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Honduras: First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria, and Financing Assurances Review—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Honduras

In the context of the first review under the three-year arrangement under the Poverty Reduction and Growth Facility and request for a waiver of performance criteria, and financing assurance review, the following documents have been released and are included in this package:

- the staff report for the First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria, and Financing Assurances Review prepared by a staff team of the IMF, following discussions that ended on August 25, 2004, with the officials of Honduras on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 10, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of September 24, 2004 updating information on recent developments.
- a press release summarizing the views of the Executive Board as expressed during its September 24, 2004 discussion of the staff report that completed the review and request.
- a statement by the Executive Director for Honduras.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Honduras*
Memorandum of Economic and Financial Policies by the authorities of Honduras*
*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

HONDURAS

First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria, and Financing Assurances Review

Prepared by the Western Hemisphere Department

(In consultation with other departments)

Approved by Markus Rodlauer and Donal Donovan

September 10, 2004

- **Fund relations.** A three-year PRGF was approved on February 18, 2004, for SDR 71.2 million (55 percent of quota). Honduras aims to reach the HIPC completion point in early 2005, assuming a year's satisfactory implementation of the PRSP, compliance with the macro-program in the six months before the completion point, and achievement of six trigger conditions.
- **Discussions.** Review discussions were held in Tegucigalpa during July 5–15 and August 17–25, 2004. The missions met with President Maduro, Central Bank President Mondragón, Finance Minister Alvarado, Minister of the Presidency Cosenza, Superintendent of Banks Mejía, and other officials.
- **Staff team.** The team comprised Ms. Cheasty (head), Messrs. Flores, Guimaraes, and Papaioannou (all WHD), Mr. Quintyn (MFD), and Mr. Reichold (PDR). Ms. Coronel, the resident representative, assisted the missions, which collaborated with a World Bank mission.
- **PRGF review and Article IV consultation.** The need for additional rounds of program discussions to address changes requested by the authorities caused the 2004 Article IV consultation (scheduled for August 2004) to be postponed until the next review, in early 2005. The Board has recently discussed longer-term issues in the ex-post evaluation.
- **Last Article IV consultation.** During the 2003 Article IV consultation, Directors called for a stronger fiscal stance through wage bill reduction and tax reform; banking reforms to address fragilities identified in the 2003 FSSA; more flexibility in the exchange regime; and improvements in governance.
- **Exchange system.** Honduras has a crawling band with a width of 7 percent on each side of the base rate; however, the exchange rate has been kept at the appreciated side of the band. The rate of crawl has been kept in line with the anticipated inflation differential (5.4 percent in 2004). Honduras has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement and maintains an exchange system free from restrictions on the making of payments and transfers for current international transactions.

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Executive Summary

- **The new PRGF was followed by several months of calm.** Social tensions then re-emerged, but have since subsided. A series of demonstrations against oil price increases was followed by a teachers' strike. Stable oil prices in July and a revised wage agreement with teachers permitted a general return to order.

- **The program is broadly on track, though some structural measures were delayed.** Growth is buoyant; the external position is stronger than programmed; and fiscal and monetary targets for end-June were met comfortably. Waivers are being sought for delays in approval of four key financial sector reform laws. Three have since been passed by congress and approval of the fourth is a prior action for completing the review.

- **The good fiscal performance has meant that the social pressures can be addressed within the program.** The revised teachers' wage agreement contains concessions, but remains consistent with program wage targets on account of savings in the budget and the closure of some ministries. The government also plans new pro-poor spending to support vulnerable groups affected by the oil price increases.

- **The authorities are taking measures to contain inflation.** The inflation target was raised to accommodate the first-round impact of the oil price increase, and measures to limit foreign borrowing and credit growth are being taken to restrain domestic liquidity in the face of high foreign exchange inflows. A cautious monetary policy is particularly important given the role of expected inflation in wage settlements.

- **The authorities have agreed on institutional reforms to modernize central bank operations.** Reflecting the conclusions of Fund technical assistance, domestic monetary operations and the financial sector will be strengthened before any movement to greater flexibility in the exchange regime.

- **While performance under the PRGF has been generally satisfactory, sustaining the program will be a challenge.** Fiscal restraint in the rest of 2004 and the enactment of a 2005 budget consistent with the program will be important tests of the government's ability to withstand growing election campaign pressures, including additional wage demands.

I. Recent Developments

A. Political and Social Environment

1. **The PRGF program was well-received by society.** Following rising social tension through 2003, approval of the PRGF was followed by several months of calm, reflecting the broad consensus the government had marshaled in support of the program. A new law which postponed the beginning of the campaign for the 2005 Presidential election also contributed.

2. **Serious social tensions re-emerged in midyear, although they have since eased somewhat.** Increases in world oil prices and the consequent erosion in purchasing power (under the full pass-through mechanism for setting domestic fuel prices) raised domestic discontent. This was exacerbated by frustrations of public sector workers affected by the December 2003 wage reforms (a pillar of the program). Public demonstrations began again, including road blockages and school takeovers by teachers. Teachers began a general strike on June 2, leading to five weeks without classes and increasing disruption in cities. The government came to a revised wage agreement with teachers on July 10. The agreement, which is consistent with the program, permitted the reopening of schools and a general return to order. Stable oil prices in July also contributed to a more settled social environment.

The Electoral Landscape

Next Election	November 20, 2005
Coverage	President, Congress, Municipal.
President	President Maduro cannot be reelected
Government	National Party
Seats in congress	128
National party (government)	61
Liberal party (main opposition)	55
Ideological differences	The National Party is slightly more conservative, but there are no major ideological differences regarding economic or social policies. Differences are larger within parties than between the parties.
Leading candidates	
National party (government)	Porfirio Lobo (President of Congress) Miguel Pastor (Mayor of Tegucigalpa)
Liberal party (main opposition)	Mel Zelaya

B. Recent Developments and Program Performance

Macro-framework

3. **Macro-performance so far in 2004 has been favorable** (Table 1). Growth is being fueled by buoyant exports (mainly of coffee and bananas) and remittances, and despite the oil price shock the expected growth rate for 2004 has been revised upward from 3.5 to 3.75 percent (with the central bank forecasting growth of 4–4.5 percent).

4. **The prices of domestic petroleum products rose by around 27 percent between January and end-August, causing inflation to rise.** Around one third of the impact was due to the fuel tariff increase implemented in January 2004. Twelve-month inflation reached 8.3 percent in June and 9.3 percent in July (reflecting also adjustments to related prices and public sector tariffs, as well as easier monetary conditions). Core inflation also rose, albeit at a lower rate.[1] In consequence, the inflation target of 6.7 percent for 2004 is no longer considered feasible.

5. **The external position has been stronger than expected despite the high oil prices, largely because of increases in remittances.** During the first half of the year family remittances continued to grow at extraordinary rates—exceeding 25 percent year-on-year—and are now expected to reach almost 15 percent of GDP in 2004 (compared to 12 percent previously). Additionally, agricultural exports are recovering on account of both higher prices and output. These factors more than offset the impact of higher oil prices—estimated at 2.3 percent of GDP in 2004—and has resulted in a substantial accumulation of international reserves. Despite delays in official loans, the June NIR target was exceeded by about US$140 million and international reserves have continued to accumulate since then.

Fiscal policy

6. **The fiscal program is on track.** All quantitative fiscal performance criteria for end-June were met, with some margin (Tables 2 and 3). The central government deficit was below the programmed level because of buoyant tax collection and savings in current outlays. Tax collection was boosted by the rise in activity, higher prices, and improved tax administration; it offset lower-than-programmed grants and concessions income. Savings in wages and goods and services helped to offset faster-than-programmed project disbursements and transfers. Poverty-reduction spending has accelerated as foreseen in the program.

7. **Performance of the combined public sector was also satisfactory.** The public enterprises' operating surplus exceeded the June benchmark, supported by strong sales by the telephone company. Two large energy projects are on track and should improve the operating surplus of the electricity company in the second half of the year. Over-performance in public

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[1] The limited price freeze enacted by congress at end-2003 expired on June 30 as planned, with no evidence that it was effective. The program includes a commitment to no further price freezes.

enterprises has, to date, offset the central bank's quasi-fiscal deficit, which is running higher than programmed on account of larger than expected sterilization costs (reflecting the higher than targeted international reserves). The ceiling on domestic financing of the combined public sector was also met.

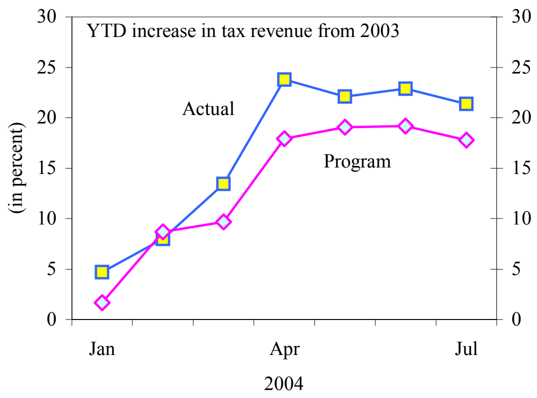
Structural Targets for the First Review

	Status
Structural Performance Criteria	
Adoption of a new Financial Institutions Law and amendment of the CNBS Law, the Deposit Insurance Law, and the Central Bank of Honduras Law to strengthen financial regulations, supervision, and the financial safety net.	Not met; 3 laws later passed; passage of financial institutions law, a prior action for review
Finalizing a timetable to comply with new regulations on capital adequacy, loan classification, and provisioning (including an investment in FONAPROVI bonds).	Met
Finalizing a timetable to make the use of indirect instruments of monetary management more effective and improve interest rate signaling.	Met
Permanent suppression of intra-year unfinanced appropriations.	Met
Structural Benchmarks	
Amendment of the Penal Code to make financial crimes punishable.	Not met; benchmark for 2nd review
Enforcement of requirement that banks publish quarterly financial statements.	Met
Finalization of an action plan for public administration reform, consistent with World Bank recommendations.	Met with delay (May)
Issue of regulations to integrate supplementary benefits into the overall salary from 2007, following the conclusions of the special wage commission	Not met; p.c. for 2nd review

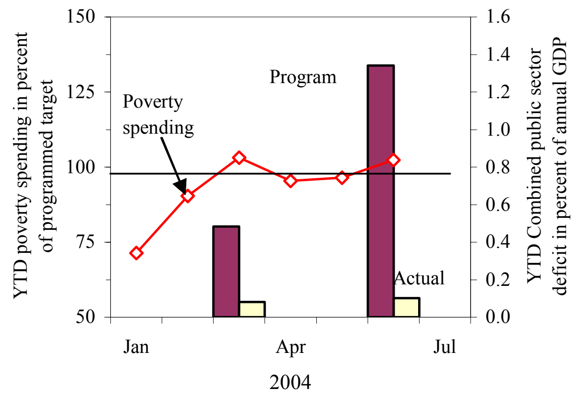
8. **Public sector wage policy was conservative.** Through end-June, the authorities resisted pressures to revisit the civil service wage reform, and achieved small savings in the sensitive areas of education and health. In the rest of the public sector, all wage agreements were in line with central government wage policy except for the award to the telephone company (where increases were granted of 15 percent this year and 13 percent for 2005). The benchmark on developing a permanent wage policy (by issuing regulations to integrate supplementary benefits into the salary from 2007) was, however, missed; the authorities explained that the continual arbitration of wage demands made impractical the establishment of a commission with a long-term focus.

Honduras: Recent Developments

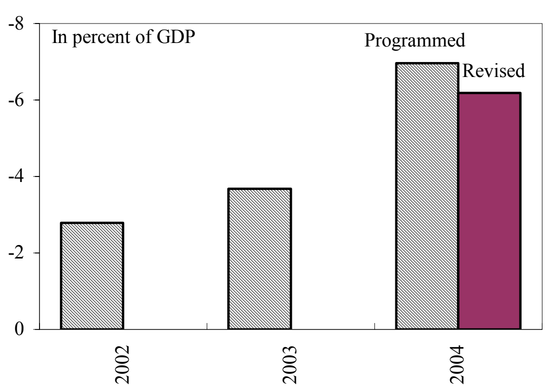
Fiscal performance has been strong with tax revenue above expectations, ...



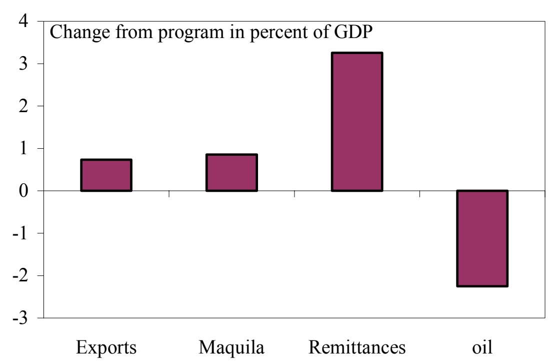
… lower than programmed deficit, and full execution of poverty reducing spending.



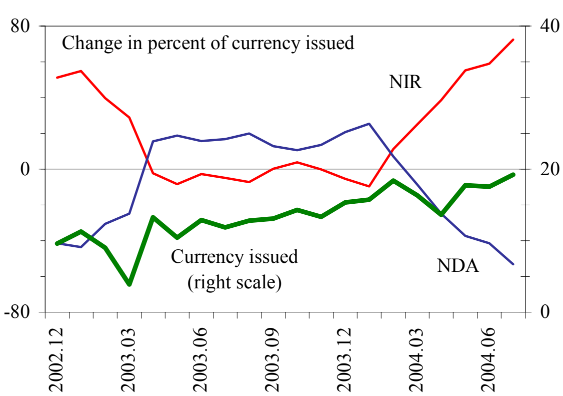
The current account will deteriorate less than expected despite high oil prices...



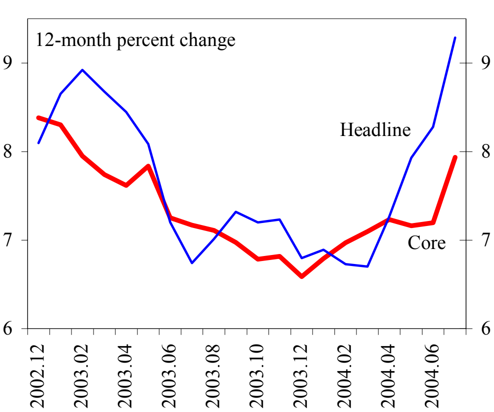
… as higher remittances are expected to more than compensate for the higher oil bill.



NIR and NDA targets have been meet, but with lack of full sterilization, liquidity increased...



… which together with higher oil prices accelerated inflation.



9. **In May, the authorities agreed with the World Bank on a reform of the public administration.** The reform has desirable features such as limits to political appointments, requirements for the professionalization of the civil service, and the delegation of personnel policy powers to an independent office. However, the reform is less far-reaching than planned, since the final coverage excluded teachers and health workers, and thus applies to only about one quarter of the civil service. This will have no immediate financial impact on the program, but underscores the difficulty in reintegrating special wage regimes into a global government wage policy and achieving efficiency gains in education and health.

10. **Congress issued a decree in late May, authorizing outlays for the 2005 elections of around 0.2 percent of GDP.** To avoid turning this into an unfinanced appropriation (and thereby breaching a continuous performance criterion), the government has not yet passed the decree, and has committed to identifying additional resources to pay for the spending without raising the deficit. The authorities are currently requesting grants from some donors in order to finance this additional expenditure

Monetary policy

11. **End-June performance criteria on NIR and NDA were met with comfortable margins.** NIR accumulation through end-June was US$170 million (over US$140 million above program). The central bank placed historically large issues of paper to sterilize the impact of the higher than expected inflows on the domestic economy. Reflecting sterilization efforts, central bank net domestic assets were held far below the program ceiling (Tables 6 and 7). In June, to contain rising sterilization costs, the central bank reduced policy interest rates by 0.25 percent (to 12.5 percent).

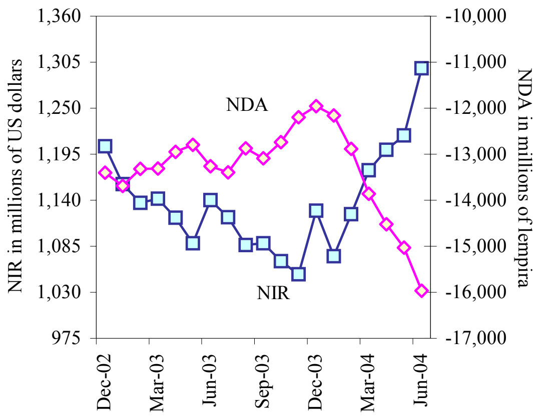
12. **Despite sterilization efforts, broad money growth has been somewhat higher than programmed, and credit flows have also been buoyant.** For the second quarter as a whole, the share of NIR inflows sterilized through open market operations declined somewhat, thus contributing to higher commercial bank liquidity and credit growth. Broad money rose by 17 percent through June, year on year, while credit to the private sector rose by just under 15 percent. The increase in credit was disproportionately concentrated in foreign currency lending, which grew by nearly 40 percent, to just under 30 percent of total credit. Most of the lending was financed by banks' borrowing from abroad, taking advantage of the interest differential. Foreign currency deposits grew moderately, with the share of foreign currency deposits in total deposits up by 1 percentage point (to 36 percent).

Financial sector

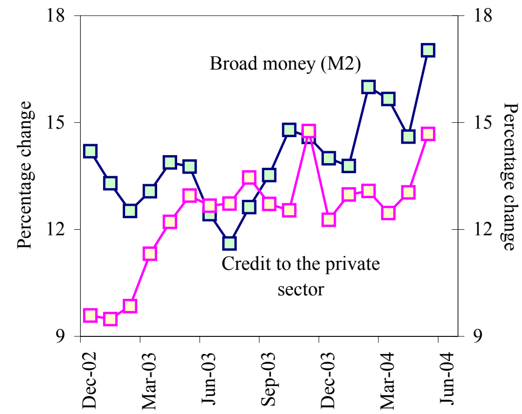
13. **Banking indicators have improved or remained stable.** At end-June, nonperforming loans remained at their end-2003 level of 8.7 percent (adjusted to reflect the 2003 bail-out of agricultural loans). Provisioning for NPLs increased over the period, from 38 percent to 46 percent, and the return to equity rose. The capital-adequacy ratio of the system (as reported by banks) remained stable at 13 percent in December 2003–June 2004. Part of the changes in the indicators could be attributable to banks already beginning to apply the more stringent new loan classification and provisioning rules (Table 8).

Honduras: Recent Monetary Developments, 2003-2004

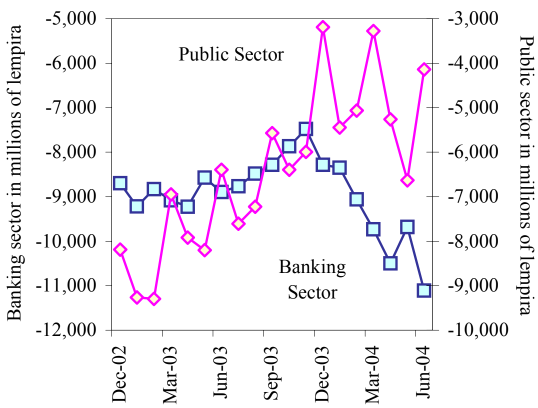
Central Bank Aggregates



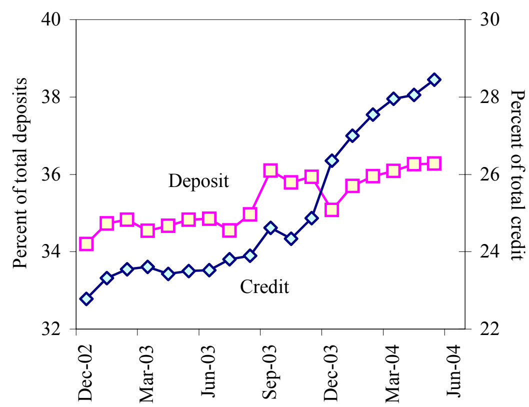
Monetary Aggregates



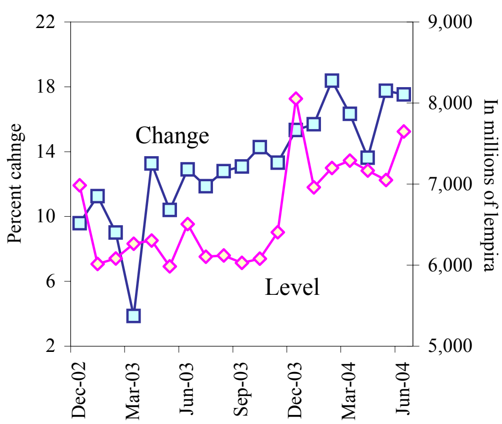
Selected Central Bank NDA Components



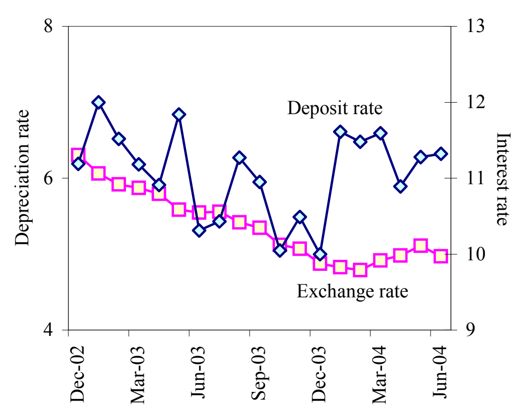
Dollarization



Currency issued



Interest rates and exchange rate depreciation



14. **The performance criteria on the passage of four key financial sector laws were not met.** The laws were submitted to congress, but were not approved before the June recess (see Box 1). Three have been approved since then: the central bank law; the law governing the supervisory authority; and the deposit insurance law. Approval of the fourth (the banking institutions law—which contains the bank resolution framework) is a prior action for completing the review. Likewise, the structural benchmark amending the Penal Code to strengthen penalties on financial crimes was not met. Submission to congress of the revised Penal Code was postponed in order to incorporate a broader set of crimes such as electronic and credit card fraud, and its approval is now expected by end-September 2004.

15. **The supervisory authority (CNBS) issued a timetable to comply with new regulations on capital adequacy, loan classification, and provisioning.** The regulations require banks to maintain a minimum capital adequacy ratio of 10 percent at all times. The new provisioning rules will be phased in evenly over three years, and will apply uniformly to all banks. The new regulations on loan classification have been issued, to be enforced as soon as the new financial institutions law is approved. All banks published quarterly financial statements in line with the continuous benchmark, and credit bureau information was improved and can now be accessed by internet.

Governance and transparency

16. **Significant progress has been made in governance reforms.** Besides the law shortening the election period, a first reading of a constitutional amendment eliminating the immunities of congressmen and certain government officials has passed congress; and an important property law was passed, facilitating the titling of land. Congress approved an organic budget law aimed at improving expenditure control and transparency (including by reiterating the exclusion of unfinanced appropriations), and the Bankers' Association adopted and publicized a code of ethics. Further, in an effort to assure the public and the international community of the continuity of policies in the transition to a new government, congress gave the PRSP the status of a law.

II. POLICY DISCUSSIONS

Macroeconomic framework

17. **The macro-framework for 2004 has been revised to incorporate higher growth, a stronger balance of payments, and somewhat higher inflation.** Targets for 2005–06 remain unchanged, and will be updated during the second review.

Honduras: Macroeconomic Framework, 2003-2006

	2003	Prog. 2004	Rev. 2004	2005	2006
(Annual percentage changes)					
GDP at constant prices	3.2	3.5	3.75	4.0	4.5
Consumer prices, end of period	6.8	6.7	8.00	6.0	5.0
(In percent of GDP, unless otherwise noted)					
Combined public sector savings	1.1	3.9	3.9	4.8	5.9
Anti-poverty spending	7.5	8.1	8.1	8.7	9.4
Combined public sector balance	-4.9	-3.0	-3.0	-2.5	-1.7
Of which :					
Central government balance	-6.0	-3.5	-3.5	-3.0	-2.5
External current account balance	-3.7	-7.1	-6.2	-3.6	-3.0
Gross international reserves (months of imports)	3.8	4.0	4.0	4.0	4.0

18. **The inflation target has been revised upward to 8 percent.** The authorities are aiming to strike a balance between accommodating the direct impact of the fuel price increase while containing more general inflationary pressures. While fuel prices accounted for a significant part of the higher inflation, core inflation also rose—suggesting that easier monetary conditions have also played a role. The authorities emphasize that inflation is still largely being driven by temporary factors. However, given the central role of a credible expected inflation target in containing wage agreements, they have decided to take measures to limit domestic liquidity, to ensure that the revised target can be met.

19. **The NIR floor for end-2004 has been raised.** Although current NIR trends point to an even larger increase, staff agreed with the authorities that uncertainty about sustained reserve accumulation in the (seasonally weak) second semester suggested the need for a conservative floor. The revised target ensures continued reserve cover of four months of imports and more than 100 percent of short-term liabilities (Tables 9 and 10).

Fiscal policy

20. **The 2004 fiscal deficit targets remain as programmed, at 3.5 percent for central government and 3 percent of GDP for the public sector.** In July, the authorities requested room to accommodate additional pro-poor spending in the fiscal program to help alleviate social tensions and the impact of the high oil prices on vulnerable groups. But in light of the good fiscal outturn for June, and the need to contain inflation, they have now concluded that the spending can be effected without raising the deficit target. All of the new spending will be financed concessionally from abroad, thereby permitting domestic financing to be reduced to -0.9 percent of GDP, compared with -0.2 percent of GDP in the original program. World Bank staff have confirmed that the projects are consistent with the updated Honduras PRSP.

21. **In July, the authorities reached a revised wage agreement with teachers.** The agreement, which ended the teachers' general strike, contains concessions (higher-than-previous aggregate limits on teachers' supplementary benefits in 2004–06). However, it remains consistent with the wage targets in the program—to which the authorities remain fully committed—on account of savings accumulated through June and the accelerated closure of some ministries.

22. **The achievement of a sustainable government wage policy still faces important risks**. The revised agreement is still significantly less generous than the benefits available to teachers before the wage reform; hence there is a possibility of further protests in the lead-up to the 2005 elections. Developing a permanent solution to the issue of supplementary benefits (by integrating them into the overall salary) remains key and has been programmed as a performance criterion for end-December—although this will be a major challenge, given teachers' strong opposition. Moreover, in light of the success of the teachers' renegotiation, other public employees have begun to request higher wage increases.

23. **Further improvements in tax administration are expected**. The authorities are making progress toward the amendment of the tax code and the establishment of specialized tax courts in line with the program. They have publicly announced the plan to implement a presumptive income tax and introduce anti-transfer-pricing measures.[2] They are also improving taxpayer registration and records, and broadening the scope of on-line tax collection (with electronic filing now compulsory for large tax payers). The number of audits is in line with the objective of doubling them in 2004, and the authorities are analyzing options for pre-shipment services to reduce customs undervaluation.

24. **The system for tracking anti-poverty spending is working but its automation is taking longer than expected.** The lag in reporting PRSP spending has been significantly reduced, its regularity improved, and the coverage of financing strengthened. Improvements in the automated system have significantly raised the government's ability to monitor PRSP spending through the budget. However, further progress with automation is subject to delays in implementing a UNIDO project and is also affected by the closure of the agency responsible for coordinating the data (as part of the public sector restructuring).

25. **The authorities remain committed to the fiscal targets for 2005–06, which remain unchanged from the original program.** However, they noted that, if significant new and sustainable concessional financing becomes available on account of the recent Consultative Group meeting, they may seek a revision of the targets during the second review.[3] Assuming the current buoyant performance of tax revenue continues, and the ratification of CAFTA takes time, the authorities see no need for additional measures to

[2] The anti-transfer-pricing measures will be implemented in separate legislation rather than in the tax code.

[3] A Consultative Group meeting, in June, generated substantial pledges (US$1.8 billion, or 25 percent of GDP), but the breakdown of pledges between new money and pre-existing commitments is still being verified, as is the timing of disbursements.

achieve the 2005 targets.[4] Staff cautioned that the need for measures would have to be reassessed during the second review, and that adoption of timely measures to cushion the economy against revenue losses associated with CAFTA would be particularly important.

Monetary policy

26. **While the authorities expect inflation to come down as oil prices stabilize, they have also decided to take measures to contain credit expansion and signal their commitment to controlling inflation.** They noted the limited effectiveness of interest rates as an instrument for tightening monetary policy, given the high foreign exchange inflows. Staff recognized the constraints, but pointed out that the composition of the inflows so far (remittances, export earnings) did not suggest substantial interest sensitivity.[5] The inflows were fueling credit and raising the level of dollarization in the economy, thereby exacerbating Honduras's external vulnerability. Hence the authorities agreed to continue their policy of sterilization, but to supplement it by additional measures to contain credit growth and limit banking system vulnerabilities. Specifically, they will:

- Introduce temporary remunerated obligatory investments (central bank deposits) for all banks on deposits (both in domestic currency and dollars), while maintaining current reserve requirements;[6]

- Reduce the existing prudential limits on banks' external borrowing relative to capital, to a level at which the limits immediately become binding; and

- Revise the prudential measures regulating foreign exchange lending—with a view to eliminating gaps in the regulations that limit lending financed by borrowing.

27. **The discussion on monetary strategy took place in the context of the authorities' continued commitment to the current exchange regime.** Within the current crawling band, there is no scope for exchange rate appreciation to reduce the need to sterilize (as the exchange rate is at the appreciated end of the band). Staff and the authorities agreed that a step appreciation (by moving the band) was not warranted at this time; the authorities left open, however, the possibility of slowing the rate of crawl as a supporting measure to contain inflation, if needed. Following the recommendations of recent Fund technical assistance, the

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[4] CAFTA is estimated to have a revenue cost of around 0.2 percent of GDP in the first full year of application and higher long-run costs.

[5] Around three-quarters of the NIR over-performance in the first half of 2004 can be explained by higher current account receipts. The increase projected for the rest of the year is largely due to backloaded aid disbursements (which will not be fully spent on imports within 2004).

[6] Investments equivalent to 1 percent of deposits have been required starting in early September and the current plan is to raise the requirement to 2 percent by end-October. The authorities preferred to use this instrument (rather than open-market operations) to limit the upward impact on the interest rate and on quasi-fiscal costs.

authorities will focus on strengthening domestic monetary operations and the financial sector before moving to a more flexible exchange rate regime.

28. **The authorities intend to take a set of specific institutional reforms to modernize central bank operations.** These reforms are aimed at gradually moving to monetary targeting, introducing a short-term operational target (the overnight interest rate) within a framework of daily liquidity management and open market operations, and upgrading weekly primary auctions. Actions to be taken before the second review include: (1) approval by the central bank board of the work plan for implementing the strategy; (2) replacement of non-negotiable government and BCH debt by negotiable securities; (3) design and testing of a methodology for weekly liquidity forecasting; (4) design of a methodology for daily liquidity forecasting to serve as a guide in the conduct of daily auctions; and (4) formal announcement of the new monetary regime to the banking system. Staff emphasized the importance of careful preparation and successful capacity-building to ensure that these, and subsequent reforms, are implemented smoothly.

29. **The authorities are also pursuing other reforms to strengthen the monetary policy framework.**

- **Liquidity support mechanism.** The full implementation of the new mechanism specified in the central bank law was not possible by the first review, as planned, partly because of the delay in passing the law, but also because the authorities lack part of the operational infrastructure (a registry of commercial banks' collaterals) to deliver liquidity support as quickly as envisaged in the law. They have arranged for technical assistance to develop this; and access to liquidity support within the turn-around time specified in the law is now expected by end-2004.

- **Central bank recapitalization.** The new central bank law requires the ministry of finance to maintain the statutory capital of the central bank at all times. Specifically, it provides for the government to reach agreement on the modalities for recapitalizing the central bank's past losses, and covering future losses after the end of each year, and it empowers the minister of finance to issue bonds for these purposes. Staff stressed the importance of clarifying the details of the agreed plan by the time the audited central bank statements are published in September 2004.

Financial sector reform

30. **Financial sector reforms are proceeding broadly in line with the program, albeit with some delays.**

- **Legal framework.** Three of the four laws that constitute the financial sector reform package have been passed by congress. The fourth—the financial institutions law—includes the banking resolution framework and clarifies the enforcement powers of the supervisory authority. Congressional debate was recently postponed to allow the Supreme Court to rule on its constitutionality, which was upheld apart from minor considerations. The law has now returned to congress and its passage is a prior action for completion of the review (see Box 1).

- **New prudential regulations.** The timetable for banks' compliance with new prudential regulations was issued (a June performance criterion). However, the required bank-specific capital increases remain to be finalized. Banks made a first report on the implications of the new loan classification and provisioning requirements in August; these reports are currently being examined by the Banking Commission. The assessment of, and compliance with, capital needs is facilitated by World Bank preparation of a Financial Sector credit.

- **Supervision.** The supervisory authority is also developing a strategy for intensive supervision of any weak banks identified in the exercise, and for holding actions to limit losses. Weak but viable banks will have access to a recapitalization fund, the modalities of which will be worked out in consultation with the World Bank.

Other issues

31. **The authorities remain confident that the remaining 2004 governance reform agenda will be completed.** Important pending reforms include the revision to the Penal Code (a structural benchmark for June but an expanded set of revisions now expected by end-September 2004); amendments to the National University law (now in congress); and the establishment of dedicated tax courts (still targeted for end-2004). The government remains committed to a policy of no bail-outs.

32. **The authorities reaffirmed their commitment to transparency.** To this end, they have agreed to publish the staff report for the PRGF and the Joint Staff Assessment. They have decided to withhold consent to publication of the data ROSC recently issued to the Board until the implementation of a program of statistical improvements. They have also notified the Fund of Honduras's intention to participate in the GDDS. Importantly for the program, an inter-institutional working group has made substantial progress in defining systems for reconciling fiscal and monetary data and speeding its delivery.

33. **The central bank is in the process of addressing the vulnerabilities identified in the February 2004 safeguards assessment.** Main weaknesses included the need to publish the audited financial statements, and lack of an independent audit oversight mechanism. An audit committee has been established (albeit including central bank board members), and the central bank has sent its full financial statements to the Fund—including the external auditor's opinion and the explanatory notes—and has committed to publishing them by end-September 2004.

Program financing and debt sustainability

34. **The program remains fully financed.**

- **Agreement was reached with the Paris Club to reschedule arrears and debt service falling due through mid-2005.** The agreement includes a generous treatment of post-cutoff date debt and closed the financing gap of the program for 2004 (see Box 2). Through end-June, the performance criteria on non-accumulation of external payment arrears and the contracting of external debt only on concessional terms were observed.

- **Delays in disbursements of World Bank and IDB program loans will be made up in the second half of 2004.** Indeed, the World Bank has now disbursed more than programmed due to the augmentation of the PRSC loan by about US$13 million.

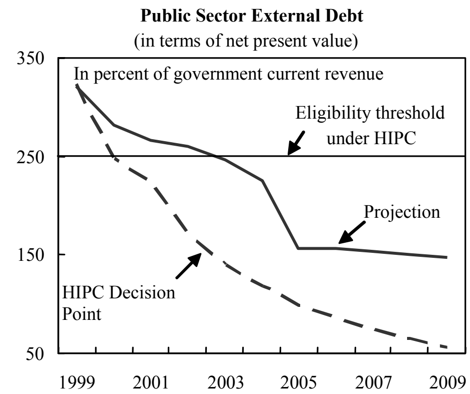
Disbursements of Program Loans in 2004

	Program				Revised Program			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	(In millions of U.S. dollars)							
World Bank								
PRSC Loan	...	45	...	...	...	...	58	...
IDB								
PRSC I	15	...	...	...	15	...	...	...
PRSC II	15	...	...	...	...	...	15	...
Financial Sector Loan	15	...	...	...	...	...	...	15
Total	45	45	...	...	15	...	73	15

- **Due to new loans, total external financing for 2004 is expected to exceed the programmed amounts by about US$60 million (¾ percent of GDP).** The additional financing includes a new concessional US$30 million loan from Taiwan Province of China, as well as higher disbursements from the Bank, the IDB, and the OPEC Fund.

- **The 2005 program is fully financed, though the consultative group meeting is expected to yield only moderate amounts of new money.** The combination of the new identified financing, interim HIPC debt relief from the Paris Club, and HIPC and beyond-HIPC debt relief after the completion point will close the financing gap for the 2005 program.

35. **There is almost no change in debt sustainability compared with the program.** The staff analysis has been updated to reflect the impact of the Paris Club agreement and the financing for the new target (Table 11). The impact of the additional financing is slightly more than offset by higher GDP. Hence, debt relief upon reaching the completion point (expected in early 2005) would lower debt ratios well below the HIPC thresholds.



III. Program Modalities and Risks

36. **Revisions are proposed to quantitative performance criteria for end-December 2004, and new ones are set for end-June 2005** (Attachment II, Table 1)**.** Revised targets are proposed for net international reserves and net domestic assets of the central bank. The nominal targets for the deficits of the central government and the combined public sector, and poverty-reduction spending, have been revised slightly while remaining constant in terms of GDP. Indicative targets have been revised for end-September 2004 and set for March, September, and December 2005.

37. **New structural performance criteria are proposed for December 2004** (Attachment II, Table 2). They address compliance with the new prudential regulations, progress with the modernization of indirect monetary instruments, the issue of regulations to integrate supplementary benefits into overall salaries from 2007, and the passage of a 2005 budget consistent with the program. To avoid the need for future waivers on account of unforeseen temporary delays in external financing, an adjuster is proposed (on the ceiling on domestic financing and on NIR and NDA of the central bank) for temporary shortfalls in foreign financing, capped at ¾ percent of GDP.

38. **The risks to the program identified in staff report dated 2/2/04 (www.imf.org) remain significant.** The re-emergence of social unrest underscores the difficulties facing the government in sustaining domestic consensus on the program through the 2005 election period. The authorities note that so far they have succeeded in resolving these pressures within the framework of the program, and have stressed their strong commitment to continuing to do so.

I. Staff Appraisal

39. **Performance under the PRGF has been satisfactory.** The authorities are to be commended for their fiscal restraint, the robust recovery of confidence evidenced by the large reserve inflow, and their resolute pursuit of difficult structural reforms—all of which contributed to the favorable early results of the program. Projections for growth, exports, and international reserves accumulation have all been revised upward; fiscal and monetary

targets were met with significant margins; and anti-poverty spending has begun to rise. These achievements testify to the importance of the program adopted by the authorities.

40. **The government's commitment to social consensus has played an important role in maintaining support for the program.** Despite the significant social and political tensions, support for the program remains strong across a wide spectrum of society—a key asset in the government's strategy.

41. **Sustaining the program will, nevertheless, be a challenge.** To this end, a continuation of the current fiscal restraint for the rest of 2004 and the enactment of a 2005 budget consistent with program targets will be important tests of the government's ability to withstand the rising election campaign pressures. The support of congress, in refraining from any unfinanced appropriations, will play a vital role in this regard.

42. **The revised teachers' wage agreement remains consistent with the program, but leaves no room for further concessions.** To address the risk of a re-emergence of wage pressures next year, the authorities should put high priority on developing a permanent solution for government wage policy in the coming months. Moreover, the government will need to be resolute in containing the growing number of wage demands by other groups inspired by the teachers' success. Any significant further concessions would risk overwhelming the program.

43. **Staff welcomes the government's intention to increase pro-poor investment spending.** A response to vulnerable groups affected by the oil price increase is important, and the staff supports the authorities' strategy, given the limited mechanisms for income support in Honduras.

44. **Control of inflation will be a key element in achieving the objectives of the authorities' program.** While Honduras does not target inflation, the gradual decline in the inflation rate has been one of the central stabilizing factors in the economy over the last several years. Control of inflation is also a prerequisite for establishing credible and sustainable wage agreements. Hence, the staff welcomes the authorities' willingness to act, including to contain the expansion of bank borrowing and lending in foreign exchange, which has been adding to vulnerability as well as fuelling inflation. The need to contain inflation highlights also the importance of maintaining conservative fiscal targets for 2005–06.

45. **The staff supports the authorities' action plan for modernizing central bank operations.** This will make indirect monetary instruments more effective—by enabling liquidity to be better forecast and managed, and by enhancing the scope for interest rate signaling. Moreover, successful implementation of these reforms will lay the basis for a move toward greater exchange rate flexibility in future.

46. **The four financial sector laws are a key step toward strengthening the banking system.** They create the basis for a modern autonomous central bank, effective oversight of banks, and an appropriate safety net. Together with the new prudential regulations, they

contribute importantly to meeting the completion point trigger condition on substantial compliance with the Basel criteria. The staff urges strict enforcement of the timetable for compliance with the new regulations, which should gradually strengthen banking system capitalization and hence the system's ability to withstand shocks. The authorities should stand ready to take quick action to deal with non-compliant banks. In this connection, the support of the World Bank is particularly welcome.

47. **Major progress has been made with institutional reforms.** The scope of the public administration reform represents a step toward the professionalization of the civil service, though its scope is less wide than desired. The early initiation of the public sector restructuring exercise testifies to the government's resolve to achieve lasting fiscal consolidation. Tax administration reforms have proven extremely effective so far, though the planned amendments to the tax code will be key for achieving their full impact on the program. Political and judicial reforms have successfully addressed sensitive issues, which should contribute to reducing perceptions of corruption and improving the investment climate. These reforms should be accompanied by a clear and committed transparency policy of the government, including the publication of Fund reports.

48. **Based on Honduras's satisfactory performance, staff recommends completion of the first review of the PRGF arrangement, and the granting of waivers for four performance criteria.** The monetary over-performance to date creates favorable conditions for achieving the end-2004 program targets, as does the buoyancy of tax revenue. The staff supports the authorities' requests for waivers of the missed performance criteria based on the temporary nature of the non-observances. The amendments of the CNBS Law, the Deposit Insurance Law, and the Central Bank of Honduras Law have now been passed by Congress and the adoption of a new Financial Institutions Law has been set as a prior action for completion of the review.

Box 1. Legal Reforms of the Financial Sector

The four key financial sector laws are: a new central bank law; a new financial institutions law; amendment of the law governing the supervisory authority (CNBS); and amendment of the deposit insurance law.

- **The central bank law:** (1) strengthens the autonomy of the central bank by committing the ministry of finance to maintaining the central bank's statutory capital at all times, including the recapitalization of past losses and reimbursement for future losses, and by delinking the terms of the governor and board from the political cycle; (2) improves the central bank's monetary management by adopting a new framework for operations, including interest rate targeting; (3) enhances the central bank's lender-of-last-resort functions by providing for rapid liquidity support to viable banks; and (4) increases the transparency of operations by requiring publication of audited central bank financial statements.

- **The financial institutions law:** includes (1) legal changes necessary for the implementation of consolidated supervision; (2) a gradual reduction in banks' related lending and the share of banks' equity in nonfinancial firms, as part of consolidated supervision; (3) establishment of the legal basis for better risk management practices through a set of new regulations; (4) regulation to reinforce governance requirements on banks' boards of directors; (5) introduction of an improved bank resolution framework, including strengthening of sanctions and a special supervision framework for weak banks; and (6) the transfer of banking supervision, including the authorization and revocation of banks' licenses, from the central bank to the CNBS. The CNBS has already prepared corresponding regulations on these measures which will be issued upon congress's approval of the financial institutions law.

- **The amended CNBS law**: includes legal reforms to strengthen CNBS autonomy and accountability. These reforms are in line with the Basel Core principles

- **The amended deposit insurance law**: includes legal changes to adapt FOSEDE to its new role of manager of the deposit insurance scheme. Moreover, according to the new financial institutions law, FOSEDE's previous responsibility to resolve problematic banks has been transferred to the CNBS.

Box 2. April 2004 Debt Rescheduling Agreement with the Paris Club

The Paris Club creditors agreed on April 14, 2004 with the Government of Honduras to a rescheduling of its public external debt obligations. The previous agreement with the Paris Club—arranged in 1999 after the devastations of Hurricane Mitch—expired in early 2002. Lack of performance under the previous PRGF arrangement prevented a follow-up agreement with the Paris Club until the recent approval of the new PRGF program by the Board in February 2004. Since Honduras did not resume payments to Paris Club creditors since early 2002, significant payment arrears accumulated on both pre- and post-cutoff date obligations.

The latest agreement treats both accumulated arrears until end-2003 as well as current maturities falling due in 2004 and the first half of 2005. The authorities decided to signal their commitment to reaching the HIPC completion point in early 2005 by not requesting the usual three-year consolidation period.

In addition to the treatment of pre-cutoff date debt on Cologne terms, the agreement also includes a generous and unusual treatment of post-cutoff date debt. The specifics are summarized below:

- The agreement covers arrears as of December 31, 2003 and maturities falling due between January 1, 2004 and June 30, 2005.
- Obligations arising from pre-cutoff date (June 1, 1990) debt are rescheduled on Cologne terms with a reduction in the net present value (NPV) of 90 percent (or a topping-up to 90 percent for previously rescheduled debt).
- Remaining official development aid (ODA) debts after cancellation are rescheduled over 40 years, of which 16 years' grace at the initial interest rates. Remaining non-ODA debts are rescheduled at market rates over 23 years, of which 6 years' grace.
- Post-cutoff date arrears at end -2003 from credits granted between June 1, 1990 and June 20, 1999 are deferred until July 2005 (to be repaid in equal installments by January 2010).
- Ninety percent of ODA current maturities on post-cutoff date debt from credits granted between June 1, 1990 and June 20, 1999 are deferred until July 2005 (also to be repaid in equal installments by January 2010).

Comparable treatment. As usual in Paris Club rescheduling agreements, Honduras is required to seek comparable treatment from all non-Paris Club creditors.

Table 1. Honduras: Selected Economic Indicators

				Est.	Orig.	Proj.		
	2000	2001	2002	2003	2004	2004	2005	2006
(Annual percentage changes, unless otherwise indicated)								
National income and prices								
GDP at constant prices	5.7	2.6	2.7	3.2	3.5	3.8	4.0	4.5
GDP deflator	9.7	8.0	6.3	6.4	7.7	7.8	7.2	6.1
Consumer prices (end of period, eop)	10.1	8.8	8.1	6.8	6.7	8.0	6.0	5.0
Exchange rate (eop, depreciation -)								
Lempiras per U.S. dollar	-4.4	-5.0	-6.3	-5.0	…	-2.1	...	...
Real effective rate 1/	7.9	4.2	-3.7	-7.8	…	1.5	...	...
Money and credit								
Net domestic assets	19.8	8.8	7.9	31.6	8.9	10.0	7.9	10.0
Combined public sector credit	2.6	3.1	-0.9	46.0	-3.1	17.5	9.4	9.0
Private sector credit	15.4	12.2	9.6	12.3	8.3	15.4	11.4	9.0
Broad money	20.6	14.2	14.3	14.3	10.7	14.4	11.1	10.4
Lending rate (eop, in percent)	24.6	23.2	21.1	18.0	...	18.7	...	...
Deposit rate (eop, in percent)	14.5	14.3	13.1	11.0	...	11.0	...	...
(In percent of GDP)								
Combined public sector								
Noninterest revenue and grants	27.1	27.1	25.3	26.0	27.2	27.0	27.8	27.7
Noninterest expenditure	26.6	29.8	28.6	30.6	29.7	29.6	30.5	29.8
Primary balance	0.5	-2.7	-3.3	-4.6	-2.5	-2.6	-2.7	-2.3
Net interest payments	1.3	0.5	0.3	0.5	0.5	0.4	0.1	0.0
Savings	7.1	3.7	2.1	0.5	4.0	4.0	5.0	5.5
Capital expenditure	7.0	7.7	5.8	6.2	6.8	6.9	7.8	7.5
Overall balance	**-0.8**	**-3.2**	**-3.6**	**-5.1**	**-3.0**	**-3.0**	**-2.5**	**-1.7**
External financing 2/	1.5	3.0	1.9	1.9	3.2	3.9	2.9	2.6
Domestic financing	-0.7	0.1	1.7	3.2	-0.2	-0.9	-0.3	-0.8
Savings and investment								
Fixed capital formation	26.1	22.9	22.1	23.1	26.2	25.0	25.1	25.4
Gross national savings	22.2	18.9	19.3	19.4	20.0	21.4	22.1	22.4
(In millions of U. S. dollars, unless otherwise indicated)								
Balance of payments								
Gross international reserves	1,285	1,386	1,492	1,416	1,492	1,715	1,815	1,915
(in months of imports) 3/	4.4	4.7	4.6	3.7	4.0	4.4	4.3	4.3
Change in net international reserves (increase -)	-20	-80	-129	77	-78	-300	-100	-100
External current account balance (percent of GDP)	-4.0	-4.0	-2.8	-3.7	-7.1	-6.2	-3.6	-3.0
(excluding official transfers)	-9.1	-10.4	-6.9	-7.0	-10.1	-9.4	-7.2	-6.6
Exports, f.o.b. (annual percent change)	18.0	-4.2	-1.1	1.4	8.5	13.0	5.7	6.3
Imports, f.o.b. (annual percent change)	6.4	3.7	1.5	9.4	10.8	19.8	3.3	6.2
Public sector debt (in percent of GDP) 4/								
Public sector external debt (in percent of GDP) 4/	71.5	69.6	68.2	66.1	61.1	61.0	46.5	46.2
Public sector external debt service (in percent of exports of goods and services) 4/5/	7.0	8.7	8.1	8.6	7.7	7.4	5.8	5.4

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

1/ As of end-May for 2004.

2/ Includes external financing gap starting in 2005.

3/ Refers to the following year's imports of nonmaquila goods and nonfactor services.

4/ Includes medium- and long-term public and publicly guaranteed external debt, after HIPC and beyond HIPC debt relief. HIPC completion point is assumed in March 2005.

5/ Debt service paid.

Table 2. Honduras: Operations of the Central Government

(In percent of GDP)

				Prel.	Orig.	Rev. Program		
	2000	2001	2002	2003	2004	2004	2005	2006
Total revenue and grants	**18.7**	**20.0**	**19.4**	**19.6**	**20.7**	**20.4**	**20.7**	**20.6**
Current revenue	17.7	18.2	18.3	18.5	19.7	19.4	19.3	19.2
Tax revenue	16.4	16.2	15.9	16.3	17.5	17.5	17.4	17.2
Nontax revenue	0.8	0.9	1.0	0.9	1.0	0.8	0.9	1.0
Transfers	0.6	1.1	1.4	1.3	1.1	1.1	1.0	1.0
Grants	1.0	1.8	1.1	1.1	1.0	1.0	1.4	1.4
Of which: HIPC relief 1/	0.2	0.7	0.5	0.1	0.1	0.1	0.6	0.6
Total expenditure	**24.4**	**26.1**	**24.7**	**25.7**	**24.2**	**23.9**	**23.9**	**23.4**
Current expenditure	17.4	18.6	18.8	19.8	18.3	17.9	17.8	17.3
Wages and salaries	8.9	10.1	10.8	10.5	10.4	10.2	10.0	9.6
Goods and services	2.7	2.8	2.4	2.2	2.4	2.3	2.5	2.7
Transfers 2/	3.2	3.6	3.8	5.1	3.6	3.7	3.5	3.5
Interest payments	2.6	2.1	1.9	1.9	1.9	1.8	1.7	1.6
External 3/	2.1	1.8	1.6	1.6	1.4	1.3	1.2	1.1
Domestic	0.4	0.4	0.3	0.3	0.5	0.4	0.5	0.5
Capital expenditure	5.9	6.7	5.0	5.5	5.2	5.4	5.7	5.7
Fixed capital formation	2.7	2.8	2.2	2.3	2.2	2.3	2.4	1.8
Transfers	3.2	3.9	2.8	3.2	3.0	3.1	3.3	3.9
Net lending 4/	1.1	0.6	0.9	0.4	0.6	0.6	0.5	0.4
Unidentified expenditure	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	**-5.7**	**-6.1**	**-5.3**	**-6.0**	**-3.5**	**-3.5**	**-3.2**	**-2.9**
Public sector reorganization	...	...	...	...	0.0	0.0	0.2	0.4
Program balance	**...**	**...**	**...**	**...**	**-3.5**	**-3.5**	**-3.0**	**-2.5**
Financing	**5.7**	**6.1**	**5.3**	**6.0**	**3.5**	**3.5**	**3.0**	**2.5**
External financing	**1.4**	**3.5**	**1.8**	**1.7**	**-2.4**	**3.7**	**1.9**	**1.1**
Disbursements	2.2	3.9	2.4	2.4	2.9	3.4	3.1	2.6
Amortization	-6.5	-1.9	-2.3	-2.5	-2.5	-2.4	-2.2	-2.0
Zero coupon bonds	-1.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Exceptional financing	6.6	1.6	1.8	1.8	-2.7	2.8	1.1	0.6
Domestic financing	**4.3**	**2.6**	**3.4**	**4.4**	**0.5**	**-0.2**	**0.0**	**0.0**
Financial system	1.6	2.1	0.2	2.4	0.5	-0.2	0.0	0.0
Bonds	0.5	0.3	0.6	0.3	0.0	0.0	0.0	0.0
Extraordinary transfers 5/	0.0	0.0	2.3	1.2	0.0	0.0	0.0	0.0
Floating debt	-0.3	0.2	0.4	0.5	0.0	0.0	0.0	0.0
New domestic arrears	2.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap 6/	**...**	**...**	**...**	**...**	**5.4**	**0.0**	**1.0**	**1.3**
Memorandum items								
PRSP spending								
New definition	...	...	7.5	7.5	8.1	8.1	8.7	9.4
Old definition	5.1	2.9	2.4	2.5	3.2	3.2	3.8	4.5

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

1/ Comprises HIPC interim relief from IBRD/IDA starting in 2000, and the IDB ant the Fund starting in 2001.

2/ Includes the cost of support plan for agricultural loans (1 percent of GDP in 2003).

3/ On an accrual basis.

4/ Includes the costs of closing financial institutions: Bancorp in 1999, Solfisa and Banhcrecer in 2001, and Banco Capital in 2002 (0.6, 0.2, 0.5 and 0.5 percent of GDP, respectively).

5/ From the state telephone company, Hondutel.

6/ To be covered with HIPC and beyond-HIPC debt relief following the HIPC completion point (assumed March 2005) and additional external financing.

Table 3. Honduras: Operations of the Central Government - Quarterly (Cumulative)

(In millions of lempiras)

	2004								2005			
	Q1		Q2		Q3		Q4					
	Prog.	Actual	Prog.	Actual	Orig.	Rev.	Orig.	Rev.	Q1	Q2	Q3	Q4
Total revenue and grants	**5,765**	**5,716**	**13,410**	**13,625**	**20,298**	**20,282**	**27,331**	**27,420**	**6,673**	**15,357**	**23,187**	**31,105**
Current revenue	**5,175**	**5,303**	**12,496**	**12,917**	**19,061**	**19,180**	**25,965**	**26,092**	**5,773**	**13,962**	**21,301**	**29,021**
Tax revenue	4,478	4,631	11,102	11,447	16,971	17,265	23,178	23,480	5,042	12,501	19,110	26,099
Nontax revenue	329	390	658	571	987	812	1,316	1,141	339	678	1,016	1,355
Transfers	368	282	735	899	1,103	1,103	1,470	1,470	392	783	1,175	1,567
Capital revenue	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Grants	590	414	914	708	1,237	1,103	1,367	1,329	900	1,394	1,886	2,084
Of which: HIPC relief 1/	0	0	8	0	14	14	110	110	0	66	113	902
Total expenditure	**6,335**	**6,280**	**15,170**	**14,023**	**22,334**	**21,976**	**31,942**	**32,172**	**7,418**	**17,187**	**25,393**	**35,885**
Current expenditure	**5,381**	**4,955**	**12,280**	**11,011**	**17,497**	**17,139**	**24,180**	**24,109**	**5,914**	**13,545**	**19,276**	**26,657**
Wages and salaries	3,004	2,831	6,860	6,565	9,840	9,840	13,750	13,750	3,265	7,455	10,694	14,944
Goods and services	798	399	1,595	1,063	2,393	2,101	3,190	3,050	948	1,896	2,845	3,793
Transfers 2/	853	1,019	2,578	2,258	3,315	3,315	4,784	4,944	931	2,863	3,662	5,301
Interest payments	726	706	1,247	1,126	1,950	1,884	2,455	2,364	770	1,330	2,075	2,619
External 3/	567	562	928	879	1,471	1,470	1,816	1,815	578	947	1,502	1,854
Domestic	160	144	319	247	479	414	639	549	191	382	573	764
Capital expenditure	**742**	**1,381**	**2,468**	**3,065**	**4,204**	**4,204**	**6,918**	**7,218**	**1,326**	**3,288**	**5,587**	**8,522**
Fixed capital formation	290	514	1,014	1,035	1,748	1,673	2,909	3,059	701	1,440	2,516	3,631
Transfers	452	867	1,454	2,030	2,456	2,531	4,009	4,159	626	1,848	3,071	4,891
Net lending 4/	211	-56	422	-52	634	634	845	845	177	354	530	707
Unidentified expenditure	0	0	0	0	0	0	0	0	0	0	0	0
Public sector reorganization	0	0	0	0	0	0	0	0	81	163	244	326
Overall balance	**-570**	**-564**	**-1,760**	**-399**	**-2,036**	**-1,694**	**-4,611**	**-4,751**	**-663**	**-1,667**	**-1,962**	**-4,455**
Financing	**570**	**430**	**1,760**	**477**	**2,036**	**1,694**	**4,611**	**4,751**	**663**	**1,667**	**1,962**	**4,455**
External financing	**-3,769**	**877**	**-3,515**	**1,704**	**-3,481**	**3,342**	**-3,170**	**5,042**	**522**	**1,328**	**2,277**	**2,916**
Disbursements	818	1,018	1,791	2,082	2,741	2,551	3,771	4,565	901	2,147	3,296	4,668
Amortization	-943	-861	-1,654	-1,600	-2,551	-2,550	-3,263	-3,260	-954	-1,674	-2,578	-3,301
Zero coupon bonds	-20	-38	-39	-38	-59	-59	-79	-78	-21	-41	-62	-83
Exceptional financing	-3,624	758	-3,612	1,260	-3,611	3,400	-3,600	3,815	595	896	1,622	1,631
Domestic financing	**-603**	**-447**	**-923**	**-1,227**	**-1,226**	**-1,648**	**600**	**-291**	**141**	**-99**	**-1,401**	**0**
Financial system	-603	-288	-923	-1,748	-1,226	-1,648	600	-291	141	-99	-1,401	0
Bonds	0	-122	0	398	0	0	0	0	0	0	0	0
Extraordinary transfers 5/	0	200	0	200	0	0	0	0	0	0	0	0
Floating debt	0	-237	0	-78	0	0	0	0	0	0	0	0
New domestic arrears	0	0	0	0	0	0	0	0	0	0	0	0
Financing gap 6/	**4,941**	**...**	**6,197**	**...**	**6,743**	**0**	**7,181**	**0**	**0**	**439**	**1,085**	**1,539**
Memorandum items												
PRSP spending	1,935	1,995	4,655	4,765	7,195	7,195	10,698	10,900	2,570	5,783	8,995	12,850

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

1/ Comprises HIPC interim relief from IBRD/IDA starting in 2000, and the IDB ant the Fund starting in 2001.

2/ Includes the cost of support plan for agricultural loans (1 percent of GDP in 2003).

3/ On an accrual basis.

4/ Includes the costs of closing financial institutions: Bancorp in 1999, Solfisa and Banhcrecer in 2001, and Banco Capital in 2002 (0.6, 0.2, 0.5 and 0.5 percent of GDP, respectively.

5/ From the state telephone company, Hondutel.

6/ To be covered with HIPC and beyond-HIPC debt relief following the HIPC completion point (assumed March 2005) and additional external financing.

Table 4. Honduras: Operations of the Combined Public Sector 1/

(In percent of GDP)

	2000	2001	2002	Prel. 2003	Orig. 2004	Rev. 2004	Rev. 2005	Rev. 2006
Total revenue and grants	**28.8**	**28.9**	**26.9**	**27.4**	**28.7**	**28.4**	**29.5**	**29.3**
Current revenue	27.3	26.8	25.7	26.2	27.5	27.1	27.9	27.8
Tax revenue	17.3	17.0	16.8	17.1	18.4	18.3	18.2	18.0
Nontax revenue 2/	3.8	4.2	4.8	5.1	5.3	5.0	5.3	5.3
Interest earnings	1.7	1.8	1.6	1.5	1.4	1.4	1.7	1.7
Operating balance of public enterprises	4.6	3.8	2.5	2.5	2.5	2.4	2.8	2.8
Capital revenue	0.4	0.3	0.1	0.1	0.2	0.2	0.2	0.2
Grants	1.0	1.8	1.1	1.1	1.0	1.0	1.4	1.4
Of which: HIPC 3/	0.2	0.7	0.5	0.1	0.1	0.1	0.6	0.6
Total expenditure	**29.5**	**32.0**	**30.5**	**32.5**	**31.8**	**31.4**	**32.2**	**31.4**
Current expenditure	20.2	23.1	23.6	25.7	23.6	23.1	23.1	22.7
Wages and salaries	11.4	12.8	13.5	13.2	13.1	12.9	12.7	12.2
Goods and services	3.5	3.8	3.4	3.2	3.4	3.3	3.6	3.7
Transfers 4/	1.8	2.4	2.5	4.2	2.8	2.8	2.7	2.8
Operating losses of the central bank	0.0	0.4	0.9	1.1	1.1	1.2	1.3	1.3
Interest payments	3.0	2.3	2.0	1.9	1.9	1.8	1.8	1.6
External 5/	2.4	1.9	1.6	1.6	1.4	1.3	1.2	1.1
Domestic	0.5	0.4	0.3	0.4	0.5	0.4	0.5	0.5
Other	0.6	1.5	1.2	2.0	1.2	1.2	1.1	1.1
Capital expenditure	7.0	7.7	5.8	6.2	6.8	6.9	7.8	7.5
Fixed capital formation	5.8	6.7	5.3	5.9	6.2	6.2	6.8	5.8
Transfers	1.0	0.7	0.4	0.2	0.6	0.7	0.9	1.6
Other capital expenditure	0.2	0.3	0.1	0.0	0.0	0.0	0.0	0.1
Net lending	2.3	1.2	1.1	0.7	1.4	1.4	1.3	1.2
Public sector reorganization	...	...	...	...	0.0	0.0	0.2	0.4
Overall balance	**-0.8**	**-3.2**	**-3.6**	**-5.1**	**-3.0**	**-3.0**	**-2.5**	**-1.7**
Financing	**0.8**	**3.2**	**3.6**	**5.1**	**3.0**	**3.0**	**2.5**	**1.7**
External financing	**1.5**	**3.0**	**1.9**	**1.9**	**-2.3**	**3.9**	**1.8**	**1.2**
Disbursements	2.4	4.0	2.5	2.7	3.1	3.7	3.2	2.7
Amortization	-6.7	-2.5	-2.4	-2.6	-2.5	-2.5	-2.4	-2.1
Zero coupon bonds	-1.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Exceptional financing	6.7	1.6	1.8	1.8	-2.7	2.8	1.1	0.6
Domestic financing	**-0.7**	**0.1**	**1.7**	**3.2**	**-0.2**	**-0.9**	**-0.3**	**-0.8**
Banking system	0.4	0.4	-1.0	2.4	-0.2	-0.9	-0.3	-0.8
Bonds	0.5	0.0	0.3	0.0	0.0	0.0	0.0	0.0
Deposits abroad 6/	-1.3	-0.7	2.0	0.0	0.0	0.0	0.0	0.0
Floating debt	-0.3	0.4	0.5	0.8	0.0	0.0	0.0	0.0
Financing gap 7/	**...**	**...**	**...**	**...**	**5.4**	**0.0**	**1.0**	**1.3**
Memorandum items								
Current account balance	7.1	3.7	2.1	0.5	4.0	4.0	5.0	5.5
Primary balance	0.5	-2.7	-3.3	-4.6	-2.5	-2.6	-2.5	-1.8
Current primary balance	8.4	4.2	2.4	1.0	4.4	4.4	5.1	5.4

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

1/ Includes the nonfinancial public sector and the quasi-fiscal deficit of the central bank.

2/ Includes contributions to the social security system.

3/ Comprises HIPC interim relief from IBRD/IDA starting in 2000, and the IDB and the Fund starting in 2001.

4/ Includes the cost of support plan for agricultural loans (1 percent of GDP in 2003).

5/ On an accrual basis.

6/ Includes the change in deposits of the state telephone company held abroad.

7/ To be covered with HIPC and beyond-HIPC debt relief following the HIPC completion point (assumed March 2005) and additional external financing.

Table 5. Honduras: Operations of the Combined Public Sector - Quarterly (Cumulative) 1/

(In millions of lempiras, cumulative since the beginning of the year)

	2004								2005			
	Q1		Q2		Sep.		Dec.					
	Prog.	Actual	Prog.	Actual	Original	Revised	Original	Revised	Mar.	Jun.	Sep.	Dec.
Total revenue and grants	**8,425**	**8,367**	**18,729**	**17,842**	**28,277**	**28,361**	**37,970**	**38,159**	**9,947**	**21,905**	**33,010**	**44,202**
Current revenue	7,757	7,915	17,660	17,085	26,807	27,026	36,293	36,520	8,987	20,390	30,943	41,877
Tax revenue	4,752	4,883	11,651	11,699	17,794	18,088	24,275	24,577	5,330	13,078	19,974	27,252
Nontax revenue 2/	1,734	1,677	3,468	2,864	5,202	5,027	6,936	6,761	1,979	3,959	5,938	7,917
Interest earnings	450	376	901	877	1,351	1,451	1,802	1,902	637	1,275	1,912	2,549
Operating balance of public enterprises	820	979	1,640	1,645	2,460	2,460	3,280	3,280	1,040	2,079	3,119	4,159
Capital revenue	74	35	149	45	223	223	298	298	57	114	170	227
Grants	594	416	921	712	1,246	1,112	1,379	1,341	904	1,401	1,896	2,098
Of which: HIPC 3/	0	0	8	0	14	14	110	110	0	66	113	902
Total expenditure	**9,075**	**8,705**	**20,533**	**18,313**	**30,074**	**29,903**	**41,937**	**42,255**	**10,800**	**23,820**	**35,006**	**48,342**
Current expenditure	7,334	6,670	15,559	14,515	22,845	22,673	31,109	31,127	8,185	17,363	25,498	34,719
Wages and salaries	3,781	3,689	8,659	7,657	12,415	12,415	17,348	17,348	4,135	9,472	13,580	18,977
Goods and services	1,138	690	2,276	1,447	3,414	3,121	4,551	4,411	1,338	2,676	4,015	5,353
Transfers 4/	932	766	1,864	1,489	2,796	2,796	3,728	3,728	1,024	2,047	3,071	4,094
Operating losses of the central bank	362	444	724	853	1,086	1,256	1,448	1,675	488	976	1,463	1,951
Interest payments	736	745	1,266	1,186	1,978	1,912	2,492	2,401	780	1,351	2,108	2,662
External 5/	567	572	928	891	1,471	1,470	1,816	1,815	579	948	1,502	1,854
Domestic	169	173	338	295	507	443	676	587	202	404	606	808
Other	385	337	770	1,883	1,155	1,172	1,540	1,563	420	841	1,261	1,682
Capital expenditure	1,269	1,636	4,029	3,097	5,813	5,813	8,940	9,240	2,141	5,509	8,087	11,729
Fixed capital formation	1,255	1,479	3,815	2,671	5,398	5,323	8,138	8,288	1,961	4,959	7,165	10,243
Transfers	-2	140	182	408	366	441	737	887	161	514	867	1,412
Other capital expenditure	16	17	33	17	49	49	65	65	18	37	55	73
Net lending	472	399	944	701	1,416	1,416	1,889	1,889	474	947	1,421	1,895
Required measures	**0**	**0**	**0**	**0**	**0**		**0**		**81**	**163**	**244**	**326**
Overall balance	**-651**	**-338**	**-1,804**	**-471**	**-1,798**	**-1,542**	**-3,967**	**-4,096**	**-771**	**-1,752**	**-1,751**	**-3,814**
Financing	**651**	**109**	**1,804**	**136**	**1,798**	**1,542**	**3,967**	**4,096**	**771**	**1,752**	**1,751**	**3,814**
External	-3,734	713	-3,426	1,685	-3,345	3,492	-2,977	5,301	332	1,165	1,770	2,745
Disbursements	882	1,024	1,931	2,290	2,955	2,779	4,065	4,925	905	2,175	3,327	4,739
Amortization	-972	-1,032	-1,705	-1,828	-2,630	-2,628	-3,363	-3,361	-1,024	-1,796	-2,771	-3,543
Zero coupon bonds	-20	-38	-40	-38	-59	-59	-79	-78	-21	-41	-62	-83
Exceptional financing	-3,624	760	0	1,262	-3,612	3,400	-3,600	3,815	472	827	1,276	1,631
Domestic	-556	-604	-968	-1,549	-1,600	-1,951	-237	-1,205	439	149	-1,104	-470
Banking system	-556	-312	-968	-1,438	-1,600	-1,951	-237	-1,205	439	149	-1,104	-470
Bonds	0	-108	0	-34	0	0	0	0	2	-726	-2,416	-2,220
Deposits abroad 6/	0	-99	0	-130	0	0	0	0	438	875	1,313	1,750
Floating debt	0	-85	0	54	0	0	0	0	0	0	0	0
Financing gap 7/	**4,941**	**0**	**6,197**	**0**	**6,743**	**0**	**7,181**	**0**	**0**	**439**	**1,085**	**1,539**

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

1/ Includes the nonfinancial public sector and the quasi-fiscal deficit of the central bank.

2/ Includes contributions to the social security system.

3/ Comprises HIPC interim relief from IBRD/IDA starting in 2000, and the IDB and the Fund starting in 2001.

4/ Includes the cost of support plan for agricultural loans (1 percent of GDP in 2003)

5/ On an accrual basis.

6/ Includes the change in deposits of the state telephone company held abroad.

7/ To be covered with HIPC and beyond-HIPC debt relief following the HIPC completion point (assumed March 2005) and additional external financing.

Table 6. Honduras: Monetary Survey 1/

	2000	2001	2002	Prel. 2003	Orig. Prog. 2004	Rev. Program 2004	Rev. Program 2005	Rev. Program 2006
I. Central Bank								
(In percent of currency issue at beginning of period)								
Net international reserves	**16.3**	**34.7**	**51.1**	**-5.4**	**32.3**	**49.1**	**34.1**	**29.0**
(Flow in millions of U.S. dollars)	20.0	79.9	128.8	-77.2	77.7	150.0	100.0	100.0
Net domestic assets	**-12.5**	**-26.7**	**-41.6**	**20.7**	**-26.3**	**-37.4**	**-22.8**	**-18.2**
Combined public sector	1.8	-10.2	1.4	39.3	-2.5	-15.0	-5.1	-15.2
Nonfinancial public sector	1.9	-16.6	-14.4	20.5	-20.4	-35.7	-24.1	-32.9
Operating losses of central bank	0.0	6.3	15.8	18.7	17.9	20.8	19.0	17.7
Rest of the banking sector	-12.9	-4.8	-35.7	-0.2	-9.8	-14.5	-21.2	-6.5
Of which: Open market operations	-5.2	-6.9	-16.7	-1.6	-11.4	-14.0	-17.5	-0.7
Private sector	-8.9	-4.8	-0.8	-15.1	-0.8	-6.9	0.7	0.5
Medium- and long-term net foreign liabilities	4.0	3.9	2.8	1.8	2.8	0.6	0.5	0.1
Other	2.9	-10.6	-9.4	-4.9	-16.0	-1.6	2.3	2.9
Currency issue	**3.8**	**8.0**	**9.6**	**15.3**	**6.0**	**11.7**	**11.3**	**10.8**
II. Financial System 2/								
(In percent of broad money at beginning of period)								
Net short-term foreign assets	**7.4**	**7.9**	**10.5**	**-0.2**	**6.1**	**10.6**	**5.7**	**5.5**
(Flow in millions of U.S. dollars)	119.0	143.6	212.7	-89.5	111.3	273.8	127.9	155.5
Net domestic assets	**13.2**	**6.3**	**3.8**	**14.4**	**4.6**	**3.7**	**5.4**	**4.9**
Combined public sector	0.8	0.8	-0.2	8.6	-0.3	-1.9	-0.6	-1.8
Nonfinancial public sector	0.8	-0.1	-2.2	6.3	-2.6	-4.4	-2.9	-4.0
Operating losses of central bank	0.0	0.9	2.0	2.3	2.3	2.6	2.3	2.1
Private sector	13.2	10.0	7.7	9.5	6.3	11.7	8.7	6.9
Medium- and long-term net foreign liabilities	0.4	0.6	0.6	0.5	0.5	-0.9	0.2	0.1
Other	-1.2	-5.1	-4.3	-4.2	-2.0	-5.2	-2.9	-0.2
Broad money 3/	**20.6**	**14.2**	**14.3**	**14.3**	**10.7**	**14.4**	**11.1**	**10.4**
(12-month percentage change)								
Currency in circulation	0.4	9.3	7.2	16.9	4.6	10.6	12.1	10.8
Broad money	20.6	14.2	14.3	14.3	10.7	14.4	11.1	10.4
Liabilities in lempiras	19.6	8.3	12.8	14.1	10.4	14.1	10.6	10.3
Liabilities in foreign currency	23.8	32.7	18.3	14.7	11.3	15.1	12.2	10.8
Credit to private sector	15.4	12.2	9.6	12.3	8.3	15.4	11.4	9.0
Credit in lempiras	17.5	13.7	8.8	7.1	8.3	10.0	12.0	9.5
Credit in foreign currency 4/	9.1	7.1	12.5	29.9	8.3	30.6	9.8	7.8
Memorandum items								
(Average stock in percent of GDP)								
Currency issue	6.6	6.2	6.2	6.3	6.3	6.3	6.3	6.4
Broad money	45.0	47.0	49.2	50.5	50.9	51.6	52.2	52.1
Credit to private sector	37.8	38.3	38.8	38.7	38.4	39.5	40.1	39.8
Open market operations	3.3	3.3	3.7	3.8	3.8	3.9	4.4	4.4
(In percent of total deposits/credit)								
Dollarization (end-period stocks)								
Foreign currency deposits	29.0	33.4	34.2	35.1	34.9	35.4	35.6	35.6
Foreign currency credit	23.2	22.2	22.8	26.4	23.9	29.8	29.4	29.1

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

1/ At current exchange rate.

2/ Comprises the central bank, commercial banks, savings and loans, and development banks, including a second-tier bank.

3/ Includes open market paper held by the private sector.

4/ Percentage change refers to amount in lempiras.

Table 7. Honduras: Summary Accounts of the Central Bank

(End-of-period stocks, in millions of lempiras)

	Prel. 2003		Prel.	2004						Revised Program 2005			
				Jun.		Sep.		Dec.					
	Jun.	Dec.	Mar.	Orig. Pr.	Prel.	Orig. Pr.	Rev. Pr.	Orig. Pr.	Rev. Pr.	Mar.	Jun.	Sep.	Dec.
Net international reserves	**19,767**	**20,009**	**21,146**	**21,079**	**23,605**	**21,557**	**23,501**	**22,613**	**23,964**	**24,761**	**25,527**	**26,301**	**27,034**
(In millions of U.S. dollars)	*1,140*	1,127	1,176	1,155	1,297	1,165	1,270	1,205	1,277	1,305	1,330	1,355	1,377
Net domestic assets	**-13,258**	**-11,953**	**-13,857**	**-13,827**	**-15,956**	**-14,839**	**-16,382**	**-14,075**	**-14,963**	**-16,368**	**-17,002**	**-18,193**	**-17,019**
Combined public sector	-6,415	-4,934	-5,019	-5,884	-5,845	-6,513	-6,994	-5,154	-6,139	-5,697	-5,985	-7,235	-6,599
Nonfinancial public sector	-8,986	-8,151	-8,685	-9,808	-9,917	-10,796	-11,467	-9,796	-11,031	-11,017	-11,733	-13,410	-13,202
Cumulative losses of central bank	2,570	3,217	3,667	3,924	4,072	4,283	4,473	4,642	4,892	5,320	5,748	6,175	6,603
Rest of the banking sector	-8,589	-7,980	-9,428	-8,407	-10,730	-8,479	-10,064	-8,699	-9,145	-11,168	-12,338	-12,606	-11,054
Of which													
Open market operations	-5,270	-4,626	-6,069	-5,372	-6,862	-5,364	-6,835	-5,475	-5,754	-7,855	-8,857	-9,049	-7,334
Private sector	-2,047	-2,273	-2,612	-2,206	-2,632	-2,306	-2,732	-2,406	-2,832	-2,456	-2,406	-2,356	-2,306
Medium- and long-term net foreign liabilities	-2,815	-2,743	-2,730	-2,676	-2,721	-2,596	-2,701	-2,516	-2,691	-2,639	-2,680	-2,731	-2,651
Other	6,671	6,049	6,007	5,345	6,038	5,055	6,184	4,700	5,919	6,089	6,794	7,148	6,128
Currency issue	**6,509**	**8,056**	**7,289**	**7,252**	**7,650**	**6,718**	**7,119**	**8,538**	**9,001**	**8,394**	**8,525**	**7,875**	**10,015**

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

Table 8. Honduras: Structure and Performance of Banking Sector

(In percent unless otherwise indicated)

	1999	2000	2001	2002	Prel. 2003	End-June 2004
Total assets (in millions of lempiras) 1/	**53,071**	**60,379**	**66,923**	**75,118**	**89,386**	**98,844**
(in percent of GDP)	68.8	67.5	67.6	69.5	74.3	77.6
Number of banks	**22**	**21**	**21**	**19**	**16**	**16**
Of which						
In process of liquidation or taken over	1	0	1	1	0	0
Domestic	20	19	19	17	10	10
Foreign	2	2	2	2	6	6
Bank concentration						
Number of banks accounting for at least:						
25 percent of total assets	2	2	2	2	2	2
75 percent of total assets	10	9	8	7	6	6
Bank rating (CAMEL) 2/						
Number of banks (Category IV and V)	4	5	5	3	2	2
Share of total assets	11.9	18.8	16.6	5.3	11.2	11.8
Capital adequacy						
Regulatory capital to risk-weighted assets	11.4	12.3	12.7	12.9	13.0	13.1
Capital (net worth) to assets	8.7	8.8	9.2	8.1	7.6	7.3
Asset quality and composition						
Nonperforming loans (NPLs) to total loans 3/	9.2	10.6	11.4	11.3	8.7	8.7
NPLs net of provisions to capital	48.2	51.7	52.6	43.0	37.4	32.7
Restructured loans to regulatory capital	0.0	9.9	41.8	47.2	20.5	10.7
Provisions to total loans	2.1	2.8	3.4	4.0	3.2	3.8
Provisions to NPLs	24.1	27.7	27.2	38.7	38.2	46.0
Sectoral distribution of loans to total loans:						
Commerce	21.7	20.3	19.2	17.7	15.8	16.0
Construction and real estate	14.9	15.7	15.5	12.9	18.7	19.8
Agriculture and related sectors	15.6	16.5	13.8	11.2	7.8	8.7
Manufacturing	19.4	18.0	16.9	17.5	19.4	20.1
Consumption	6.9	6.9	10.0	13.8	13.0	13.4
Other	21.5	22.6	24.6	26.9	25.3	22.5
Profitability						
Return on assets (ROA) 4/	1.4	0.9	0.9	0.8	1.2	1.4
Return on equity (ROE)	11.2	7.6	8.4	8.2	11.8	16.8
Interest margin to total income	37.4	37.4	39.4	41.5	45.0	45.8
Personnel expenses to administrative expenses	42.3	39.9	40.8	38.0	36.7	37.1
Liquidity						
Liquid assets to total assets	23.7	23.7	26.6	30.1	24.9	27.6
Liquid assets to total short-term liabilities	63.2	59.5	58.2	64.1	53.2	60.1
Dollarization						
Foreign currency deposits in percent of total	28.7	29.0	33.4	34.2	35.1	35.8
Foreign currency credit in percent of total credit	24.6	23.2	22.2	22.8	26.4	31.8

Sources: National Commission of Banking and Insurance; and Fund staff estimates.

1/ Includes contingent assets.

2/ As of end-August for 2003.

3/ NPLs exclude restructured loans, mostly to the agricultural sector.

4/ Assets include off-balance sheet items.

Table 9. Honduras: Balance of Payments

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

				Prel.	Orig. Prog.	Rev. Proj.					
	2000	2001	2002	2003	2004	2004	2005	2006	2007	2008	2009
Current account	**-240**	**-258**	**-183**	**-255**	**-512**	**-456**	**-278**	**-253**	**-270**	**-314**	**-376**
Trade balance	-1,233	-1,392	-1,448	-1,692	-1,927	-2,120	-2,152	-2,283	-2,440	-2,623	-2,816
Exports	1,437	1,376	1,361	1,380	1,505	1,560	1,649	1,753	1,874	2,001	2,139
Imports 1/	-2,670	-2,768	-2,809	-3,072	-3,433	-3,679	-3,802	-4,036	-4,314	-4,624	-4,955
Services	394	339	451	524	544	559	626	692	755	821	893
Of which											
Value-added maquila industries	575	561	613	710	728	791	854	923	996	1,076	1,162
Tourism receipts	260	256	301	342	374	376	414	451	487	526	568
Income (net)	-153	-178	-190	-198	-202	-233	-221	-224	-227	-242	-258
Of which											
Interest payments	-187	-154	-142	-129	-145	-147	-140	-134	-130	-125	-122
Current transfers (net)	753	973	1,004	1,112	1,073	1,337	1,470	1,562	1,643	1,730	1,806
Public sector 2/	306	410	270	229	214	238	284	295	302	297	274
Private sector	447	563	734	883	859	1,100	1,186	1,267	1,341	1,434	1,532
Capital account	**-24**	**171**	**130**	**-14**	**393**	**545**	**223**	**189**	**251**	**298**	**359**
Foreign direct investment (net)	282	193	176	198	195	248	234	250	267	285	304
Portfolio investments (net)	-61	-4	-4	-4	-4	-4	-4	-4	-4	-4	-4
Public sector loans (net)	-13	107	-29	8	15	62	54	37	65	82	106
Disbursements 3/	169	271	163	221	223	270	256	228	243	258	270
Amortizations 3/	-182	-164	-192	-213	-207	-207	-202	-191	-178	-176	-164
Other medium- and long-term loans (net)	-24	-44	-26	-106	115	125	-15	-15	-15	-15	-15
Short-term loans (net)	-210	-82	13	-111	72	114	-47	-79	-61	-49	-32
Errors and omissions	117	75	63	58	0	0	0	0	0	0	0
Overall balance	**-147**	**-12**	**9**	**-211**	**-119**	**89**	**-56**	**-65**	**-18**	**-16**	**-17**
Net international reserves (- increase)	-20	-80	-129	77	-78	-300	-100	-100	-100	-100	-100
Of which: IMF (net)	6	4	-24	-25	13	13	3	3	-17	-32	-25
Exceptional financing 4/	167	92	120	134	197	211	85	54	0	0	0
Financing gap 5/	**0**	**0**	**0**	**0**	**0**	**0**	**71**	**111**	**118**	**116**	**117**
Memorandum items:											
Terms of trade (percent change)	-8.0	-6.8	-8.6	-5.2	1.9	-1.4	-0.2	1.8	1.7	1.4	1.3
Exports of goods and services (percent change)	11.5	-2.7	3.3	7.0	8.5	11.2	6.9	7.1	7.3	7.3	7.3
Of goods only	18.0	-4.2	-1.1	1.4	8.6	13.0	5.7	6.3	6.9	6.8	6.9
Imports of goods and services (percent change)	9.3	4.4	0.7	9.9	10.8	18.0	3.8	6.2	6.9	7.2	7.2
Of goods only	6.4	3.7	1.5	9.4	11.6	19.8	3.3	6.2	6.9	7.2	7.2
Current account (in percent of GDP)											
Including official transfers	-4.0	-4.0	-2.8	-3.7	-7.1	-6.2	-3.6	-3.0	-3.0	-3.3	-3.7
Excluding official transfers	-9.1	-10.4	-6.9	-7.0	-10.1	-9.4	-7.2	-6.6	-6.4	-6.4	-6.4
Overall balance (in percent of GDP)	-2.4	-0.2	0.1	-3.0	-1.7	1.2	-0.7	-0.8	-0.2	-0.2	-0.2
Gross reserves (end of period)	1,285	1,386	1,492	1,416	1,492	1,715	1,815	1,915	2,015	2,115	2,215
In months of next year imports of nonmaquila goods and nonfactor services	4.4	4.7	4.6	3.7	4.0	4.4	4.3	4.3	4.2	4.1	4.0
In percent of short term external debt 6/	271.8	261.8	253.8	279.2	237.2	266.8	282.9	307.1	319.3	334.7	329.7
Outstanding external debt 7/	4,307	4,455	4,489	4,584	4,400	4,495	3,636	3,849	4,027	4,208	4,424
Debt to GDP ratio (in percent)	71.5	69.6	68.2	66.1	61.1	61.0	46.5	46.2	45.3	44.3	43.6
Public sector debt service paid to exports (in percent) 7/	7.0	8.7	8.1	8.6	7.7	7.4	5.8	5.4	4.7	4.8	5.1
Nominal GDP (millions of U.S. dollars)	6,025	6,400	6,580	6,937	7,200	7,369	7,814	8,333	8,899	9,502	10,148

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

1/ Includes special imports for private energy projects of US$181 million in 2004 and US$37 million in 2005.

2/ Includes HIPC grants from the World Bank, IDB, and the Fund.

3/ Net of debt relief operation granted by the Central American Bank for Economic Integration (CABEI) in 2000, with purchase of zero-coupon bond recorded in portfolio investment.

4/ Includes debt relief from Paris Club (1999-2004), the Central American Emergency Trust Fund (1999-2000), HIPC relief from CDC, and program loans from the World Bank and the IDB.

5/ To be covered with HIPC and beyond-HIPC debt relief following the HIPC completion point (assumed March 2005) and additional external financing.

6/ External debt due within a year.

7/ Medium- and long-term public and publicly guaranteed external debt, after HIPC and beyond HIPC debt relief. HIPC completion point is assumed in March 2005.

Table 10. Honduras: Summary of Macroframework

	2002	Est. 2003	Projection 2004	2005	2006	2007	2008
(Annual percentage change)							
National income and prices							
GDP at constant prices	2.7	3.2	3.8	4.0	4.5	4.5	4.5
Of which							
Consumption	3.9	3.9	2.2	4.3	4.3	4.2	4.2
Investment	-5.9	7.9	16.8	0.6	4.5	7.1	7.9
Exports	4.7	4.5	3.8	6.2	6.9	6.5	6.4
Imports	1.7	9.0	7.8	4.1	5.9	7.1	7.4
Consumer prices (end of period)	8.1	6.8	7.8	8.0	5.0	4.0	3.0
GDP per capita (in U.S. dollars)	964	976	1,003	1,035	1,077	1,123	1,169
Poverty rate 1/	64	62	60	58	57	56	54
(In percent of GDP, unless otherwise stated)							
Combined public sector							
Savings	2.1	0.5	4.0	5.0	5.5	5.5	5.5
Anti-poverty spending	7.5	7.5	8.1	8.7	9.4	9.4	9.4
Overall balance	-3.6	-5.1	-3.0	-2.5	-1.7	-1.7	-1.7
Of which							
Central government balance	-5.3	-6.0	-3.5	-3.0	-2.5	-2.5	-2.5
General government balance	-2.9	-3.6	-1.1	-0.9	-0.5	-0.4	-0.4
Public sector debt	72.9	72.1	66.0	51.4	50.7	49.4	48.3
Savings and investment							
Fixed capital formation	22.1	23.1	26.2	25.0	25.1	25.4	25.8
Private sector	16.8	17.2	20.2	18.2	19.3	19.6	20.0
Public sector	5.3	5.9	6.0	6.8	5.8	5.8	5.8
Gross national saving	19.3	19.4	20.0	21.4	22.1	22.4	22.5
Private sector	17.3	18.0	16.0	16.4	16.6	16.9	17.0
Public sector	2.0	1.4	4.0	5.0	5.5	5.5	5.5
External current account balance	**-2.8**	**-3.7**	**-6.2**	**-3.6**	**-3.0**	**-3.0**	**-3.3**
Gross international reserves							
(in months of imports) 2/	4.6	3.7	4.4	4.3	4.3	4.2	4.1
External public debt 3/							
NPV of public sector external debt before HIPC relief	48.4	44.4	42.0	39.6	37.3	35.2	33.5
NPV of public sector external debt after HIPC relief 4/	47.8	46.5	43.5	29.9	29.3	28.5	27.7
(in percent of currrent government revenue)	260.5	251.4	223.0	154.7	152.6	148.4	144.4
(in percent of exports) 5/	126.8	126.9	117.5	78.9	76.3	73.9	71.6
Public sector external debt after HIPC relief 4/	68.2	66.1	61.0	46.5	46.2	45.3	44.3

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

1/ Taken from I-PRSP based on Honduras Multipurpose Household Survey. Projections based on income-poverty elasticity of 0.6 percent.

2/ Refers to the next year imports of nonmaquila goods and nonfactor services.

3/ Comprises medium- and long-term public and publicly guaranteed external debt.

4/ Assumes HIPC completion point in March 2005 and beyond HIPC relief from Paris Club creditors.

5/ Three-year backward-looking average of exports of goods and services.

Table 11. Honduras: External Debt Sensitivity Analysis

(In percent of GDP, unless otherwise noted)

	2002	Prel. 2003	Rev. Program 2004	Rev. Program 2005	Rev. Program 2006	Projection 2007	Projection 2008	Projection 2009
I. Active Scenario								
External public debt 1/								
NPV of public sector external debt	47.8	46.5	43.5	29.9	29.3	28.5	27.7	27.1
(In percent of current government revenue) 2/	260.5	251.4	223.0	154.7	152.6	148.4	144.4	141.1
(In percent of exports) 3/	126.8	126.9	117.5	78.9	76.3	73.9	71.6	69.7
Public sector external debt	68.2	66.1	61.0	46.5	46.2	45.2	44.3	43.6
Indicators								
Central government revenue	18.3	18.5	19.4	19.3	19.2	19.2	19.2	19.2
Exports of goods and services (percentage change)	3.3	7.0	10.8	7.5	7.2	7.3	7.2	7.3
Real GDP growth (in percent)	2.7	3.2	3.8	4.0	4.5	4.5	4.5	4.5
Combined public sector primary balance	-3.3	-4.6	-2.6	-2.5	-1.8	-2.0	-1.9	-1.9
II. Sensitivity Analysis								
1. Lower current revenue and expenditure								
(by 2 percentage points of GDP per year)								
NPV of public sector external debt								
(in percent of current government revenue)	260.5	251.4	249.8	172.4	170.3	165.5	161.1	157.4
Central government revenue	18.3	18.5	17.4	17.3	17.2	17.2	17.2	17.2
2. Lower export growth								
(by 2 standard deviations for 2004–05)								
NPV of public sector external debt								
(in percent of exports)	126.8	126.9	125.6	95.6	105.2	108.7	105.3	102.5
Exports of goods and services (percentage change)	3.3	7.0	-8.4	-11.7	7.2	7.3	7.2	7.3
3. Lower real GDP growth								
(by 2 standard deviations for 2004–05)								
Public sector external debt	68.2	66.1	64.1	51.4	51.1	50.0	49.0	48.2
Real GDP growth (in percent)	2.7	3.2	-1.3	-1.1	4.5	4.5	4.5	4.5
4. Lower primary balance								
(by 2 percentage points of GDP per year)								
Public sector external debt	68.2	66.1	63.0	49.9	51.3	52.0	52.6	53.4
Combined public sector primary balance	-3.3	-4.6	-4.6	-4.5	-3.8	-4.0	-3.9	-3.9
5. Real exchange rate depreciation								
(by 15 percent in 2004)								
Public sector external debt	68.2	66.1	71.8	54.7	54.3	53.2	52.1	51.3
Memorandum items:								
Standard deviation for period 1993–2003								
Real GDP growth	2.5							
Exports of goods and services (percentage change)	9.6							

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

1/ After debt relief under the enhanced HIPC Initiative. Includes beyond HIPC relief from Paris Club creditors.
2/ Central government current revenue excluding grants.
3/ Three-year backward looking average of exports of goods and services.

Table 12. Honduras: External Financing Requirements and Sources

(In millions of U.S. dollars)

	2000	2001	2002	Prel. 2003	Orig. Prog. 2004	Rev. Projection 2004	2005	2006
1. Gross financing requirements	**-1,119.5**	**-1,179.2**	**-909.5**	**-922.5**	**-1,303.0**	**-1,474.1**	**-1,069.5**	**-1,077.0**
External current account deficit								
(excluding official transfers)	-545.4	-667.3	-453.7	-484.1	-726.0	-693.6	-562.7	-548.1
Debt amortization	-505.6	-388.5	-308.9	-474.5	-286.0	-254.5	-380.0	-401.8
Medium- and long-term debt	-296.0	-306.8	-322.3	-363.8	-359.0	-368.5	-333.3	-322.6
Public sector	-181.5	-164.4	-192.3	-212.8	-207.0	-207.4	-202.0	-191.2
Commercial banks	-88.5	-98.3	-83.7	-57.0	-74.0	-60.0	-81.3	-81.3
Corporate private sector	-26.0	-44.1	-46.3	-94.0	-77.0	-101.1	-50.0	-50.0
Short-term debt (net) 1/	-209.6	-81.7	13.4	-110.7	72.0	114.1	-46.7	-79.3
Repayment of arrears	-8.1	-14.3	-0.6	0.0	-198.0	-211.6	0.0	0.0
Gross reserves accumulation	-55.6	-100.5	-106.7	76.9	-77.0	-299.7	-100.0	-100.0
IMF repurchases and repayments	-4.9	-8.6	-39.5	-40.8	-15.0	-14.8	-26.8	-27.1
2. Available financing	**1,119.5**	**1,179.2**	**909.5**	**922.5**	**1,303.0**	**1,474.1**	**998.4**	**966.1**
Foreign direct investment (net)	282.0	193.0	175.5	198.0	195.0	247.7	234.4	250.0
Debt financing from private creditors	90.8	98.9	104.2	45.4	266.0	286.1	117.3	118.3
Medium- and long-term financing	90.8	98.9	104.2	45.4	266.0	286.1	117.3	118.3
Public sector	0.0	0.0	0.0	0.0	0.0	0.0	1.0	2.0
Commercial banks	48.0	52.4	70.0	47.6	76.0	112.0	76.3	76.3
Corporate private sector	42.8	46.5	34.2	-2.2	190.0	174.1	40.0	40.0
Official creditors 2/	474.6	679.4	428.9	450.2	521.0	606.1	583.8	570.9
Loan disbursements	168.9	271.2	163.0	221.2	313.0	374.0	308.6	281.5
Of which: program loans					90.0	104.2	52.5	53.0
Grants	305.7	408.2	265.9	229.0	208.0	232.1	275.2	289.4
IMF 3/	21.3	21.9	4.5	0.0	36.0	35.8	38.8	35.2
Accumulation of arrears								
(exceptional)	21.7	0.8	75.4	132.5	0.0	0.0	0.0	0.0
Debt rescheduling (already agreed)	...	...	...	...	303.0	318.2	32.3	0.7
Of which: arrears	...	...	...	...	198.0	211.6	...	...
Other flows 4/	229.1	185.3	121.0	96.4	-18.0	-19.8	-8.4	-9.1
3. Financing gap	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**71.0**	**110.9**
Of which:								
Unidentified financing	...	...	...	...	...	...	0.0	24.0
Possible debt rescheduling								
(including beyond HIPC)	...	...	...	...	...	...	71.0	86.9

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

1/ Original maturity of less than 1 year. Stock at the end of the previous period.

2/ Excluding the IMF.

3/ Including IMF HIPC grants.

4/ Includes all other net financial flows, and errors and omissions.

Table 13. Honduras: Indicators of Fund Credit

(In units indicated)

				Projections					
	2001	2002	2003	2004	2005	2006	2007	2008	2009
Stock of existing and prospective Fund credit 1/									
In millions of SDRs	175.1	144.6	115.4	125.7	127.8	129.7	118.3	96.6	79.9
In percent of quota	135.2	111.7	89.1	97.1	98.7	100.2	91.3	74.6	61.7
In percent of exports of goods and services	9.1	7.8	6.4	6.2	5.9	5.6	4.7	3.6	2.8
In percent of external debt	4.9	4.4	3.7	4.1	5.2	5.0	4.3	3.4	2.7
In percent of gross reserves	15.9	13.2	12.1	10.7	10.3	10.0	8.6	6.7	5.3
Obligations to the Fund from existing and prospective Fund arrangements									
In millions of SDRs	10.3	32.7	30.7	11.0	19.2	19.3	22.7	22.5	17.5
In percent of quota	7.9	25.2	23.7	8.5	14.9	14.9	17.5	17.4	13.5
In percent of exports of goods and services	0.5	1.8	1.7	0.5	0.9	0.8	0.9	0.8	0.6
In percent of external debt	0.3	1.0	1.0	0.4	0.8	0.7	0.8	0.8	0.6
In percent of gross reserves	0.9	3.0	3.2	0.9	1.6	1.5	1.7	1.6	1.2

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

1/ End of period.

Table 14. Honduras: Review and Phasing of Disbursements under the PRGF Arrangement, 2004–2007

	Expected Disbursements		
Date	In millions of SDRs	In percent of quota	Conditions to be Observed
February 2004	10.171	7.85	Board approval of PRGF Arrangement
September 2004	10.171	7.85	First review; and end-June 2004 performance criteria
March 2005	10.171	7.85	Second review; and end-December 2004 performance criteria
September 2005	10.171	7.85	Third review; and end-June 2005 performance criteria
March 2006	10.171	7.85	Fourth review; and end-December 2005 performance criteria
September 2006	10.171	7.85	Fifth review; and end-June 2006 performance criteria
February 2007	10.171	7.85	Sixth review; and end-December 2006 performance criteria

Source: Fund staff projections.

Table 15. Honduras: Status of Compliance in Meeting the HIPC Completion Point Conditions (as of May 2004)

Conditions	Primary Monitoring Responsibility	Status of Compliance	Pending Actions
1. Maintenance of macroeconomic stability as evidenced by performance under a program supported by a PRGF arrangement	IMF	Good start. New PRGF arrangement approved in February 2004.	Maintain program on track, at least through early 2005.
2. Successful implementation of the full PRSP for at least one year	IDA/IMF/IDB	1st PRSP Progress Report showed mixed progress to date in PRSP implementation.	Satisfactory implementation of PRSP during 2003–04, to be documented in 2nd PRSP Progress Report.
3. Preparation and implementation of a participatory, comprehensive anti-corruption strategy.	IDB	Mostly satisfied.	Satisfactory progress in completing implementation of TSC strengthening plan.
4. Reform of the social security system	IDA/IDB	Good progress.	Satisfactory progress in: (i) completing the registration of IHSS affiliates, (ii) implementing the new health facility certification program, and (iii) completing actuarial studies and adjusting contribution rates, if needed, to ensure a sound pension system.
5. Strengthening of the basic health services for the poor	IDB	Fully satisfied.	None
6. Improvement in the quality of education by increasing the number of schools with community participation (PROHECO)	IDA	Fully satisfied.	None
7. Increase in the efficiency and targeting of safety nets	IDA	Good progress.	Extend participatory planning methods in FHIS projects from 50 to all of the 87 poorest municipalities.
8. Strengthening of the financial sector by application of the Basel Core Principles	IMF	Some progress.	Prepare and implement a plan for improving the efficiency and soundness of the financial system, with benchmarks appropriate for Honduras.

HONDURAS: FUND RELATIONS
(As of July 31, 2004)

I. Membership Status: Joined December 27, 1945; Article VIII

II. General Resources Account:

	SDR Million	Percent of Quota
Quota	129.50	100.00
Fund holdings of currency	120.87	93.34
Reserve Position	8.63	6.66

III. SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	19.06	100.00
Holdings	0.11	0.59

IV. Outstanding Purchases and Loans:

	SDR Million	Percent of Quota
PRGF Arrangement	123.56	95.41

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	02/27/2004	02/26/2007	71.20	10.17
PRGF	03/26/1999	12/31/2002	156.75	108.30
PRGF	07/24/1992	07/24/1997	47.46	33.90
Stand-By	07/27/1990	02/17/1992	30.50	30.50

VI. Projected Obligations to Fund (without HIPC assistance) (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	12/31/03	2004	2005	2006	2007	2008
Principal	...	8.02	18.25	18.43	21.66	21.66
Charges/interest	...	0.47	0.90	0.80	0.70	0.59
Total	...	**8.49**	**19.15**	**19.23**	**22.36**	**22.25**

VII. Implementation of Enhanced HIPC Initiative:

Commitment of HIPC assistance	
Decision point date	June 30, 2000[1]
Assistance committed (NPV terms)	End-1999
Total assistance (US$ million)	556.00
Of which: Fund assistance (US$ million)	30.30
Completion point date	Floating
Delivery of Fund assistance (SDR million)	
Amount disbursed	8.80
Interim assistance	8.80
Completion point	0.00
Amount applied against member's obligations (cumulative)	3.63

VIII. Safeguards Assessments Policy:

A full safeguards assessment of the central bank with respect to PRGF arrangement was completed on February 17, 2004. It found that progress has been made in strengthening the BCH's safeguards framework since a transitional assessment was conducted in 2001, but some weaknesses remain. The most important vulnerabilities relate to non-publication of the audited financial statements and absence of a solid mechanism to follow-up on audit recommendations as well as an independent audit oversight mechanism. The BCH is in the process of addressing these vulnerabilities.

IX. Exchange Arrangement:

Honduras' *de jure* exchange arrangement is a crawling band. The exchange rate for the lempira is determined daily in foreign exchange auctions. Banks and exchange houses must sell to the central bank 100 percent of their daily net purchases of foreign exchange at the exchange rate established the previous day. Buyers of foreign exchange (banks, exchange houses, and private individuals) bid at a price that cannot differ by more than 7 percent from the base exchange rate, in either direction. The base exchange rate is adjusted every five auctions according to the anticipated inflation differential between Honduras and its major trading partners and to changes in the exchange rates of currencies of trading partners of Honduras with respect to the U.S. dollar. The official buying exchange rate on July 30, 2004 was L 18.28 per U.S. dollar.

Honduras has accepted the obligations under Article VIII, Section 2, 3, and 4 of the Articles of Agreement, and maintains a system that is free of restrictions on the making of payments and transfers for current international transactions.

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[1] World Bank Board, July 6, 2000.

X. Article IV Consultation:

The last Article IV consultation with Honduras was concluded on May 5, 2003. On the occasion, Directors considered the Financial System Stability Assessment. Honduras was automatically placed on the 24-month Article IV consultation cycle when the PRGF arrangement was approved.

XI. FSAP Participation and ROSCs:

FAD ROSC conducted on February 26–March 2, 2001 (IMF Country Report No. 02/16).
FSAP conducted on October 14–19, 2002 and January 20–February 4, 2003.
STA ROSC data module conducted on July 8–24, 2003.

XII. Technical Assistance:

Dept.	Purpose	Time
FAD	Impact of CAFTA on fiscal accounts	May 2004
	Public expenditure management, tracking of poverty reducing spending, and fiscal transparency.	Sep.– Oct. 2003
	Resident expert in tax administration.	May 2001–June 2003
	Tracking capabilities of poverty-reducing spending.	March 2001
	Reform of the tax system and its administration.	January 2001
	Implementation of an administrative control system and operations of autonomous and other public agencies.	November 1997
INS	Course on trade and exchange rate policies.	February 2002
MFD	Flexibilization of exchange rate system	June 2004
	Modernization of monetary operations	April 2004
	Banking crisis management framework.	August 2003
	Peripatetic short-term advisor for bank supervision, on-site inspection, and the bank restructuring framework.	Jun. 1998–Dec. 2002
	Financial supervision and the regulatory framework	September 1996 and April 1997
	Operation of interbank market for foreign exchange.	June 1994
STA	Government finance statistics	July-Aug. 2004
	Follow-up on money and banking statistics.	September 2003
	Follow-up on money and banking statistics.	September 2001
	Follow-up on money and banking statistics.	Aug.–Sept. 2000
	Follow-up on money and banking statistics.	July–Aug. 2000
	National income accounts.	January 1999
	Development of money and banking statistics.	May 1998
	Balance of payments statistics.	April–May 1995

XIII. Resident Representative:

Ms. Coronel assumed duty in February 2003.

HONDURAS—RELATIONS WITH THE WORLD BANK
(As of June 30, 2004)

Partnership in Honduras' development strategy

1. Honduras' Poverty Reduction Strategy Paper (PRSP), which was completed in October 2001 and endorsed by the Boards of the World Bank and IMF, has placed poverty reduction squarely at the center of the government's development agenda. The main objective of the strategy, which analyzes the causes of poverty and encompasses investment programs and reforms in a broad range of sectors, is to reduce poverty by 24 percentage points over the period 2001–15. The strategy itself is structured around six pillars as follows: (i) accelerating equitable and sustainable growth to levels consistent with the income poverty reduction targets; (ii) reducing rural poverty; (iii) reducing urban poverty; (iv) enhancing investment in human capital; (v) strengthening social protection for specific vulnerable groups; and (vi) ensuring the sustainability of the strategy through governance and institutional reforms and enhanced environmental sustainability. A PRSP Progress Report which was finalized in December 2003, maintains the same long-term vision and targets of the PRSP.

2. The Fund and World Bank will continue to cooperate closely, within their respective mandates, in assisting the government to implement its poverty reduction and economic growth strategy and the related reform agenda. The Fund will continue to lead the policy dialogue on macroeconomic issues (i.e., fiscal, monetary, and exchange rate policy), while the World Bank leads the policy dialogue on poverty reduction, governance, public sector management, and sectoral structural reforms (in areas including the social sectors, land regularization, environment, competitiveness, and judicial reform). They will collaborate closely and jointly manage the dialogue in the areas of PRSP preparation and implementation, HIPC, financial sector issues and civil service reform.

Bank Group assistance strategy

3. The World Bank completed a new Country Assistance Strategy (CAS) in May 2003, which is fully aligned with the six pillars of the Honduras' Poverty Reduction Strategy. The core goal of the CAS is to support Honduran efforts to shift to a sustainable and inclusive higher-growth trajectory as a principal means of reducing poverty and inequality. Within this broad objective, the main emphasis of the Bank's lending and knowledge services to Honduras are threefold: (i) to increase productive economic opportunities by helping to remove structural and institutional barriers to economic growth and broad-based participation in growth; (ii) to invest in human capital and the protection of vulnerable groups; and (iii) to support the transparent and responsive functioning of the public sector. In terms of new lending, the CAS program comprises 14 operations over a 4-year period (FY2003–06), amounting to about US$296 million, of which, about US$70 million would be in the form of quick-disbursing budgetary support.

4. As of June 30, 2004, the IDA active portfolio in Honduras consists of 20 projects for a total commitment of US$464 million, of which US$317 million remain to be disbursed (Honduras was declared IDA-only in September1991). Lending for rural poverty and human resource development includes four credits: Fifth Social Investment Fund Credit (US$60 million), a Learning and Science Promotion Credit-PROFUTURO supplementary credit (US$4 million), a Community Based Education Credit (US$42 million), and a Health System Reform Credit (US$27 million). Lending for transport and infrastructure includes a Road Reconstruction and Improvement Credit (US$67 million). Lending for natural resource management and environment consists of a Rural Land Management Supplementary Credit (US$8 million), an Access to Land Pilot Credit (US$8 million), a Sustainable Costal Tourism Credit (US$5 million), and a Regional Development in the Copan Valley Credit (US$12 million). Lending for modernization of the state consists of an Economic and Financial Management Technical Assistance Credit (US$19 million), and a Financial Sector Technical Assistance Credit (US$10 million). Lending for disaster preparedness consists of an Emergency Disaster Management Credit (US$11 million). Lending for improvement of the investment climate and private sector participation consists of a Trade Facilitation and Productivity Enhancement Credit (US$28 million).

5. In addition to the preceding operations, IDA's Board of Executive Directors approved five new credits during the first semester of 2004: a Land Regularization and Administration Credit (US$25 million), a (Nuestras Raices) credit to support development in indigenous and Afro-Honduran communities (US$15 million), a Forestry and Rural Productivity Credit (US$20 million), a fast-disbursing Poverty Reduction Support (PRS) Credit (US$58.8 million) and a PRS Technical Assistance Credit (US$8 million). These credits have not yet been declared effective.

6. **Future assistance**: The base case lending scenario of the CAS comprises 12 investment operations for US$226 million over FY2003–06, and an additional US$70 million in the form of fast disbursing budgetary support. The investment operations are aimed at strengthening governance and transparency, investing in human capital and addressing long-standing barriers to the inclusion of the poor in economic growth. The fast-disbursing credits include the recently approved Poverty Reduction Support Credit and a possible Financial Sector Adjustment Credit. Under the base case scenario, which is now in effect, World Bank disbursements are expected to average around US$100 million p.a. over the CAS period.

7. With regard to economic and sector work, the CAS includes two types of activities. The first set includes core diagnostic analyses, which are country-specific and address important cross-cutting issues, including deepened understanding of poverty, growth, public expenditures and fiduciary issues. This includes the Development Policy Review, Country Financial Accountability Assessment and Country Procurement Assessment Report that were completed in FY2004, as well as a Poverty Assessment (scheduled for FY2005) and a Public Expenditure Review (FY2006). The second group of activities, are Central America-wide or sub-regional in scope, focusing on topics and themes relevant to several countries but

including sufficient country-specificity to further Honduras' development agenda and support the design of lending operations. This includes sector studies on the coffee shock, rural growth, CAFTA, HIV/AIDS, decentralization and disaster mitigation.

Honduras: Financial Relations with the World Bank Group

(In millions of U.S. dollars)

A. Active IDA Operations
(As of June 30, 2004) 1/

	Disbursed	Undisbursed
IDA projects by sector		
Education	18.4	28.3
Environment	12.7	5.8
Financial Sector	0.8	9.8
Health	3.8	28.2
Municipal Development	0.9	12.0
Poverty Reduction	36.8	67.8
Private Sector Development	0.0	30.1
Public Sector Governance	9.5	10.7
Rural Sector	3.3	50.1
Social Protection	44.5	34.0
Transportation	39.1	33.1
Urban Development	4.1	7.4
Subtotal active projects	**173.8**	**317.4**
Subtotal closed projects	1,685.3	0.0
Total	**1,859.1**	**317.4**

B. IBRD/IDA Loan Disbursements
(Calendar Year)

	1998	1999	2000	2001	2002	2003	2004
Gross disbursements	67.9	273.0	38.2	98.0	51.4	44.5	23.8
Amortization (cash)	50.1	49.0	35.2	27.3	28.2	29.3	8.5
Net disbursements	17.8	224.0	3.0	70.7	23.2	15.2	15.2

Source: World Bank estimates.

1/ Net of cancellations.

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IMF-World Bank collaboration in specific areas

8. Fund and Bank staff have maintained a close working relationship, especially with respect to (i) the PRSP, its subsequent updates and joint assessments; (ii) the HIPC Initiative, (iii) financial sector reform; and (iv) civil service reform. The World Bank and IMF Resident Representatives routinely consult and coordinate with each other on major public policy matters, and Bank staff have participated in the Fund's PRGF missions.

- **Poverty Reduction Strategy paper (PRSP)**. The Fund and Bank have been supporting the government in the preparation of the PRSP, completed in August 2001, and have followed closely its implementation in 2002–2003, as documented in the first PRSP Progress Report that was completed in December 2003. The Bank and Fund collaborated in the production of Joint Staff Assessments, which accompanied the presentation of the PRSP and PRSP Progress Reports to their respective Boards.

- **HIPC Initiative.** The Fund and Bank have been tracking the status of floating completion point conditions established under the Enhanced HIPC Initiative. The structural and social reforms being monitored involve measures in the areas of governance and transparency, social security system reform, provision of basic health services for the poor, quality of education, safety nets and financial system reform.

- **Financial Sector.** The Fund and the Bank co-managed the preparation of the 2003 Honduras Financial Sector Assessment Program (FSAP). Based on the FSAP, the government embarked on a comprehensive financial system reform that aims at strengthening the regulatory framework and ongoing supervision, enhancing the efficiency of the financial safety net, and improving mechanisms for antimoney laundering and financing of terrorism. The Fund and the Bank continue to assist the government on these issues through a comprehensive technical assistance program.

- **Civil Service Reform**. The Fund and Bank have been supporting civil service reforms that aim to create a better trained, efficient and professional civil service, and to limit the unsustainable growth in the public sector wage bill observed over the last decade.

Other relevant structural conditions

Conditions to reach the HIPC completion point include strengthening of the financial sector by compliance with the Basel Core Principles, preparation and implementation of a participatory anti-corruption strategy, adoption of the social security reform plan approved by the IHSS Board in May 2000, strengthening of the basic health services to the poor, improvement in the quality of education by increasing the number of schools with community participation, and increases in the efficiency and targeting of safety nets. The World Bank and IDB are monitoring these reforms and providing technical assistance.

HONDURAS: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(In millions of U.S. dollars)

Loans programmed for 2004	**Status**	**Amount**
Financial sector program	Approved	25.0
Poverty Reduction Sector Program	Approved	30.0
Improvement of the PPP Atlantic Corridor		
(Sections of the CA-5 Norte Highway	Approved	50.0
Middle Education and Labor Program	Approved	30.6
Strengthening of Fiscal Management	Approved	15.0
Municipal Development Program Tegucigalpa II	Expected approval	22.5
Expansion of health services coverage	Expected approval	16.6
Privatization Four International Airport	Expected approval	22.0
Social Protection Program	Expected approval	20.0
PPP support to rural electrification and to the energy sector	Expected approval	35.0
Approved total		150.6
Expected approval total		116.1
Total		**266.7**

A. Operations (as of June 30, 2004)

	Approved	**Undisbursed**	**Disbursed**
Agriculture	45.0	20.3	24.0
Urban Development	82.4	34.1	47.1
Education and Health	74.1	39.2	33.8
Energy and Transport	34.4	15.6	18.7
Social Investment	165.5	100.6	63.3
Water Sanitation	44.3	26.1	17.2
Environmental Protection	76.9	52.4	23.1
Preinvestment	12.0	6.8	4.8
Reform and Modernization of State	134.2	122.7	9.1
Total	**668.7**	**417.9**	**241.1**

B. Net Flow of Resources

	1999	**2000**	**2001**	**2002**	**2003**	**2004e**
Disbursements	76.4	68.2	104.9	47.7	89.7	120.0
Amortization	24.9	33.2	24.4	28.5	-44.8	-47.5
Net flow of resources	51.5	35.0	80.5	19.2	44.8	72.5
Commitments made	85.2	142.1	96.4	67.1	82.5	90.0
Undisbursed commitments	315.9	387.5	378.9	400.3	363.8	333.8

HONDURAS—STATISTICAL ISSUES

Introduction

1. Honduras' data on the banking system, the public finances, trade, and external debt satisfy the 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 national accounts by expenditure, and private capital flows.

2. The Honduran authorities participated in a ROSC data module (July 2003), signaling their interest in participating in the General Data Dissemination System (GDDS). Preparations for GDDS participation are well advanced, including the drafting of metadata. Participation would act as a spur to strengthening the country's system, and provide a framework for channeling technical assistance resources in an optimal fashion.

Real sector

3. The published series of national accounts are based on the conceptual framework of the 1953 SNA. Estimates are prepared at current prices and at constant prices of 1978. Estimates are limited to GDP by industrial origin and by final uses. The latter is incomplete, as private consumption and change in inventories are calculated as a residual (allocated to the two categories using an erroneous methodology). The main shortcomings of these estimates are the lack of universal coverage and the deficient quality of the data sources. The Central Bank of Honduras (CBH) has been implementing a program to improve the national account estimates since 1993, and revised estimates for the period 1978–97 have been prepared, based on almost the same data sources but following improved procedures for the calculation at both current and constant prices. The CBH has started a four-year program for implementing the 1993 SNA and changing the base year.

4. An STA mission (January 1999) recommended the replacement of the old series with the new ones, and made some recommendations for further improvements in the calculation at constant prices by industries, as well as for the calculation of changes in inventories and private consumption. The mission also recommended that high priority be given to the implementation of the 1993 SNA and the change of the base year, and made detailed recommendations to this effect.

5. The CPI weights used to be 20 years old. A new household expenditure survey has been underway since April 1999. As a result of this project, the authorities have revised the CPI basket and updated the weights. The CBH has been producing in parallel the old and new indices during the transition period. The new indices became official in April 2000.

6. The new indices reflect improved coverage and quality of the data sources. The main improvements in coverage refer to inclusion in the survey of (i) population at all levels of income; (ii) goods and services with a participation of over 0.02 percent of total expenditure

from a universe of 2,480 items; (iii) the concept of generic groups for similar items to be incorporated in the calculation; (iv) the use of geometric mean; and (v) all representative urban areas. There are no official wage indices for minimum wages and data on employment are limited to a single estimate per year.

Monetary accounts

7. An STA mission (July–August 2000), reviewed the procedures used by the CBH for compiling the detailed (sectorized) balance sheet for the CBH and other depository corporations as well as the analytical surveys. The mission designed new forms for reporting data to STA for publication in *IFS* and to WHD for operational purposes. In addition, the mission made recommendations to improve the timeliness and quality of data reported monthly to STA. Accordingly, the authorities reported monetary data in the revised format from January 1996 to December 2001, but since February 2002 data had been reported only in the old format, despite several requests made to the CBH to resume the reporting of data in the revised format. In general, the revised formats for reporting of monetary data by the CBH followed the methodology recommended in the new *Money and Financial Statistics Manual*. However, there are some shortcomings that need to be addressed such as the lack of fully sectorized balance sheet for the depository corporations.

Balance of payments

8. Balance of payments statistics are compiled in broad conformity with the fourth edition of the *BPM4*. Considerable progress has been made, however, in preparations to adopt the *BPM5*, with preliminary annual estimates already available for 1993–2003, although not yet published. No international investment position is compiled. Departures from the criterion of residency underlie the treatment of the maquila sector, and some financial sector transactions in foreign currency. Net exports of the maquila industry are recorded as net services rather than as exports and imports of goods for processing. Nonrecording of profits of foreign enterprises operating in the maquila industry likely understates the external current account deficit, while direct investment in this industry is excluded from the financial account. Source data on direct investment, several services, and certain foreign transactions of private enterprises are relatively weak. Most annual surveys have low response rates, and results are obtained with long delays.

9. An STA mission visited Tegucigalpa during May 2004 to assist the CBH in preparing a comprehensive work program to implement the recommendations on balance of payments statistics made by the July 2003 data ROSC mission and to provide technical assistance in balance of payments statistics.

Government finance

10. The Ministry of Finance (MoF) disseminates government finance statistics (GFS) covering only the central administration. The MoF also compiles annual GFS for the nonfinancial public sector (NFPS) for internal use and for reporting to the Western Hemisphere Department (WHD). Honduras has not reported GFS data for the *Government Finance Statistics Yearbook (GFSY)* recently. The Central Bank of Honduras (CBH) does report budgetary central government data, although with considerable delay, for publication in the *International Financial Statistics (IFS)*.

11. The fiscal ROSC mission in 2002 and the data ROSC mission in 2003 both found that fiscal data in Honduras have serious weaknesses. These data are not fully aligned with international standards, and there is no plan to migrate to the *Government Finance Statistics Manual 2001 (GFSM 2001)*. The GFS have problems with coverage and sectorization. The Public Administration Law does not include the judicial and legislative branches as part of the central administration, creating shortcomings in reporting fiscal data. There are large discrepancies between the overall balance from the "above-the-line" data compiled by the MoF and the financing data compiled by the CBH.

12. There is a need for stronger collaboration between the ministry of finance and the central bank to derive accurate and timely estimates of external financing of the nonfinancial public sector.

Honduras: Core Statistical Indicators

(As of July 22, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet 1/	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	6/30/04	4/30/04	4/30/04	4/30/04	04/04	04-04	05/04	04/04	03	6/03	2003	02
Date Received	7/21/04	7/1/04	7/1/04	7/1/04	7/1/04	7/1/04	07/04	7//04	07/02/04	12/10/03	0604	5/03
Frequency of Data 2/	D	D	D	D	M	W	M	M	Y	M	A	M
Frequency of Reporting 3/	D	D	D	D	M	W	M	M	Y	V	A	V
Source of Update 4/	N	A	A	A	A	A	N	A	A	A	A	A
Mode of Reporting 5/	E	E	E	E	E	E	E	E,V	E,V	E,V	E,V	E,V
Confidentiality 6/	C	B	B	B	C	C	C	C	C	B	C	B
Frequency of Publication 3/	D	M	M	M	M	W	M	A	A	V	A	A

1/ Summary version.
2/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annual, or O-other.
3/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, V-irregularly in conjunction with staff visits, or O-other irregular basis.
4/ A-direct reporting by central bank, ministry of finance, or other official agency, N-official publication or press release, P-commercial publication, C-commercial electronic data provider, E-EIS, or O-other.
5/ E-electronic data transfer, C-Cable or facsimile, T-Telephone, M-mail, V-staff visits, or O-other.
6/ A-for use by the staff only, B-for use by the staff and the Executive Board, C-for unrestricted use, D-embargoed for a specified period and thereafter for unrestricted use, or E-subject to other use restriction

Tegucigalpa, Honduras
August 25, 2004

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Rato:

We enclose with this letter the Supplementary Memorandum of Economic Policies (MEP) that updates our economic program and poverty reduction strategy for 2004–06, and defines objectives and quarterly financial and structural targets for 2004–05.

1. Based on performance under the PRGF arrangement through end-June 2004, we request completion of the first review, and the establishment of performance criteria through June 2005. We request waivers for the performance criteria requiring the approval of a package of financial sector laws before June 30, on the understanding that passage of the laws by congress is a prior action for completing the review.

2. The government believes that the policies set forth in the attached Memorandum of Economic Policies (MEP) are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate to this purpose. Honduras will consult with the Fund on the adoption of these measures, and in advance of the revisions to the policies contained in the MEP, in accordance with the Fund's policies on such consultation. Honduras will provide the Fund with all necessary data on a timely basis for monitoring purposes. During the program period, the government will not introduce or intensify any exchange rate restrictions or multiple currency practice, conclude any bilateral payment agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement, or introduce or intensify import restrictions for balance of payments purposes. Consistent with its intention to keep the public informed about its policies and objectives, the government will publish the MEP and will report periodically on progress under the program.

3. We propose that the Fund carry out the second review based on the observance of the end-December 2004 quantitative and structural performance criteria established in Tables 1 and 2 of the attached memorandum, and the third review on the basis of the end-June 2005 performance criteria in the tables.

4. We are confident that the program will deliver sustained growth and substantive poverty reduction, and hence that it deserves the support of the international community.

Sincerely yours,

/s/	/s/
María Elena Mondragón de Villar President Central Bank of Honduras	Arturo Alvarado Sánchez Minister of Finance

SUPPLEMENTARY MEMORANDUM OF ECONOMIC POLICIES OF THE GOVERNMENT OF HONDURAS

1. In light of developments in the first half of 2004 and, in particular, changes in the economic environment resulting from unanticipated high oil prices, the Government of Honduras intends to make the changes described below to its economic program (which was defined in the Memorandum of Economic Policies).[1] This supplementary memorandum also defines performance criteria for the first half of 2005.

Macroeconomic framework

Honduras: Macroeconomic Framework, 2004-2006

	2003	2004 prog	2004 rev	2005	2006
(Annual percentage changes)					
GDP at constant prices	3.2	3.5	3.75	4.0	4.5
Consumer prices, end of period	6.8	6.7	8.00	6.0	5.0
(in percent of GDP, unless otherwise noted)					
Combined public sector savings	1.1	3.9	3.9	4.8	5.9
Anti-poverty spending	7.5	8.1	8.1	8.7	9.4
Combined public sector balance	-4.9	-3.0	-3.0	-2.5	-1.7
Of which :					
Central government balance	-6.0	-3.5	-3.5	-3.0	-2.5
External current account balance	-3.7	-7.1	-6.2	-3.6	-3.0
Gross int'l reserves (target in months of imports)	3.8	4.0	4.0	4.0	4.0

2. **Growth.** Real GDP is now expected to grow by 3.75 percent (or more) in 2004, compared with a program target of 3.5 percent (¶8). This reflects buoyant activity in a wide array of sectors but in particular high coffee production.

3. **Inflation.** It will not be possible to reach the original program objective for inflation of 6.7 percent because of the direct impact of the high oil prices, the indirect effect on transport costs and on electricity tariffs, and the liquidity created by high foreign exchange inflows. The government expects inflation (eop) to reach 8–8.5 percent in 2004 (8 percent in the macro-framework), assuming no further oil price increases. Core inflation is also rising (at a lower rate), but the central bank believes that its policy response, as described in paragraph 12 below, will be adequate to contain inflationary pressures.

4. **External current account.** Despite the additional import bill on account of the high oil prices (projected to amount to 2.3 percent of GDP by end-2004), the external current account deficit is expected to be contained to 6.2 percent of GDP, rather than the

[1] Paragraph and table references refer to the original Memorandum of Economic Policies.

programmed 7.1 percent of GDP (¶8)—reflecting not only the good performance of coffee and banana exports, but in particular increased remittances.

5. **International reserves.** The government has also revised upwards its projected accumulation of international reserves, in light of the over-performance to date. Taking into account updated projections of foreign financial support, NIR are now expected to grow by US$300 million as opposed to US$78 million in the program (¶28). However, the program target for the accumulation of NIR is raised to US$150 million during 2004, because higher accumulation is not a policy goal, and because uncertainties surrounding reserve pressures in the traditionally difficult second semester make it important for the government to retain a margin to use reserves if necessary.

Fiscal policy

6. **Deficit targets.** The 2004 deficit target for the combined public sector will remain at 3.0 percent of GDP and the central government deficit target at 3.5 percent (¶21). Given the over-performance in the first half of the year, there is room to accommodate within the program measures to cushion the impact of higher oil prices on the incomes of the poor. Higher than programmed foreign financing will reduce the government's domestic financing needs compared to the original target, thereby alleviating some of the pressure on inflation.

7. **Teachers' wages.** The government has renegotiated the wage agreement with teachers (¶26). The new agreement will have the force of law. (1) The salaries law passed in December 2003 will remain in force, with one amendment: the issue of regulations to integrate supplementary benefits into the overall salary from 2007 following the conclusions of the special wage commission—previously a structural benchmark for end-June (Table 2)—becomes a performance criterion for end-December 2004. (2) The cap on supplementary benefits in the 2004 budget will be increased according to the agreement, which raises the projected teachers' wage bill by L 120 million in 2004 and L 240 million in 2005 and 2006, by granting an extension of supplementary benefits to some newly eligible teachers. The wage targets in the program will not, however, be changed; the government will offset the increase in teachers' wages by reductions in wage costs elsewhere. (3) Since the recent teachers' protests have highlighted the strains imposed by limits on supplementary benefits, the government recognizes the need to demonstrate that the 2005 budget can be sustainably executed while applying the new (higher) limits.

8. **Other wages.** The government has strictly applied the programmed wage policy to all other public sector employees (¶26), with the only exception of Hondutel workers, who were granted a 15 percent wage increase for 2004 and a 13 percent increase for 2005. The higher wage increase is justified by the higher than programmed profitability of Hondutel, and there will be no change in the program targets for the operating surplus of public enterprises. The government does not believe the Hondutel accord will affect other wage demands, since all decentralized agencies have already agreed on their wage policy for 2004.

9. **Election spending.** Congress has issued a decree authorizing election spending amounting to around 0.2 percent of GDP. To avoid turning this into an unfinanced appropriation (and thereby breaching a continuous performance criterion), the government will, before passing the decree, identify additional resources to pay for the spending without raising the deficit.

10. **The 2005 budget.** Currently, the government believes it can meet the fiscal targets for 2005 without taking any further measures (beyond those in ¶27). However, if performance in the rest of 2004 is less favorable, or if CAFTA is ratified such that it will enter into force in 2005, the government will adopt any additional measures needed to ensure the targets can still be met. The need for supplementary measures will be assessed at the second review.

11. **HIPC tracking.** Monthly reports of all PRSP spending are now published on the web (with little more than a month's lag), and both loan and grant resources are also published. The automation of the system is now expected to be implemented in the last quarter of 2004 (¶15).

Monetary and exchange rate policy and management

12. **Inflation objective.** The central bank will take measures to dampen inflationary pressures. These will include temporary obligatory investments for all banks of 1 to 2 percent of deposits (both in domestic currency and dollars) while maintaining current reserve requirements. The obligatory investments will be remunerated at a rate equivalent to 50 percent of the rate on shortest-maturity CAMs (for investments in domestic currency) or CADDs (for investments in foreign currency). The central bank will use open market operations and other measures as needed to contain inflation, including by increasing the interest rate if necessary to achieve sufficient sterilization.

13. **Target on net international reserves.** As discussed in paragraph 5 above, the end-December target on NIR will be set at US$1,277 million (rather than raised in line with projections). This means that gross reserves will continue to cover four months of imports and more than 100 percent of short-term liabilities.

14. **Credit in foreign currency.** The growth of lending in dollars is a matter of concern, since it could increase the vulnerability of Honduras's banking system. To dampen this tendency, the central bank will reduce the limits on banks' external borrowing relative to capital to the current level observed in the banking system. Moreover, the central bank and the CNBS will revise the measures regulating all foreign exchange lending (¶29).

15. **Strengthening monetary management.** The central bank has agreed on a timetable for modernizing central bank operations (¶29). The new scheme will include upgraded weekly auctions following the issue of negotiable certificates and the announcement of amounts to be placed to allow interest rates to reflect market conditions, the conduct of daily repo auctions as needed to manage interbank liquidity, and the adoption of an overnight

interest rate corridor with an automatic liquidity window (ceiling) and issuance of one-day certificates (floor) to provide a monetary signal to the market. Before the second review, the central bank will take the following actions: (1) the Board of Directors will approve the work plan for implementing the strategy; (2) nonnegotiable government and BCH debt will be replaced by negotiable securities; (3) a methodology for weekly liquidity forecasting will be designed and tested; (4) a methodology for daily liquidity forecasting will be designed to serve as a guide in the conduct of daily auctions; and (5) the new monetary regime will be formally announced to the financial system, including its characteristics and the starting date.

16. **Lender-of-last-resort.** The central bank has arranged for technical assistance to allow it to implement the new framework for liquidity support to the financial system. This is expected to be in place by December 31, 2004.

17. **Central bank recapitalization.** The new central bank law provides for a mechanism to recapitalize the central bank for losses incurred between the beginning of 1997 and end-2003, and authorizes the minister of finance to issue a bond to cover these losses, in an amount to be certified by the CNBS (¶31). The mechanism and the terms of the bond will be agreed before the second review of the program. The law also requires the central bank to agree with the ministry of finance on modalities for reimbursing future cash losses. In line with the new law, the authorities commit to maintaining a minimum capital of L 500,000 at all times.

Financial sector reform

18. **Financial sector laws.** The government requests waivers of the performance criteria requiring passage of four key financial sector reform laws before June 30, 2004. The laws were sent to congress earlier, but the June recess impeded congress from passing them by the test-date. Three of the four have now been approved and passage of the financial institutions law is a prior action for completion of the review.

19. **Timetables for bank reform.** The CNBS has developed timetables for financial institutions to comply with the new regulations on capital adequacy and provisioning issued in June 2004 (¶36–37). According to these regulations, financial institutions should maintain at all times a minimum CAR of 10 percent, calculated in line with the definition included in CNBS No. 056/2004. New regulations governing loan classification adopted in CNBS No. 037/2004 have been issued and will be applied immediately to all financial institutions. Compliance with the timetable of new provisioning rules set in CNBS No. 057/ 2004 will be closely monitored under the program.

20. **Strengthening the financial system.** Recognizing that the application of the new prudential regulations may require additional effort by some banks, the CNBS is working with the World Bank to develop a system for intensive supervision of identified weak banks and to define holding actions to prevent additional losses, such as limits on profit distribution, new lending, and other expenditures, but also including resolution of nonviable banks if they do not comply with the timetable for applying the new provisioning rules and

capital increases as agreed. This will be finalized by end-September 2004. The strategy will include the specification of modalities governing resort to the recapitalization fund—which will be agreed with the Fund before the second review (previously, this review). Resources of the recapitalization fund will be used only to augment capital increases by shareholders of viable banks. Specific rules governing access will be determined in consultation with the World Bank.

21. **Risk management.** Recognizing that a main challenge in strengthening the financial system is ensuring the quality of bank assets, the CNBS will define a framework for supervision based on risk analysis, according to international best practice, and will effect a gradual transition to compliance with the second Basel capital accord, over the medium term.

22. **Penalties for financial crimes.** The reform of the Penal Code (¶39) has been delayed, largely because the government decided to take the opportunity to incorporate a broader set of criminal activities including electronic and credit card fraud. The passage of the revised law, including strengthened penalties for financial crimes, is now expected by end-September 2004.

Other reforms

23. **Transparency.** The authorities are committed to a policy of transparency (¶44). To this end, they will publish the staff report for the program and the Joint Staff Assessment. They have also notified the Fund of their intention to join the GDDS; and will continue the program of statistical improvements, including the elaboration of quarterly balance of payments data and a systematized reconciliation of above- and below-the-line fiscal data. At that time, the authorities will publish the ROSC for data standards. The central bank has provided the Fund with full financial statements (including auditor's notes) and will publish them by end-September 2004. All commercial banks are publishing quarterly financial statements.

Program modalities

24. **Conditionality.** Revised performance criteria for end-December 2004 and new performance criteria for June 2005 are shown in Table 1. Indicative targets for end-September 2004 have also been revised and new ones set for March, September, and December 2005.

25. **Adjuster.** To ensure that uncertainties about the timing of disbursements of foreign financial support do not jeopardize the government's compliance with program targets, the 2005–06 program will be amended by including a capped adjuster of 0.75 percent of GDP on NIR, NDA of the central bank, and the ceiling on domestic financing for temporary (within-year) shortfalls in foreign financing.

Table 1. Honduras: Financial Benchmarks and Performance Criteria for 2004-05 under the PRGF Arrangement 1/

	2004				2005			
			Revised					
	Mar.	June	Sep.	Dec.	Mar.	June	Sep.	Dec.
Performance criteria 2/								
(End-of-period stocks in millions of lempiras, unless otherwise specified)								
Ceiling on net domestic assets of the central bank 3/	-12,871	-13,827	-16,382	-14,963	-16,368	-17,002	-18,193	-17,019
Actual	-13,857	-15,969						
Floor on net international reserves of the central bank 3/ (in millions of U.S. dollars)	1,110	1,155	1,270	1,277	1,305	1,330	1,355	1,377
Actual	1,176	1,297						
Ceiling on stock of arrears on external debt-service payments of the public sector (in millions of U.S. dollars)	0	0	0	0	0	0	0	0
Actual	0	0	...	...	...	...	...	...
(Cumulative amounts in millions of lempiras from December 31, 2003)								
Ceiling on the wage bill of the central government	3,004	6,860	9,840	13,750	3,265	7,455	10,694	14,944
Actual	2,831	6,565						
Ceiling on the overall deficit of the central government	570	1,761	1,694	4,751	633	1,667	1,962	4,455
Actual	430	477						
Ceiling on the overall deficit of the combined public sector	651	1,804	1542	4,096	771	1,752	1,751	3,814
Actual	109	136						
Ceiling on net domestic financing of the combined public sector 3/	-556	-968	-1,951	-1,205	439	149	-1,104	-470
Actual	-604	-1,549						
Ceiling on contracting or guaranteeing of nonconcessional external debt of the combined public sector (in millions of U.S. dollars)	3.3	3.3	3.3	3.3	0	0	0	0
Actual	0	0						
Financial benchmarks								
Floor on the operating surplus of the public enterprises	820	1,640	2,658	3,544	1,040	2,079	3,119	4,159
Actual	981	1,669						
Floor on anti-poverty spending	1,935	4,654	7,204	10,900	2,570	5,783	8,995	12,850
Actual	1,995	4,765						

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

1/ As defined in the technical memorandum of understanding.
2/ Performance criteria are for end-June and end-December 2004, and end-June 2005; targets for other periods are indicative.
3/ The floor on net international reserves will be lowered, while the ceiling on net domestic assests and net domestic financing of the combined public sector will be raised by up to 0.75 percent of GDP for temporary (within year) shortfalls in foreign financing.

Table 2. Honduras: Structural Targets for 2004-05 under the PRGF Arrangement

	Target Date
Prior Action for First Review	
Adoption of a new Financial Institutions Law	...
Structural Performance Criteria	
Adoption of a new Financial Institutions Law and amendment of the CNBS Law, the Deposit Insurance Law, and the Central Bank of Honduras Law to strengthen financial regulation, supervision, and the financial safety net.	End-June 2004
Finalizing a timetable to comply with new regulations on capital adequacy, loan classification, and provisioning (including on investment in FONAPROVI bonds).	End-June 2004
Compliance with new regulations on capital adequacy, loan classification, and provisioning, according to the agreed timetable.	End-December 2004
Finalizing a timetable to make the use of indirect instruments of monetary management more effective and improve interest rate signaling.	End-September 2004
Launch the mechanism to make the use of indirect monetary instruments more effective and improve interest rate signaling.	End-December 2004
Issue of regulations to integrate supplementary benefits into the overall salary from 2007 as envisaged in the salaries law, in accordance with the conclusions of the special wage commission.	End-December 2004
Passage of a 2005 budget consistent with the macroeconomic targets and other objectives of the program supported by the PRGF arrangement, including all tax and tariff measures needed to meet the 2005 deficit target.	End-December 2004
Permanent suppression of intra-year unfinanced appropriations.	Continuous
Structural Benchmarks	
Amendment of the Penal Code to make financial crimes punishable.	End-September 2004
Finalization of an action plan to accelerate asset recovery from failing banks.	End-September 2004
Publication of full central bank financial statements, including the external auditor's opinion and the explanatory notes.	End-September 2004
Enforcement of requirement that banks publish quarterly financial statements.	Continuous
Finalization of an action plan for public administration reform, consistent with World Bank recommendations.	End-April 2004
Amendment of the Tax Code in line with understandings under the program.	End-September 2004
Full automation of poverty-reduction expenditure tracking.	End-December 2004
Establishment of two chambers of Tax Courts.	End-December 2004

Statement by the IMF Staff Representative
September 24, 2004

The following information has become available since the staff report was issued. This information does not alter the thrust of the staff appraisal.

- **On September 20, the Honduran Congress passed the financial institutions law.** Adoption of the law was a prior action for the first review, and a key element of the financial sector reform strategy in the program. It includes a new bank resolution framework, introduces consolidated supervision, improves risk management and governance, and strengthens the sanctions regime.

- **The government has submitted to Congress a draft budget for 2005 that is consistent with the program.** Congress is expected to approve the budget by end-November.

- **The central bank took measures to contain inflation and strengthen prudential rules for foreign borrowing by banks, as discussed with the staff in August.** Remunerated reserve requirements were raised by 1 percentage point effective September 18, and by another 1 percentage point from November 13. The limit to foreign borrowing by commercial banks was reduced from 3 to 2 times the level of banks' capital.

- **Congress has ratified the elimination of constitutional immunities for public officials and members of congress.** The law will take effect as of October 11, 2004, and constitutes a major enhancement of governance and transparency.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

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September 24, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes First Program Review and Financing Assurances Review Under Honduras' PRGF Arrangement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Honduras' performance and the financing assurances review under a SDR 71.2 million (about US$104.3 million) three-year Poverty Reduction and Growth Facility (PRGF) arrangement approved in principle on February 18, 2004 (see Press Release 04/29) and effective since February 27, 2004. The completion of this review allows Honduras to draw a further SDR 10.17 million (about US$14.9 million), bringing the total amount released under the arrangement to SDR 20.34 million (about US$29.8 million). In completing the review, the Board waived the nonobservance of the performance criteria related to the approval of a package of financial sector laws before June 30.

Following the Executive Board discussion on Honduras, Agustín Carstens, Deputy Managing Director and Acting Chair, said:

"Honduras's performance under the PRGF arrangement has been strong. The economic recovery is gathering pace; the external position has strengthened, notwithstanding the impact of high oil prices; and anti-poverty spending has begun to rise. These favorable early results under difficult circumstances testify to the authorities' resolve in implementing their program and augur well for the economic outlook. It is now critical to build on these achievements to consolidate the hard-won stabilization and reform gains.

"The government's commitment to social consensus has played an important role in maintaining domestic support for the program—which has remained strong across a wide spectrum of society. Congressional support for reform has been a key and welcome element in the success of the program to date.

"Continued implementation of sound fiscal policies will be essential to sustaining the success of the program. In particular, this will require enactment of a 2005 budget that is in line with the program, followed by steadfast implementation of the budget in the course of the year.
The support of congress in refraining from any unfinanced appropriations will play a vital role in this regard.

“Adherence to the revised teachers’ wage agreement reached in July 2004 will be essential to the success of the program, and the development of a permanent teachers’ wage policy is key to medium-term fiscal sustainability. Moreover, wage policy in other parts of the public sector will also need to remain consistent with the program.

“The central bank has sent a clear signal of its determination to preserve the important gains made in reducing inflation in recent years. Its plans for modernizing monetary operations are welcome, in particular, by strengthening monetary instruments and improving interest rate signaling. Successful implementation of these reforms will allow a progressive strengthening of the monetary policy framework.

“The four financial sector laws recently approved by congress are a significant milestone in addressing the weaknesses of the banking system. It is important that the new framework be implemented fully, as planned. Progress in financial sector reform is one of the trigger conditions for achieving the completion point under the enhanced HIPC Initiative—which Honduras aims to reach in early 2005.

“Other institutional reforms are also moving ahead. The important political and judicial reforms under way will contribute to reducing perceptions of corruption and improving the investment climate.

“Overall, Honduras’s satisfactory performance under the PRGF arrangement is commendable. Continued implementation of the authorities’ program should lay a strong foundation for durable growth and poverty reduction,” Mr. Carstens said.

Statement by Luis Martí, Executive Director for Honduras
and Gerardo Peraza, Senior Advisor to Executive Director
September 24, 2004

Key Points

- *The economic reform package is taking hold and translating into buoyant exports and a recovery of key domestic sectors.*
- *The authorities' re-affirmed their commitment to bring down the deficit of the public sector in line with the program.*
- *The central bank has maintained a prudent monetary policy and it is stepping up its effort to tightening monetary conditions.*
- *The passage of all the financial sector laws demonstrates authorities' commitment to bring the legal framework in compliance with Basel criteria.*

Background

The Honduran authorities would like to thank the staff and management for all their support and advice on the way to the first review under the PRGF arrangement.

As this Chair pointed out in our last statement, the current program embodies a number of quite distinctive elements when compared with previous Fund arrangements. It was built on strong ownership and domestic consensus. The program also was frontloaded and several key structural reforms were defined as prior actions. Now, the authorities are pleased to inform that despite political and social pressures the program is broadly on track. All quantitative targets for end-June were met with margins. On the structural front, all structural performance criteria were observed albeit delays in the approval of the financial sector laws.

The authorities' current projections for 2004 are indicating a GDP growth in the rage of 4-4½ percent thanks to buoyant exports and a strong recovery in the manufacturing sector. According to preliminary figures, exports of goods reached US$825 million in January-June, a 16 percent increased compared to the same period in 2003. The external current account will remain largely unchanged around 3.7 percent of GDP after excluding special imports from private energy projects (US$180 million). Higher traditional exports (coffee, banana, and shrimp) and family remittances are more than compensating the higher cost of oil imports and hence contributing to a substantial accumulation of international reserves. In mid-September, gross international reserves reached US$1.7 billion or around 4½ months of imports.

The 12-month inflation rate was 8.7 percent in August, below the 9.3 percent registered in July. This year's inflation is primarily a result of higher world oil prices that pushed up transportation and electricity generation costs. Adverse weather conditions in selected regions also affected the prices of basic grains and produce, and thus the behavior of the CPI.

Macroeconomic policies and structural reforms

The authorities remain committed to the 2004 fiscal deficit targets of 3.5 percent of GDP for the central government and 3 percent of GDP for the public sector. Enhanced tax administration, on top of last year fiscal measures, is projected to generate 1.2 percent of GDP in additional tax revenues. This improved fiscal stance will allow the authorities to achieve their planned fiscal consolidation while making room for higher poverty-reduction spending. In addition, domestic financing will fall by almost 1 percent of GDP (compared with -0.2 percent of GDP in the program) thanks to higher concessional external financing.

Political and social conditions in Honduras have not been easy. The authorities had to revise the wage agreement with teachers after a six-week strike to save the school year. However, they will offset the increase in the teachers' wage bill by reductions in wage costs elsewhere—leaving the ceiling on the wage bill of the central government unchanged for 2004. The authorities and the teachers' union will form a commission to design a clear policy on the integration of supplementary benefits into the base wage by end-December—now a structural performance criteria under the arrangement. So far, both parties have agreed on a makeup schedule for missed classes and enhanced community participation in the assessment of school achievements.

The Honduran cabinet recently endorsed a Minister of Finance's initiative to cut back 25 percent of non-essential unused budget allocations as of September 2004. The initiative will affect the entire public sector and serve as a contingency measure to prevent spending overruns in the run up to presidential elections next year. This is a clear signal that the authorities are moving away from past practices that led to fiscal slippages during the political cycle, an important vulnerability identified in the EPA.

On September 14, the authorities submitted the 2005 budget to congress. This draft bill aims to a fiscal deficit target of 2.5 percent of GDP for the public sector and is fully consistent with the ceilings as indicated in Table 1 of the Supplementary Memorandum of Economic Policies (EBS/04/129). While the authorities remain confident that all 2005 fiscal target are within reach, they will be monitoring the situation closely and be ready to adopt additional measures if needed. The authorities are confident that the passage of the amendments to the tax and penal codes will help to consolidate ongoing fiscal reforms and provide more breathing room for contingencies. The authorities will remain committed to the continuous PC on suppressing unfunded appropriations.

The Central Bank has pursued a prudent monetary policy, tightening the liquidity resulting from the higher accumulation of international reserves. While policy interest rates have remained broadly unchanged since end-December 2003, the central bank has increased its placements of short-term certificates to dampen inflationary pressures. In addition, to contain credit growth and limit banking system vulnerabilities, the authorities introduced in mid-September a temporary investment requirement equivalent to 1 percent of total bank deposits (to be raised to 2 percent in November), and reduced the existing prudential limit on banks' external borrowing relative to capital. The Central Bank plans to launch by end-December an enhanced monetary management framework that will strengthen its operations. The Central Bank welcomes Fund's intention to provide technical assistance on this area.

Another key priority of the authorities is the strengthening of Honduras' financial system. The set of laws recently approved by Congress constitutes a comprehensive reform package to address the most important vulnerabilities identified in the FSAP. In addition, this enhanced legal framework also contributes importantly to comply with the Basel criteria—a Completion Point trigger condition. Since the approval of the program, the National Commission on Banks and Insurance Companies (CNBS) has adopted key complementary actions such as reinforcing governance requirements for banks' board of directors and improving the quality of and access to credit bureau information. As described in the staff report, the CNBS has developed timetables for financial institutions to comply with the new regulations on capital adequacy and provisioning issues. The CNBS has made substantial progress, in consultation with the World Bank, in the design of the strategy to strengthen the financial system including access to the recapitalization fund.

The authorities remain committed to implement governance reforms, combat corruption and improve transparency as set out in the MEP (EBS/04/10). In a landmark vote, congress stripped deputies and other key public officials of immunity from delinquent actions. The corresponding legislative decree, already sanctioned by President Maduro and published in the Official Gazette, eliminated the constitutional provision on immunity of public servants. The authorities will up hold their commitment to abstain from all possible bailouts over the period covered by the program. While the modalities for accessing the recapitalization fund are yet to be discussed with Fund and World Bank staff, the authorities will restrict the use of the recapitalization fund only to augment capital increases by shareholders of viable banks. The Central Bank will publish its full financial statements (including auditor's notes) by end-September 2004. The authorities have also notified the Fund of their intention to join the GDDS.

Finally, on behalf of the Honduran authorities, this Chair would like to reiterate its appreciation to management and staff for their decisive support with visits, technical assistance, and continuous contacts since the approval of the program. The authorities acknowledge that the program is not a risk-free ride and that vulnerability persists. However, they are convinced that a thorough program implementation is the key to achieve faster growth and a systematic reduction in poverty. Of course, successful implementation of the reform agenda has been only possible thanks to the Honduran authorities' strong ownership and permanent consultation with a broad range of stakeholders.