality of pro-poor spending remains low and public investment has declined.



Sources: Honduran Authorities and Fund staff estimates. Poverty spending identified since 2004.

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Box 1. Honduras: Performance under the 2008 SBA

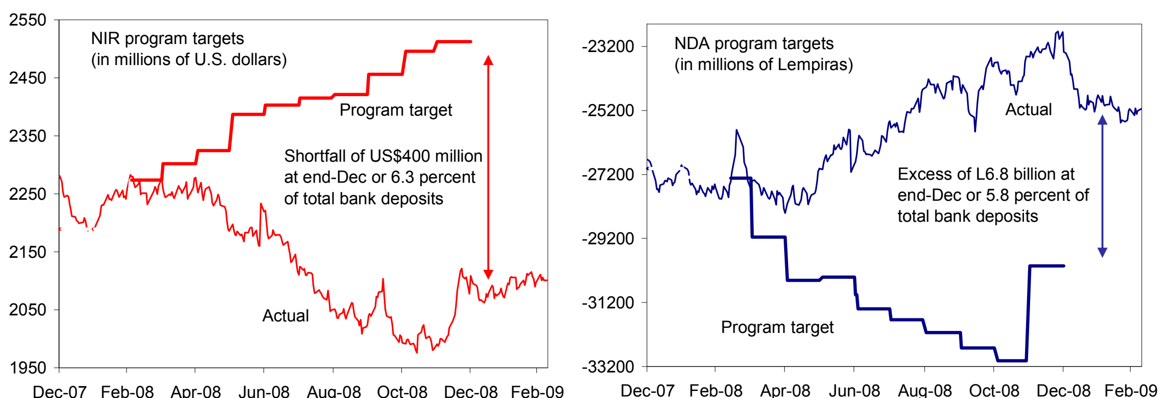
The main goals of the 2008 SBA were to correct the imbalances caused by the expansionary policies of 2006–07 and serve as a bridge to a new PRGF arrangement. Key objectives included: limiting the fiscal deficit to 1½ percent of GDP; containing current government spending while allowing a large increase in public investment; strengthening monetary policy to restrain domestic demand and keep inflation stable; reinstating the crawling exchange rate band to safeguard international reserves; and strengthening the energy sector. Progress was made in some areas despite adverse external conditions, but large deviations in monetary and exchange rate policies increased vulnerabilities. As a result, the first review was not concluded and agreement on a medium-term policy strategy that could be supported by a PRGF arrangement could not be reached.

- ***Fiscal policy was broadly in line with the program even though demands from pressure groups continued to be accommodated***. The overall deficit target was missed by a small margin (0.2 percent of GDP), but the central government's wage bill and anti-poverty spending were in line with the program. At the general government level, however, the wage bill reached 11¾ percent of GDP (72 percent of tax revenue). While the government phased out fuel subsidies and improved the targeting of electricity subsidies, implementation delays and high world oil prices caused overruns in total subsidies, which were accommodated by lower investment. The largest slippages were in net lending by the public pension institutes, mostly as a result of pressure from the teachers' union.

- ***The finances of the public electricity company (ENEE) were strengthened***. In 2008, average electricity tariffs were adjusted by 30 percent (more than envisaged under the program), and subsidies were better targeted to the poor. By mid-2008, arrears of ENEE with private generators (1.6 percent of GDP) were eliminated, helping reduce the exposure of the financial system to the energy sector. However, arrears with generators reemerged in late 2008 due to cash flow problems associated with unpaid customer bills and delayed reimbursement of electricity subsidies by the central government.

- ***Monetary policy remained expansionary***. While the central bank increased its policy interest rate by 150 basis points to 9 percent in the first semester of 2008, interest rates remained negative in real terms. In the third quarter, the central bank tried to offset the contractionary effects of the food/fuel price shock by easing monetary conditions, and relaxed monetary conditions further with the onset of the global financial crisis in late 2008. As a result, program targets on net international reserves and net domestic assets were missed by large margins.

An expansionary monetary policy and a fixed exchange rate led to large deviations from the program targets



- ***The exchange rate remained fixed***. Aside from a brief attempt to let the lempira move within a narrow band, the central bank continued to accommodate in full the demand for foreign exchange and kept the exchange rate pegged at the most appreciated edge of the band.

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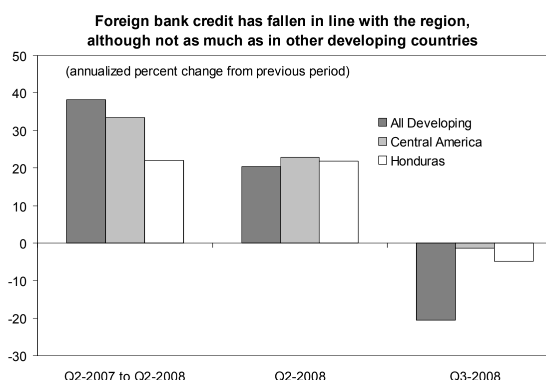
14 percent by August and slowing to 8.8 percent by March 2009 (close to the mid-point of the official inflation target of 8–10 percent); at the same time, core inflation has continued to show an upward trend and reached 9.2 percent by March.

- ***External position***. The external current account deficit reached 14 percent of GDP (up from 10 percent in 2007) largely due to higher oil prices (the oil import bill was 3 percent of GDP higher than in 2007). However, non-oil imports continued to grow and exports slowed down. Although net capital inflows increased significantly, they were insufficient to cover the current account deficit and international reserves fell by US$173 million. Reserves stabilized in the first three months of 2009, partly due to external disbursements and seasonal factors. The real exchange rate has appreciated by close to 20 percent since the exchange rate was de facto pegged in October 2005; staff analysis suggests that, by end-2008, the lempira could be overvalued by some 10–15 percent (Appendix I).

- ***Financial system***. Signs that the financial system was under some stress became apparent in 2008 as economic activity and bank credit growth slowed (Figure 5). The banking system's negligible exposure to "toxic" foreign assets and weak linkages to international financial markets lessened the direct impact of the global financial crisis on banks' balance sheets. Nonetheless, banks have started to increase their liquidity buffers in response to rising costs of foreign credit lines and lower availability of external credit. More recently, banks have become increasingly cautious in extending loans, bringing private sector credit growth to a near halt.



4. ***Honduras' relatively high level of international reserves has helped mask the costs of the de facto peg***. The fixed exchange rate in place since late 2005 has helped anchor inflation expectations, but has entailed significant costs. These include: (i) increasing external vulnerabilities (with reserve coverage declining since 2006 and converging to the regional average); (ii) keeping transactions costs high for banks, exporters, and importers, and; (iii) limiting the scope for countercyclical policies (Box 2).

5. ***The economic slowdown may create further strains in the financial system***. The 2009 Financial System Stability Assessment (FSSA) found that the Honduras' banking system has strengthened since the 2003 FSAP, but that significant challenges remain. In particular, financial soundness indicators understate vulnerabilities, and stress tests show

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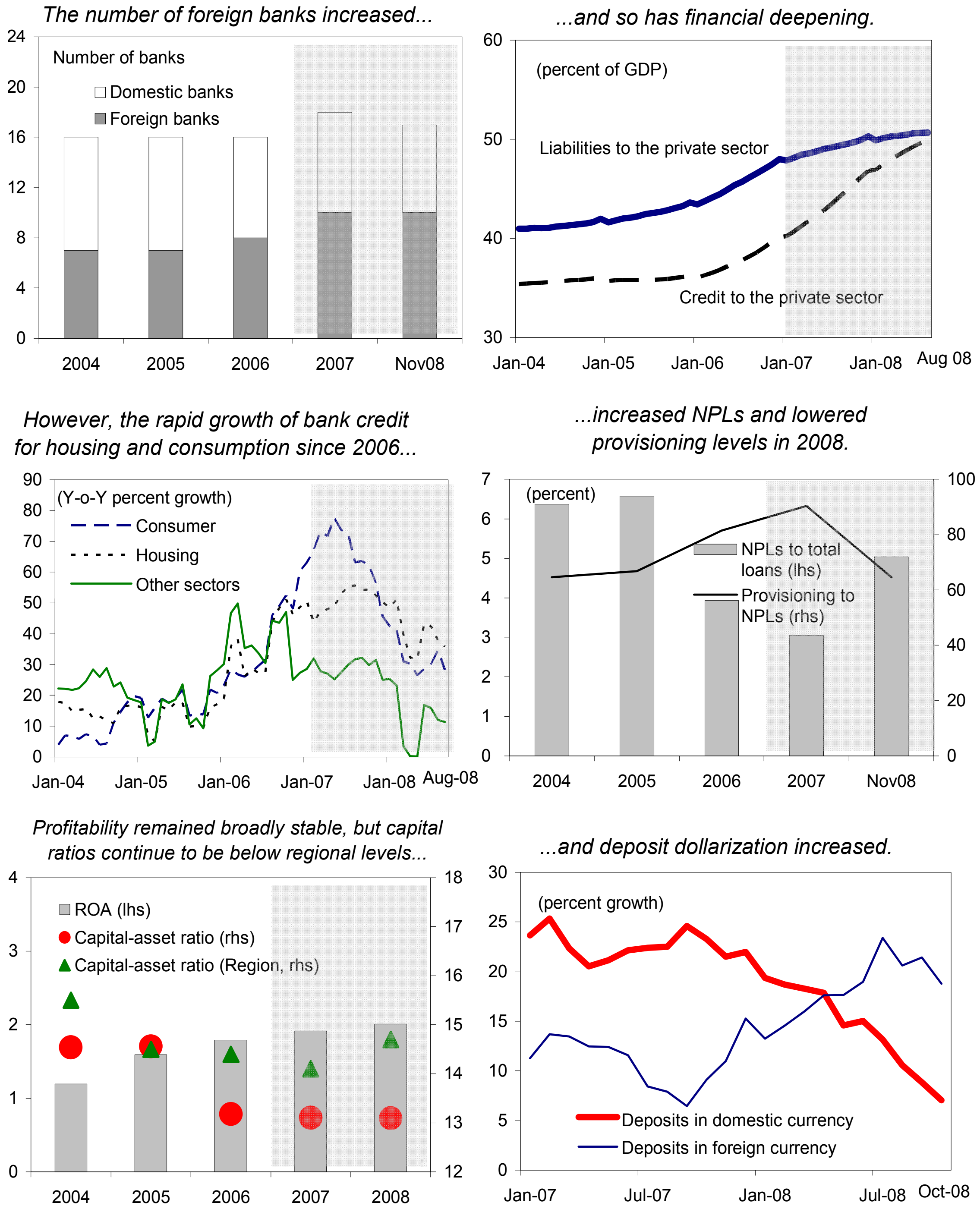
Figure 5. Honduras: Financial Sector Developments

Financial system indicators began to weaken in 2008, as credit growth eased.



Sources: Comisión Nacional de Bancos y Seguros; Banco Central de Honduras; and Fund staff estimates.

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Box 2. Exchange Rate Regime Options

In May 2008, at the request of the authorities, a Fund technical assistance mission assessed Honduras' foreign exchange rate regime and options for alternative arrangements. The MCM mission noted that despite some advantages, the *de facto* fixed exchange rate regime had imposed significant costs on the economy. While the mission was in the field, the authorities adopted a new operational rule allowing for a very narrow band and a maximum depreciation of 0.4 percent per month. The mission noted that this arrangement would be challenging to manage and unsustainable over time. In particular, it noted that policy inconsistencies were likely to arise among inflation, international reserves and exchange rate objectives, and the arrangement could lead to inflation inertia and/or overvaluation if the parameters of the band were not set appropriately.

The first option examined implied taking fuller advantage of the de jure crawling band presently in place. The mission noted that such an arrangement could help maintain a partial anchoring role for the exchange rate, stabilize inflation, and absorb short-term shocks. However, the mission also noted that the relatively narrow range of the band could create the presumption that exchange rate risks are lower than they really are, and give rise to inconsistencies between exchange rate and inflation objectives.

As a second option, the mission explored the possibility of pegging to a basket of currencies. It noted that this type of arrangement could help moderate the impact of movements in bilateral exchange rates, helping support price stability and maintain external competitiveness. However, the mission stressed that pegging to a basket presents many challenges, including choosing the appropriate basket composition.

The third option was a managed float. The mission noted that a number of preconditions had to be in place to adopt this option, including: developing liquid foreign exchange and money markets; developing a framework for effective conduct of monetary policy; and fostering foreign exchange risk management capacity. The mission underlined that this type of arrangement, although challenging, could present a more durable option for Honduras than the other alternatives.

that solvency ratios would be insufficient to withstand potential credit losses stemming from a slow down in growth, an abrupt exchange rate depreciation or a sharp rise in interest rates.[2] The report also raised questions about the quality of banks' credit policies during the period of rapid growth, particularly for consumption and housing.

Stress tests indicate that the financial system is vulnerable to credit risk

	Initial CAR	Average Drop in CAR	Average CAR after shock	Number of Banks with CAR below 10 percent	Percent of System assets
	(In percent)				
Credit Risk:					
Scenario I	14.0	-5.6	8.4	9	80.1
Scenario II	14.0	-7.3	6.6	9	80.1

Sources: CNBS and Fund staff calculations.

[2] The stress tests undertaken by the FSAP were updated during the 2009 Article IV mission using data through December 2008. Scenario I simulates a crisis that replicates the path of selected macro variables in the aftermath of Hurricane Mitch. Scenario II simulates a crisis led by a protracted deterioration in global financial markets, with induced effects on global growth and commodity prices (see Honduras—Financial Stability Assessment, SM/09/21 (1/23/09).

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6. ***The upcoming presidential election in November 2009 poses additional challenges***. The authorities' response to lower oil prices and the global slowdown has been to further relax macroeconomic policies. The central bank has continued to ease monetary policy (Box 3) while domestic demand is being further supported by the decision to pass through fully the decline in world oil prices, reduce electricity tariffs, and raise the minimum wage by 42 percent, on average. Discussions with the main Presidential candidates on a policy agenda for the last year of the current administration that could facilitate consensus on macroeconomic policies have not started; more recently, the President has called for a referendum to amend the constitution, with the specifics still to be disclosed.

Box 3. Honduras: The Recent Easing of Monetary Policy

A slowdown in deposit and credit growth and a decline in banks holdings of open market bills prompted the central bank to relax monetary conditions in late 2008 to support economic activity. Private credit has not rebounded yet following these measures, largely due to a sharply lower demand, but the risk of an additional drain on international reserves has increased. The monetary measures adopted include:

- Lowering the policy interest rate (TPM) by a total of 325 bps (to 5¾ percent) and the rate on open-market bills by up to 600 bps (to 3.9 percent) in the first quarter of 2009. This reduction in rates more than offsets the monetary tightening of the first half of 2008.
- Lowering the spread between the interest rate on the central bank's credit facility and the TPM from 300 bps to 25 bps. In addition, to discourage banks from parking liquid deposits at the central bank, the interest rate on the central bank's deposit facility was lowered to zero (from 5 percent in October 2008).
- Eliminating reserve requirements in local currency for banks directing at least 60 percent (previously, 80 percent) of their loans to "productive" sectors (earlier in 2008, the requirement had been lowered in steps from 12 to 5 percent of local currency deposits).
- Unifying the liquidity requirements on foreign currency deposits at 8 percent in late March. While the requirement had been lowered in steps (from 22 percent in early 2008 to 9 percent in October) for banks directing at least 60 percent of their loans to productive sectors, it had remained at 24 percent for the other banks. The bulk of the liquidity requirements (6 percent of foreign currency deposits) will be transferred to the central bank in monthly steps during April-June 2009.
- Setting up a credit line (for six months) to facilitate loans for low-and middle-income housing. Banks can provide loans for these purposes for up to one-half of banks' capital (US$105 million, equivalent to 4.8 percent of the monetary base).

In December 2008 congress approved a law allowing the central bank to extend credit: (i) for up to US$500 million (12.1 percent of the monetary base) to a state-owned bank during 2009–10 to subsidize new lending to housing, agriculture and small firms, and (ii) for up to US$100 million (2.4 percent of the monetary base) to the central government over the next six months, which contravenes the stipulations of the central bank law that was last amended in 2004.

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II. Report on the Discussions

A. Outlook for 2009 and the Medium-Term

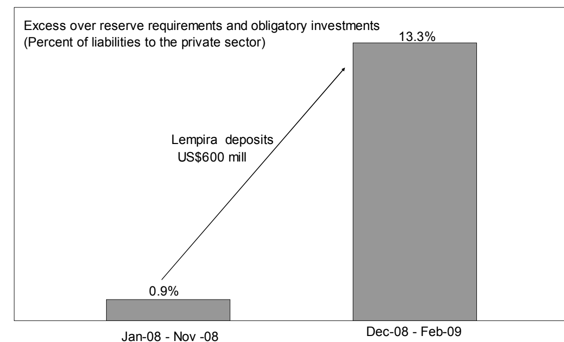
Net capital inflows in 2009 are projected to be significantly lower

	2006	2007	2008	2009
	(in millions of US$)			
Current Account	-404	-1274	-1978	-1326
Capital and Financial Account	1013	1187	1677	1038
Overall Balance	349	-158	-195	-288
	(in percent of GDP)			
Current Account	-3.7	-10.3	-14.0	-8.0
Capital and Financial Account	9.3	9.6	11.9	6.3
Overall Balance	3.2	-1.3	-1.4	-1.7

Source: BCH and Fund staff estimates.

7. ***The mission noted that the global crisis will have a large negative effect on the 2009 outlook for Honduras***. It noted that output growth was likely to slow further, as a result of the ongoing weakening of exports, remittances, and private investment. While lower oil prices would help reduce the external current account deficit, that effect is likely to be offset by substantially lower net capital inflows (foreign direct investment and private borrowing). The mission presented a baseline scenario (under current policies), where output growth would slow to at least 1½ percent, the external current account deficit would fall to 8 percent of GDP (down from 14 percent in 2008), and the deficit in the balance of payments would be close to US$300 million.

The recent easing of monetary policy could put pressure on international reserves



8. ***Staff emphasized that external and domestic headwinds created large downside risks***. Although the baseline scenario assumes a significant decline in exports (10½ percent), remittances (7½ percent) and FDI (32 percent) compared to 2008, the mission stressed that risks were tilted to the downside. On the domestic front, staff argued that: (i) the large minimum wage increase of early 2009 could put pressure on wages and prices, reduce employment, and erode competitiveness; (ii) the excess liquidity held by banks could put sudden pressures on international reserves if banks decided to increase their holdings of foreign assets; (iii) the decline in fiscal revenues could be larger than projected and spending pressures could intensify; and (iv) lower growth could weaken the indicators of banking soundness and related vulnerabilities. More generally, staff stressed that maintaining an expansionary policy stance in an adverse global environment would continue to put pressures on international reserves, which could weaken private sector confidence and increase external vulnerabilities.

9. ***The mission indicated that, without a policy correction, Honduras medium-term outlook may become unsustainable***. The baseline scenario illustrates that maintaining a lax monetary policy, a fixed exchange rate and a somewhat looser fiscal stance would be inconsistent with an external current account deficit lower than 8–9 percent of GDP over the medium term, or with a strong pick up in capital inflows. In that scenario, net international reserves could reach critically low levels by 2010–11, risking an external crisis, with attendant consequences for growth and poverty reduction. The scenario also showed that

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reforms of the public pension funds and public enterprises would be necessary to avoid a steady deterioration in the overall public sector balance. Moreover, maintaining relatively low deficits would not be enough to prevent a further deterioration in the composition of public spending unless underlying structural issues are addressed.

On current policies the external position may become unsustainable

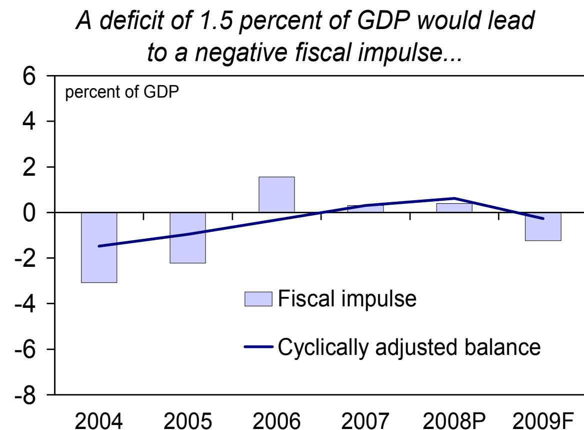
	2005	2006	2007	Est. 2008	Projection 2009	2010	2011
				(annual percentage change)			
Macroeconomic parameters							
Real GDP	6.1	6.6	6.3	4.0	1.5	1.9	2.2
CPI inflation (eop)	7.7	5.3	8.9	10.8	9.4	8.1	6.3
				(in percent of GDP, unless otherwise indicated)			
Budget and public debt							
Overall public sector balance	-1.4	-1.9	-1.6	-1.7	-2.5	-2.1	-2.1
Overall central government balance	-2.3	-1.1	-2.9	-2.4	-2.8	-2.9	-2.9
Public sector debt	46.3	31.7	19.6	19.1	20.4	22.1	23.5
External sector							
External current account balance	-3.0	-3.7	-10.3	-14.0	-8.0	-9.2	-9.3
Gross international reserves (US$ millions)	2,502	2,798	2,705	2,692	2,401	1,779	1,111
(in months of non-maquila imports)	4.8	4.3	3.4	4.0	3.3	2.3	1.3
Net international reserves (US$ millions)	1,975	2,405	2,282	2,109	1,820	1,195	527

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

B. Key Macroeconomic Policies and Objectives for 2009

10. ***The authorities and the mission agreed that the priority for economic policy should be to preserve macroeconomic stability and lay the foundations for sustained growth***. The mission indicated that strong macroeconomic policies were essential to avoid further losses of net international reserves and reduce the risks of disorderly balance of payments adjustments. The mission stressed that a fixed exchange rate system limited the scope for countercyclical policies given the need to protect the balance of payments position and recommended for 2009 a policy mix encompassing a combined public sector deficit of 1½ percent of GDP and a significant strengthening of monetary policy. The authorities indicated their intention to maintain the exchange rate fixed while continuing to gear macroeconomic policies to support domestic demand in order to mitigate the impact of the global crisis and keep real GDP growing at 2–3 percent. The authorities regarded these policies (which constitute the pillars of their "anti-crisis" plan) as consistent with a small balance of payments surplus in 2009, since they envisage that lower oil prices would reduce the external current account deficit while net capital flows will remain broadly unchanged from 2008 levels.

A deficit of 1.5 percent of GDP would lead to a negative fiscal impulse...



11. ***The draft budget for 2009 discussed during the mission envisaged a combined public sector deficit of 2½ percent of GDP*** (0.8 percentage points higher than in 2008). Staff highlighted the risk that the draft budget could lead to a further deterioration in the composition of public expenditure, limiting the desired effect on growth, and

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to a permanent weakening of the fiscal position. Staff recommended maintenance of the fiscal deficit at about 1½ percent of GDP, stressing that the fiscal space from lower oil prices (about 2 percent of GDP) provided ample room to accommodate automatic stabilizers and support domestic demand through higher public investment. The mission underscored that the weak balance of payment position left little scope for a fiscal expansion. The authorities have recently indicated that they are considering to incorporate these recommendations in the draft budget to be submitted to congress in late April. In particular, they will seek to set a fiscal deficit target of 1½ percent of GDP by limiting the increases in the wage bill and reducing non-priority current expenditures, while strengthening the social and financial safety nets.

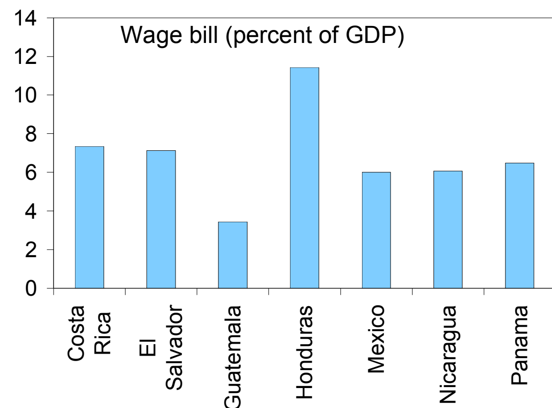
..but there is ample room to boost investment if additional resources are not used to increase current expenditures

	2008	2009 1/	absolute difference
	(in percent of GDP)		
Additional resources			**3.0**
Operating Balance of Public Enterprises	0.5	1.5	0.9
Fuel and electricity subsidies	1.4	0.2	1.2
Financing	1.7	2.5	0.9
Use of additional resources			**3.0**
Tax revenue	16.2	15.6	0.6
Wages and salaries	11.7	12.0	0.4
Goods and services, other current expenditure	4.9	5.5	0.6
Capital expenditure	5.5	5.8	0.3
Net interest and central bank losses	0.7	-0.4	1.1

Sources: Honduran Authorities and Fund staff estimates.
1/ Authorities projection.

12. ***Improving revenue administration and reallocating spending to priority sectors would help support growth***. The authorities noted that they intend to implement some elements of a draft anti-evasion law through budgetary norms to arrest the erosion of tax revenue. The mission welcomed this move but recommended to seek congressional approval of the entire draft law and to reduce tax exemptions; it also cautioned against a planned tax amnesty, stressing that it would undermine tax compliance and compromise revenues. The mission welcomed the authorities' intention to adjust electricity tariffs in line with costs to avoid an increase in subsidies and to keep wage increases in line with projected inflation. At the same time, staff noted that the recent large increase in the minimum wage, and the planned rise in public sector employment would make it difficult to stabilize the government wage bill as a share of GDP in 2009 and beyond. The mission encouraged the authorities to secure the necessary consensus to continue strengthening tax compliance, contain the growth of current government spending and exercise firm control over net lending of pension funds to create space to increase priority spending (including investment) by at least 1 percentage point of GDP in 2009.

The wage bill is among the highest in the region and pressures are mounting.



13. ***A tighter monetary policy stance is necessary to safeguard Honduras' external position, contain inflationary pressures, and reduce downside risks***. With banks holding large excess liquidity, the mission indicated that there was ample room to strengthen monetary policy without risks of crowding out. In particular, staff recommended increasing

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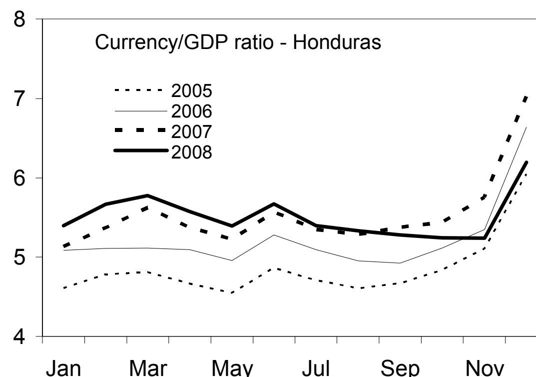
the policy interest rate in line with targeted inflation (8–10 percent) to allow an active use of open-market bills and to start undoing the recent reductions in reserve requirements. The authorities did not see a strong case for raising interest rates or reserve requirements, noting that monetary policy had to remain geared at supporting credit and domestic demand, even if this implied some losses of international reserves.

A further weakening in the demand for currency could lead to additional reserve losses



14. ***The mission argued that a more flexible exchange rate would help protect the external position and relief the burden from monetary policy***. Staff noted that the large real exchange rate appreciation observed under the *de facto* peg had been largely the result of the high price and wage inflation differential between Honduras and its trading partners, and argued that further losses in competitiveness would maintain the pressures on reserves and raise the risk of a disorderly balance of payments adjustment. The mission noted that the earlier recommendation of letting the exchange rate band crawl in line with inflation differentials (as was done during 2000–04), and allowing greater flexibility within the band in the short term, remained appropriate. Moreover, it argued that, if supported by the fiscal and monetary policies being recommended, the impact of increased exchange rate flexibility on inflation and financial stability was likely to be relatively small.[3] The authorities considered that any exchange rate movement would be inflationary and counterproductive in an electoral year, and remained skeptical about the benefits of higher exchange rate flexibility on competitiveness and the external position.

15. ***The effects of the policies recommended by staff can be illustrated with the help of an alternative scenario***. Boosted by investment and exports, real GDP growth would gradually reach 4 percent over the medium term, in line with Honduras' long-term trends.

The economic policies recommended by the mission would help protect the external position

		Est.	Projection					
	2007	2008	2009	2010	2011	2012	2013	2014
			(annual percentage change)					
Macroeconomic parameters								
Real GDP	6.3	4.0	1.6	2.8	3.6	4.0	4.1	4.1
CPI Inflation (eop)	8.9	10.8	7.8	6.2	5.6	5.5	5.5	5.5
			(in percent of GDP, unless otherwise indicated)					
Budget and public debt								
Overall public sector balance	-1.6	-1.7	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5
Overall central government balance	-2.9	-2.4	-2.6	-2.5	-2.2	-2.0	-1.9	-1.9
Public sector debt	19.6	19.1	18.8	19.7	20.5	21.1	21.3	21.6
External sector								
External current account balance	-10.3	-14.0	-6.4	-6.9	-7.0	-7.1	-6.0	-5.6
Gross international reserves (US$ millions)	2,705	2,692	2,755	2,834	2,997	3,254	3,697	4,256
(in months of non-maquila imports)	3.4	4.0	3.9	3.7	3.7	3.7	4.0	4.3
Net international reserves (US$ millions)	2,282	2,109	2,172	2,249	2,412	2,683	3,099	3,658

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

[3] Staff's estimates of the pass-through coefficients are about 0.1 in the short-term and 0.4–0.5 in the long-run. Staff also estimates that a 200 basis point increase in interest rates on domestic currency loans, accompanied by a 100 basis point increase in interest rates on foreign currency loans, and an exchange rate depreciation of 5 percent would reduce banks' capital adequacy ratio from 14 percent to about 13 percent.

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The scenario also showed that a strengthening of monetary policy, supported by exchange rate flexibility and a fiscal deficit remaining stable at around 1½ percent of GDP, would be consistent with an external current account deficit below 6 percent of GDP, a strong pick up in capital flows, and an increase in international reserves over the medium term.

C. Increasing the Resilience of the Financial System

16. ***The authorities and staff agreed that, despite recent progress, financial sector vulnerabilities remained***. The rapid entry of foreign banks since 2005 has put pressure on profitability and could lead to further consolidation as economic activity slows down. Deposit and credit dollarization (at about 30 percent) are relatively high, and there are signs of an incipient process of currency substitution outside the banking system. Moreover, many banks have increased their exposure in U.S. dollars to domestic households and real estate, while net international reserves coverage of broad money (M2), although still comfortable at 37 percent, has fallen since 2006.

17. ***An active prudential policy would help reduce the credit risks associated with a growth slowdown***. A norm issued in March 2008 increases mandatory provisions, but compliance with the norm is weak and banks are delaying the build up of provisions. In line with the conclusions of the FSSA, and recent technical assistance on banking supervision, there was agreement that efforts in the short-run should focus on:

- ***Enhancing the monitoring of bank liquidity and crisis preparedness***, including by identifying corrective measures and preparing contingency plans for bank failures and other systemic risks, and enhancing the role of the Early Warning Committee through increased cooperation with the central bank; and

- ***Improving the implementation of risk-based supervision while raising the provisioning coverage of non performing loans***, including by enforcing existing prudential rules through the issuance of a sanctions regulation and enhancing training and recruitment; improving data audits and information systems to better detect credit risks; and implement enhanced AML/CFT supervision consistent with risk-based supervision.

18. ***More generally, staff noted that, despite notable improvements since the 2003 FSAP, increasing the resilience of the financial system required additional reforms***. These include:

- ***Strengthening risk management*** by encouraging banks to stress test their portfolios, adjust provisioning of new loans to capture credit risk, prepare risk profiles to adequately manage risks, and assess the level of indebtedness of all borrowers.

- ***Improving the financial safety net***, by replenishing the resources of the deposit guarantee fund (FOSEDE) and establishing a capitalization fund to support purchase and recovery transactions in the context of bank resolutions.

- ***Strengthening the regulatory framework***, by broadening the perimeter of regulation to capture all systemic risks, adopting measures to address the procyclicality of

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banking indicators, and continue strengthening the cross-border and consolidated supervision of regional banking groups.

- ***Strengthening institutions***, by improving the governance and supervision of the public pension system, and modernizing the funds' investment policies. In addition, the management and the board of directors of pension funds, the superintendence of banks, and the central bank should be less subject to political interference.

D. Medium-Term Policies and Reforms

19. ***The mission discussed with the government and the two main presidential candidates the policies and reforms that would help promote sustainable growth and reduce poverty***. Staff informed the candidates that there had been little progress in updating the poverty reduction strategy during 2008 and stressed that the structural reform priorities that had been identified in the last PRGF arrangement with the Fund (in 2004) remained relevant, especially those related to strengthening governance and the independence of institutions.

20. ***Staff emphasized that a strengthened macroeconomic policy framework was necessary to lay the foundations for sustained growth***. The mission argued that:

- **The main goal of fiscal policy should be to improve the quality of spending and safeguard fiscal sustainability by keeping deficits at around 1½ percent of GDP**. To attain this goal it would be necessary to consolidate improvements in revenue administration; make further progress in energy sector reforms; contain the public sector wage bill and launch a civil service reform; and restore the financial viability of the public pension institutes. Adopting these reforms within a medium-term expenditure framework would help address critical infrastructure and anti-poverty spending needs.

- **Monetary and exchange rate policies should be geared at keeping inflation low and maintaining external stability**. Staff stressed the importance of continuing to develop indirect instruments for monetary policy, restoring reserve requirements that are simple and uniform, recapitalizing the central bank to improve its ability to control liquidity, and over the medium term allowing greater exchange rate flexibility than the one allowed by the present *de jure* system. Staff argued that a gradual move toward a flexible exchange rate arrangement would help maintain a role for the exchange rate as a nominal anchor and improve the economy's resilience to shocks.

21. ***The significant debt relief obtained during 2005–2007 has allowed Honduras to maintain public debt low and on a sustainable path***. The accompanying debt sustainability analysis (SM/09/92, Sup. 1) shows that with strengthened policies starting in 2010, public debt would remain sustainable over the medium term, with a present value (PV) of public debt-to-GDP below 20 percent. However, large adverse shocks (exogenous or policy related) would weaken public sector debt dynamics. While the sensitivity analysis shows that public sector indicators remain fairly robust to many stress tests, shocks that bring the primary fiscal deficit to levels similar to those envisaged in the 2009 draft budget, or that

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result in a permanent decline in real GDP growth, would place the PV of public-debt-to-GDP on an upward trend.[4]

III. Staff Appraisal

22. ***Since the last Article IV consultation, significant macroeconomic imbalances have arisen in Honduras***. While economic growth continued to be robust, performance weakened during 2008 reflecting the impact of external shocks and an expansionary monetary policy in a *de facto* fixed exchange rate system. Economic activity slowed, inflation reached double digits, the current account widened to 14 percent of GDP, and international reserves declined. In addition, external competitiveness has deteriorated and financial soundness indicators have weakened, partly as a result of rapid credit expansion.

23. ***The macroeconomic policies agreed in the context of the SBA approved in March 2008 were not fully adopted***. While the overall fiscal deficit target was missed only by a small margin, the envisaged reallocation of spending towards investment did not take place, owing to higher oil-related subsidies, increases in the public sector wage bill, and lack of control over net lending by public pension funds. Significant increases of fuel prices and electricity tariffs in early 2008 helped reduce untargeted subsidies and strengthen the finances of the state electricity company. However, large slippages in monetary and exchange rate policies accentuated pressures on the balance of payments, and kept the SBA off-track.

24. ***With external and domestic headwinds tilting risks to the outlook heavily to the downside, it would be advisable to strengthen macroeconomic policies***. While lower oil prices will help reduce the external current account deficit, this effect is likely to be more than offset by substantially lower net capital flows. Given this risk, a main goal of economic policy in 2009 should be to avoid further losses of international reserves and reduce the risks of disorderly adjustments in the balance of payments, which are harmful for growth. A comprehensive strategy that keeps the fiscal deficit at about 1½ percent of GDP, strengthens monetary policy significantly, and increases the resilience of the banking system would be most effective to attain those objectives. Increased exchange rate flexibility would also contribute to those objectives, including by relieving some of the pressures from monetary policy.

25. ***An overall fiscal deficit of about 1½ percent of GDP in 2009 would help protect the external position and lower the risk of a permanent increase in government spending***. This deficit target would also help maintain external and public debt ratios low and resilient to shocks over the medium term. Improving revenue administration and reallocating spending to priority sectors, particularly investment, will be key to support growth over the

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[4] The main scenario for the DSA assumes that economic policies are strengthened in 2010 in order to avoid making specific assumptions about the path that key macro variables would follow if the present macroeconomic policy stance leads to a disorderly adjustment in the balance of payments. The scenario also assumes continued implementation of the government's strategy to develop government securities and establish a benchmark yield curve to develop local capital markets.

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medium term. To this end, it would be important to adopt the anti-evasion law and continue enhancing tax compliance, control net lending of pension funds, and resist pressures to increase primary current expenditures (especially wages) and reduce electricity tariffs further.

26. ***A strengthened monetary policy framework is critical to contain inflationary pressures and reduce downside risks***. With banks holding large excess liquidity, there is ample room to strengthen monetary policy without risks of crowding out. Staff recommends gradually increasing interest rates in line with inflation objectives and start undoing recent reductions in reserve requirements. Greater exchange rate flexibility would also contribute to protect the external position and avoid further erosion in competitiveness.

27. ***The rapid expansion of credit of previous years will pose major challenges to the financial sector***. Swift implementation of the recommendations of the FSSA update will be key to mitigate the credit risks associated with the projected growth slowdown and avoid a sharp deterioration in financial soundness indicators. In the short-term, it is essential to enhance the monitoring of banks' liquidity and crisis preparedness, improve the implementation of risk-based supervision, and increase provisions. There is also a need to strengthen risk management, the financial safety net, and the regulatory framework.

28. ***A broad policy dialogue ahead of the presidential elections to build consensus around key macro policies would be helpful***. Basic agreement on policies to preserve macroeconomic stability and lay the foundations for sustained growth would reduce risks of disorderly adjustments during the electoral period. On medium term issues, priority should be given to strengthening governance and institutions, as well as to gearing fiscal policy toward improving the composition of public spending while continuing to safeguard fiscal sustainability. In addition, monetary policy should be strengthened by enhancing the independence of the central bank, increasing the reliance on indirect instruments of monetary control, and moving gradually toward a flexible exchange rate regime.

29. ***It is proposed that the next Article IV consultation with Honduras takes place on the standard 12-month cycle***.

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Table 1. Honduras: Selected Economic Indicators

I. Social Indicators

Population	7.5 million	Life expectancy at birth in years (2007)	70
Per capita income in U.S. dollars (PPP, 2007)	3,620	Adult literacy (ages 15 and above, 2007)	80 percent
Rank in UNDP Development Index (2008)	117 of 179	Percent of pop. below poverty line (2007)	64
Unemployment rate (2008)	4	Gini index	55
Underemployment rate (2008)	35.2	Oil imports (2008 actual)	US$ 1.8 billion
Net FDI (as percent of GDP, 2008)	6.2	Main exports	coffee, bananas, shrimp, and maquila

II. Economic Indicators

	2004	2005	2006	2007	Prel. 2008	Proj. 2009	Proj. 2010
	(Annual percentage change, unless otherwise indicated)						
National income and prices							
GDP at constant prices	6.2	6.1	6.6	6.3	4.0	1.5	1.9
Consumer prices (end of period, eop)	9.2	7.7	5.3	8.9	10.8	9.4	8.1
Exchange rate (eop, depreciation -)							
Lempiras per U.S. dollar	-4.9	-1.2	0.0	0.0	0.0	0.0	0.0
Real effective rate	-1.4	4.2	0.7	2.3	13.6	...	...
Money and credit							
Net domestic assets 1/	-75.0	-25.7	-21.5	16.0	12.6	29.2	...
Combined public sector credit	...	22.9	...	58.9	128.6	18.5	...
Private sector credit	15.7	17.0	28.1	32.4	11.5	12.0	...
Broad money	17.6	17.4	21.6	18.2	4.8	7.3	...
Lending rate (eop, in percent)	18.2	16.8	13.8	13.4	17.6	…	...
Deposit rate (eop, in percent)	11.1	10.4	7.6	8.1	9.2	…	...
	(In percent of GDP)						
Combined public sector							
Noninterest revenue and grants	22.7	22.6	22.5	22.9	23.8	23.1	23.3
Noninterest expenditure	24.8	24.1	24.8	25.1	26.4	25.9	25.9
Primary balance	-2.1	-1.5	-2.3	-2.2	-2.6	-2.8	-2.6
Net interest payments	0.3	-0.1	-0.4	-0.6	-1.0	-0.3	-0.5
Savings	2.6	2.5	2.6	2.2	2.3	1.5	1.3
Capital expenditure	5.5	5.1	4.8	5.3	5.5	5.3	4.8
Overall balance	**-2.4**	**-1.4**	**-1.9**	**-1.6**	**-1.7**	**-2.5**	**-2.1**
External financing	3.8	1.8	1.9	1.0	2.6	1.8	0.8
Domestic financing	-1.4	-0.6	0.5	0.3	-0.9	0.7	1.2
Savings and investment							
Fixed capital formation	27.1	24.9	27.3	32.4	32.2	26.0	24.1
Gross national savings	19.3	21.9	23.6	22.1	18.2	18.0	15.0
	(In millions of U. S. dollars, unless otherwise indicated)						
Balance of payments							
Gross international reserves	2,138	2,502	2,798	2,705	2,692	2,401	1,779
(in months of imports) 2/	4.8	4.8	4.3	3.4	4.0	3.3	2.3
Change in net international reserves (increase -) 1/	-497	-352	-430	124	173	288	625
External current account balance (percent of GDP)	-7.7	-3.0	-3.7	-10.3	-14.0	-8.0	-9.2
(excluding official transfers)	-9.7	-4.6	-5.5	-11.4	-15.8	-9.2	-10.2
Exports, f.o.b. (annual percentage change) 3/	20.8	11.3	4.5	6.9	7.2	-11.7	5.3
Imports, f.o.b. (annual percentage change) 3/	22.1	12.3	11.6	20.8	17.8	-16.7	8.2
Public sector debt (in percent of GDP) 4/	61.7	46.3	31.7	19.6	19.1	20.4	22.1
Public sector external debt (in percent of GDP) 4/	59.0	44.9	27.9	16.4	15.7	15.8	15.2
Public sector external debt service (in percent of exports of goods and services) 5/	3.3	3.7	2.5	1.9	1.1	1.6	1.5

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

1/ Includes adjustments made for NIR and NDA due to Fund MDRI debt relief granted in January 2006 ($155 million).
2/ Refers to the following year's imports of nonmaquila goods and nonfactor services.
3/ Goods only.
4/ Includes medium- and long-term public and publicly guaranteed external debt after HIPC, beyond HIPC, and MDRI. All external debt is denominated in foreign currency.
5/ Debt service paid.

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Table 2. Honduras: Operations of the Central Government

(in percent of GDP)

	2004	2005	2006	2007	Prel. 2008	Proj. 2009
Total revenue and grants	**17.2**	**17.6**	**18.0**	**19.1**	**19.4**	**18.1**
Current revenue	16.4	16.4	16.5	17.5	17.4	16.6
Tax revenue	14.5	14.5	15.2	16.3	15.7	15.2
Nontax revenue	0.8	1.0	0.9	0.8	1.2	1.1
Of which: Telecommunications measures		0.0	0.0	0.0	0.6	0.5
Transfers	1.1	0.8	0.4	0.3	0.4	0.3
Capital revenue	0.1	0.1	0.0	0.0	0.0	0.0
Grants	0.8	1.1	1.5	1.6	2.0	1.5
Of which: MCC		0.0	0.4	0.1	0.3	0.2
Total expenditure	**20.2**	**19.9**	**19.2**	**22.0**	**21.8**	**21.0**
Current expenditure	15.2	15.6	16.0	18.0	17.1	17.0
Wages and salaries	8.5	8.2	8.3	9.2	9.2	9.4
Goods and services	1.8	2.4	2.5	2.9	2.6	2.9
Transfers	3.3	3.7	3.6	5.2	4.8	3.6
Of which: Electricity subsidies 1/	...	...	0.5	0.5	0.4	0.3
Of which: Direct fuel subsidies	...	...	0.3	0.5	1.0	0.0
Of which: Urban transport subsidies 2/		...	0.1	0.1	0.2	0.1
Of which: PRAF				0.2	0.2	0.2
Interest payments	1.5	1.3	1.0	0.7	0.6	0.7
External	1.1	0.9	0.7	0.4	0.3	0.2
Domestic	0.4	0.4	0.3	0.3	0.3	0.5
Other current expenditure	...	0.2	0.6	0.0	0.0	0.4
Capital expenditure	5.0	4.4	3.3	4.1	4.7	4.0
Net lending	0.0	-0.1	-0.2	-0.1	-0.1	0.0
Overall balance	**-2.9**	**-2.3**	**-1.1**	**-2.9**	**-2.4**	**-2.8**
Financing	**2.9**	**2.3**	**1.1**	**2.9**	**2.4**	**2.8**
External financing	**3.9**	**1.9**	**1.2**	**1.1**	**2.6**	**1.8**
Disbursements	4.3	2.9	1.8	1.8	2.9	2.2
Amortization	-2.4	-2.7	-1.2	-1.0	-0.5	-0.4
Exceptional financing	2.0	1.7	0.7	0.3	0.4	0.1
Change in arrears	0.0	0.0	0.0	0.0	0.0	0.0
Domestic financing	**-1.0**	**0.5**	**0.1**	**1.8**	**-0.3**	**1.0**
Financial system	-1.7	0.6	-1.3	-0.2	-0.1	0.0
Central bank	-1.5	0.8	-1.2	0.0	-0.8	0.1
Rest of the financial system	-0.2	-0.1	0.0	-0.3	0.6	-0.1
Bonds outside the financial system	0.1	0.1	0.1	0.4	1.6	0.7
Floating debt	0.6	-0.3	1.2	1.6	-2.3	0.3
Privatization / deposits abroad 3/	0.3	0.0	0.1	0.1	0.6	0.0
Statistical discrepancy 4/	0.1	0.0	-0.2	0.0	0.0	0.0
Memorandum items:						
Poverty spending (ERP)	7.0	7.7	7.0	7.7	7.7	6.8
Of which: Wages and salaries		2.7	2.9	3.0	2.9	3.1
Of which: Poverty spending net of wages		4.9	4.1	4.7	4.8	3.7
Current Primary Spending	13.7	14.3	15.0	17.3	16.5	16.3
Nominal GDP (million of Lempiras)	161,507	183,748	206,289	234,622	267,877	313,562

Sources: Honduran authorities; and Fund staff estimates.

1/ Includes Direct electricity subsidy and Bonochenta.
2/ Includes Urban transport subsidy and public transport fare stabilization subsidy.
3/ Includes proceeds of the sale of a cellular band license in 2008.
4/ For 2008 discrepancies are due to methodological differences betweeen the Ministry of Finance and the Central Bank.

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Table 3. Honduras: Operations of the Combined Public Sector

(in percent of GDP)

	2004	2005	2006	2007	Prel. 2008	Proj. 2009
Total revenue and grants	**24.2**	**24.2**	**24.1**	**24.4**	**25.5**	**24.0**
Current revenue	23.1	22.8	22.7	22.5	23.2	22.1
Tax revenue	15.3	15.2	15.5	16.3	16.2	15.5
Nontax revenue	4.2	4.1	4.4	4.1	4.7	4.3
Interest earnings	1.5	1.6	1.6	1.4	1.7	1.0
Operating balance of public enterprises	2.1	2.0	1.2	0.6	0.5	1.4
Capital revenue	0.3	0.3	0.3	0.3	0.3	0.2
Grants	0.8	1.1	1.1	1.6	2.0	1.7
Of which: MCC		0.0	0.0	0.1	0.3	0.4
Total expenditure	**26.6**	**25.6**	**26.0**	**25.9**	**27.1**	**26.6**
Current expenditure	20.5	20.3	20.0	19.9	20.9	20.7
Wages and salaries	10.9	10.6	10.8	11.3	11.7	12.0
Goods and services	2.8	3.4	3.6	3.8	3.7	4.2
Transfers	2.3	2.6	3.4	3.5	3.4	2.2
Operating losses of the central bank	0.9	0.7	0.5	0.0	0.3	0.2
Interest payments	1.7	1.5	1.2	0.8	0.7	0.7
External	1.1	0.9	0.7	0.4	0.3	0.3
Domestic	0.6	0.6	0.5	0.4	0.4	0.4
Other	1.8	1.6	0.6	0.6	1.1	1.3
Capital expenditure	5.5	5.1	4.8	5.3	5.5	5.3
Net lending	0.6	0.2	1.2	0.7	0.7	0.7
Overall balance	**-2.4**	**-1.4**	**-1.9**	**-1.6**	**-1.7**	**-2.5**
Financing	**2.4**	**1.4**	**1.9**	**1.6**	**1.7**	**2.5**
External financing	**3.8**	**1.8**	**1.9**	**1.0**	**2.6**	**1.8**
Disbursements	4.5	3.0	1.8	1.8	2.9	2.2
Amortization		-2.8	-0.5	-1.1	-0.6	-0.4
Exceptional financing	2.0	1.7	0.7	0.3	0.4	0.1
Change in arrears	0.0	0.0	0.0	0.0	0.0	0.0
Domestic financing	**-1.4**	**-0.6**	**0.5**	**0.3**	**-0.9**	**0.7**
Financial system	-1.3	-0.1	-0.1	-0.3	-0.1	0.8
Central bank	-1.3	0.3	-0.2	0.9	0.2	0.0
Net credit to the NFPS	-2.3	-0.4	-0.6	0.9	0.0	-0.3
Operating balance of the central bank	0.9	0.7	0.5	0.0	0.3	0.2
Rest of the financial system	0.0	-0.4	0.1	-1.2	-0.4	0.8
Bonds outside the financial system	0.0	0.2	0.2	0.1	0.2	0.3
Floating debt	0.4	-0.3	0.2	0.5	-2.0	-0.3
Privatization proceeds / deposits abroad 1/	-0.4	-0.4	0.3	0.0	1.1	0.0
Statistical discrepancy 2/	0.0	0.2	-0.5	-0.3	-0.1	0.0
Memorandum items:						
Arrears of ENEE with private generators, eop stock		...	...	1.6	0.0	0.0
Nominal GDP (million of Lempiras)	161,507	183,748	206,289	234,622	267,877	313,562

Sources: Honduran authorities; and Fund staff estimates.

1/ Includes proceeds of the sale of a cellular band license in 2008.

2/ For 2008 discrepancies are due to methodological differences betweeen the Ministry of Finance and the Central Bank.

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Table 4. Honduras: Summary Accounts of Central Bank and Financial System

	2005	2006	2007	Prel. 2008	Proj. 2009
			(in millions of Lempiras)		
			I. Central Bank		
Net International Reserves 1/	**37,326**	**45,447**	**43,110**	**39,844**	**34,393**
(in millions US$)	1,975	2,405	2,282	2,109	1,820
Accumulation over the year	352	430	-124	-173	-288
Net Domestic Assets	**-26,213**	**-31,854**	**-26,748**	**-23,376**	**-16,542**
Credit to the public sector (net)	-1,429	-5,137	-2,111	604	492
of which: operating losses of the BCH	6,008	6,947	6,888	7,602	8,302
Other depository institutions (net)	-17,634	-20,055	-19,161	-19,106	-15,415
Other financial institutions	-2,612	-3,531	-2,339	-2,019	1,581
Nonfinancial private sector	-2,286	-1,848	-1,055	-472	-389
Medium and long-term net foreign liabilities	657	825	699	604	375
Other items net 2/	-2,909	-2,107	-2,781	-2,986	-3,186
Currency	**11,113**	**13,593**	**16,363**	**16,468**	**17,852**
			II. Other Depository Institutions		
Net Foreign Assets	**4,757**	**2,040**	**328**	**1,213**	**4,047**
(in millions US$)	252	108	17	64	214
Foreign assets (in million of US$)	731	717	767	813	813
Foreign liabilities (in millions of US$)	-479	-609	-750	-749	-599
Net Domestic Assets	**74,328**	**95,508**	**116,971**	**123,552**	**129,750**
Credit to the combined public sector	-1,379	-1,210	-3,324	-2,789	-298
Credit to the private sector	70,696	91,048	120,815	134,807	150,984
Credit to financial corporations (net)	19,265	23,790	22,780	21,299	12,874
Credit to the monetary authorities (net)	22,693	26,410	27,235	28,220	24,284
Cash in vault	2,209	3,150	4,457	4,612	4,999
Reserves in BCH	8,968	10,453	14,120	18,494	18,119
Obligatory investments	0	0	2,255	6,829	7,360
Letras BCH	11,502	12,807	8,658	5,114	1,166
Credit to other Financial institutions (net)	-3,427	-2,620	-4,454	-6,921	-11,410
Other items net 2/	-14,254	-18,120	-23,301	-29,765	-33,810
Liabilities	**79,085**	**97,547**	**117,299**	**124,765**	**133,797**
Deposits in national currency	54,249	68,782	84,032	87,595	94,407
Deposits in foreign Currency	24,118	28,091	32,523	35,989	38,209
			III. Financial System		
Net Foreign Assets	**42,741**	**48,311**	**44,137**	**41,661**	**38,856**
(in millions US$)	2,262	2,557	2,336	2,205	2,056
Foreign assets (in million of US$)	3,456	3,744	3,692	3,619	3,443
Foreign liabilities (in millions of US$)	-1,194	-1,188	-1,356	-1,414	-1,386
Net Domestic Assets	**47,904**	**61,892**	**86,162**	**94,857**	**107,564**
Credit to the combined public sector	-2,809	-6,346	-5,435	-2,185	2,083
Credit to the private sector	72,864	93,317	123,551	137,713	154,238
Other items net 2/	-22,152	-25,079	-31,954	-40,670	-48,758
Broad Money (M4)	**90,644**	**110,203**	**130,300**	**136,518**	**146,420**
			(Rate of growth 12 months)		
Currency issue	18.5	22.3	20.4	0.6	8.4
Currency in circulation	17.3	17.3	14.0	(0.4)	8.4
Broad money	17.4	21.6	18.2	4.8	7.3
Credit to the private sector	17.0	28.1	32.4	11.5	12.0
M1	14.5	23.5	15.3	2.0	7.9
Memorandum:					
			(In millions of lempiras)		
Stock of letras BCH	24,095	24,928	16,705	10,159	5,343
of which: Other Depositary Institutions	11,516	12,807	8,658	5,114	1,166
Annual operating losses of the BCH	1,289	939	-59	714	700
			(End of period stock as a percentage of GDP)		
Currency in circulation	4.8	5.1	5.1	4.4	4.1
Broad money	49.3	53.4	55.5	51.0	46.7
Liabilities of ODIs with the BCH in LC (in percent of domestic currency deposits)	30.7	27.3	22.1	21.4	15.6
Gross international reserves (as percent of M2)	74.8	66.8	53.5	50.8	44.0
Implicit reserve requirements in local currency	13.7	13.4	14.4	13.0	11.9
Credit to the private sector	39.7	45.2	52.7	51.4	49.2
Stock of letras BCH	13.1	12.1	7.1	3.8	1.7
Total deposits	42.6	47.0	49.7	46.1	42.3

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

1/ Reserve requirements on foreign-currency deposits and open-market bills denominated in foreign currency have been treated as reserve liabilities.

2/ Includes the revaluation account reflecting changes in the value of assets due to exchange rate fluctuations.

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Table 5. Honduras: Balance of Payments

(In millions of U.S. dollars; unless otherwise indicated)

				Prel.	Projection					
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Current account	**-290**	**-404**	**-1,274**	**-1,978**	**-1,326**	**-1,668**	**-1,833**	**-1,952**	**-2,034**	**-1,996**
Trade balance	-1,497	-2,027	-3,178	-4,342	-3,312	-3,739	-4,022	-4,298	-4,553	-4,776
Exports	5,048	5,277	5,642	6,046	5,339	5,623	5,973	6,312	6,657	7,032
Of which: maquila	3,150	3,168	3,223	3,345	3,005	3,153	3,331	3,489	3,627	3,770
Imports	-6,545	-7,303	-8,820	-10,389	-8,651	-9,362	-9,994	-10,610	-11,210	-11,808
Of which: maquila	-2,076	-2,084	-2,113	-2,190	-1,829	-1,936	-2,045	-2,149	-2,249	-2,353
Of which: Petroleum products	-839	-1,006	-1,211	-1,815	-861	-1,030	-1,160	-1,271	-1,358	-1,400
Services	-229	-291	-349	-305	-363	-400	-425	-441	-464	-481
Of which: Turism receipt	463	515	546	621	590	626	675	734	793	849
Income (net)	-460	-537	-399	-351	-403	-402	-468	-548	-638	-741
Of which: payments on direct investments	-479	-621	-535	-411	-550	-553	-623	-704	-797	-898
Of which: public sector interest payments	-91	-73	-46	-44	-41	-38	-35	-36	-34	-38
Current transfers (net)	1,895	2,450	2,652	3,021	2,752	2,873	3,082	3,335	3,622	4,002
Public sector 1/	158	191	142	259	202	191	198	208	218	370
Private sector	1,737	2,259	2,510	2,762	2,551	2,682	2,884	3,128	3,403	3,632
Capital account	**594**	**1,485**	**1,166**	**49**	**22**	**22**	**16**	**24**	**25**	**18**
Of which: HIPC debt relief	563	241	…	…	...	...	...	...	...	...
Of which: MDRI from IMF	...	129	...	...	...	...	...	...	...	...
Of which: MDRI from WB	...	1,081	...	...	...	...	...	...	...	...
Of which: debt relief from IADB	...	...	1,128	...	...	...	...	...	...	...
Financial account	**86**	**-472**	**21**	**1,628**	**1,016**	**1,020**	**1,149**	**1,283**	**1,401**	**1,459**
Direct investment (net)	599	669	928	875	593	741	853	981	1,128	1,148
Of which: FDI to maquila	196	185	220	212	116	145	167	192	221	225
Portfolio investments (net)	-23	-21	-25	-7	-15	-6	-6	-5	-5	-5
Other investments	-490	-1,119	-881	760	438	285	302	307	278	317
Commercial credit (net)	12	37	16	149	17	37	40	43	46	48
Currency and deposits (net)	21	67	-13	187	52	85	88	92	97	102
Public sector long-term borrowing (net)	-550	-1,317	-1,040	333	387	146	161	162	121	149
Disbursements	287	195	256	407	457	207	223	227	184	216
Amortization	-838	-1,511	-1,295	-75	-70	-61	-62	-66	-63	-67
Other medium and long-term borrowing (net)	-6	89	110	0	-2	9	5	2	5	8
Other and short-term borrowing (net)	34	4	45	91	-15	8	8	8	9	10
Errors and omissions	-152	-260	-72	105	0	0	0	0	0	0
Overall balance	**236**	**349**	**-158**	**-195**	**-288**	**-625**	**-668**	**-645**	**-608**	**-519**
Net international reserves (- increase)	**-352**	**-430**	**124**	**173**	**288**	**625**	**668**	**145**	**108**	**49**
Reserve assets	-364	-296	93	13	290	623	668	158	62	17
Reserve liabilities	12	-134	31	160	-2	2	0	-13	46	32
Of which: IMF (net)	-25	-138	1	0	-2	2	0	-13	-6	-6
IMF disbursements	15	15	0	0	0	0	0	0	0	0
MDRI	...	-155	...	...	...	...	...	...	...	...
Exceptional financing	**116**	**81**	**35**	**22**	**0**	**0**	**0**	**0**	**0**	**0**
Debt relief (excluding MDRI from IMF)	95	44	8	22	0	0	0	0	0	...
Multilateral debt relief from IMF and World Bank	...	34	27	0	...	...	...	...	...	0
Arrears (net)	21	3	0	0	0	0	0	0	0	0
Financing gap	**...**	**...**	**...**	**...**	**0**	**0**	**0**	**500**	**500**	**470**
Memorandum items:										
Terms of trade (percent change)	9.0	-0.8	-3.5	-4.0	5.6	-2.4	-2.2	-1.9	0.0	0.1
Exports of goods and services (percent change)	11.0	4.8	6.8	8.2	-10.9	5.4	6.4	6.0	5.7	5.8
Imports of goods and services (percent change)	11.9	11.6	19.4	16.5	-14.9	8.1	6.8	6.2	5.8	5.4
Import Volume (Percent change)	-6.8	2.2	9.6	-0.5	3.3	1.9	2.6	3.0	4.1	3.3
Current account (in percent of GDP)	-3.0	-3.7	-10.3	-14.0	-8.0	-9.2	-9.3	-9.2	-8.7	-8.0
Non-Oil Current Account (percent of GDP)		5.5	-0.5	-1.2	-2.8	-3.5	-3.4	-3.2	-2.9	-2.4
Gross reserves (end of period) 2/	2,502	2,798	2,705	2,692	2,401	1,779	1,111	952	890	873
In months of next year imports (excluding maquila)	4.8	4.3	3.4	4.0	3.3	2.3	1.3	1.1	1.0	0.9
Debt to GDP ratio (in percent)	44.9	27.9	16.4	15.7	15.8	15.2	14.9	16.8	18.0	19.5
Petrocaribe financing		…	…	124.084	120	…	…	…	…	…
Nominal GDP (millions of U.S. dollars)	9,714	10,879	12,374	14,126	16,537	18,201	19,715	21,303	23,323	24,809

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

1/ Includes HIPC grants from the FIDA, IDB, IMF (until 2005), and the World Bank (until June 2006).

2/ Includes foreign currency deposits of financial institutions at the central bank for reserve requirements.

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Table 6. Honduras: External Vulnerability Indicators

	2004	2005	2006	2007	Prel. 2008	Projection 2009	2010	2011
				(percent change)				
Exports of goods and services, U.S. dollars	19.2	11.0	4.8	6.8	8.2	-10.9	5.4	6.4
Imports of goods and services, U.S. dollars	20.8	11.9	11.6	19.4	16.5	-14.9	8.1	6.8
Terms of trade (deterioration -)	1.4	9.0	-0.8	-3.5	-4.0	5.6	-2.4	-2.2
Real effective exchage rate, end-of-period	-1.4	4.2	0.7	2.3	13.6	...	...	...
				(percent of GDP, unless otherwise indicated)				
Current account balance	-7.7	-3.0	-3.7	-10.3	-14.0	-8.0	-9.2	-9.3
Capital and financial account	11.3	7.0	9.3	9.6	11.9	6.3	5.7	5.9
External public debt	59.0	44.9	27.9	16.4	15.7	15.8	15.2	14.9
External public debt (in percent of exports of goods and services)	100.4	75.9	50.3	31.5	31.8	42.1	42.3	42.2
Debt service on external public debt (in percent of exports of goods and services)	3.3	3.7	2.5	1.9	1.1	1.6	1.5	1.4
Gross official reserves								
in millions of U.S. dollars	2138	2502	2798	2705	2692	2401	1779	1111
in percent of short-term external debt	296	398	457	476	439	398	294	183
in months of next year's imports 1/	4.8	4.8	4.3	3.4	4.0	3.3	2.3	1.3
NIR								
in millions of U.S. dollars	1623	1975	2405	2282	2109	1820	1195	527
in percent of short-term external debt	225	314	393	401	344	302	198	87
in months of next year's imports 1/	2.6	2.8	2.9	2.4	2.6	2.0	1.3	0.5

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

1/ Imports of goods and non-factor services excluding maquila.

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Table 7. Honduras: Structure and Performance of the Banking Sector

(In percent, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007 1/	Nov-08 2008
Total assets (in millions of lempiras) 2/	**75,118**	**89,386**	**106,020**	**126,737**	**157,941**	**191,612**	**210,841**
(In percent of GDP)	70	74	77	80	100	109	91
Number of banks	**19**	**16**	**16**	**16**	**16**	**18**	**17**
Of which							
In process of liquidation or taken over	1	0	0	0	0	0	0
Domestic	17	10	9	9	8	8	8
Foreign	2	6	7	7	8	10	9
Bank concentration							
Number of banks accounting for at least							
25 percent of total assets	2	2	2	2	2	2	2
75 percent of total assets	7	6	6	6	7	9	6
Bank rating (CAMEL)							
Number of banks (Category IV and V)	3	2	1	1	1	2	1
Share of total assets	15.3	11.2	8.2	2.1	2.6	3.5	1.8
Capital adequacy							
Regulatory capital to risk-weighted assets	12.9	13.0	14.5	14.6	13.2	12.9	13.5
Capital (net worth) to assets	8.1	7.6	8.4	8.4	8.4	8.3	9.0
Asset quality and composition							
Nonperforming loans(NPLs) to total loans 3/	11.3	8.7	6.4	6.6	3.9	3.0	5.0
NPLs net of provisions to capital	43.0	37.4	13.7	11.2	4.1	2.1	12.4
Restructured loans to regulatory capital	47.2	20.5	6.1	2.8	1.3	0.8	0.5
Provisions to total loans	4.0	3.2	3.7	3.4	3.2	2.8	3.2
Provisions to NPLs	38.7	38.2	64.6	66.8	81.5	90.4	64.5
Sectoral distribution of loans to total loans:							
Commerce	17.7	15.8	16.0	18.8	17.8	17.8	11.5
Construction and real estate	12.9	18.7	19.1	19.1	23.3	26.2	31.4
Agriculture and related sectors	11.2	7.8	7.8	5.9	5.5	4.5	5.0
Manufacturing	17.5	19.4	20.3	19.1	19.0	16.0	16.6
Consumption	13.8	13.0	13.4	13.5	15.1	16.5	16.5
Other	26.9	25.3	23.4	23.6	19.4	19.0	18.9
Profitability							
Return on assets (ROA) 4/	0.8	1.2	1.2	1.6	1.8	1.9	1.9
Return on equity (ROE)	8.2	11.8	14.9	19.0	21.7	23.1	21.2
Interest margin to total income	41.5	45.0	44.4	47.0	49.1	50.0	48.3
Personnel expenses to administrative expenses	38.0	36.7	35.4	37.3	36.0	40.8	42.9
Liquidity 5/							
Liquid assets to total assets	30.1	24.9	28.1	29.2	26.2	22.4	20.0
Liquid assets to total short-term liabilities	64.1	53.2	60.7	64.3	56.6	49.6	49.4
Dollarization							
Foreign currency in percent of total deposits	34.2	34.5	36.0	32.0	29.4	28.1	30.4
Foreign currency credit in percent of total credit	26.2	28.7	33.8	34.8	36.3	30.7	29.3

Sources: National Commission of Banking and Insurance.

1/ Preliminary.
2/ Includes contingent assets.
3/ NPLs exclude restructured loans, mostly to the agricultural sector.
4/ Assets include off-balance sheet items.
5/ Includes cash, public sector securities, and other liquid assets.

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Appendix I. Honduras—Exchange Rate Assessment[1]

This appendix discusses long-term trends and provides an assessment of Honduras' exchange rate. The assessment suggests that, as of end-2008, the lempira could be 10–15 percent more appreciated than its equilibrium level.

I. Honduras' Real Exchange Rate and Exchange Rate Regimes

1. ***Honduras' real effective exchange rate (REER) has appreciated significantly since the early 1990s*** (Figure 1). After being pegged to the U.S. dollar for more than 60 years, Honduras abandoned its fixed exchange rate system in 1990. The ensuing removal of exchange controls and the elimination of the parallel exchange rate in the context of expansionary fiscal and monetary policies led to a sharp nominal and real depreciation.[2] From its trough in October 1990 to December 2008, Honduras' REER has appreciated by 110 percent. Aside from a brief interruption during 2000–05, the appreciation has been fairly steady. By end-2008 the real value of the lempira was similar to that in early 1990, prior to the devaluation.[3]

2. ***The bulk of the real appreciation of the lempira has taken place within a crawling band system***. After letting the exchange rate float during 1992–1994, Honduras adopted a crawling band system in order to allow nominal exchange rate flexibility and safeguard external competitiveness. In particular, the *de jure* arrangement intended to allow exchange rate movements within the band (currently +/- 7 percent from a reference exchange rate) and preserve competitiveness by relating the rate of crawl to the anticipated inflation differential between Honduras and its trading partners.

3. ***Honduras' de facto exchange rate system, however, has been different from its de jure arrangement***. Since 1998 the central bank has accommodated all the demand for foreign exchange at the daily auctions. By doing this, the central bank has managed to keep the exchange rate at the most appreciated end of the band. The rate of crawl has been set following different criteria:

- During 1994–99, it was kept below the inflation differential with trading partners (resulting in a sustained real appreciation).
- During 2000–04, it was kept broadly aligned with the inflation differential (allowing a real depreciation due to the fall in the U.S. dollar).

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[1] Prepared by M. Garza and S. Maziad.

[2] For a comprehensive discussion of these episodes see EBS/93/112, SM/96/261, and SM/07/55.

[3] Guatemala is the only other country in the region where the real exchange rate exhibits a similar pattern. Since 1990, the appreciation of the real exchange rate has been more moderate in all other neighboring countries.

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- Since October 2005, the rate of crawl has been kept at zero. By end-2008, this policy has produced a real appreciation of about 20 percent, the largest in the region during this period (Figure 2).

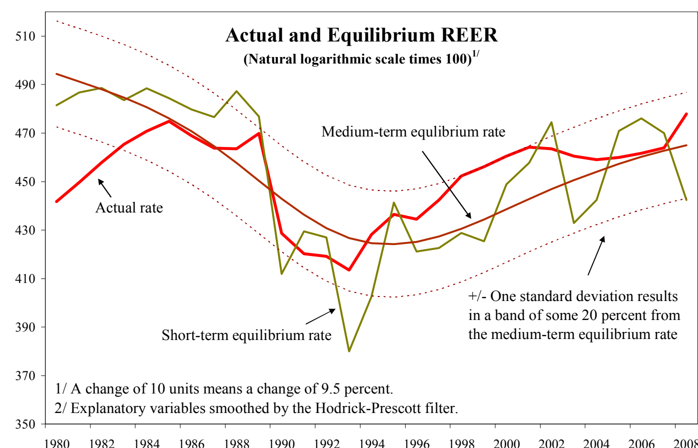
II. Assessing the Level of the Real Exchange Rate[4]

4. ***The current (end-2008) level of Honduras' REER was assessed using the three methodologies used by IMF staff to evaluate the appropriateness of exchange rates in its member countries***. The methodologies consist of: (i) the equilibrium real exchange rate **(ERER)** approach, which calculates the gap between the actual REER and the equilibrium rate that is obtained from an equation that relates the actual REER to its medium-term fundamental determinants; (ii) the external sustainability (**ES**) approach, which estimates the gap between the current account balance and the (sustainable) balance that stabilizes the country's net foreign asset (NFA) position; and (iii) the macroeconomic balance (**MB)** approach, which calculates the gap between the current account balance projected over the medium term at the prevailing exchange rate and the *equilibrium* balance (CA norm) derived from the level of fundamentals projected to prevail in the medium term. The estimate of "misalignment" is given by the change in the nominal exchange rate that is regarded as necessary to close the gap between the projected real exchange rate or current account with their equilibrium or sustainable levels over the medium-term.

5. ***Main results***

a) ***The ERER approach suggests that, as of end 2008, the lempira was overvalued by some 13–15 percent***. While the point estimates show a wide confidence interval, the results from applying this methodology suggest that:

- The ERER in Honduras is positively and significantly related to government spending (semi-elasticity of 6), remittances (semi-elasticity of 3), the NFA position (semi-elasticity close to 2), the external terms of trade, and productivity (Box A.1).



[4] For details on the methodologies see http://www.imf.org/external/np/pp/eng/2006/110806.pdf and "Exchange Rate Assessment: CGER Methodologies," IMF Occasional Paper 2008, No. 261.

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Box A.1. Honduras: Application of CGER Methodologies

ERER approach. Cointegration analysis gives evidence of a long-run relationship between Honduras' REER and the terms of trade (*tot*), trade openness (*open*), workers' remittances (*transf*), central government spending (current and capital) (*spend*), productivity (*prod*), and the net foreign asset position (*nfa*). The REER, the terms of trade, and productivity (the ratio of per capita GDP in Honduras relative to the U.S.) are expressed in natural logs; trade openness is the ratio of imports and exports to GDP; all other variables are measured as ratio to GDP. The Hodrick-Prescott filter was used to smooth all variables for 1980–2008. All explanatory variables were significant and had the expected sign. The estimated long-run relation is as following: [1/]

$$\ln reer = 1.84 \ln tot - 0.74\, open + 3.18\, transf + 6.0\, spend + 1.8 \ln prod + 2.1\, nfa$$

ES approach. The estimation of the exchange rate misalignment utilizes the standard CGER trade elasticity of 0.71 for exports and 0.92 for imports, which implies a current account balance elasticity of 0.42 to the REER. Key assumptions are the rate of output growth (higher under a strengthened policy scenario) and the targeted NFA position (higher under the passive scenario) of minus 41 percent of GDP, or the average observed over 2004–08. This target also stabilizes gross international reserves at 3½ months of imports and total external debt at about 30 percent of GDP. Based on these elasticities and assumptions, this approach estimates the real exchange rate adjustment that would bring the current account balance in line with its NFA-stabilizing level over the medium-term.

MB approach. This approach relies on the standard CGER coefficients and trade elasticities to calculate the CA norm. The fundamental variables consist of the fiscal balance (*fiscal*), demographic-dependency ratio (population over 65 years of age relative to those aged 30-64) (*dependency*), population growth (*pop*), oil balance as a share of GDP (*oil balance*), relative income (ratio of PPP-based per capita income in Honduras to the U.S.) (*income*), per capita output growth (*growth*), and the lagged current account as a share of GDP (*CA lag*). All variables are measured as deviations from a trade-weighted average of trading partners. The CA norm for Honduras was calculated as follows:

$$CA = -0.0029 + 0.19\, fiscal - 0.12\, dependency - 1.03\, pop + 0.17\, oil\ balance + 0.02\, income - 0.16\, growth + 0.37\, CA\ lag$$

[1/] In assessing the equilibrium REER, Dudine (2007), SM/07/55 applied a slightly different reduced form, namely an export price index (rather than the terms of trade) and excluded workers remittances.

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- The equilibrium real exchange rate depreciated during 1980–95, as a result of the trend declines in productivity, the terms of trade, and the NFA position (Figure 3). Since 1995, however, the equilibrium rate has appreciated, largely due to trend increases in government spending and remittances, which have more than offset the decline in the terms of trade.

Changes in Equilibrium Exchange Rate 1/
(Average annual percentage change)

	1980-95	1996-05	2006-08
REER	**-4.7**	**3.3**	**2.6**
Terms of trade	-1.2	-4.2	-3.2
Trade openness	-0.8	-1.2	-0.8
Remittances	0.6	3.7	6.0
Government spending	0.4	4.3	3.3
Productivity	-2.5	-0.5	0.9
NFA position	-1.2	1.3	-3.6

1/ + means appreciation.

- The short-term equilibrium real exchange rate depreciated during 2008, due to the negative terms of trade shock (higher oil prices). The shock widened the gap between the actual and short-term equilibrium exchange rate to more than 30 percent.

b) ***The ES approach and the MB approach suggest an overvaluation of about 10–15 percent by end-2008.***

- In the ES approach, the sustainable current account deficit (i.e., the one that stabilizes the net international reserve and external debt positions) is estimated at 3½ percent of GDP. The medium term external current account deficit under current policies, on the other hand, is projected at 8 percent of GDP (or 10 percent of GDP, after stripping the effect of oil prices). These figures suggest that a real depreciation of about 14 percent (30 percent if undertaken at end-2008) would be necessary to close the gap between the two current account estimates over the medium term.

Honduras: External Sustainability Approach[1]
(Percent of GDP, unless otherwise indicated)

Scenarios	NFA position	Growth (percent)	External current account deficit: Projected [2]	Sustainable	Gap	Overvaluation (percent)
For 2008	-41.0	3.0	10.0	3.3	13.2	30.6
Current policies	-41.0	3.0	8.1	3.3	5.8	13.4
Strengthened policies 3/	-44.7	4.1	5.5	5.5	0.1	0.2

Sources: Fund's staff estimates and projections.
[1] Based on the CGER elasticities (0.71 for exports and 0.92 for imports), implying a trade balance elasticity to the REER of 0.42.
[2] Corrected deficit of 10 percent in 2008 after adjusting for oil prices, and projected deficit of 8.1 percent for 2014 under current policies.
[3] Increased FDI would sustain a decline in the NFA position.

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- Under the strengthened policies scenario recommended in the staff report (where growth is assumed to rise to 4.1 percent, FDI to increase, and the exchange rate to depreciate gradually) the sustainable current account deficit would rise to 5½ percent of GDP. In this scenario, the strengthened policies alone tend to eliminate the gap between the projected current account deficit and the sustainable deficit by the end of the projection period.

- In the MB approach, the estimated CA norm (based on the projected path of the fundamental determinants of the current account balance) yields a deficit of 6¾ percent of GDP. Using the standard elasticities (Box 1), the gap between the projected current account deficit and the estimated CA norm over the medium term could be eliminated with a real depreciation of about 11 percent.

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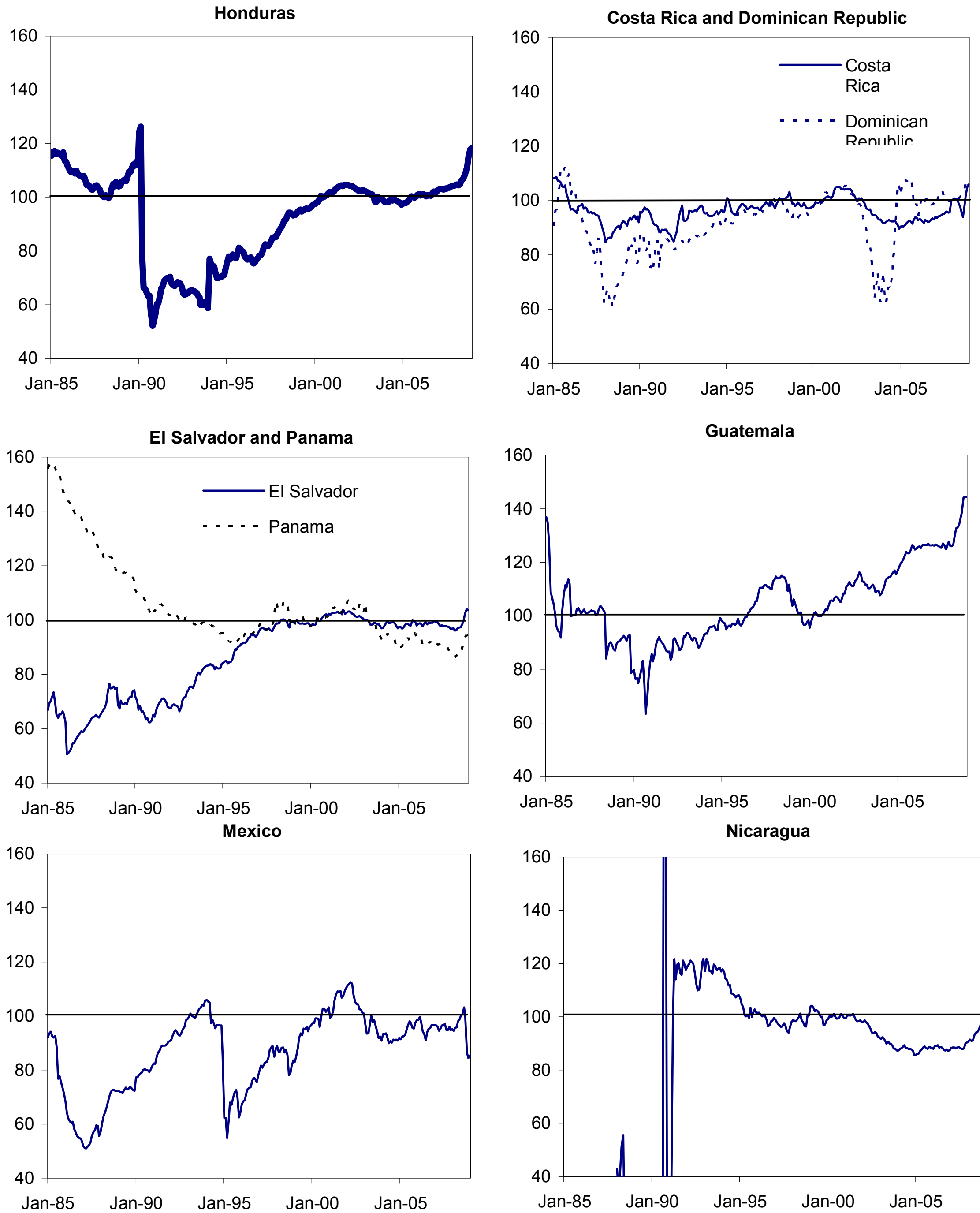
Figure 1. Real Effective Exchange Rates in the Central American Region and Mexico
(Index 2000=100; + is appreciation)

Owing to a steady appreciation since the 1990s, the Honduran real exchange rate has lost competitiveness relative to the region, except with Guatemala.



Source: IMF's Information Notice System.

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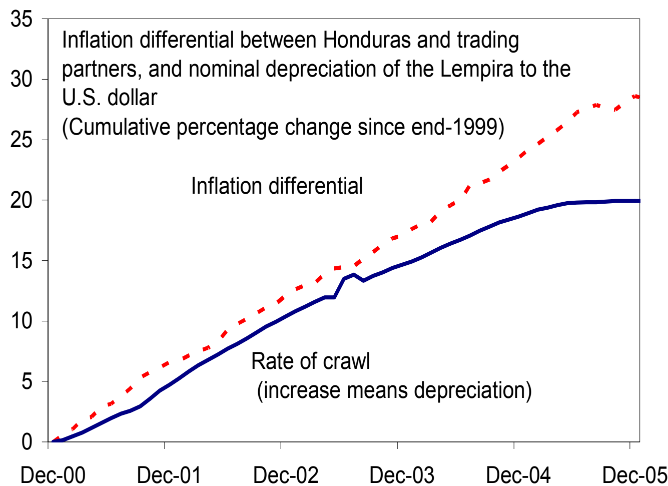
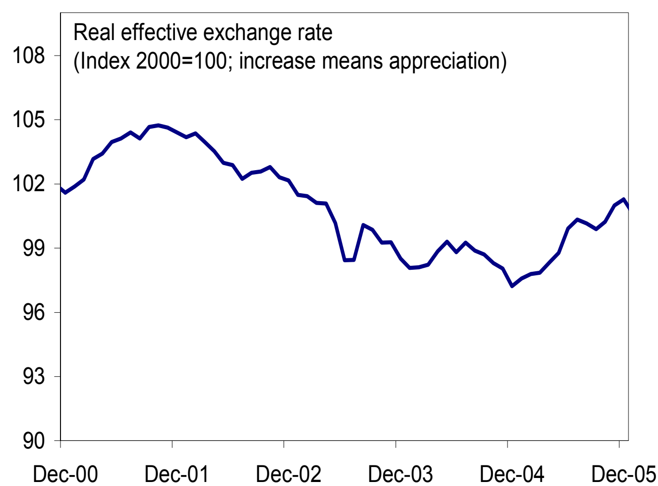
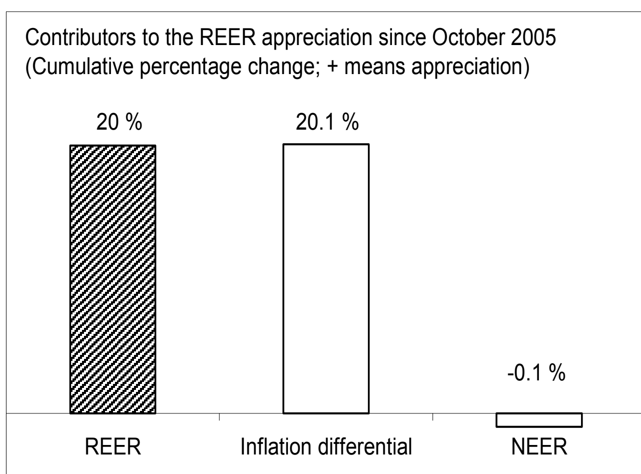
Figure 2. Honduras-Exchange Rate Developments

During 2000-04, the central bank let the exchange rate crawl broadly in line with the inflation differential; and there was a slight real depreciation.





Under the peg, there has been a real appreciation of 20 percent due to a high inflation differential.



The real appreciation has been the largest in the region since October 2005.

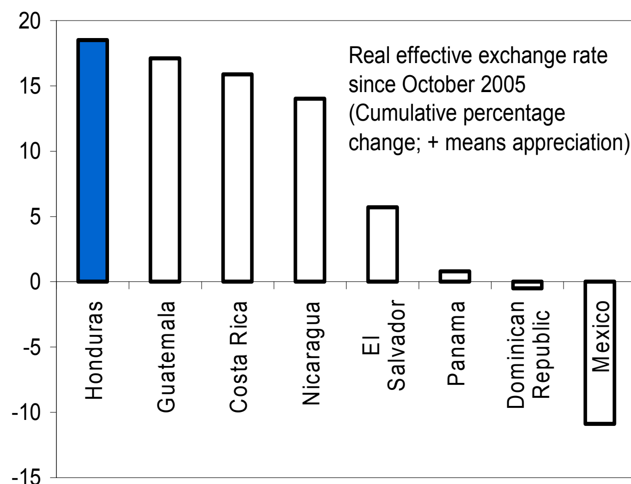


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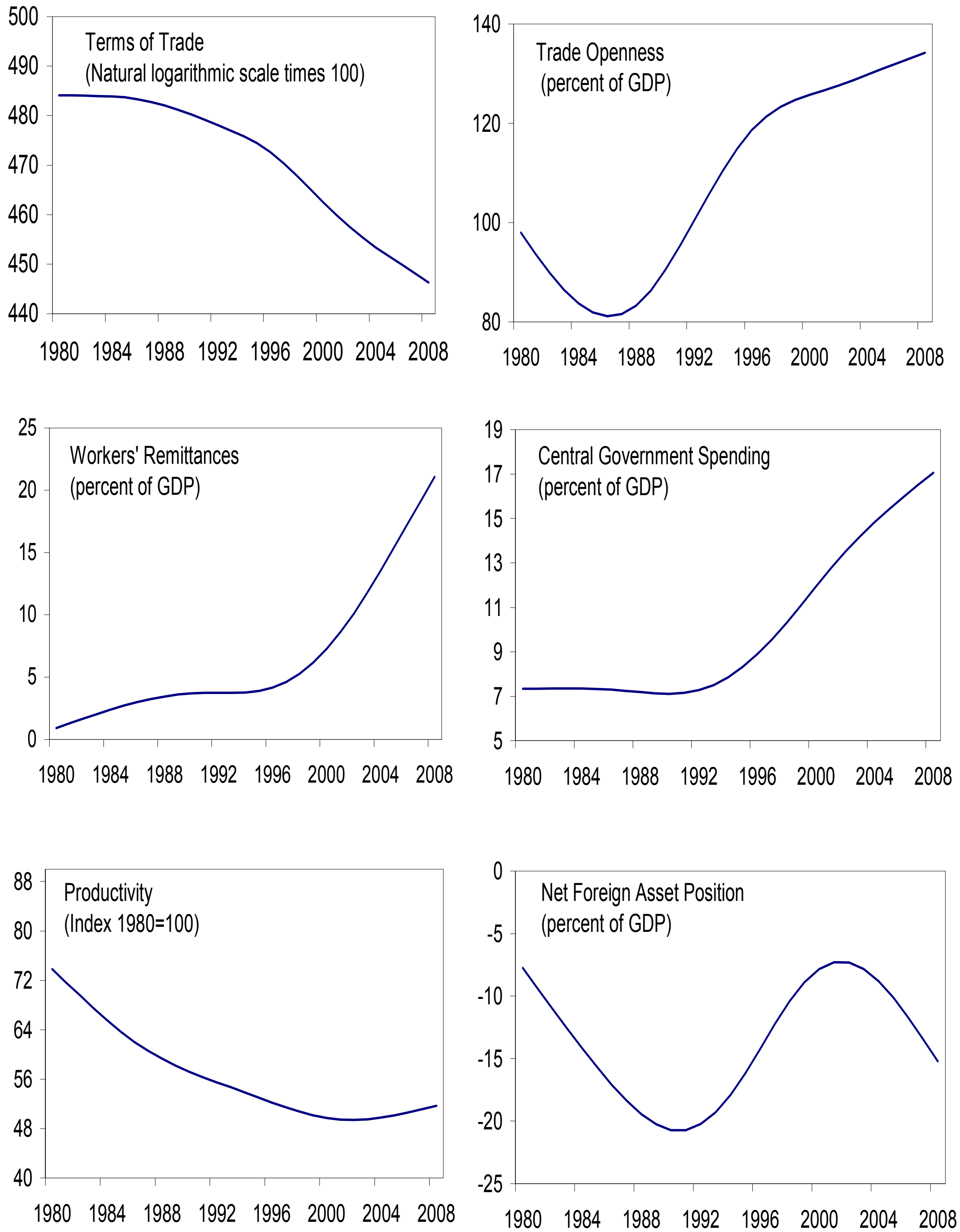
Figure 3. Honduras-Determinants of the Equilibrium Exchange Rate

(Variables smoothed by the Hodrick-Prescott filter)



Sources: Fund Staff Estimates and Honduran Authorities.

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Appendix II. Honduras—Summary of Appendices

Fund Relations

Honduras' outstanding purchases amount to SDR 20.34 million, 15.71 percent of the quota. Honduras' *de jure* exchange arrangement is a crawling band, but the de facto exchange rate regime is a conventional pegged arrangement. The last Article IV consultation with Honduras was concluded on February 21, 2007. An FSAP mission was conducted in 2003 and an update was carried out in September–October 2007. Under the Fund's safeguards assessment policy, the Banco Central de Honduras (BCH) was subject to an update assessment with respect to the 12-month precautionary SBA approved on April 7, 2008. The update assessment of the BCH, which was completed on August 27, 2008, found that while the bank has enhanced financial statement transparency and data quality since the 2004 safeguards assessment, risks exist in the high level oversight of the bank's control framework.

Relations with the World Bank Group

As of January 1, 2009, the IDA active portfolio in Honduras consists of 17 projects for a total commitment of US$411.2 million; of which US$227.4 million remain to be disbursed (Honduras was declared IDA in September 1991). The active projects are focused on the performance of utilities, notably in the energy sector; public sector performance, transparency and accountability; the quality of education; and economic governance. Overall, the IDA expects to disburse $90.0 million in calendar year 2009 and $46.0 million in 2010 and $46.0 million in 2011, of which $10 million in 2009 would be in the form of fast-disbursing budget support. The current CAS covers the period 2007–2010.

Relations with the Inter-American Development Bank

As of January 15, 2009, there were 28 projects in the Bank's loan portfolio for US$683.7 million, with an undisbursed balance of US$456.7 million. After Bank's Debt Relief the annual allocation for 2009 is US$97.1 million. Total MDRI debt relief from the IADB to Honduras was approved in February 2007 and the amount was US$1,367 million (principal plus interest). A new country strategy was approved on May 7, 2008.

Statistical Issues

Data provision has some shortcomings, but is broadly adequate for surveillance. Data on the banking system, the public finances, trade, and external debt broadly satisfy minimum criteria required for surveillance and program monitoring purposes. However, incomplete coverage of institutions and reporting lags inhibit a full and timely assessment of financial sector developments, and a consistent and reliable method is needed for deriving estimates of private capital flows.

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Appendix III. Draft PIN

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/xx
FOR IMMEDIATE RELEASE

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2009 Article IV Consultation with Honduras

On April [29], the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Honduras.[1]

Background

Since the last Article IV consultation in early 2007, the economy continued to grow above trend and economic imbalances widened. In 2008, growth slowed to 4 percent (6¼ percent during 2004–07). Partly due to developments in world fuel and food prices, annual inflation rose to 14 percent in August and slowed to 8.8 percent by March 2009.The external current account deficit reached 14 percent of GDP (up from 10 percent in 2007) due to higher oil prices and continued domestic demand pressures. During 2007-08, net international reserves fell by $300 million (13 percent), while the Lempira has appreciated by 20 percent in real terms since October 2005. In January 2009, the minimum wage was raised by over 40 percent, on average, well above the inflation objective of 8–10 percent.

Supported by the large debt relief obtained in the early part of the decade, the deficit of the combined public sector has remained low, closing at 1¾ percent of GDP in 2008. Important efforts were made last year to strengthen the finances of the electricity company (ENEE). In particular, average electricity tariffs were adjusted by over 30 percent, arrears were eliminated, electricity subsidies were better targeted to

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

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the poor, and untargeted fuel subsidies were phased out. There were, however, overruns in the general government's wage bill and on untargeted subsidies, as the government tried to mitigate the impact of higher food and oil prices on personal income. Also, net lending by pension funds (mostly to teachers) remained high, limiting further the room for public investment.

Despite a widening external imbalance, the central bank maintained the exchange rate fixed and pursued an expansionary monetary policy in an attempt to mitigate the adverse effects of the import price shock. Monetary conditions were eased further since late 2008 to stimulate domestic demand, amid the global crisis including by: lowering the policy interest rate, eliminating reserve requirements in local currency for banks directing at least 60 percent of their loans to certain sectors, and allowing the central bank to extend credit to a state bank to subsidize new lending to housing, agriculture, and small firms, and to the central government.

The banking system has not been directly affected by the global crisis. However, following a period of rapid credit growth, financial soundness indicators have weakened, largely due to the economic slowdown. Banks have sought to maintain high liquidity due to rising costs of foreign credit lines and lower availability of external credit. In this context, and despite the substantial easing of monetary policy, credit to the private sector has been sluggish, partly due to the weak near-term outlook.

A 12-month Stand-By Arrangement (SBA) expired on March 30, 2009. No review was completed, since the monetary and exchange rate policies implemented deviated from those agreed under the SBA.

Executive Board Assessment

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Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements.

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Table 1. Honduras: Selected Economic Indicators

I. Social Indicators

Population	7.5 million	Life expectancy at birth in years (2007)	70
Per capita income in U.S. dollars (PPP, 2007)	3,620	Adult literacy (ages 15 and above, 2007)	80 percent
Rank in UNDP Development Index (2008)	117 of 179	Percent of pop. below poverty line (2007)	64
Unemployment rate (2008)	4	Gini index	55
Underemployment rate (2008)	35.2	Oil imports (2008 actual)	US$1.8 billion
Net FDI (as percent of GDP, 2008)	6.2	Main exports	coffee, bananas, shrimp, and maquila

II. Economic Indicators

					Prel.	Proj.
	2004	2005	2006	2007	2008	2009
	(Annual percentage change, unless otherwise indicated)					
National income and prices						
GDP at constant prices	6.2	6.1	6.6	6.3	4.0	1.5
Consumer prices (end of period, eop)	9.2	7.7	5.3	8.9	10.8	9.4
Exchange rate (eop, depreciation -)						
Lempiras per U.S. dollar	-4.9	-1.2	0.0	0.0	0.0	0.0
Real effective rate	-1.4	4.2	0.7	2.3	13.6	...
Money and credit						
Net domestic assets 1/	-75.0	-25.7	-21.5	16.0	12.6	29.2
Combined public sector credit	...	22.9	...	58.9	128.6	18.5
Private sector credit	15.7	17.0	28.1	32.4	11.5	12.0
Broad money	17.6	17.4	21.6	18.2	4.8	7.3
Lending rate (eop, in percent)	18.2	16.8	13.8	13.4	17.6	...
Deposit rate (eop, in percent)	11.1	10.4	7.6	8.1	9.2	...
	(In percent of GDP)					
Combined public sector						
Noninterest revenue and grants	22.7	22.6	22.5	22.9	23.8	23.1
Noninterest expenditure	24.8	24.1	24.8	25.1	26.4	25.9
Primary balance	-2.1	-1.5	-2.3	-2.2	-2.6	-2.8
Net interest payments	0.3	-0.1	-0.4	-0.6	-1.0	-0.3
Savings	2.6	2.5	2.6	2.2	2.3	1.5
Capital expenditure	5.5	5.1	4.8	5.3	5.5	5.3
Overall balance	**-2.4**	**-1.4**	**-1.9**	**-1.6**	**-1.7**	**-2.5**
External financing	3.8	1.8	1.9	1.0	2.6	1.8
Domestic financing	-1.4	-0.6	0.5	0.3	-0.9	0.7
Savings and investment						
Fixed capital formation	27.1	24.9	27.3	32.4	32.2	26.0
Gross national savings	19.3	21.9	23.6	22.1	18.2	18.0
	(In millions of U. S. dollars, unless otherwise indicated)					
Balance of payments						
Gross international reserves	2,138	2,502	2,798	2,705	2,692	2,401
(in months of imports) 2/	4.8	4.8	4.3	3.4	4.0	3.3
Change in net international reserves (increase -) 1/	-497	-352	-430	124	173	288
External current account balance (percent of GDP)	-7.7	-3.0	-3.7	-10.3	-14.0	-8.0
(excluding official transfers)	-9.7	-4.6	-5.5	-11.4	-15.8	-9.2
Exports, f.o.b. (annual percentage change) 3/	20.8	11.3	4.5	6.9	7.2	-11.7
Imports, f.o.b. (annual percentage change) 3/	22.1	12.3	11.6	20.8	17.8	-16.7
Public sector debt (in percent of GDP) 4/	61.7	46.3	31.7	19.6	19.1	20.4
Public sector external debt (in percent of GDP) 4/	59.0	44.9	27.9	16.4	15.7	15.8
Public sector external debt service (in percent of exports of goods and services) 5/	3.3	3.7	2.5	1.9	1.1	1.6

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

1/ Includes adjustments made for NIR and NDA due to Fund MDRI debt relief granted in January 2006 ($155 million).
2/ Refers to the following year's imports of nonmaquila goods and nonfactor services.
3/ Goods only.
4/ Includes medium- and long-term public and publicly guaranteed external debt after HIPC, beyond HIPC, and MDRI. All external debt is denominated in foreign currency.
5/ Debt service paid.