HONDURAS: Country Assistance Strategy

1. Introduction

On behalf of our Honduran authorities we wish to convey their appreciation for the assistance received from the World Bank Group. The dialogue with the Bank and its lending and non-lending services has been crucial for setting and supporting priorities, especially in the aftermath of Hurricane Mitch, when any assistance was urgent. The establishment of the Central America Emergency Trust Fund and the upgrading of the Liaison Office into a full Resident Mission in Tegucigalpa are also highly valued.

The Board of Executive Directors considered the previous World Bank strategy for Honduras in August 1993, more than six years ago. The document established that IDA assistance would concentrate on helping the Government in its efforts to achieve three medium-term objectives: reduce poverty, modernize the economy and the public sector, and enhance sustainable resource management. Since the last CAS, Honduras has experienced important changes in its socioeconomic evolution, associated with the relative consistency in the policies adopted by three successive Administrations. However, these significant advances were temporarily halted at the end of 1998, as a result of Hurricane Mitch, which devastated the economy and caused enormous social losses.

2. Lessons Learned: Structural Reforms and Economic Performance

Since the early 1990’s the Honduran authorities have been implementing a number of reforms aimed at stabilizing the economy, promoting economic growth, and improving social conditions. The IMF, IDA, and the IDB have supported these reforms. Structural reform measures consist of: Tax and tariff reforms, including raising sales tax from 7 to 12 percent in 1998; liberalizing the exchange rate and open trade policies; and improvements were also...
achieved in rural development and environment protection. In addition, reform policies were also adopted in the energy, water, transport and telecommunications sectors; substantial financial sector reforms were implemented, including granting more autonomy to the central bank and moderning the public sector. Regarding social sectors, policies have focused on expanding and improving the quality of primary services in health, nutrition, education, water and sanitation, and targeting these services more effectively to the poor.

**Economic Performance:** During 1995-1998, the Honduran economy grew at an average rate of 4.0 percent, reaching 5.1 percent in 1997, and it was expected to reach 5.5 percent in 1998. The rate of increase of consumer prices slowed down to 12.8 percent in 1997, from over 25 percent in the two previous years, reflecting a reduction in money growth, declining food prices, and achieving stability in the exchange rate. Over the same period, the overall fiscal performance was strengthened and the non-financial public sector deficit was reduced to 0.2 percent of GDP in 1998. The gross international reserves of the central bank rose from the equivalent of 1.7 months of imports of goods and services in 1995 to 2.9 months in 1998.

<table>
<thead>
<tr>
<th>Table No.1</th>
<th>Honduras: Selected Macroeconomic Indicators, 1995-1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Domestic Product, constant 1998 prices</td>
<td>4.1</td>
</tr>
<tr>
<td>Consumer Price Index (end of period)</td>
<td>26.8</td>
</tr>
<tr>
<td>Nonfinancial public sector balance (% of GDP)</td>
<td>-1.6</td>
</tr>
<tr>
<td>Gross reserves in months of imports (end of period)</td>
<td>1.7</td>
</tr>
<tr>
<td>Real effective exchange rates index</td>
<td>82.3</td>
</tr>
</tbody>
</table>

(*) Preliminary  
(**) Estimated  
Source: World Bank and Banco Central de Honduras

**Social Development:** Honduran authorities have made considerable efforts in the social sectors. In 1997 public spending in these sectors was equivalent to almost 8 percent of GDP, comparing favorably to countries with similar income levels. The share of social expenditures in non-interest public expenditures has been kept to around 40 percent. Notwithstanding the efforts made, poverty levels remained high, about 63 percent of poor households, on average, and 46 percent living in extreme poverty. In addition, there are wide rural-urban disparities in social indicators.

3. **Looking Ahead: 1999 and Beyond**

The strategy presented in the current CAS seeks to assist Honduras rebuilding efforts, while creating the foundations for a stronger economy and a more equitable income distribution. To support these objectives, the document proposes three analytical frameworks: the poverty agenda; public expenditure reform, focusing on the social sector; and a strategy for
infrastructure rehabilitation and private sector development. The CAS' objectives are in line with the country’s current strategy. In spite of the extensive damage to the social and economic infrastructure caused by Mitch, the current administration is committed to the implementation of its reconstruction plan, maintaining macroeconomic stability, accelerating the process of structural adjustment, strengthening social policies, and combating poverty.

On March 19, 1999, five months after Mitch, Honduras subscribed a new ESAF supported program with the Fund. Its main objectives are to reach a rapid economic recovery and to address social needs. The six-month review of the program shows the full commitment of the administration to accomplish the ESAF goals and targets. All quantitative performance criteria have been achieved; however, due to factors beyond the direct control of the government, there were delays in meeting the structural performance criteria. The macroeconomic developments from 1999 are in line with the expectations. Real GDP is estimated to decline by 3 percent (Table No. 1). There are some preliminary indications of a gradual upturn based on a recovery in banana sector, robust growth in the shrimp and maquila industries, and rebound in tourism and construction. Consumer prices are expected to slow to 12 percent and the country’s international reserve position has strengthened.

The prudent macroeconomic management allowed for better than the ESAF envisaged performance, in the monetary and fiscal sectors. The non-financial public sector deficit is expected to close at 6 percent of GDP smaller than the 8.3 percent forecast, due to stricter enforcement of the tax code and a prudent financial management in the decentralized public sector agencies. In the financial sector, total balancing liquidity is expected to increase substantially and the average bank lending rate will remain largely unchanged. In early September, our authorities reacted promptly and effectively to a crisis situation of a relatively small private bank, avoiding a negative impact on the rest of the financial system. To preserve stability, Congress approved legislation (last October) that provides a government guarantee to all banking system deposits for a three-year period; subsequently this decree will be replaced by a limited deposit insurance scheme funded and administrated by banks.

Important advances have been made in carrying out structural reforms. Regarding privatization, in November, the government issued an invitation for bids for 51 percent shares in the telecommunications agency. In the electricity sector, a tariff base has been established in line with a long-run marginal cost as a precursor to the privatization of power distribution. The remaining obstacles to private sector participation in infrastructure projects have been removed, including those in road construction and water supply services. The authorities are about to invite bids for the private sector management of the country’s main airports.

Honduran authorities give the highest priority to transparency and accountability in the use of domestic and external resources. In this regard, the government has supported the social monitoring initiatives presented by civil society and the strengthening of the decentralization and consensus process through a civil society commission for the reconstruction and transformation of the country. Other measures include the endorsement of a program, with the support of the IDB, for the strengthening of the mechanisms for public sector procurement to ensure full accountability in the use of resources combined with simplified and transparent
procedures. The main elements of the program are: (i) implementing a system of project inspection by independent auditors; (ii) making available to the government the assistance of specialized firms in project management; (iii) training of officials responsible for procurement and contracts; and (iv) developing a new system of procurement aimed at ensuring transparency. In line with the above-mentioned project, beginning October 1999, with USAID financing, three international accounting firms began to audit a sample of externally financed projects. The government is also seeking approval of a law on illicit gains by public officials, which will require all government employees to submit sworn declarations of assets at the start and upon ending their terms in office. Finally, with respect to coordinating efforts with the international community, after the Consultative Group Meeting on Central America held in Stockholm in May 1999, a monitoring commission was established. The commission formed by local representatives of the governments of Canada, Germany, Spain, Sweden, and the United States, is working jointly with the Honduran authorities.

4. Remaining Challenges

Notwithstanding the progress made, the authorities are aware that Honduras continues to face important challenges. Our authorities are committed to speed up the reconstruction program, while ensuring transparency and accountability in the use of resources; thus, maintaining macroeconomic stability, pursuing sound fiscal and monetary policy, and moving forward with reforms in the areas of privatization, public sector modernization, and social security system.

One of the main priorities is achieving sustainable reduction in poverty, through an acceleration of economic growth and an increase in the efficiency and equity of social expenditures. To this end, social policies will be reinforced, particularly in the areas of management, implementation capacity and decentralization. The government has begun to work on reassessing social conditions and poverty in the post-hurricane period as part of the preparatory work for the Poverty Reduction Strategy paper. The strategy, including outcome indicators and progress benchmarks, will be developed through a participatory process and with the assistance of the World Bank, UNDP, IDB and IMF.

Our authorities are conscious that the country has to reduce its vulnerability to natural disasters and improve its ability to handle future emergencies. Therefore, the efforts will focus on targeting poor areas, strengthening decentralized institutions, and undertaking sustainable watershed management. In this regard, the Government has requested IDA support to put in place a strategy in order to reduce the vulnerability of critical infrastructure and settlements.

Concerning the financial sector, the authorities will continue to strengthen the regulatory framework and supervision to bring them in line with international standards. In this regard, the current World Bank support is highly appreciated and the government will continue to seek technical assistance and IDA support through a Financial Sector Adjustment Credit. Regarding IFC’s strategic priorities, our authorities believe that these should be reinforced in the short-term by assuming a "catalytic role" in the financing of small and medium enterprises and by strengthening the domestic financial sector. Historically, there has not been a single operation of the Corporation with a Honduran financial institution.
5. Concluding Remarks

Our authorities wish to express their appreciation to all creditors and donors for their continued support to Honduras' stabilization and structural adjustment efforts, and for the important assistance received during the emergency caused by Hurricane Mitch. The government expressed its gratitude, in particular, to the donor community that through the Central America Emergency Trust Fund is helping it meet its debt-service obligations to multilateral institutions and to free up resources for reconstruction.

Our authorities consider that the CAS' high case-lending scenario is the most likely. This is the case given the expected strong macroeconomic performance, the progress in the financial sector, and the priorities and work program envisaged by the government. We would like to suggest that the Bank try to coordinate the "CAS cycle" -- to the maximum extent possible -- with the Honduras' political cycle as a critical, prerequisite for ensuring the country's ownership and priorities.

Finally, on behalf of our Honduran authorities, we would like to express this chair's acknowledgment to the Bank team in charge of the preparation of the CAS document.