

FILE COPY

RESTRICTED

Report No P-595

This report was prepared for use within the Bank and its affiliated organizations. They do not accept responsibility for its accuracy or completeness. The report may not be published nor may it be quoted as representing their views

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

REPORT AND RECOMMENDATION
OF THE
PRESIDENT
TO THE
EXECUTIVE DIRECTORS
ON A
PROPOSED LOAN
AND A
PROPOSED DEVELOPMENT CREDIT
TO THE
REPUBLIC OF HONDURAS
FOR THE RIO LINDO HYDROELECTRIC PROJECT

May 14, 1968

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A
PROPOSED LOAN AND A PROPOSED
DEVELOPMENT CREDIT TO THE REPUBLIC OF HONDURAS
FOR THE RIO LINDO HYDROELECTRIC PROJECT

1. I submit the following report and recommendation on a proposed loan from the Bank in an amount in various currencies equivalent to US\$7.5 million and on a proposed credit from the Association in an amount in various currencies equivalent to US\$4.0 million, both to the Republic of Honduras, to assist in the financing of the Rio Lindo Hydroelectric Project.

PART I - HISTORICAL

2. The proposed project is the third power project to be financed in Honduras by the Bank Group. The first loan, made in 1959, helped finance an interim power program for the installation of additional diesel capacity and the rehabilitation and expansion of the distribution facilities at the capital city of Tegucigalpa. The second loan, a year later, helped finance the 30MW Cañaveral Hydroelectric Project, the largest power project so far built in Honduras. Both loans were made to the Empresa Nacional de Energía Eléctrica (ENEE) an autonomous government corporation responsible for promoting the electric power development of Honduras. ENEE in May 1967 formally applied for assistance in financing the Rio Lindo Hydroelectric Project. The field appraisal was completed in October 1967, and since Honduras is a blend country for Bank/IDA lending it was decided to recommend financing this project with a joint Bank loan/IDA credit.

3. Negotiations were held in Washington on April 16-25, 1968. The Government was represented by Mr. Victor Moya, Public Credit Chief of the Ministry of Economy and Finance, and the ENEE by Messrs. Eduardo Mendieta (member of the Board), Ernesto Crespo (General Manager) and César Batres (Legal Adviser).

4. The proposed loan, the eighth for Honduras, would increase the Bank's total lending in Honduras to US\$46.8 million (net of cancellations), and the proposed credit, the third to Honduras, would increase the Association's lending in the country to \$15.9 million (net of cancellations). The following is the summary of Bank loans and IDA credits in Honduras, as of April 30, 1968:

Loan or Credit Number	Year	Borrower	Purpose	Amount (US\$ million)		
				Bank	IDA	Undis- bursed
135	1955	Republic of Honduras	Highway Maintenance	4.2		-
195	1958	Republic of Honduras	Highway Construction	5.5		-
226	1959	Empresa Nacional de Energía Eléctrica	Power (Inte- rim Project)	1.4		-
261	1960	Empresa Nacional de Energía Eléctrica	Power (Cafiave- ral Project)	8.8		-
1	1961	Republic of Honduras	Western High- way Exten- sion		8.4	-
400	1965	Republic of Honduras)	North Road (6.0		6.0
71	1965	" " ")	(3.5	1.9
463	1966	Empresa Nacional Portuaria	Port (Puerto Cortés)	4.8		4.4
495	1967	Republic of Honduras	Western High- way Paving	<u>8.6</u>		<u>8.6</u>
Total (less cancellations) of which has been repaid to the Bank and others				39.3	11.9	20.9
				<u>7.6</u>		
Total now outstanding				31.7		
Amount sold				2.4		
of which has been repaid				<u>1.7</u>		
Total now held by Bank and IDA				<u>31.0</u>	<u>11.9</u>	
Total undisbursed				<u>19.0</u>	<u>1.9</u>	<u>20.9</u>

5. Four Bank loans and one IDA credit have been fully disbursed. On the remainder, disbursements are generally proceeding satisfactorily. Construction work on the North Road (loan 400-HO and credit 71-HO) however has been delayed because the Government's consultants recommended a new alignment on the basis of information that became available after the loan and the credit were approved. The proposed new alignment was accepted by the Bank and IDA and work on the project is now proceeding normally.

6. No further loans or credits to Honduras are expected to be ready for presentation to the Executive Directors in 1968.

PART III - THE PROJECT

9. An appraisal report entitled "Appraisal of the Rio Lindo Hydroelectric Project - Empresa Nacional de Energia Eléctrica (ENEE) - HONDURAS" (TO-623a) on the proposed project is attached.
10. The total electric power capacity for Honduras is about 73MW of which ENEE's share is about 47MW or 65%. In 1966 total electricity production in Honduras was about 204 million Kwh. This represents, on a per capita basis, the lowest production of any country in Central America.
11. ENEE was established by law in 1957 as an autonomous authority, wholly owned by the Government, responsible for promoting the electrical power development of the country. ENEE is governed by a five-member Board of Directors, including the Minister of Communications and Public Works (Chairman), the Minister of National Resources, and representatives of the National Economic Planning Council, the National Development Bank and the National Chamber of Commerce and Industry. A general manager, appointed by the Board, is responsible for all managerial and administrative functions. The general organization of ENEE is satisfactory and, with assistance from consultants, its management and staff are capable of carrying out the Project.
12. The proposed Project consists in: (a) the construction of the 40MW Rio Lindo Hydroelectric Scheme; (b) the expansion of ENEE's transmission system; and (c) the provision of engineering services for feasibility studies of future development of hydroelectric power in western Honduras. The total estimated cost of the proposed project is US\$17.7 million and the estimated foreign exchange cost, to be covered by the proposed loan and credit, is US\$11.5 million. The project is expected to be completed by the end of 1970. A financing plan satisfactory to the Bank has been prepared by ENEE for the period 1967-71 and its total financial requirements for that period (including debt service) will be covered, in addition to the proposed loan and credit, by ENEE's internal cash generation (32%), by borrowing from other sources (21%) and by capital contributions by the Republic of Honduras (3%).
13. ENEE's power sales increased at an average rate of over 25% per annum in 1966 and 1967. This high rate of growth was largely due to the very rapid growth of sales in the prosperous San Pedro Sula area in northern Honduras. Total sales by ENEE are estimated to increase at an average annual rate of about 20% during the period 1967 through 1971 and at an average rate of about 11% per annum during 1972 through 1977. The Project is needed to meet this growing demand for power on ENEE's system and is the most economic alternative means of meeting this demand.

14. All contracts except those for engineering services will be awarded on the basis of international competitive bidding. Disbursements will be made only for the foreign currency costs of imported equipment and services. Expenditures prior to the date of the loan will not be eligible for reimbursement.

15. ENEE's financial position is sound and is expected to remain so. It is estimated that ENEE's rate of return on plant in operation will be over 11% per year on the average during the construction period of the Project. Coverage by internal cash generation of total debt service requirements during this period is also satisfactory.

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

16. The draft Loan Agreement and draft Development Credit Agreement between the Republic of Honduras and respectively the Bank and the Association, and the draft Project Agreement between the Bank and the Association and the Empresa Nacional de Energía Eléctrica, which contain the covenants normally utilized for power projects, as well as the Report and the Recommendation of the Committees provided for in Article III, Section 4(iii) of the Articles of Agreement of the Bank and in Article V, Section 1(d) of the Articles of Agreement of the Association, respectively, are being distributed to the Executive Directors separately.

PART V - THE ECONOMY

17. Honduras, with a gross national product per capita of approximately US\$230, is the poorest of the Central American countries and one of the poorest in Latin America. The last IBRD economic report dealing with Honduras (WH-170a, dated June 5, 1967), observed that during 1961-1965 rapid economic growth had taken place, thanks to an impressive performance of exports both to the world markets (coffee, cotton, and in 1965, bananas) and to the rest of the Central American Common Market. In the same period the financial performance, especially after the 1962 tax reform, had been good, although fiscal equilibrium was due in large part to a poor investment effort. However, with the much poorer prospect for exports in the next few years, future growth prospects were not good unless considerable increase took place in the development effort and in the resource mobilization required to finance it. Specifically, there appeared to be an urgent need for improvement in project preparation and administration, for higher taxes, and for larger long-term borrowing from abroad. Debt service payments, that in 1965 were equivalent to 2.3 percent of export earnings, were thus expected to increase substantially, even with some portion of external assistance forthcoming on concessionary terms.

18. The general background for this conclusion has not changed significantly since the report was written. In 1966, GNP growth was well below the previous years, at about 4.7 percent in real terms, i.e., some

1.3 percent on a per capita basis, and in 1967, as a result the leveling off of exports (due to a drop in coffee and cotton exports), the rate of growth in GNP declined further to some 3.5-4.0 percent, or barely above the rate of growth in population. International reserves, that had increased steadily in the previous years, declined in 1967. Public savings on current account increased in 1966, but fell back in 1967, due to large current expenditures, particularly for health and education. Delays in project implementation kept public investments at a low level, well below budgetary targets. Debt service payments increased marginally to US\$3.5 million in 1967, equivalent to about 3 percent of export earnings.

19. The Honduran Government entered on January 1, 1968 in a one-year stand-by arrangement with the IMF for US\$11 million, which is based on a financial program that includes significant public revenue and expenditure measures. The Honduran Government intends to present to Congress by June 1968 a fiscal package that would provide for increases in the yields of income and property taxes, excise taxes on luxury items, the inheritance and donation tax, and public utility tariffs. Furthermore, economies centered on reducing non-developmental expenditures will be introduced in the course of the year. In fact, the President of Honduras recently directed the Government to cut the 1968 budget current expenditures by 4 million lempiras, or by 3.4 percent. If fully implemented, the program will raise 1969 public savings to a level adequate to support a higher development effort without endangering price stability and putting under pressure the level of international reserves.

20. On the basis of the projects now under way or about to be implemented, a significant increase in Government capital outlays is likely in 1968, although the present Government investment target (that would imply a 1968 investment level more than two and a half times as high as in 1967), is not likely to be achieved. The high disbursement rate on foreign loans in prospect for 1968 should, however, be sufficient to ensure at least a partial success of the investment effort for this year.

21. Traditional exports and private investments are expected to increase significantly in 1968. Important road, power and port projects are being carried out. Legislation on industrial incentives that grants preferential treatment to Honduras was recently approved by the Central American Common Market countries. The rate of growth in GNP in 1968 is expected to be somewhat higher than in 1967, around 5-6 percent.

22. However, the 1969 and longer-term possibilities of development depend primarily on the ability of the Honduran Government to introduce effective fiscal and administrative reforms, without further delay. Vast regions of the country are still isolated and their economic potential untapped: rapid expansion of infrastructure (power, roads, telecommunications) is required to promote their development, and this implies a major and immediate public effort, both on project preparation and on financial measures to support the higher expenditure levels. Adoption

of the proposed import surcharge which is now being considered by all the Central American countries for possible enactment this summer would contribute substantially toward such a higher development effort. Another development which will have a considerable impact on the whole economy, is represented by a large pulp and paper project, whose initiation is expected in 1969.

23. According to the present fiscal program of the Honduran Government, gross external financing would cover on average about 65 percent of the public investment expenditures over the next three years. This share compares with a 60 percent share of much lower investment expenditures in 1963-67. The total external public debt, that in mid-1967 amounted to US\$88.1 million, would increase significantly and could reach by the end of 1968 some US\$120 million. If all new loans were to be incurred on conventional terms, debt service payments would steadily increase to about 7 percent of export earnings in the mid-1970's; servicing of new loans would absorb approximately 15 percent of the expected increase in exports earnings and an even higher proportion of the foreseeable increase in Government revenues. In these circumstances, some assistance to Honduras on concessional terms seems appropriate.

PART VI - COMPLIANCE WITH ARTICLES OF AGREEMENT

24. I am satisfied that the proposed loan and the proposed credit would comply respectively with the Articles of Agreement of the Bank and of the Association.

PART VII - RECOMMENDATION

25. I recommend:

(a) that the Executive Directors of the Bank adopt the following resolution:

RESOLUTION NO. _____

Approval of Loan to the Republic of Honduras in an amount equivalent to US\$ 7,500,000

RESOLVED:

THAT the Bank shall grant a loan to the Republic of Honduras in an amount in various currencies equivalent to seven million five hundred thousand United States dollars (US\$ 7,500,000), to mature on and prior to February 15, 1993, to bear interest at the rate of six and

one-quarter per cent ($6-1/4\%$) per annum, and to be upon such other terms and conditions as shall be substantially in accordance with the terms and conditions set forth in the form of Loan Agreement (Rio Lindo Hydroelectric Project) between the Republic of Honduras and the Bank and in the form of Project Agreement (Rio Lindo Hydroelectric Project) between the Bank, the International Development Association and Empresa Nacional de Energía Eléctrica, which have been presented to this meeting.

(b) and that the Executive Directors of the Association adopt the following resolution:

RESOLUTION NO.

Approval of Development Credit to the Republic of Honduras
in an amount equivalent to US\$ 4,000,000

RESOLVED:

THAT the Association shall grant a development credit to the Republic of Honduras in an amount in various currencies equivalent to four million United States dollars (US\$ 4,000,000) to mature on and prior to February 15, 2018, to bear a service charge at the rate of three-fourths of one per cent ($3/4$ of 1%) per annum, and to be upon such other terms and conditions as shall be substantially in accordance with the terms and conditions set forth in the form of Development Credit Agreement (Rio Lindo Hydroelectric Project) between the Republic of Honduras and the Association and the form of Project Agreement (Rio Lindo Hydroelectric Project) between the Association, the International Bank for Reconstruction and Development and Empresa Nacional de Energía Eléctrica, which have been presented to this meeting.

Attachment

Robert S. McNamara
President

Washington, D.C.

May, 14, 1968