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ROBERT R. NATHAN

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Evaluation of the

A.I.D. Export Promotion Program in Honduras

Under Macroeconomics IQC
Contract No. PDC-0000-I-80-6135-00

March 1988

Prepared for
U.S. Agency for International Development,
USAID/Tegucigalpa

Prepared by
Robert R. Nathan Associates, Inc.
In association with
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PREFACE

This report was prepared under the A.I.D. Macroeconomics IQC, Contract No. PDC-00-I-80-6135-00, and was managed by USAID/Tegucigalpa. The basic scope of work for the series was jointly designed by the Economic Affairs Office of the Honduras Mission.

The research involved was carried out by a joint RRNA/DAI/A.I.D. research team over a five-week period during February and March 1988. The RRNA Team Leader was Mr. Edgar Gordon, while Dr. Jennifer Bremer-Fox served as Agricultural Economist, and Mr. Edward Krowitz was the Institutional Economist. DAI consultant Dr. Jorge Vega served as Industrial Economist.

The research team would like to thank Honduras Mission Director Mr. John Sanbraillo for his active cooperation and that of his staff during the performance of this evaluation. Juan Butari, as Project Officer, provided invaluable help and liaison within the Mission and in meeting with GOH officials and members of the private sector. Jerry LaPittus provided valuable perspective on macroeconomic policies while Randall Petersen provided statistics and institutional history. Several other USAID office Directors and technicians were of considerable help to the team, especially Al Zucca, advisor to the Ministry of Economics.

GLOSSARY

A.I.D.	Agency for International Development
APROCACHO	Association of Cocoa Producers
CACM	Central American Common Market
CEFEX	Export promotion certificate providing a tax credit (Certificado de Fomento a las Exportaciones)
CENTREX	Center for export licencing (El Centro de Tramites de Exportacion)
CETRA	A right to buy foreign exchange that the exporter can retain or sell at a freely negotiable price (Certificado Transferible de Opcion a divisas por Exportacion)
CONAFEXI	Export and Investment Coordinating Council (Consejo Nacional de Fomento de Exportaciones e Inversiones)
DGPEI	Directorate of Export and Investment Promotion (Direccion General de Promocion de Exportaciones e Inversiones)
EDSP	Export Development Services Project
EPR	Effective Protection Rate on Tariffs
ESF	Economic Stabilization Fund
FEPRO	Federation of Agricultural and Agro-Industrial Producers
FIDE	Foundation for Entrepreneurial Research and Development (Fundacion para la Investigacion y Desarollo Empresarial)
FHIA	Agricultural Research Institute (Fundacion Hondurena de Investigation Agricola)
FY	Fiscal Year
GDP	Gross Domestic Product
GNP	Gross National Product
GOH	Government of Honduras
IMF	International Monetary Fund
NTAE	Nontraditional Agricultural Exports

OECD	Organization for Economic Cooperation and Development
PAAD	Program Assistance Approval Document
TAE	Traditional Agricultural Export
USAID	An A.I.D. Country Mission

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I. INTRODUCTION AND EXECUTIVE SUMMARY

After a brief examination of the macroeconomic setting, this evaluation addresses the various constraints hindering export expansion in Honduras such as availability of resources, lack of skilled labor, and high transport costs. Against this background, it analyzes Honduras's export policies and then the Mission's implicit export strategy. That strategy covers efforts to influence government economic measures affecting exports through negotiation and ESF conditionality; the creation of institutions to promote exports, mainly in the framework of the Export Services and Development project such as FEPRO and FIDE; and other agricultural projects that indirectly affect exports. For each activity we present recommendations which should be considered in FY 1988. The evaluation ends with a discussion of lessons learned and a series of issues which should be considered in connection with the FY 1989 program.

Objectives of the Study

The principal objective is to evaluate the implicit export strategy of A.I.D. in Honduras as it has worked in practice, i.e., those elements of ESF conditionality affecting exports, the Export Services and Development project, and various agricultural projects that have direct or indirect influence on exports of particular commodities. The secondary objective is to examine Honduran government policies and institutional and other restraints bearing on exporting, in order to assess the adequacy of A.I.D.'s policies and its influence on the host government.

Background of the Study

Generally, traditional commodity exporting economies have not developed export strategies. Exports were the product of market forces, somewhat influenced, usually negatively, by official policies aimed at other problems. Import protection, for example, might raise the cost of production of some exports. Barriers to inward foreign investment could have the same effect. This was the situation in Honduras until the early 1980s when an overvalued exchange rate led to a shortage of foreign exchange, and the imposition of exchange controls. A series of measures was undertaken by the Honduran government, prodded by A.I.D. and the business community, to encourage exports. It has been a policy of bits and pieces, handicapped by the government's unwillingness to consider devaluation as an option. As a consequence, export volume was probably no higher in 1987 than in 1980.

Summary of Results

Structure and Performance of the Honduran Export Sector

Honduras is a traditional agricultural economy with a small manufacturing sector serving mainly domestic consumers. Its exports are bananas, coffee, wood, minerals, meat, sugar, fresh fruits and vegetables, and various industrial products. Honduras has historically followed conservative financial policies which permitted it to maintain the same exchange rate, 2 lempira to the dollar, without serious problems from 1917 to about 1981. In the late 1970s GNP was growing 6-7 percent per year.

A surge of inflation in the 1980-82 period overvalued the lempira in relation to the dollar and, together with the continued appreciation of the dollar against the other principal trading currencies, increased the effective rate of the lempira 30 percent by 1985. The government imposed exchange controls for the first time and, as a result, a black market developed. A return to tighter monetary and fiscal policies since 1983 has moderated inflation; but the exchange rate is still seriously overvalued compared with 1980, a situation made worse by the more aggressive devaluation policies of Honduras's competitors in the Caribbean basin. Export volume, which rose 8 percent per year from 1975 to 1980, declined in the early 1980s and then recovered, was still 8 percent below its 1980 level in 1986. As a result, the balance-of-payments deficit has been financed in part by an annual increase in arrears.

For analytic purposes for the whole period, major exports are divided into bananas, which have stagnated; four commodities (wood, meat, minerals and tobacco) that declined throughout; and three that have had strong upward trends. Among the minor exports (nontraditional), industrial products have suffered badly, while a number of newly introduced agricultural commodities have grown quite rapidly.

Institutional and Other Constraints

Apart from the problem of overvaluation, Honduras faces various constraints that affect exporting. Although there are abundant supplies of arable land and labor, productivity is low. Half the labor force is illiterate, and skilled labor and competent managerial personnel are at a premium. Medium-term credit from commercial sources is usually not available for most industrial and agricultural investment purposes. Since they have exported mostly commodities for which marketing is not a problem once basic quality standards are met, most businessmen lack the experience of making contact with buyers outside of Central America and knowing how to adapt their products to foreign standards. These problems need to be solved if Honduras is to follow the path of sustained export growth by diversification.

Honduran Government Policies Bearing on International Competitiveness

Honduran export policy since 1984 has been a search for measures to overcome the lack of competitiveness without actually devaluing. The idea of export policy is new and alien, and there is probably a feeling that success could have the effect of reducing balance-of-payments assistance. Second, high levels of protection, particularly for the industrial sector, make manufactured exports much less profitable than domestic sales.

The Honduran authorities, pressured by A.I.D. and exporters, have tried to increase the financial return to the export of certain products, case by case. This effort has taken several forms: the retention of a portion of foreign exchange that could either be sold in the black market or used to import without waiting for months for a licence; tax reimbursements; the reduction of the marginal export tax; and so on. However, at the end of 1987, a calculation of the actual lempira/dollar exchange rate by adding these various advantages but subtracting export taxes on the two principal commodity exports, bananas and coffee, shows that the taxes offset the subsidies, leaving the exchange rate about the same.

At the beginning of 1988, the Central Bank, in cooperation with the Mission, took the potentially more interesting step of creating an official second exchange rate, disguised as a market for certificates (CETRA) representing a portion of foreign earnings repatriated to Honduras. The certificates are a right to buy foreign exchange, and as in other retention schemes, can be sold or used to import. The scheme is restricted to nontraditional exports, the miscellaneous agricultural and industrial products, each of which is a tiny fraction of Honduran exports, and which collectively constitute less than 15 percent of the total.

Characteristically, the Central Bank has been "choosing" eligible commodities instead of simply establishing a negative list of commodities not eligible. At this point the products listed are equal to 5 percent of total exports; there are no products from the industrial sector, which has suffered the most from overvaluation. The actual rate for selected products could be as high as 2.3/1 if the market and tax reimbursement really works, an assumption never to be taken for granted in Honduras. For exports as a whole the actual rate is depreciated by 1 percent, to 2.02/1.

Other reforms are the temporary import law to allow exporters to import inputs at world prices; the establishment of export processing zones to attract foreign manufacturers; the reform of tariff assessment and nomenclature; and the administration of customs.

A.I.D.'s Implicit Export Strategy

The basic problem with A.I.D.'s export strategy is that it is implicit rather than explicit. Having decided, in 1985, that a devaluation was not feasible for political reasons, the Mission emphasized a variety of activities that were actually or potentially useful in assisting exporting but, overall, have had very little impact up to now. As a result the export strategy is divided among a number of projects which have the virtue of consistency but not mutual reinforcement.

As part of ESF conditionality, the Mission has developed a policy dialogue with the Honduran authorities that has led to most of the measures described above. Our major recommendation in this area is that the Mission require the rapid expansion of the certificate market to all nontraditional exports and its effective operation as a condition to the FY 1988 ESF disbursement.

The Export Services and Development project has three main parts: export promotion in the Ministry of Economy; the support of FEPRO for agricultural production and sales; and FIDE for the industrial sector. Honduras has had no official export promotion unit and only reluctantly agreed to establish one in 1987, even though A.I.D. was paying most of the cost. The main issue and our principal recommendation is that competitive salaries be paid to insure staffing with commercially qualified personnel.

FEPRO has proved to be ineffective because of weak management working in too many areas. On the basis of an earlier evaluation, the Mission is already reorganizing. Our recommendation is that the proper focus is on the problems that are generally agreed to be holding back agriculture: the lack of credit, the high cost of transport, and the provision of information to help in establishing contacts with foreign markets.

FIDE has proved to be a more effective organization in the promotion of industrial exports. With the creation of the export promotion directorate in the Ministry of Economy, we agree with another evaluation team's recommendation that FIDE's emphasis on trade should be reduced and its investment promotion expanded.

Both FEPRO and FIDE were supposed to be eventually self-sustaining through fees for services. In practice, their income covers only a very small fraction of their expenses, the rest coming from A.I.D. The team argues that both organizations are being asked to provide public goods that benefit the economy indirectly. The direct recipients should not be asked and probably cannot afford to pay the whole cost. If these institutions work as intended, A.I.D. support for operational expenses should be phased out and turned over to the Honduran government.

Other agricultural projects have assisted coffee, livestock, and forestry production. They have generally been effective but, in our opinion, concentrate too much on production and not enough on marketing to aid exports efficiently.

The Export Strategy - Options for the Future

For the FY 1989 program we have made two major recommendations:

1. A.I.D. should make it a condition of its ESF assistance that Honduras devalue to a realistic exchange rate; or as a fallback, that the CETRA market embrace more than half the merchandise and all invisible transactions. (A devaluation would have the advantages of being a serious signal to exporters

of a shift in policy; it would cover invisible and capital transactions as well as merchandise; and it could generate much more tariff and counterpart revenue. With a realistic exchange rate of at least 2.7/1 and an actual rate of very close to 2/1, there can be no serious promotion of exports without some measure of this kind).

2. For other elements of export promotion, A.I.D., as an annual exercise and in cooperation with the Honduran export council (CONAFEXI), should produce an export strategy paper built around a priority listing of the products that should be assisted. A.I.D. should use the listing to adapt activities in particular projects to the export goal.

Export promotion in Honduras is not a hopeless cause, but it is a very difficult one until the government is motivated to change its basic policy of not rocking the boat and to seek solutions that solve rather than defer its problems.

II. STRUCTURE AND PERFORMANCE OF THE HONDURAN EXPORT SECTOR

In this section we examine the roles of the agricultural and industrial sectors, fiscal and financial policy, the rates of growth of GDP, the trend of investment, the financing of the balance of payments, labor and natural resource restraints on exporting, and the trend in total export volume and in its principal sub-sectors.

Structure of the Economy

Honduras is one of the poorer of the developing countries. Its income per capita, using GDP in current prices and the official exchange rate, is about $800. Assuming that the black market rate is a more accurate indicator of the lempira's value, the real figure may be closer to $600. Although its soil and forest resources are abundant, its productivity is low. That is not a surprising finding, since less than half the population finish the sixth grade and there is a shortage of skilled labor and managerial and technical personnel.

The basic division of GDP between value added produced in manufacturing and in agriculture has been rather stable since the end of the 1960s. For almost two decades, agriculture has produced about 25 percent of product and manufacturing roughly 13-14 percent. It would appear that once manufacturing production was able to satisfy the home market and engage in some modest exporting, mostly to neighboring countries, it ceased to have an independent effect on growth. The longer term trend continues to be dominated by agriculture, which supplies more than three-quarters of Honduras's export income, most of it derived from bananas and coffee.

Nevertheless, manufacturing is potentially more important over the long run as an incremental source of exports. The sector is confined to agro-based activities and other, largely consumer products such as sugar refining, food, beverages, textiles, clothing, and wood products, which together account for almost 80 percent of the sectoral value added. Production is concentrated in 0.2 percent of the firms, which employ 23 percent of the labor force and are responsible for 54 percent of output. At the other end of the scale, 98 percent of the enterprises have fewer than five employees each.

Although Honduras has been an open economy with exports and imports of goods and services each equal to about one third of GDP, manufacturing grew up behind a wall of protection. Fortunately for the efficient use of resources, this policy was not compounded by the high cost production of intermediate goods such as steel or synthetics.

Another prominent feature of Honduras's economy has been its dependence on foreign capital, especially official assistance. With the exception of a few years in the early 1970s, foreign savings has financed investment equal to about 10 percent of GDP, on the average. Honduras's reliance on aid is not recent, but the form has changed: it is now receiving more grants and fewer loans. Since national savings has averaged less than 10 percent since 1980, foreign capital is essential for growth.

The legacy of earlier and continuing borrowing is a large foreign debt, estimated at $2.6 billion in 1987, or about 65 percent of GDP. Debt service has been mounting rapidly as grace periods expire. In combination with the stagnation of export earnings since 1980, the debt burden, as measured by the debt service ratio has risen from 15 percent to more than 30 percent. The high level of debt service already reached and its probable rise in the future, in the absence of policy changes, makes vigorous export promotion all the more necessary as a precondition for sustained growth. //

Recent Macroeconomic Behavior

Honduras' GDP grew 6-7 percent per year in the late 1970s, stagnated or declined in the period 1980-83, and averaged about 3 percent per annum from 1984 through 1987. Growth reached 4 percent last year, the best performance since 1979. Because population increase throughout this time was in excess of 3 percent per year, real per capita GDP is still 10 percent below what it was a decade ago.

Growth has depended mainly on the world demand for agricultural exports, which directly and indirectly affected agricultural and manufacturing output. The latter went through more violent fluctuations, rising 8 percent per year in the late 1970s and declining 3 percent per annum during 1980-82, in part because of payments problems in the other Central American countries.

Private investment, after reaching a peak of 15 percent of GDP in 1980, declined to a plateau of 7-8 percent since 1982. Although investment by the public sector has risen a couple of percentage points of GDP, the two components together have not exceeded 17-18 percent recently.

The most direct way to analyze the domestic financial situation is to begin with the consolidated public sector budget, summarized in Table 1.

Table 1. Consolidated Public Sector Budget

	1984	1985	1986	1987
	------------ percent of GDP ------			
A. Budget				(est)
Total Expenditure	31.8	30.3	27.7	28.2
o.w. capital	11.6	9.8	7.3	5.9
Total Revenue	20.6	21.8	21.4	21.8
Deficit(accrual)	-11.2	-8.5	-6.3	-6.4
" (cash)	-11.2	-8.5	-6.3	-5.2
External Financing				
1) loans, net	8.9	5.7	2.3	-0.1
2) grants	1.1	1.6	1.8	1.0
3) arrears	0.2	0.0	0.0	1.3
Domestic Financing				
1) banking system	1.3	0.6	1.0	1.9
2) other	-0.2	0.6	1.2	1.1
B. Money Supply	---------- Percent change --------			
M3	7.7	4.3	11.5	18.3
C. Prices				
GDP deflator	4.6	4.6	5.5	1.8
D. Interest Rates	--------- Percent per annum ------			
Lending	16	16	16	15+
Time Deposit	10	10	9+	9+
Government Bond	10	10	10+	10+

From 1984-86, the deficit was reduced by cutting capital spending, holding current expenditures constant, and raising revenues in 1985 to a new plateau. In 1987, current spending rose about 2 percent of GDP, but total expenditure rose only a half of a percent because of a continuing fall in the capital account. The more serious problem was the reduction of external financing, which forced an increased reliance on the domestic banking system and a pile-up of internal arrears.

As a result, the broad measure of money supply began to rise, to 11.5 percent in 1986 and 18.3 percent in 1987. Prices, on the other hand, showed no effect and rose even more slowly in 1987.

The possible explanations are (1) the increase in supply -- a 4.2 percent rise of GDP including the 7 percent growth of agricultural production, a rundown of inventories, and an import increase -- has exerted some depressing effect on prices; (2) the price indices do not accurately reflect price developments; (3) high real interest rates compensate for expected inflation; and (4) more liquidity than usual is tied up in bank deposits waiting to pay for imports. Whatever the reason, the fact remains that there has been a substantial build-up of liquidity that could set off a more rapid price rise.

One effect of this development was the progressive depreciation of the lempira in the black market during the course of 1987. Excess liquidity may also have affected the visible balance of payments although licencing obscures its connection to imports. Total imports rose and exports fell while, coincidentally, foreign assistance declined. Table 2 shows that Honduras' always difficult foreign exchange situation grew worse in 1987.

Table 2. Honduras's Foreign Exchange Situation
(Millions of dollars)

	1983	1984	1985	1986	1987
Current Account	-261	-333	-337	-251	-321
Capital Account	211	294	273	206	175
Balance	-51	-38	-64	-45	-145
Change in arrears	47	36	49	38	120

The current account deficit increased again once coffee prices, which were high in 1986, fell to more normal levels. But simultaneously A.I.D. grants fell $50 million and loan disbursements $90 million. The accumulation of arrears, which appears to be a normal method of balance-of-payments finance, then rose by $120 million instead of the usual $40 million. Outstanding arrears at the end of the year were estimated to be about $350 million.

Honduras, then, has succeeded in keeping its rate of inflation low but faces a major balance-of-payments problem as a result of an overvalued exchange rate inherited from the inflation of the early 1980s (see Chapter IV). The consequences are a large overhang of arrearages that threatens new loan disbursements, a serious debt service problem, and a long wait for import licenses. If 1987's excess internal liquidity is not reabsorbed soon, internal prices will start to rise again and make the payments issue even more intractable.

Real Resource Constraints

Agricultural

Honduras's capacity to increase production is generally not constrained by available land. Much arable land either is not cultivated or is devoted to cattle raising. Productivity is low by regional standards because of inadequate inputs, irrigation, and poor technical practices. Short-term gains for some exports are held back by the lack of technical packages. They are being developed by FHIA, the research institute, exporters like Citrus Development Corp. or local growers like APROCACAHO for other commodities.

The greatest threat to expanded production and exports is the continued deterioration of the forests. Slash and burn cultivation on steep slopes, poor management by COHDEFOR, the forestry parastatal, and insufficient incentives for reforestation have led to a situation in which resources are being used up faster than they are replenished.

Industrial

In principle, the only real constraint to manufacturing activity is, in the long run, the accessibility to markets. Since most raw materials and intermediate inputs needed for industrial processes are internationally traded, their absence is not a real constraint. Countries with few natural resources have managed to develop a solid industrial sector.

Previous studies reveal that perhaps as much as 40 percent of industrial capacity in Honduras is idle. Since most companies were not created with the purpose of exporting, some adaptation of their technology and production processes would be necessary to allow them to compete effectively in international markets. A study conducted by International Parks, Inc. in 1984 concluded that the analysis of $50-55 million of potential excess export capacity out of the $79 million possible available in existing plants "indicates no immediate opportunity for increasing exports. . .The export possibilities investigated will all require further capital investment ranging from $5-25 million total and will take considerable time to effect." This conclusion indicates that price and the overvalued exchange rate are only two of the obstacles to industrial exporting. The others are product design and quality standards.

Composition and Recent Trends

Overview

In this section we examine the 12-year period 1975-86, to determine generally the effect of overvaluation of the exchange rate. We can only describe tendencies because exports were also affected by different phases of industrial country growth, by supply conditions within Honduras, and by restraints on trade imposed internationally.

The working assumption is that the exchange rate in the period 1975-80 was realistic or at least substantially more competitive than in the subsequent six years. During this period inflation was low, and the balance of payments was in equilibrium without exchange controls. OECD growth, which was about 2 percent per annum during 1975-80, negative in 1980-82, and roughly 3 percent per year in 1982-86, would have had an independent favorable or depressing effect on sales abroad. Within Honduras, the nationalization of forestry in 1974 seems to have had a profound effect on the profitability of wood exports. The price at which coffee sells depends on production in the major suppliers and on whether it was sold at a premium within Honduras's quota in the International Coffee Agreement or outside at a discount.

There was a break in the real growth of exports about 1980. From 1975 until then, export volume rose an average of 8 percent per year. From 1980 to 1986 the trend was declining. The picture will probably look somewhat better when final estimates for last year are available.

The analysis of exports in Honduras has usually divided them into two categories: traditional and nontraditional. Traditional exports are defined as commodities whose sales exceed 2 percent of total exports. Nontraditional exports are all the rest. The export promotion law confines its benefits to nontraditional commodities. In practice, the export sectors where foreign producers predominate have arranged better financial arrangements for themselves than the minor benefits of the promotion law.

A more useful approach would be to try and classify exports by their medium- to long-term growth prospects. In Table 3 the so-called traditional exports have been grouped as follows: bananas, which have stagnated since 1980; four that have declined throughout the period; and three, led by coffee, that have had a strong upward trend.

Table 3. Growth Prospects for Honduran Exports

	Merchandise Exports (in constant 1985 prices)				percent growth		
	1975	1980	1983	1986	80/75	83/80	86/83
Bananas	118	279	206	250	19	-10	7
Wood	73	43	42	35	-10	-1	-6
Meat	35	60	33	21	11	-19	-14
Minerals	39	26	-33	31	-6	6	-1
Tobacco	10	17	12	5	11	-12	-23
Coffee	125	147	190	206	3	9	3
Sugar	2	15	19	19	52	9	-1
Shrimp	30	39	50	41	5	9	-7
Sub total	432	626	584	607	8	-2	1
Nontraditional	128	202	161	162	10	-7	0
Total	560	828	745	768	8	-3	-1

Source: Mission database and team calculations.

Although bananas show a break in growth in 1980 and a decline up to 1986, if 1987 is taken into account the trend would be slightly upward. The more favorable behavior of the past few years appears to be a combination of stronger world markets and the zero marginal export tax extended by Honduras last year.

Among the other traditional exports, wood, tobacco and meat show steeply declining trends while minerals are almost unchanged. For wood, the problem is internal supply. Meat has apparently suffered from the overvalued exchange rate in the U.S. market.

Shrimp and sugar had strong growth trends even in the initial period of overvaluation but have declined more recently. Shrimp exports were strong in 1987, according to preliminary reports, and the prospects for increased sales look good with the new investment in farming.

The decline in nontraditional exports is more difficult to analyze because the category consists of so many products, none of which is individually very important. Second, there is a large other category for which no information is available. Finally, a number of products viewed as most promising for the future (and supported by the EDSP) are not yet even tracked by the Central Bank as separate line items in the commodity accounts (e.g., cardamom, tomatoes, cucumbers).

Some products that have only been produced in Honduras since 1980, have given the agricultural portion of the nontraditional exports a slower rate of decline than the industrial sub-sector.

Table 4 presents some of the most important commodities in the NTAE group. Four commodities -- pineapple, palm oil, fruit preserves, and grapefruit -- account for more than half of all NTAEs in 1986. A similar but not identical group -- pineapple, palm oil, melons, cocoa, and fruit extracts -- accounts for 84 percent of the increase in the lempira value of exports since 1980. The highest growth rates were shown by palm oil, melon, and cocoa, followed by pineapple.

Whereas the more important agricultural exports have continued to grow and new crops have had spectacular gains, the major categories in the industrial group have had large declines and some smaller ones only moderate advances (with the exception of wicker furniture) as Table 4 indicates.

Major Nontraditional Exports
(Growth in constant prices from 1980/81 to 1985/86)

Agricultural	1986 Value (mil. Lemp.)	Percent	Industrial	1986 Value (mil.) Lemp.)	Percent
Pineapple	20.6	2.4	Wood Manufac.	17.6	-9
Palm oil	14.5	**	Soap	2.9	-32
Grapefruit	8.7	3.2	Cigars	9.8	8
Melons	6.9	35.9	Wicker Furnit.	5.1	19
Cocoa	5.6	29.7	Corsets, etc.	1.4	-38
Molasses	4.9	1.9	Barbed Wire	1.1	-18
Plantains*	4.4	65.2	Starch	1.4	-21
Fruit extracts	4.2	**	Canned Fruit	12.4	-3
Sesame seed	3.6	4.9			
Resin	2.6	-12.3			
SUBTOTAL	76.2			51.7	

Source: BCH and team calculations.
* Non-CACM area only.
** No exports in 1980 or 1981.

III. INSTITUTIONAL AND OTHER CONSTRAINTS

This chapter examines the various constraints that hold back export growth, other than government policies affecting the exchange rate, the tariff system, and exchange controls which are analyzed in the next chapter. The constraints examined in this chapter are the lack of investment, the shortage of skilled labor, inadequate financing, high transport costs, the lack of international marketing expertise, and foreign trade barriers.

The factors constraining growth in the Honduran export sector may be divided into factors related to government policies, such as trade barriers, and factors not related to government policies, such as the conservative nature of the Honduran financial establishment. This distinction is particularly useful in the short run; over the longer run, many of the non-policy factors have been and will continue to be shaped by government policy.

Both policy and non-policy constraints must be addressed in order to achieve expanded export levels. Policy-related factors are dealt with in the following section. This section deals with non-policy constraints, including the limitations of key private sector institutions.

The team has identified six principal constraints:

1. Lack of investment
2. Shortage of skilled labor
3. Inadequate financing, both debt and equity
4. High transport costs, particularly internationally
5. Lack of international marketing expertise and information
6. Quotas on imports or exports originating outside Honduras

These factors affect both the industrial and the agricultural sectors, although the form that they take and their importance as constraints differ between the two.

Lack of Investment

As discussed in the review of macroeconomic performance in the previous section, private sector investment since 1982 has been much below the peak levels of the late 1970s. Representatives of the Honduran business community attribute this situation to a number of factors. First, local investors see the possibilities for additional import substitution and investments aimed at the CACM region as poor. Stagnant exports have reduced the growth rate and the policy of high real interest rates to protect the exchange rate make investments costly. Investment in export activities is not realistic for most activities with an overvalued exchange rate and the lack of offsetting incentives.

A second and related factor is the unsettled security situation in neighboring countries. Although Honduras continues to display a high degree of political stability, Hondurans and potential foreign investors alike are fearful that the coming period may see a spillover of neighboring countries' problems into Honduras.

Shortage of Skilled Labor

Honduran businesspeople cite the lack of skilled labor as a major barrier to investment in new enterprises. This lack is especially critical in three areas: (1) skilled technicians, such as maintenance engineers with the capability to maintain sophisticated manufacturing equipment; (2) mid-level managers, qualified to serve as head accountants or plant foremen; and (3) individuals with knowledge of international marketing and trade procedures. Established enterprises have built up a staff over time, but new enterprises find it difficult to locate suitable candidates in these three areas, a situation that adds to the entrepreneur's perception of the riskiness of new ventures.

A related problem is the low productivity of the Honduran labor force. Somewhat surprisingly, this problem is cited more frequently as a constraint to agricultural exports than to industrial manufactures. On the contrary, offshore investors in products requiring a high labor content, such as undergarments, praised the quality of the Honduran labor force. Observers of the agricultural sector, however, cited low labor productivity as a problem for both production and processing of nontraditional products, adding to the management load imposed on such enterprises.

Both skill constraints are generally attributed to the comparatively low level of educational preparation in Honduran society, a situation that is not amenable to change in the short term. There are, however, a number of schools for the training of workers. The National Institute of Professional Training (INFOP), created in 1972 as an autonomous entity and financed mostly by public and private sectors (also receiving support from foreign institutions), is the most important training institution for workers in Honduras, graduating close to 6,000 industrial workers each year. Recently the GOH has been making an effort to improve the quality of education provided by INFOP. This effort has resulted in the creation of a board of certification

(Comision Asesora de Recursos Humanos, CADERH) responsible for testing graduates of INFOP and other technical training institutions. It is important that the GOH continue to support the efforts of INFOP and CADERH.

Other countries -- including Korea -- have faced similar problems with a work force unfamiliar with the requirements of export production. Their experience suggests that the problem can be solved if adequate attention is devoted to it by public and private sector interests.

Inadequate Financing

Short-term credit is available but medium-term loans are scarce. Honduras has a large and well-capitalized private banking system, but observers both inside and outside the system characterize it as having the traditional approach in which lending is almost exclusively in the form of short-term collateralized credits for import trade or existing businesses, public sector securities, and other activities perceived as having low risk. The few medium-term loans for export investment that are approved are financed almost entirely through special programs such as the EDSP.

The average maturity of loans granted by the commercial banks (according to the Econsult study for A.I.D.) was 8.5 months in 1986 and has been declining throughout the 1980s from its peak of 10.3 in 1981. Commerce has the shortest average maturity (5.3 months in 1986), agriculture and services have the longest, excluding real estate (10.5 and 11.7), while maturities for industrial loans average 8.4 months.

The sectoral share of commercial bank credit has been fairly constant during the first half of the 1980s. Industry, commerce, and agriculture received approximately equal shares of the total (24.3, 23.8, and 23.4 percent of the 1986 total).

Although available statistics do not provide a detailed breakdown of lending for agriculture and industry, the portfolio is reportedly dominated by lending for traditional production. A representative of a leading commercial bank estimated that only 10 percent of the agricultural portfolio (2 percent of the total portfolio) was for export-oriented production. A large share of the agricultural portfolio consists of loans for livestock, basic grains, and traditional exports such as coffee (the private coffee bank accounts for approximately 5 percent of commercial bank lending for all sectors). He estimated that a much larger share of the industrial loans was for export-oriented production (perhaps 40 percent of industrial loans, or 10 percent of the total portfolio).

From the viewpoint of expanding exports, there is a credit problem for agricultural products requiring medium-term finance, which falls particularly hard on agricultural and agro-industrial projects for the production of perishable crops. Agricultural land and such products are generally not acceptable as collateral, even with a legally secure title, because of the uncertain situation surrounding Honduran land reform efforts, the possibility of peasant land invasions, and the generally underdeveloped state of rural land markets. Unless even well-established agricultural and rural enterprises have access to other forms of collateral, they are effectively denied access to bank funds.

Government efforts to resolve this problem have thus far focused on titling programs (which have been extremely limited in their outreach, because of high costs) and public sector lending programs, such as BANADESA (which have suffered from the long and familiar list of problems to which such programs are prone). Neither solution has been effective.

High International Transport Costs

Although Honduras's location in Central America would appear ideal for reaching the U.S. market, Honduran exporters in fact pay freight rates reported to be the highest in the region and, in some cases, higher than comparable rates from much more distant locations. High freight rates pose an especially serious problem for agricultural producers and others shipping goods with a relatively low value per unit volume. In addition, the differential appears to be much higher for perishable products travelling in reefer (refrigerated) containers than for other products. High rates can also be a problem for contract manufacturers (e.g., for clothing), for whom the ability to win contracts may turn on price differences of a few cents per unit.

High freight rates are due to three factors: (1) the limited number of shipping lines serving Honduras, all of which follow "conference pricing" procedures that tend to raise rates; (2) the low and uncertain volume currently exported, as well as its seasonality, all of which have reduced shippers' bargaining power; and (3) the high costs associated with operating out of Puerto Cortes, which has become the most expensive port in the region, reportedly because of inadequate management by the government-owned port authority.

Low volumes are undoubtedly a factor, but the team's analysis of freight rates for agricultural products found that volumes are not in and of themselves a sufficient explanation.[1] In January-August 1987, for example, Honduras shipped 2.1 million pounds of cucumber to the United States, while Belize shipped 2.7 million pounds, but Belizean exporters paid 9.8 US cents per kilo, compared with 17.8 US cents for Honduran exporters. During the same period, Chilean melon exporters shipped a much smaller volume than Honduran exporters (7.6 million pounds compared with 12.5 million) but paid only a

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1. The analysis compared the customs value (the reported FAS value) and the CIF value of U.S. imports for January-August 1987, as reported in U.S. customs statistics (the monthly report of general imports and imports for consumption). The difference between the two is a rough indicator of international freight rates, including port and loading charges, insurance, and other charges.

fractionally higher freight rate (21.2 US cents per kilo compared with 19.21 cents), despite the vastly greater distance.

Higher volumes would undoubtedly put Honduran exporters in a better position to negotiate favorable rates with the three shipping lines serving the United States, but higher volumes are difficult to achieve against a background of high rates. Direct intervention by the GOH or other parties may be needed to resolve this classic chicken-and-egg situation.

Lack of International Marketing Expertise

Like many countries trying to move into new export markets, Honduras is hampered by investor unfamiliarity with international market requirements and procedures. The information requirements fall into two broad categories.

First, investors need better information on the requirements of the market they are trying to serve, including quality standards, design, minimum volumes, varietal preferences in the case of agricultural commodities, and so on. Without this information, entrepreneurs cannot redirect existing operations or establish new ones to produce an exportable product. Much of the current output of Honduran farms and manufacturers simply does not have a market outside the country.

Second, investors need specific information on importing firms, brokers, and other potential clients. The experience of Honduran investors demonstrates why names from computerized databases are not enough; several Honduran exporters have had difficulties with disreputable brokers or have found that information available in such databases was too general to help in locating a client meeting their specific requirements.

As these anecdotal reports of difficulties indicate, public sector services are more suitable sources for information in the first category than in the second. Such services can help potential exporters to gain familiarity with the broad requirements of the markets at which they are aiming, but lack the in-depth knowledge of specific markets that would enable them to be of real assistance in meeting the second information need. As further discussed below, foreign investors offer one of the best (and certainly the cheapest) methods of meeting these crucial information requirements.

The lack of information for exporters is generally agreed to be a major problem for Honduran exporters. A very large number of institutions exist that have a mandate to assist exporters and investors in one way or another, but few of them offer real assistance of a practical nature.

Foreign Trade Barriers

Prospects for expansion of Honduran exports could be limited in one case by international agreement and by protectionism on the part of major trading partners such as the United States.

Honduras is already exceeding its quota for coffee exports under the International Coffee Agreement, for example. That means in practice that much of its coffee exports are sold outside of quota at lower prices. U.S. imports of Honduran meat are also limited by quota but the more important problem now is uncompetitive prices. Access to the fresh produce market in the Southern United States is restricted because of USDA regulations for medfly control.

On the industrial side, Honduras benefits from the temporary lifting of quotas under the Caribbean Basin Initiative. This makes Honduras an attractive site for Asian manufacturers seeking to enter the U.S. market. CBI does exclude a number of products in which Honduras would be most likely to be competitive (e.g., most leather products).

IV. HONDURAN GOVERNMENT POLICIES BEARING ON INTERNATIONAL COMPETITIVENESS

This section examines how Honduran preferences for price stability and fear that foreign balance-of-payments aid might be reduced have led to a consensus against devaluation. It then discusses how protectionist policy favors domestic sales over exports; the promotion of exports by financial return or by isolating them in free trade zones; and attempts to reduce the impact of import barriers on the cost of production of exports.

Introduction - the Macroeconomic Policy Framework

The Honduran government has chosen stability as its most important economic objective. It links stability to maintaining the two lempira to the dollar exchange rate as an unalterable feature of economic policy. Every government is against devaluation (until it takes place) but what makes this stand more unyielding than most is the unusual financial stability that has characterized this country in the past. The current exchange rate was established in 1917 and was maintained without the aid of exchange controls until 1981. The government has made a real effort to reduce the public sector deficit in most years; it has kept money supply growth moderate and maintained high real interest rates (equal to 10-12 percent in the past several years) to limit price increases, capital flight, and the black market discount of the lempira.

But its stance is to some extent a sham. By a series of ad hoc concessions to exporters, A.I.D. export promotion programs, and surcharges on tariffs, the lempira has been partially devalued for selected exports and most imports. Foreign assistance, leaky foreign exchange controls, and payments arrearages keep enough imports flowing to keep the economy moving, albeit slowly. A.I.D. hopes to rationalize and deepen the effective devaluation in 1988 and next year with the help of the IMF. However, the program under consideration will only partly reduce existing overvaluation of the exchange rate.

Until about 1980, inflation was low, exports were increasing, and there were no exchange controls. This is the most recent year during which the lempira might have been considered competitive. The competitiveness of the lempira is affected by the rise and fall of the dollar in relation to the other major trading currencies and by whether its price increase is higher or lower than the weighted average of its trading partners.

An acceleration of local inflation early in the 1980s and the unprecedented appreciation of the dollar led to an overvaluation of roughly 30 percent at the peak in 1985, compared to the 1980 base, as measured by the real effective exchange rate.[2] The estimate declined to about 20 percent in 1986 and 1987. In relation to the dollar alone, the lempira had appreciated 7-8 percent by 1987.

The Central Bank has made another calculation of overvaluation by comparing the prices and exchange rates of competing exporting countries in the Caribbean basin. That index indicates a fairly steady lempira appreciation reaching about 40 percent in 1986. This suggests that Honduras is steadily falling behind its competitors because they have more than made up their more rapid rate of inflation by deeper devaluations.

The black market rate has fluctuated a good deal throughout the period. It was over 2.5/1 by 1985 but then appreciated to approximately 2/1 in early 1987. During that year it reached a peak of 2.7-8/1. Currently, the rate is about 2.5/1. The market is affected by the availability of official foreign exchange for imports, the level of real interest rates, and the political outlook in the region.

These various estimates suggest that a realistic rate for the lempira is probably in the range of 2.5-2.7/1. The gap, however measured, is unlikely to become smaller in the near future. Honduran prices can be expected to grow at least as fast as those in the United States, their competitors are more likely to devalue, and the U.S. dollar will probably not depreciate much more.

These calculations assume that all transactions are carried out at 2 lempira to the dollar. Although incentives exist in the law, and the Central Bank has multiplied the number of special arrangements whereby exporters may retain and sell portions of their exchange earnings in the black market; on the average, the weighted lempira/dollar exchange rate has been about 2/1 or less when export taxes are taken into account (see below).

Overvaluation is an art, not a science. Base periods rarely resemble the present in all the relevant details. For example, the volume and terms of capital and the debt service burden are different. It also depends on the objective. What it would take to restore Honduras to the relatively modest position of 1980 would probably be substantially less than measures designed to put the economy on the road to export-led growth.

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2. The real effective exchange rate is calculated by relating the lempira to a weighted group of trading partner currencies, adjusted to a base year by price indexes in each country.

Disincentives to Exporting Posed by a High Level of Import Protection

The import substitution industrialization strategy followed by Honduras has led to the adoption of certain restrictions on imports as well as high import tariffs on most locally produced items. Currently, the import protection policy incorporates different interacting instruments such as tariffs, tariff exemptions, import surcharges, administrative procedures and foreign exchange controls (tariff structure is discussed in the section on tariff reform).

As is usual in these regimes, this policy has introduced an anti-export bias in the Honduran economy, defined in absolute and relative terms. Absolute bias exists when as a result of protection to intermediate inputs, local exporters have to pay higher prices for these inputs than those in the international markets, thus losing competitive advantage in the world market. On the other hand, relative bias exists when protected firms are able to sell their products in local markets at prices that are above the international levels, while exporting firms must sell their products at world prices. The serious problem in Honduras is relative bias, which has become worse in recent years as tariff surcharges have been applied and monopoly rents have been created by licensing imports, while the effective exchange rate for exports has changed very little.

The only study measuring the extent of the anti-export bias in the Honduran economy was made for A.I.D. by J. Berlinsky, who calculated the effective protection rate (EPR) for both import-substituting and exporting firms producing manufactures. In Table 5, we summarize his results. On the average in 1981, while the EPR for products sold in the domestic market was 85.5 percent, the EPR for exports was -15.7 percent. In other words, exporters were penalized by the high cost of the inputs they must use.

Most products selling in the domestic market are heavily protected. Not only are consumer goods such as textiles and household equipment in this category but the raw materials and intermediate goods which go into them are protected as well. The exceptions are construction materials and machinery.

In a more recent study done by the same author for 1985, using domestic versus international price comparisons but for a much smaller sample, the level of effective protection for internal sales is even larger: 178 percent. The increase reflects the overvaluation of the exchange rate that occurred between those dates and the effect of import licensing which produces scarcity prices for imported commodities.

The GOH has adopted incentives to favor nontraditional exports which can reduce and even eliminate the absolute anti-export bias for those few commodities that have so far been eligible. But the relative bias would still be quite large. These are export certificates (CEFEX), which are a reimbursement of indirect taxes assessed on the FOB value of the export, and the temporary import regime. Both, which were established by law in 1984 and modified in 1987, were not taken into account in Berlinsky's calculations.

A firm has two choices. It can either opt for reimbursement of CEFEX on 100 percent of FOB value and not take advantage of the Temporary Import Law; or it can take advantage of the import facility and have the CEFEX levied on its value added.

To illustrate how this works, take the example of a firm whose local value added content (measured at international prices) equals 40 percent of the value of its product. If this product is eligible for the maximum CEFEX rate of 15 percent of its FOB value, and the 60 percent imported inputs pay an average tariff of 17 percent (according to Berlinsky the average tariff on imported inputs is 17.2 percent), its effective protection rate for exports will then be 4.8 percent. In other words, it has a subsidy of approximately 5 percent to export, the equivalent of an exchange rate of 2.1/1.

The EPR is positive in this case because we are using the maximum CEFEX rate. Nevertheless, the EPR for the same products sold in local markets would be much higher. If the firm above had been given 10 percent CEFEX, its EPR would be zero. For a CEFEX rate less than 10 percent (which may be the case of most products), its EPR would be negative.

If a firm uses the temporary import law, the CEFEX is granted on the FOB value minus the value of duty-free inputs. In this situation a firm is paying international prices for its inputs, so that there are no tariffs to offset. Again assuming domestic value added is 40 percent, and a 15 percent CEFEX reimbursement, the firm will receive 15 percent of 40 percent, that is, 6 percent.

The maximum return from exporting as illustrated in these examples is far less than for domestic sales where, as the table below indicates, the average rate of protection in 1981 was 80-90 percent. We do not have the comparable detail for 1985, but the EPR is probably far higher today because quantitative restrictions arising out of exchange control regulations have allowed prices to be charged that exceed simple tariff protection.

The Government's Commitment to Exporting

All governments are in favor of exporting: the issues are how much promotion they are prepared to undertake and the extent to which they are willing to put a higher priority on the export objective than other economic policy goals.

In the past year, the Honduran government has taken a strong public position in favor of export promotion. It declared 1987 to be the "year of the exporter" and did, in fact, make a number of legislative and regulatory changes which increased financial incentives for most exporters. But many of these measures were a result of steady prodding by A.I.D. and pressure from certain powerful groups of exporters.

Effective Protection Rates for Imports and Exports
1981

Product Category (SIC)	Effective Protection (percent) Imports	Exports
1. NON-DURABLE CONSUMER GOODS	88.8	-17.6
31. Processed Food, Beverages and Tobacco	82.6	-18.8
32. Textiles, Clothing and Leather	202.9	-13.5
34. Paper Products and Printing	91.5	-6.5
35. Chemicals, Rubber and Plastics	81.8	-12.7
39. Other Manufacturers	136.9	-12.8
2. DURABLE CONSUMER GOODS	114.2	-12.2
33. Wood Products	99.8	-11.5
38. Metallic Products, Machinery and Equipment	122.0	-12.6
3. FUEL AND LUBRICANTS	79.0	-12.2
35. Chemicals, Oil, Rubber and Plastics	79.0	-12.2
4. RAW MATERIALS AND INTERMEDIATE PRODUCTS	79.6	-9.9
32. Textiles, Clothing and Leather	96.5	-8.9
33. Wood Products	93.7	-15.0
34. Paper Products and Printing	114.4	-13.1
35. Chemicals, Oil, Rubber and Plastics	71.2	-8.7
36. Mineral Non-Metallic Products	350.4	-6.8
37. Basic Metallic Industries	77.0	-13.0
38. Metallic Products, Machinery and Equipment	39.6	-7.7
5. CONSTRUCTION MATERIALS	21.9	-11.8
36. Mineral Non-Metallic Products	21.9	-11.8
6. CAPITAL GOODS AND TRANSPORT. EQUIPMENT	23.6	-6.6
38. Metallic Products, Machinery and Equipment	23.6	-6.6
AVERAGE	85.5	-15.7

Source: Berlinsky, Julio "Honduras: Estructura de Proteccion de la Industria Manufacturera". July, 1986.

The difficulties of establishing an export promotion directorate in the Ministry of Economy indicate that the priority attached to this activity is not very high. The directorate only came into existence at the end of 1987, several years after the signing of the export project agreement in which it is included. The directorate was crippled almost immediately by the budget bureau's decision to cut off its access to aid dollars. Although compromises are being worked out and the budget largely restored, the cautious manner in which the minister in charge approached the problem indicates that he, at least, was not convinced of the high priority of exports. There is an export advisory council, but it is new. Even if it proves to be technically effective, it will require political direction not in evidence today to impose an export policy on the administration. Finally, after an interview with the planning secretariat, we concluded that investment for the production of exports does not appear to be important element in the investment planning process.

More fundamentally, Honduras does not have much incentive to undertake a major effort. The foreign exchange position is difficult but not threatening to the economy as long as the U.S. government and the development banks continue to be heavily involved. If export performance were noticeably better, it could serve as an excuse to reduce aid. Conversely, one might argue that nothing less than a more serious shortage of foreign exchange would motivate the government to change its leisurely approach to the problem.

Export Promotion (Other than Institution Building)

This section describes and analyzes the various measures that have affected or might affect the profitability of exporting in the near future. They consist of three categories of macroeconomic policy measures: (1) those which directly improve the return to exporting, (2) those which avoid local controls altogether, and (3) those which reduce the price of imported inputs. Chapter V is devoted to institutions that work at the company or sectoral level.

Increasing the Return to Exporting

The Creation of the Exchange Certificate Market (CETRA)

The exchange certificate market is the newest of the various schemes to increase the profitability of exporting nontraditional products. It differs from the ad hoc exchange retention arrangements described further on by establishing a new market under the supervision of the Central Bank. The Bank issued the regulation creating the CETRA (Certificado Transferibles de Opcion a Divisas por Exportacion) at the end of December 1987, to take effect at the beginning of February. It permitted exporters of specifically enumerated products to retain or resell a lempira-denominated certificate equal to 30 percent of their foreign exchange receipts as an option to buy the same amount of dollars.

The certificate is valid for four months during which it may be resold only once. This gives the exporter the option of importing or obtaining a freely negotiated price for the retained portion, i.e., essentially one that bears a closer relationship to the black market than the official rate.

The system has been in operation for too short a period of time to judge its effectiveness. A small number of transactions have taken place since the end of February. Prices have been the equivalent of 2.30/1, well below the black market rate of 2.50-60/1. Even at 2.50/1 the incentive is small; the exporter earns an additional 7.5 percent for every dollar of export receipts, with a retention rate of 30 percent.

Both the rate of retention and product eligibility may be changed by Central Bank decree. The eligible commodities are only a minor portion of total exports or total nontraditional exports, confined mainly to agricultural products, with only a few processed and industrial manufactures. (At this time they include the following: african palm oil, sesame seeds and sesame seed oil, cultivated shrimp, pineapples, melons, plantains, cacao, cardamom seeds, bee honey, processed tobacco and wood products, cucumbers, lemons, natural flowers, ornamental plants, red and black peppers, oranges, strawberries, china peas, surgical absorbent cotton, rosin, turpentine, and pine oil).

The value of CETRAs as an export promotion device in 1988 under the existing regulations, is difficult to evaluate. The previous year's trade data from Customs Department does not distinguish some of the minor categories, such as surgical cotton, nor make a distinction for major ones, such as differentiating cultivated from ocean shrimp. More than half of the eligible products are not enumerated separately in the trade data for previous years: 14 of the 26 eligible products were not enumerated in the 1986 trade data, and 12 of the 26 in 1987 data.

Those CETRA commodities identified in the data had a 1986 value equal to 5 percent of total exports, and about one-third of all nontraditional exports. Data for the first seven months of 1987 appear to confirm the minor applicability of CETRA. One of the largest export items for which CETRA are available is cultivated shrimp. Given its bureaucratic complications, the CETRA is probably not as attractive as an equivalent amount of foreign exchange. As a promotional device its current value is limited. Its significance lies in the fact that for the first time, the GOH has established what amounts to an official second exchange rate which could become the instrument to devalue the lempira more effectively than the various ad hoc arrangements now in force.

Other Incentive Measures

The Central Bank of Honduras is in charge of the foreign exchange control system. Over the past several years, it has, by regulation, provided the most important incentives to individual industries by allowing them to retain varying percentages of foreign exchange for their own needs. The companies may dispose of these resources without further reference to the Central Bank to pay for imports, services, make remittances, and so forth. To the extent exchange is sold in the black market, or used for imports without having to wait four to five months for an authorization, the arrangement provides an increase in the effective exchange rate (see section IV).

The most significant arrangement completely frees the banana exporters of exchange control. In practice, the companies retain about 40 percent of proceeds. The same applies to the mineral companies, but mineral exports represent only a small percentage of the total, compared with about one-third for bananas. Other facilities are for:

- Ocean shrimp -- up to 20 percent to pay for industry imports and meet international prices
- Citrus -- up to 20 percent of export proceeds for two firms to meet debt and other service payments
- Meat -- permission to sell earnings over a minimum price in the parallel market
- Barter and compensation agreements -- provide a variety of implicit exchange rates, depending on the commodities involved

Exporters to the Central American region are authorized to have foreign exchange deposits denominated in the buying country's currency, which they may sell at freely negotiated prices. This provision arose from the breakdown of the area's common market clearing mechanism which had permitted repatriation. There are also special regulations for companies involved in traditional exports to stimulate sales.

Through these arrangements the Central Bank has created a family of floating exchange rates which vary from export to export. The rationale, other than responding to exporter pressure, is not clear.

Reduction in Banana Export Taxes

As a promotional device the Honduran government passed a law that exempted banana companies from export taxes on exports above a minimum level of 38.5 million cases, effective June 1987. Individual amounts are set for the two major companies, Tela railroad and the Standard Fruit companies. The exemptions are valid for a period of six years starting in 1987 and running through 1992. The benefits were to be divided equally between the exporters and producers. Except for minor producers accounting for less than 1 percent of production, the companies are the same. In return for these benefits, the firms were obligated to invest a certain minimum level, 14 million lempira ($7 million) for each of the six years.

The law was instituted to reverse the declining trend in banana exports. During 1980-83, export volume fell 3 percent per year. There was some recovery in the next three years, but it was only in 1987 that preliminary figures indicated that export volume was about 7 percent higher than in 1980.

The law sets the minimum level at 38.5 million cases of banana exports. Average annual exports in 1980-85 averaged about 10 percent higher than this figure. Ministry of Finance officials estimate the fiscal loss for 1987 at 10 million lempira, out of expected receipts from the banana export tax of 38 million lempira.

Tax Reimbursement (CEFEX)

In 1984 the GOH enacted an Export Promotion Law, introducing new incentives for nontraditional exports. This law created the CEFEX (Certificado de Fomento a las Exportaciones). Initially, CEFEX rates were set at 10 percent for goods with a domestic value added ranging from 20 percent to 50 percent of the FOB value, and at 15 percent for goods with a domestic value added exceeding 50 percent of the FOB value. The CEFEX originally applied not to the total but only to the incremental value of exports with respect to a base year value established for each producer. The procedures were arbitrary and cumbersome because they required each eligible producer of each eligible product to be authorized separately. A new law was finally passed in April 1987.

The current law establishes five different CEFEX rates, depending on domestic value added. They apply to FOB, not incremental value. The certificates are denominated in local currency and can be used by firms to pay any indirect taxes, including sales taxes, production taxes, import tariffs, and export taxes. The CEFEX rates are as follows:

Domestic Value Added (percent)	CEFEX Rate (percent)
20 - 29.9	5
30 - 49.9	8
50 - 59.9	10
60 - 89.9	14
90 - 100.0	15

The determination of each product's value added and the rebate category in which it falls is undertaken by a group within the Ministry of Economy, the Comision de Fomento a las Exportaciones (COFEX). Domestic value added is defined as the FOB value of each product, less the cost of imported inputs, payments for foreign factor services such as fees and commissions, and 50 percent of the value of containers used to pack the product. Exporters who benefit from the Free Trade Zones may not receive CEFEX benefits. The Ministry of Economy issues an authorization for each export transaction for each exporter. The exporter then applies to the Ministry of Finance for the certificate.

Although the law was passed 10 months ago, it is still not in force. Article 22 of the Law extended the benefits of the old law for six months, until November 30, 1987, to those firms that had been benefitting from it. Meanwhile, the GOH was supposed to issue a new list of products eligible to benefit from the new law. Having this list is an improvement over the previous system, which did not have a list. Since the new list had not been approved by November 30, 1987 the old regime was extended for three additional months, until March 1, 1988. The Ministry of Economy has informed us that the new list has already been completed and is awaiting the approval of the President. Supposedly, it will include about 60 products. Meanwhile the only firms obtaining CEFEX are those that had already been qualified before June 1, 1987.

Many products that have been and will continue benefiting from CEFEX are the same ones currently getting CETRA certificates. As noted above they are estimated to be about one-third the value of nontraditional exports. The total value of rebates issued under the earlier version of the law indicates that the system has so far not been a substantial incentive to exporters. According to the Ministry of Finance, rebates amounted to 2.1 million lempira in 1986 and 6.4 million lempira in 1987, or as a percentage of the value of all nontraditional exports, 1 percent and 2.5 percent respectively.

Export Processing Zones

Free zones

The first free zone was established in 1976 near the northern port of Puerto Cortes. Firms exporting outside of Central America are exempted from domestic taxes, trade duties on imports used in the export process, and taxes on export income. Employees, however, must pay taxes on salaries and wages. The firms are also exempt from licensing requirements for import and export transactions. The Free Zone is fully occupied and firms within the zone employ more than 2,000 workers. Management of the Free Zone is carried out by an autonomous government agency, and although it reportedly has a high cost of operation and service fees, a World Bank Report in 1987 indicated users were satisfied with the management and operation of the Zone.

Export Processing Zones

The success of the free zone concept induced the government to pass the Export Processing Zone law in April 1987. The new zones were designed to attract large firms to expand operations in labor-intensive production. Only businesses with an authorized paid in capital amount of 2 million lempira ($1 million) are permitted to operate in these zones. Management and operation of these zones would be left to the private firms. Firms would receive the same benefits as those operating in the Free Zone: exemption from duties on imported inputs, and tax exemption on income earned from exports not sent to Central America. Firms would also be exempt from import and export licensing and permit requirements. Tax exemptions could be granted for 20 years and exemptions from municipal taxes for up to 10 years.

No operations have yet been established under the law although several groups are considering plans to invest. One drawback is the minimum amount of capital required ($1 million). Also, firms must guarantee to expand operation so that a minimum of 5,000 jobs are created over a five-year period. Few businesses operate on that scale at the present time in Honduras. Fewer firms would be willing to commit the resources required to undertake such a commitment over a long time frame.

FIDE, the industrial export promotion institution supported by A.I.D., has been developing plans to establish zones near Tegucigalpa and San Pedro Sula to draw upon the labor supply in those areas. One of the issues is the extent to which Honduran firms may participate and sell into the local economy while not paying domestic taxes.

Reducing the Cost of Inputs into Exports

Temporary Import Law

Under this regime, first established in 1984 and then modified in 1986, exporting firms are exempt from paying duties, sales taxes, and other levies on imported raw materials, capital equipment, and other materials, goods or services used in export production destined to countries outside of Central America. The exporter meets the exemption by posting an I.O.U., which is cancelled at the time the export passes through customs. Since no import taxes are actually paid, no reimbursement of taxes is necessary. This saves the producer the cost of tying up capital and is a substantial improvement over the prior system of drawbacks.

The current regime also contains benefits not included in the old system. In the previous regime only those firms exporting 100 percent of their output could apply for the temporary imports incentive; under the present system any exporter can apply for those benefits. Likewise, firms using this system can also have access to CEFEX. This was not permitted by the old regime.

In order to participate in the regime, firms still must go through a bureaucratic process which may take four to six weeks. Once the authorization is given by the Direccion General de Industrias, entrepreneurs we interviewed tended to agree that, except for the initial difficulty in setting the allowance for wasted materials, the system is effective.

No statistics showing the value of imports made under this system have been obtained, but data available as of April 30, 1987 show that 44 firms have used the system. Fourteen of them are agro-industrial firms (32 percent), 16 are in the clothing business (36 percent), 3 manufacture wood furniture (7 percent), and the rest are in diverse activities.

Tariff Reform

Tariff reform is so far concerned with the conversion of specific to ad valorem duties and the adoption of a modern nomenclature.

Honduran import tariff policy traditionally has been governed by revenue objectives. With the adoption of import substitution strategy and the formation of the CACM, tariffs also started to have protective purposes. The structure of import tariffs in Honduras is similar to that of other developing countries starting their industrialization process. Honduras has a graduated tariff structure, in which higher rates apply to consumer goods for which local production or assembling is relatively easy to initiate such as clothing, furniture, and household appliances, while lower rates apply to intermediate inputs and capital goods.

Until last year, the tariff system had a specific and an ad-valorem component. This has recently been changed with the new tariff law eliminating specific tariffs effective January 1, 1988. This modification was actually made not only to simplify the system but because local and international inflation had made specific tariffs less and less important in fiscal terms. Since specific rates have been converted into their ad-valorem equivalents, both the level and the structure of protection have remained about the same. A new tariff nomenclature in accordance with the NAUCA 2 code of CACM members was also adopted.

Imports do not simply pay a tariff depending on their classification; there are also numerous laws granting exemptions and surcharges. Sectoral promotion laws favoring agriculture, industry, mining grant special tariff exemptions to each of these sectors, resulting in a complicated system in which more than 25 different regimes exist to import similar products. In order to offset the revenue drain caused by those exemptions, the government has promulgated several different tariff surcharges. Most imports bear the tariff surcharges such as a 10 percent surtax passed in 1981 and the additional 20 percent in 1982. Surcharges have increasingly become more important than tariffs. While surcharges represented only 14.6 percent of import revenue in 1980, by 1986 they accounted for 66 percent.

Assessment

The Government of Honduras has had no export strategy in 1981-87, since the lempira became clearly overvalued. Having ruled out devaluation for political reasons, it instituted nothing but a series of ad hoc measures in response to producer or exporter pressure for selling traditional exports. Although they appeared to be effective in a few cases, the results were probably negligible in others. Interestingly enough, foreign companies were far more successful than Honduran firms in getting a hearing.

The banana producers received a reduction in their export tax in 1987, which seemed partly responsible for the recent surge in exports. Coffee, the province of indigenous producers, carried a higher tax but world demand provided a profitable price nonetheless. Wood, the third most important export before it came under the control of a parastatal, was left to its own devices to decline year by year.

Exchange retention arrangements for bananas, shrimp, minerals, and meat created the equivalent of sectoral exchange rates that were more depreciated than the official parity of 2/1. The benefit took the form mostly of quicker and surer access to imports; and to a lesser extent, the ability to sell exports competitively and still receive a profitable return in lempira.

The Central Bank has two types of import permits: the first gives access to official exchange; the second simply gives an import right to those possessing their own foreign exchange. The exporters having retention privileges can use this self-financing regime (autofinanciamento). The Central Bank at times of exchange stringency has encouraged the use of this market by not licencing for official dollars those import categories of lower priorities like many consumer goods. In addition to retained dollars, the market includes imports financed by foreign loans and by the black market.

Because the self-financing market is broader than the black market, the effective exchange rate of many transactions is not the same as the black rate. Having a special right to use dollars for imports is financially equivalent to saving the interest and other transaction costs involved in the other time-consuming channel. Depending on the assumptions made, the return is 2.10-2.20/1, not the 2.5/1-2.6/1 currently obtainable in the black market.

The black market is fed by over-invoicing of imports, under-invoicing of exports, and financial transfers from abroad by exchange holders needing local currency. Given the looseness of exchange control it is probably fairly extensive. The Central Bank claims that the black market is equal to less than 10 percent of the import bill.

The greatest policy failure was in the nontraditional sector. Since the sector covers many products, there were no strong producer associations to generate pressure. A.I.D.'s general policy promotion measures like CEFEX and the Temporary Import Law (part of ESF conditionality) took years of bureaucratic tinkering before they became effective in 1987. Until now they have provided almost no incentive to nontraditional exports. The Mission's promotion of new agricultural products in its project activities was the only bright spot in a generally dismal field.

Nothing illustrates the GOH's lack of interest and imagination more than this episode. Business as usual and the concern for lost revenues outweighed any interest in pushing foreign sales. There seems to have been no realization that nontraditional exports had the bulk of the products that were least competitive and required more special measures to overcome the overvaluation of the lempira. Second, official policy is always aimed at aiding an existing export. The idea that an incentive should be open ended, so that new exporters selling products that have not sold abroad before could take advantage of them, never seems to occur to policy makers.

To try to compare quantitatively the patchwork "actual" dollar/lempira exchange rate with a more realistic parity of at least 2.5-2.7/1, the various export and schemes described in this section have been converted into exchange rate equivalents, using their 1987 values but weighted by 1984 exports, when coffee sales were a more average share of the total. The disincentive of export taxes, mainly on bananas and coffee, must be similarly converted and subtracted. Those taxes offset all the other incentives, leaving the overall average at 1.98/1. A different choice of weights and assumptions could shift the result perhaps a couple of percentage points at most; the calculation is somewhere in the range of 1.94-2.02/1.

Honduran policy seems to have become somewhat more flexible recently. Willingness to talk to the IMF about a standby agreement at the end of 1987 was the most positive indication. Any such accord would require substantial progress toward partially devaluing the lempira and toward a substantial reduction of the budget deficit. Talks are suspended for the time being. The government is seeking public support for higher taxes, which it identifies with a program designed by the World Bank. When or if the talks will resume is not known.

The other more hopeful indications are the formation of the CETRA market and the reorganization of CEFEX. For eligible products, the combination of the two could yield an effective exchange rate of 2.35-45/1. These are, of course, still theoretical results. The bureauracy's ability to lessen the effectiveness of any program should not be underestimated. Assuming, however, that the results are realistic, the overall effective rate is still only 2.01/1 (1.97-2.05/1) because these arrangements only apply to about 5 percent of all exports.

There is little question that the shortage of foreign exchange is putting pressure on the government. But in view of past experience these steps can be regarded, if somewhat cynically, as part of the bargaining about assistance. The GOH can probably be relied on not to do any more than necessary to achieve its aid goals.

V. A.I.D.'S IMPLICIT EXPORT STRATEGY

This chapter examines the Mission's export strategy as it has evolved in practice through the various project activities. The principal activities are the policy dialogue involved in establishing ESF conditionality each year, the creation of export promotion institutions inside and outside the government in the Export Services and Development project, and the agricultural projects concerned with individual commodities. Each sub-section contains recommendations completed after an overall assessment.

Introduction

In this section we examine A.I.D.'s implicit export strategy as it is practiced not only in the Export Development and Services Project but in policy dialogue and ESF conditionality, and other agricultural projects. The language, which is taken from the scope of work, is revealing. It suggests what is indeed the case: a series of activities that have only a loose relationship to one another.

To facilitate analysis, each sub-section deals with a separate activity and contains in it specific recommendations that should be considered in FY 1988. At the end is an overall assessment. Proposals for follow-on policies in FY 1989 and beyond are contained in Chapter VI.

Policy Dialogue and ESF Conditionality

A.I.D. has used its role as the major donor to Honduras to improve economic policy in two areas: stabilization and structural reform. Its instruments are a policy dialogue, partially institutionalized by the establishment of a Joint Working Group, and annual accords setting out mutually agreed on goals, tied to the phased disbursements of ESF funds. The macroeconomic objectives established each year -- limits on credit, the public sector deficit, and the balance of payments -- were clearly more important than the structural reform objectives.

The macroeconomic measures had a stronger impact on the economy and had easily monitored quantitative targets. The heterogenous nature of structural reform objectives and the frequent need for legislative action required more loosely stated targets and judgment rather than statistical determinations of whether they had been reached. In deciding how to use the leverage of ESF disbursements, the stabilization objectives outweighed any particular structural reform goal or even group of goals. Over time structural reform objectives can build on each other if a degree of success is achieved each year; stabilization is concerned mainly with maintaining past achievements or regaining lost ground.

At the outset, the improvement of export competitiveness was mainly a macroeconomic objective. The Mission tried to convince the GOH to devalue the lempira about 30 percent. After abandoning this objective in 1985, it concentrated on a variety of reform objectives that collectively, in its judgment, would have some of the same effect.

Once that decision was made, the leverage that the Mission could exert to bring about important changes was sharply reduced. Not only are the structural reform targets as a group less important, but the measures concerning export competitiveness are only about one quarter of the 29 and 27 targets in the reform programs for FY 1986 and 1987. Moreover, many of these measures were related only indirectly to exporting, like the reform of tariff nomenclature. Too much is riding on each disbursement of ESF for failure to execute the export portion to loom very large in the equation. The Mission is aware that only a low-key, step-by-step effort had some degree of success and they have formulated their objectives accordingly.

The present shape and effectiveness of the measures we are about to discuss are analyzed in Chapter IV. Here the concern is their origins and purposes in the period 1985-87.

The purpose of the "export promotion law" was to provide tax incentives for nontraditional exports in the form of reimbursements (CEFEX) to exporters of the indirect taxes paid on their inputs. The original legislation, passed in 1984 was ineffective because it reimbursed only for export increases over a predetermined base, and payments were made annually after the submission of a great deal of paperwork. The FY 1986-87 PAADs for ESF contained GOH commitments to introduce legislation to modify and improve the law. The amendments went into effect in April 1987, but the implementing decree was to take effect on March 1, 1988. If it works as intended, it should in conjunction with the CETRA, produce an appreciable devaluation for eligible nontraditional exports.

The same PAADs committed the GOH to simplify the bureaucratic procedures connected with the "temporary import law." The objective, to import the foreign components of exports without paying duty on them, was being thwarted by paper processing delays. The law was passed in 1987 and, according to exporters, is working well.

In the same period, A.I.D. helped to improve the incentive value of the "banana export incentive law," which reduced the marginal tax on exports over an agreed-upon base level, by proposing that the incentives be calculated on a company rather than an industry level. This law was also passed in 1987 and was in part responsible for the excellent performance of banana exports last year.

Another Mission objective was enabling legislation to establish export processing zones under private management, like the free zone in Puerto Cortes. The law was approved in April 1987 but no zones have yet been established.

Earlier in 1985, the Mission helped Honduras eased the payments problem involved in Central American trade. In the absence of an effective clearing mechanism, exporters were piling up claims in blocked importer currencies. By persuading the Central Bank to allow Honduran exporters to establish and hold accounts denominated in other Central American currencies, it created a clearing arrangement which permitted the exporter to sell at a freely negotiated rate.

The FY 1986 and 87 programs contained several conditions to convert Honduras's largely specific tariffs into equivalent ad-valorem values and to improve the administration of the Customs. All of this legislation has been approved by the Congress and has been put into force this year. These are the sort of technical issues which are highly valuable in improving the workings of the import system but would meet great bureaucratic resistance if they did not have some A.I.D. leverage behind them.

The potentially most important export promotion initiative in the policy dialogue was the condition that led to the creation of the CETRA. It was disguised as a requirement to improve foreign exchange management. The starting point was a Central Bank study summarizing the current foreign exchange control arrangements, which then led to the CETRA as a way of rationalizing the system. The CETRA market is just being organized and as yet is scheduled to cover only one-third of nontraditional exports. Only 30 percent of earnings will be retained, producing a 2.15/1 effective exchange rate.

In a meeting with the team, the vice president of the Central Bank suggested that, in principle, the CETRA could cover all nontraditional exports. But the process was proceeding product by product, with a concern that eligible exports have a minimum value added, probably 30-40 percent. The approach was decidedly leisurely.

This is an area in which traditionally the IMF and, to a certain extent, the World Bank have been active. In Honduras, up until the end of 1987, they have not been active because the GOH has refused to consider devaluation as an option. In 1988, both institutions have made specific proposals on stabilization and exchange rate issues which are influencing the Mission's program for ESF conditionality. But the continuing importance of A.I.D.'s program and the influence of the United States continue to make A.I.D. the principal player.

This record indicates that the Mission has undertaken a number of initiatives that collectively have improved or will improve the financial return to exporters to some degree or will constitute valuable structural reforms. After several years of effort, the Mission has helped to create in the CETRA/CEFEX system a potentially significant devaluation for eligible nontraditional exports. But with the general lassitude that affects Honduran export efforts, and the restriction of this measure to only 5 percent of exports, the overall effect is likely to be small for a long time. The Mission has spent a long time building a strong foundation but it has rather neglected the house in the process. If it had concentrated on CETRAs in 1985, the export effort might be much further along now.

RECOMMENDATIONS:

1. Given the large and possibly widening overvaluation of the lempira, one condition for ESF disbursement would be to include all nontraditional exports and related services like freight and insurance in the CETRA market in CY 1988. In parallel fashion, the Central Bank should increase the number of imports that can only be imported through the self-financed market. Certificates should be issued for an important number of commodities that are equal to 40, 50 or 60 percent of export proceeds to provide special incentives where necessary.

2. The CEFEX mechanism should be closely monitored to insure that it is really working as designed. Tax reimbursement is a rather clumsy and expensive method of export promotion; but as long as overvaluation is not overcome by more efficient means, it should be made to work as well as possible.

The Export Development and Service Project

Project Description

The objective is to support the Mission's strategy of increasing Honduras's foreign exchange earnings by promoting nontraditional exports. The project seeks to accomplish this goal by improving the performance and effectiveness of Honduran institutions that provide marketing and promotional assistance, and by channeling through them financial assistance and working capital to exporters of non-traditional products at subsidized interest rates. The analysis is divided into three parts: (1) export promotion within the government, (2) promotion in the agricultural sector through FEPROEXAAH, and (3) promotion in the industrial sector through FIDE.

Export Promotion within the Government

The objectives of this phase of the project were (1) to create an export promotion directorate within the Ministry of Economy that could offer the general information that Honduran exporters needed, participation at foreign trade fairs, a system of professional commercial attaches, and a service that would help foreign investors get started; (2) to establish an export council to advise on general policy; and (3) to streamline existing government export procedures.

CENTREX

The last goal was actually accomplished first. The government was encouraged to centralize all offices dealing with foreign trade transactions at a new office called CENTREX (El Centro de Tramites de Exportation).

Formerly, authorization to engage in foreign trade (import and export permits) had to be renewed monthly. For each export permit a request was made to the Directorate General of External Trade of the Ministry of Economy, accompanied by the following documents: (1) a certified commercial invoice; (2) a bill of lading; (3) a copy of the license to engage in the export trade; (4) a food health certificate from the Department of Agriculture and Livestock, if the transaction involved agricultural products; and (5) the approval of the appropriate producer's association if the commodity involved coffee, bananas, corn, beans, or cocoa. In addition, a permit from the city or municipal authority had to accompany the application, certifying that municipal taxes and license fees had been paid. For exports to markets within Central America additional customs forms were required and still others if exports were under quotas, special tariff preferences, GSP, and special U.S. exemptions for clothing exports. In all, permits or authorizations from six different government bureaus and ministries were involved, and an estimated 25 days was required to complete the process.

A one-stop approval center was established in July 1987, almost three years after the signing of the project agreement. This center grouped in one place the representatives of each of the ministries and government departments whose approval was required in the export process -- five in all, not including representatives from the private sector organizations.

Two such centers became operational in 1987: one in the capital city of Tegucigalpa in July; the other in San Pedro Sula, serving the port through which most of Honduras's foreign trade passes. The CENTREX office in the capital city processes about 300 applications per month, the port city office about twice as many. Although under one organization, the two branches operate independently.

Although the Tegucigalpa office groups representatives of all ministries under one roof, not all government representatives have received authorization to act for their agencies. The Animal Health Division of the Ministry of Natural Resources requires that all export permits be signed by the Vice Minister in Tegucigalpa. In addition the Central Bank requires that export documentation be approved in its own office in San Pedro Sula, despite the presence of its representative in the CENTREX office, who already makes a preliminary review of the application. After approval at the Central Bank office in San Pedro Sula, the document is returned to CENTREX for transmission to the exporter. No management or operational problems seem to have arisen from the separate management of the Tegucigalpa and San Pedro Sula offices. Processing time has been reduced from 25 days to just 5 days, somewhat more if animal health certificates are required, as in the case of livestock exports.

Setting up the Centrex office and centralizing the approval process has reduced delays and lowered the cost for obtaining government approval to exporters. The goal of an export permit that is valid for exporting all commodities has not been achieved, although the validity of the license has been extended to a year.

At the time of the evaluation, the CENTREX office in Tegucigalpa was located in an outlying district of the city, not easily accessible or located. The Director of the Office was confident that with budget approval of moving costs, the office would relocate to the central business district of the city.

RECOMMENDATION

In principle, there should be one export permit and it should be issued by the Central Bank or the Customs simply as an aid in the enforcement of foreign exchange controls. There may also be a need for sanitary certificates of one kind or another. No other rationale seems apparent. Honduras does not produce exports that have any national security implications nor does it sell staple products that could have a significant effect on the cost of living. CENTREX has made a very bad system more tolerable, but the best solution would be to give one ministry or the Central Bank control and eliminate the others.

CONAFEXI

The formulation of export promotion policy within the Government of Honduras, which had been divided between the Central Bank and the Ministry of Economy, was turned over in mid-1987 to a new interministerial group to advise the President, the National Council for Export and Investment Promotion (Consejo Nacional de Fomento de Exportaciones e Inversiones - CONAFEXI). The council has four private sector members, COHEP, FIDE, FEPRO, and the chamber of commerce, and five from the public sector, the president of the Central Bank and the Ministers of Finance, Economy, and Natural Resources (which includes agriculture) and the Secretary of Planning (which now includes the budget). It is presided over by the Minister of Economy. In practice, representation is frequently at the vice-ministerial level.

The decree establishing CONAFEXI was not signed until February 27, 1987, two and one half years after the project agreement was signed, and its by-laws were approved six months later. Its first meeting of all representatives was not held until May. In July, four advisors were hired in the fields of planning and programming, commercial practices, management and administration, and legal matters. This staff group has prepared an Export Strategy Plan, which has been discussed by the Council twice and is now in the final stages of approval.

CONAFEXI has only been in existence about six months but its brief history already reflects the ambiguities in Honduras's export policy. CONAFEXI was not identified in the original project agreement as a separate institution to be created. The agreement only required improvements in the capacity of the General Directorate of Foreign Trade to promote Honduran exports and attract foreign investment. By September 1986, CONAFEXI appears in the documentation as the institution through which the government would develop its export promotion strategy.

CONAFEXI has yet to become an effective institution because the Minister of Economy has not regarded it as a forum in which to make policy recommendations. In part, this may be a consequence of mixed membership. The inclusion of private sector membership raises a problem for government representatives of discussing the formulation of a policy prior to the government coming to an agreed-upon position. But the more important problem may be the Minister's unwillingness to deal with difficult problems in the Council (or anywhere else) and the reluctance of other ministries and the Central Bank to discuss and clear their policies in an interagency group chaired by another minister.

The Council did play a small role in the establishment of the CETRA market. The plan was announced at a meeting but the group was asked for suggestions of commodities that should benefit from the incentive scheme, which it subsequently supplied. At a later meeting the implications of the idea were debated.

The national export strategy plan reflects the usual tendency to avoid controversial issues. The question of the adequacy of the exchange rate or of equivalent financial incentives is examined nowhere in the plan. In the introduction, there is only a passing reference to a "currency that is not competitive for nontraditional exports." In the first meeting between the team and the Council's staff, we raised the overvaluation of the exchange rate as the major obstacle to export promotion. We were told that devaluation was ruled out as a matter of policy. Further discussion revealed that no one had considered intermediate measures like a multiple exchange rate or even the implications of the CETRA market or the operations of CEFEX.

Within those boundaries, the plan does underline real problems like high transport costs, especially for overseas shipments, inadequate credit and guidelines for coordination between the different institutions involved in export promotion, DGPEI in the Ministry of Economy, FIDE, and FEPRO.

The transport section is the most concrete and detailed and is concerned with maritime, air, and road transport. As noted elsewhere in this report, high shipping rates and port costs are a serious obstacle to the competitive shipment of perishable produce to the American market. There are a great many specific recommendations with no priority order. A working group is being formed to follow up but so far seems mostly concerned with the creation of new institutions which will then would attack the problem.

The credit section is less useful. It worries about the complexity of terms and conditions arising from numerous agreements with different foreign donors and proposes one fund with a single, presumably average cost. It did accept the point advanced by the Mission that export credit should not be subsidized.

The strategy outlined in the plan is unfocused because it examines obstacles to exporting without considering what products they hinder. An export promotion plan should begin by assessing what exports or potential exports seem to be most promising. The plan looks at bottlenecks or means by which the government can assist. In that respect, the plan has another limitation which it shares with official policy: it is concerned only with nontraditional exports. As we argued earlier in this paper, the traditional/nontraditional distinction does not coincide necessarily with the boundary between exports that have poor prospects and those that have good ones. CONAFEXI (and the Mission) needs to examine all exports initially and then set its product priorities. (The substance of this policy is examined at greater length in Chapter VI.)

Once this analytic framework is established, the Council could then decide, for example, that one of its most pressing problems is to set a higher quota for coffee exports to avoid selling so much of the crop at a discount; that the decline in wood exports is a disgrace for a country with Honduras's resources; that meat exports need a higher return if they are to recapture their U.S. market; that children's leather sandals could be sold competitively in the United States if properly marketed; and, that other sectors can be left to their own devices. The last decision is the most important: too many sector programs would be a disaster because priorities would become meaningless.

The Council could begin rewriting its plan by using its ad hoc Working Group on Comparative Advantage to start the process of export examination. The Mission could help the Council and clarify its own programs by creating a more soundly based export plan.

A bureaucratic organization depends on the effectiveness of its leader and the quality of its staff. Neither is particularly high in this case. CONAFEXI's contribution to export policy making is likely to be confined to a forum for the private sector to express and discuss its problems. Until the Honduran government takes export policy more seriously, it would probably be counterproductive for the Mission to try to make the Council a policy-making body. It would be worthwhile, however, to cooperate with it to create the analytical framework to think more effectively about export policy and to direct the information flow into what eventually would be an export policy.

RECOMMENDATIONS

1. Congratulate the Council on its plan but suggest that the experience of other countries at Honduras's stage suggests that the initial plan is really a first draft which will be revised periodically as specific problems are examined; and that the Council should use its comparative advantage working group, with Mission assistance if desired, to reconsider its export plan, establishing product priorities based on sales prospects whether or not they are nontraditional exports.

2. Try to improve the quality of the staff, perhaps with the aid of visiting experts on short-term assignments.

The Directorate of Export Promotion and Investment in the Ministry of Economy

The export promotion and investment activities of the project were to be carried out by reorganizing the General Directorate of Foreign Trade of the Ministry of Economy, the principal function of which had been the approval of import licenses, into a unit concentrating on export and investment promotion. The office was established only at the end of 1987, although A.I.D. made earlier advances for promotional activities for the Year of the Exporter campaign and for training Directorate staff.

The office is divided into a research group, which analyzes exportable supply in collaboration with the business community; a promotion division, which identifies production and market needs (it is planning to administer 12 programs abroad in 1988); an information office and library; a training division; and a support group for the overseas attaches.

Negotiations are now underway between the Ministry of Economy and the Foreign Ministry for the formal establishment of a network of honorary consuls to promote Honduran exports in overseas markets. These consuls would report to the Ministry of Economy. The Government of Honduras decided to cancel the opening of a trade promotion office in New York, planned under the project, because of the expense involved.

Marketing and promotional activity in the United States is already being undertaken by a contractor to FIDE. This includes a number of specialized sub-contractors promoting lines of apparel, secondary wood products, and cigars. The Directorate and FIDE have been discussing coordination and division of responsibility.

Paradoxically although A.I.D. furnishes most of the Directorate's support, the budget bureau decided to block most of the agency's funds. The budget is now in the process of being totally restored but the episode is of interest because it took a long time to convince the Minister of Economy to fight. He apparently did thought export promotion did not necessarily have the priority to overturn the veto easily.

A second and related issue is the salary level within the Directorate. To attract and hold personnel with commercial experience requires salaries superior to those normally paid by the government. The Minister has the discretion to pay rates that would be adequate but has not yet decided to do so. There is no question that the budget episode and the lack of decision could lead to the loss of valuable personnel if the situation is not swiftly remedied.

General export promotion has not been undertaken on any scale in the past. There is little doubt that it is necessary if Honduras is to diversify its exports. There is a mass of information that businesses, particularly the smaller ones, need about foreign markets. They will benefit from trade fairs and Missions. The Directorate also has an important function in briefing foreign buyers and investors. Only a government office that is open to all and not dependent on sales of its services can carry out this function.

It has been suggested that precisely because of the commercial nature of the activity, the Office should be organized as an autonomous agency, perhaps financed by earmarked foreign trade revenue, as in Chile and Colombia.

This may well be a better form of organization but it would seem to be premature in Honduras for two reasons: (1) the ministerial form has already begun and it would be disruptive to propose another form of organization without any assurance of success; and (2) organizing as a separate entity would isolate the activity from normal government functions even more than the fact that A.I.D. is paying most of the expenses. It is appropriate for A.I.D. to finance the start-up of the directorate but once it is established and running, the GOH must be prepared to take responsibility for the function.

If it does, that would be the moment to reconsider the issue of organization and the method of finance, an earmarking of foreign trade revenues rather than appropriations. If it does not, this part of the project will have to be written off as a gamble that was worth taking but simply did not pay off.

Both the Director General of DGPEI and the vice minister in charge expressed the view in their interviews with the team that investment may be the most efficient method of export promotion. There is much to recommend in that opinion. The most difficult step in exporting is establishing a market. Having an investor who is either the buyer in a joint venture or invests to supply his own market is an efficient way to solve the problem. The obstacles in this approach are that there are far more buyers than investors and that investment is a time-consuming process in Honduras and likely to stay that way.

The point is that promotion on a real scale has not been tried in Honduras. It should be given a chance. Investment in the country is a highly useful supplement that should be employed wherever possible.

FIDE already has experience in promoting investment and the Directorate could profit from it by letting it continue in those fields where it already has experience and expand into others that both agree are appropriate. FIDE is also deeply involved in the promotion of industrial processing zones where foreign investors are largely free of local controls. This is a second best form of investment because the feedback to the local economy is only the wages of local labor and whatever skills they might acquire. Given the bureaucratic problems of investing and operating in Honduras, that may be the most efficient way to attract it.

RECOMMENDATION

1. The Mission should make every effort to insure that the Directorate establishes sound criteria and pays salaries high enough to hire and keep the best commercial talent possible.

2. The DGPEI should focus on a limited number of promotions based on estimates of what products have the most potential.

3. A.I.D. support is limited in duration so that the GOH must take responsibility for its upkeep in later years

4. The primary business of the DGPEI is promotion of trade, using investment as a supplementary tool where feasible.

The Agricultural Sector

EDSP activities in the agricultural sector have centered around FEPROEXAAH (the Federation of Agricultural and Agro-Industrial Export Producers, or FEPRO). FEPRO, formed with the support and encouragement of A.I.D. in 1984, is a federation of producers' associations. The absence of effective support for export agriculture led A.I.D. and the GOH to include institutional development for the agricultural sector as an important element in the EDSP design. Given the poor experience with public sector institutions in Honduras and elsewhere and structural problems within the Honduran public sector (notably a salary structure too low to retain highly qualified individuals), the search for an institutional home for agricultural export support focused on private sector institutions. A federation of agricultural producers' associations was chosen as the most appropriate mechanism, and FEPRO was created.

Overview of FEPROEXAAH

FEPRO currently has 27 member associations representing a broad range of products, with a total active membership of approximately 19,000. Roughly half of the members (46 percent) are concentrated in the seven associations serving producers of traditional exports (41 percent in the coffee association), 42 percent are members of the 13 associations oriented toward nontraditional export crops, and 12 percent belong to the nine associations focused on regional development or on crops that are not currently exported, such as potatoes and pork. (Two associations, the independent banana producers association and the tobacco association, have been included in both categories because the GOH classifies certain banana and tobacco products as NTAE.)

Although FEPRO's members include associations covering virtually all of the significant NTAEs, the association's coverage of producers is very low. The ISTI evaluation of FEPRO estimated that FEPRO association members accounted for only 12 percent of total exports in seven commodity groups.

The member associations form FEPRO's General Assembly. Each association has one vote, regardless of its membership or the importance of the export crops represented. FEPRO operations are overseen by a Council of Directors (one representative from each association). Recently, an executive committee has been created to streamline decision making. Day-to-day management is in the hands of the Executive Secretariat, supported by a staff of technical and administrative personnel, which numbered 59 at the time of the ISTI evaluation.

FEPRO's main programs include commodity-oriented programs in cooperation with member institutions (six programs are currently underway, in cocoa, vegetables, cardamom, pineapple, plantains, and cultured shrimp) and a number of investment support functions:

1. An information system designed to provide investors access to market information, primarily for the U.S. market

2. A marketing unit that provides logistic support for shipments by members of FEPRO associations, particularly in connection with the commodity programs identified above

3. A training and extension unit that organizes training courses in topics related to exports and association development

4. A Center for Agricultural and Agro-industrial Production, which provides technical support to producers

5. A project design unit, which assists members in evaluating potential investment projects and in qualifying for Certificates of Eligibility (a requirement for access to the AID-funded credit lines)
6. An administrative and financial services unit, which manages FEPRO's side of the credit lines

FEPRO's office is located in San Pedro Sula, the center of private sector activity in Honduras. FEPRO requested a budget for 1988 of 2.5 million lempira ($1.25 million at the official exchange rate), which was not approved by AID. The FEPRO working group that is engaged in restructuring the project will present a revised request. Fifty-one percent of the budget is devoted to basic management of the organization and fixed costs (including operation of a small inputs store as a source of revenue and a marketing fund), 18 percent finances the commodity programs, and the remaining 31 percent finances the other programs.

Nearly all of FEPRO's budget derives from EDSP project funds. The project design called for FEPRO to rely progressively on receipts from the interest spread on the loan fund and user charges for services, but because of slower than expected drawdown of the loan funds and other factors, FEPRO's receipts in fact cover only about 10 percent of its expenses. (The finance and sustainability issue is discussed below.)

FEPRO Activities to Date

FEPRO's activities during its first four years of existence are discussed in detail in the recent ISTI evaluation report. Not surprisingly, its objectives proved far too ambitious. The breadth of the functions assigned to FEPRO undoubtedly contributed to the organization's lack of focus and diffusion of effort, undermining its effectiveness. Even setting aside the unrealistic expectations for FEPRO embodied in the project design, however, FEPRO's achievements have been disappointing. A.I.D. and FEPRO are currently engaged in an active dialogue to restructure the organization's programs to improve their impact and reduce their cost.

FEPRO's principal activities fall into four categories: (1) assistance to specific investor/exporters, (2) general assistance to exporters, (3) extension programs in cooperation with producer associations, and (4) credit.

Assistance to Specific Investor/Exporters. A large share of FEPRO's total effort has been devoted to working with particular exporters on specific investments, of which the following are the most important:

1. ACA/COAGROVAL (melons): FEPRO was instrumental in bringing ACA, a Miami-based trading company, to Honduras and in establishing a project to grow melons on 180 hectares in cooperation with a newly formed farmer's cooperative (a FEPRO member). ACA, which serves as the exporter, enabled the cooperative to qualify for the loan by providing a letter-of-credit guarantee for the 40 percent not guaranteed by the A.I.D. line of credit. FEPRO, which will receive more than one-third of the profits from this venture although it is not an investor, also arranged a contract with a private Honduran firm for technical assistance and packing services. Contracts were signed in August/September 1987, and projected exports for 1988 are not available.

2. ACA/ANAPPLAH (plantain): FEPRO also arranged a contract between ACA and ANAPPLAH, a member association, to rehabilitate and improve production technologies on 500 hectares of plantain and export the product to the United States. Initial results have been disappointing because of the inability of ANAPPLAH to deliver the agreed-upon quantities or to obtain payments from its members for the services provided (both problems due in part to design flaws in the subproject). The venture lost money in the first year and its future is uncertain. The project exported 20 containers, valued at approximately 260,000 lempira.

3. Agro International/Fruta del Sol (cucumbers): FEPRO sponsored a feasibility study by an American firm for a cold storage/packing facility and played a role in putting the firm into contact with Fruta del Sol, a cooperative and member of AHFAH (a FEPRO

member association) that has been exporting since 1983. FEPRO played a facilitating role in the early stages of the investment and also approved certificates of eligibility to finance the packing plant (and subsequent investments in other areas by a sister firm, Chestnut Hill Farms of Honduras). Fruta del Sol's vegetable exports were valued at 191,000 lempira in 1986; 1987 exports are not available.

4. FHIA Demonstration. FEPRO is conducting a number of production trials in cooperation with FHIA, the produce from which is exported. One production season has been completed to date, with mixed commercial results. Exports in 1986 and 1987 from this and other ventures managed directly by FEPRO totaled 670,000 lempira.

These activities have absorbed a considerable amount of FEPRO's time and money, including most of the time of its seven-person marketing and shipping department. The overall results have been modest in terms of exports, but FEPRO management feels compelled to continue with this type of operation as a future source of funding.

General Assistance to Exporters. FEPRO's information and other support services have not been heavily utilized. Information prepared for the ISTI evaluation indicated that 13 brokers had been contacted at some point by FEPRO, but there is no indication that these contacts were followed up to generate actual sales. The oil palm and citrus associations make the heaviest use of the system. As noted above, the marketing and shipping department has devoted most of its resources to FEPRO's own exports and has not taken an active role in assisting other exporters.

Extension Programs in Cooperation with Producer Associations. Extension and technical assistance programs for six commodities -- cacao (APROCACAHO), vegetables (AHFAH), cardamom (AHPROCAR), pineapple (AHPROPINA), plantains (ANAPPLAH), and cultured shrimp (ANDAH) -- are being analyzed to identify the most important constraints to exporting. These programs generally provide one or more extension agents to work with the growers, as well as other assistance. APROCACAHO's program is widely praised, but FEPRO's role in this program (financed by a separate A.I.D. local currency grant) is minimal. The disappointing results of the plantain program are discussed above.

Only limited additional information on the other programs is available, but both AHFAH and AHPROPINA are regarded by knowledgeable observers as extremely weak associations. Relations between FEPRO and AHFAH appear to be strained (AHFAH does not participate in the vegetable development program with FHIA, for example). A FEPRO extension worker has only recently been assigned to work with AHFAH. AHPROPINA's official active membership of six is reported to be an overstatement. One FEPRO extension worker has been assigned to work with this group, however. Two FEPRO personnel (an agronomist and a technical consultant) have been assigned to work with cardamom growers and the ISTI evaluation reports that AHPROCAR personnel are reasonably satisfied with the assistance received, despite some technical problems regarding the provision of dryers. The shrimp farmers association (15 members) has received some technical assistance from FEPRO, but no staff have been permanently assigned to date. As discussed below, shrimp farmers have received a large share of the credit approved to date, which appears to reflect the strong financial position of the farmers and the profitability of shrimp production, rather than FEPRO assistance.

Credit. Analysis of proposed investment projects and issuance of certificates of eligibility have been the central activities of FEPRO staff. FEPRO's project design unit works with potential borrowers to analyze the profitability of their ventures and produce financial plans for loan applications. Projects evaluated favorably are issued a certificate of eligibility, the first step in gaining access to the A.I.D.-funded dollar and lempira credit lines. FEPRO's financial services unit administers the certificates and monitors issuance of loans.

To date, 70 certificates have been issued and 20 loans actually approved by banks. In most cases, the borrowers have been well-established firms or growers seeking FEPRO approval in order to gain access to the attractive terms of the A.I.D.-funded lines. For example, the lempira line that has been most utilized (fund B) offers interest of 13 percent compared with 17 percent for other lines, a two-year grace period for investment funds, 20 percent retention of foreign exchange earnings by the exporter (compared with zero for commodities not qualifying for the new CETRA program), and reduced collateral requirements, because of the rediscounting and 60 percent guarantee features.

Loans receiving bank approval to date total 21 million lempira (of which only 300,000 lempira are drawn from the dollar line), for an average loan size of around $500,000. Despite a slow start, FEPRO has thus facilitated loans equivalent to 60 percent of the initial target of 34 million lempira and 80 percent of the 21-million lempira target for the lempira funds. Loans range from a low of 23,000 lempira to one small plantain grower to a high of 6.1 million lempira to a single shrimp firm. Shrimp projects have received 35 percent of the loans, ornamentals 17 percent, melons 11 percent, fruits and vegetables 27 percent, and a variety of other products (plantains, cocoa, and pineapple) the rest. Four borrowers account for more than 60 percent of the funds loaned to date.

Loan performance has generally been good to date. Only one loan (a melon loan for 1.5 million loan) has drawn against the guarantee. The team's brief review of specific projects revealed two where repayment is in doubt (including the ANAPPLAH situation outlined above), a reminder that the long-term repayment performance should not be assessed this early in the game.

Two-thirds of the certificates issued by FEPRO did not lead to a loan from a commercial bank (excluding the nine approved in recent months, some of which may well qualify in the future). In some cases, the bank's own analysis revealed that the project was not sufficiently profitable or the borrowers themselves decided not to pursue the project. In most cases, however, projects approved by FEPRO failed to gain bank funding because the client could not meet the collateral requirement for a bank loan. As further discussed below, this indicates a serious problem in the initial design of the fund, for which FEPRO cannot be held responsible.

The numerous minor design flaws which delayed disbursement of the funds have largely been overcome by A.I.D.'s direct intervention. The lack of a provision for rescheduling individual loans and renewing working capital lines may cause serious problems in the future; attention to these matters is needed to keep the programs operating smoothly.

FEPRO's credit role has been plagued by three main problems:

1. Quality of the analysis. FEPRO's personnel are enthusiastic but have only limited agribusiness and lending experience. Commercial banks uniformly provided a low estimate of the quality of the proposals provided by FEPRO.

2. Lack of clear criteria for approval. The absence of specific criteria at each stage of the process (identification of projects, analysis, issuance of certificates) reduces the value of the certificates and leaves room for non-technical factors to play too large a role in the granting of certificates.

3. Failure to take into account collateral requirements. The FEPRO review process does not address the single most important factor determining commercial bank loan approval: the quality of the collateral. Project designers seriously underestimated the conservatism of Honduran bankers when they assumed that a good project analysis and a 60 percent guarantee would be sufficient to win bank approval.

The project design assigned FEPRO a "gatekeeper" role in the credit program; FEPRO is in a position to deny access to potential borrowers, even though FEPRO support in no way ensures that a borrower will receive credit. As discussed below, FEPRO could play a useful role in facilitating credit, but the gatekeeper function, far from being effective, has been a barrier to the success of both the credit program and FEPRO itself. The FEPRO working group has accepted this conclusion and agreed to the adoption of an automatic rediscount mechanism so that certificates of eligibility can be eliminated.

FEPRO's Structure and Funding. The weakest point in FEPRO is its relationship with its member associations. FEPRO's status as a federation of associations is a polite fiction. In fact, FEPRO is a semi-autonomous A.I.D. project with an advisory board formed by association leaders. FEPRO has not made sufficient progress in moving beyond its origins to become a truly Honduran organization. This shortcoming has both structural and operational aspects.

FEPRO's structure dilutes the authority of its member associations in two important ways. First, the role of individual associations in making decisions regarding future directions for FEPRO is not linked to the size of the association or its importance in export markets. Very small, newly formed, or moribund associations have as much power as the large, well-established groups such as AHPROCAFE and the oil palm associations. This discourages the active involvement of the larger associations and encourages cliques and other undesirable management practices on the board.

This situation will be difficult to correct. Although the creation of an executive committee is a start in the right direction, it probably does not go far enough to put FEPRO under the control of the associations. Greater attention to assisting FEPRO itself (in basic management as well as in structural reform) is urgently needed if FEPRO is to become a viable organization by the end of the project.

The generous funding provided in the initial project and the overly broad scope defined for FEPRO contributed to a second structural problem: FEPRO is simply too large. FEPRO's staff of 59 equals that of APROCAFE, a major producers' association with a staff of 60 and a direct role in technical assistance and other services to its 8,000 members. FEPRO dwarfs most of the associations, which have only three or four staff members. FEPRO management recognizes this problem and is trying to reduce its staff (mostly through attrition), but management assistance may be needed to help FEPRO scale down without losing its best staff or permanently damaging morale.

A third, closely related issue is FEPRO funding. FEPRO currently depends almost entirely on A.I.D. funds. Direct support from the 27 member associations is a paltry 16,000 lempira annually. Far from supporting FEPRO financially, the associations view FEPRO as a source of free assistance, placing them in the role of supplicants and politicizing FEPRO's services. The loan fund will never generate sufficient funds to finance FEPRO. FEPRO's financial manager estimates that the loan fund could generate a maximum of 378,000 lempira annually under the current arrangement, or the equivalent of 15 percent of their current budget (3 percent of the 60 percent guaranteed amount times 21 million lempira). At present, they are not receiving even this amount, as the GOH deduction to pay interest on the underlying A.I.D. fund consumes most of the spread.

The disproportionate relationship between FEPRO's start-up scale of operation and its resource base has encouraged the organization to seek profit-making ventures in association with the member associations that are poorly managed at best. In addition to the four projects outlined above, FEPRO has completed a trial importation of fertilizer for sale. Sales were made directly to farmers and others, not through member associations. FEPRO was pleased with the results (although it remains unclear whether the operation would have been profitable with a full allocation of overhead), and plans to undertake a greatly expanded fertilizer import program in the near future.

Fertilizer importation and distribution may well be an appropriate role for FEPRO or by producers' associations (although this deserves more detailed consideration than this team was able to give). Current import regulations place small farmers at a disadvantage, as fertilizer imports by private trading companies pay a 5 percent duty, while large agribusinesses importing directly pay no duty. In addition, fertilizer distribution in Honduras is currently controlled by a single firm, which has reportedly succeeded in setting margins at uncompetitive levels. FEPRO reports that the open-market price of a quital bag of urea fell from 28 lempira before FEPRO's importation to 20 lempira after FEPRO began selling at 17-18 lempira, and has since risen to 23 lempira following the exhaustion of FEPRO supplies.

The association members are not a likely source to replace A.I.D. funding of FEPRO. As might be expected, most of the associations break even, at best. FEPRO's budget of 2.5 million lempira compares to total earnings by its member associations on the order of 7.4 million lempira (based on data included in a study of the associations as part of the ISTI evaluation). Nearly all of the members' total is accounted for by three associations: APROCAFE with earnings of 3.3 million lempira, AHPROPAPA (the potato association) with earnings of 2.0 million lempira, and COCOPLAINH with earnings of 1.4 million lempira. COAPALMA, one of the palm oil associations reports earnings of an additional 28-30 million lempira from its oil processing operation, raising the total association budget to around 35 million lempira.

Even assuming that they were willing to devote 5 percent of their total earnings to FEPRO, the associations could contribute less than 400,000 lempira to FEPRO (unless COAPALMA contributed, which would raise the total to a respectable 1.75 million lempira). Put another way, an assessment of 1 lempira per month per active association member would generate only 230,000 lempira annually.

If the associations are to provide significant financial support to FEPRO, two conditions must be met. First, FEPRO must provide services that the associations are willing to pay for (assistance with transport, importation of inputs, etc.). Second, FEPRO must come under the control of the largest associations. (A corollary is that A.I.D.'s influence must decline, which will be difficult to achieve while A.I.D. continues to be the primary funder.)

FEPRO Operations. The weakest point of FEPRO's program is its service to member associations. This function does not even have a home on the organization chart nor are any staff assigned to it. FEPRO has provided some training for association members in matters related to association management, such as accounting, but nearly all of the training appears to have been in matters related to the technical aspects of production for export.

Rather than providing other services, FEPRO has focused on developing programs of its own with only weak links to the activities of its members. As noted above, the horticulture association has not been included in the FHIA activity. The managers of another association linked to one of FEPRO's main programs expressed the view that the program was really FEPRO's, and that errors had been made because FEPRO played too large a role in management, to the exclusion of the association. Individuals closely involved in the management of two other associations expressed their mistrust of FEPRO and dissatisfaction with their past dealings.

FEPRO will have to be far more attentive to its membership if it is to survive without continuing massive A.I.D. support. It appears that the only systematic analysis of FEPRO's member associations was conducted by the ISTI evaluation team, which illustrates the weak links between FEPRO and its members. A first step would be to seek technical assistance in association management, not only for itself but to conduct a diagnosis of its members' needs and capabilities.

Key Issues in Agricultural Exporting and the Restructuring of FEBRO

The problems that have to be overcome to promote agricultural exports are

- Deciding how broad the export target should be
- How to facilitate marketing
- Provide access to credit
- Reduce high transport costs

With regard to the appropriate export target, although A.I.D.'s export strategy suggests an emphasis on new small farmers' associations serving nontraditional export products, practical considerations require including large associations serving traditional export products. With the exception of the palm oil associations (a problem in and of themselves for A.I.D.), the nontraditional export associations are simply too weak to form a viable base for a federation. This conclusion is also supported by the view that we have taken elsewhere that many traditional as well as nontraditional exports have good market development prospects.

FEPRO's Role. In order to cope with the other issues more efficiently, FEPRO must be assisted to back away from the all-encompassing role assigned to it in the EDSP design. Now and for the foreseeable future, FEPRO cannot be expected to play a significant role in all aspects of export production, from technology development (as it is currently doing with FHIA, for example) to final shipment (as it has been doing in a number of cases).

We propose that restructuring FEPRO so that it is directed to solving problems 2-4 requires that its role be defined to meet at least four criteria:

1. It must be consistent with the capabilities of the organization.
2. It must be closely tied to the organization's support base (e.g., producer associations in the case of FEPRO).

3. It must be focused around a set of related functions consistent with both of the above.

4. It must be clearly defined whether the organization (1) <u>performs</u> the function itself; (2) <u>supports</u> the individuals and groups performing the function; or (3) <u>facilitates</u> support provided to individuals and groups by others.

An example from FEPRO's experience may clarify the fourth criterion. With regard to the export function, FEPRO could export directly (as it has generally done), provide support such as information and technical assistance to exporters (as it has also done to some extent), and facilitate assistance provided to exporters by producer associations or other organizations (as it has generally not done). The role defined for FEBRO fails to meet all four criteria.

Several alternative functions fail one or more of these tests, including some that FEPRO is currently performing, some that it is considering, and some that have been proposed for it by others: (1) off-shore investment promotion; (2) export promotion; (3) exportation on a trial or commercial basis; (4) technical assistance to growers; (5) direct participation in investments; and (6) provision of inputs and credit. The unsuitability of these functions requires a brief explanation.

Off-shore investment promotion requires a general knowledge of the U.S. and European business community, personal and regular contact with individual investors, and specific knowledge regarding a wide range of agribusiness industries. FEPRO is simply not in a position to acquire or maintain these skills, nor are they appropriate for a federation of growers' associations.

Export promotion, in the generally accepted sense, requires visits to potential off-shore buyers to acquaint them with Honduran products, operation of booths at trade fairs, and similar activities. These activities are generally not necessary or appropriate for agricultural commodities, such as cocoa, fresh produce, and meat, which have ready buyers if price and quality standards can be met. There is no market for Honduran cucumbers, as such, and therefore there is no purpose in promoting one.

Exportation on a trial or commercial basis is very costly in both financial and human resource terms, but provides very little information (as freight rates, grades and standards, and prices in overseas markets are already known). Very small shipments might be air-freighted to established buyers to solicit their advice on improvements in packing and in the quality itself, but a few cases should be adequate for this purpose. Follow-up for shipments by association members by phone or in person would accomplish the same purpose at a much lower cost to FEPRO.

Direct technical assistance to growers has been a major FEPRO activity but, in the evaluation team's view, not one that should be continued in its current form. The current structure has created a gap between FEPRO and its associations, the latter perceiving that FEPRO is bypassing them to deal with their members and providing services that the associations should provide. They are correct. The APROCACAHO grant, reviewed in the discussion of other agricultural projects below, provides a model for an alternative and more promising approach. This grant channeled A.I.D. funds directly to the association as seed money to establish a program of extension and other services for its members.

Existing FEPRO involvement in specific investments must not be allowed to become a precedent for the future. Not only have the specific results been disappointing, but the projects have weakened FEPRO ties with the associations and used up FEPRO resources better devoted elsewhere. In some cases, such as the COAGROVAL arrangement, FEPRO would appear to be receiving a return completely out of proportion to its input. Such an arrangement is not sustainable and only creates problems for the future.

FEPRO has no business becoming directly involved in the sale of inputs or the provision of credit to association members (much less to growers who are not association members), at least not at this stage in its development. In addition to taxing FEPRO's management resources, these activities bypass the associations and, worse, place FEPRO in competition with them, as well as cutting the associations off from a potentially valuable source of funds.

FEPRO ought to be redefined in ways that offer at least the potential to remain within the limits defined by these criteria. Some or all of the following seven functions are consistent with such a definition. All rely most heavily on facilitation, rather than direct provision of services, in order to reduce demands on FEPRO's scarce resources by mobilizing resources elsewhere in the system.

1. Technical information for growers: Serve as a liaison helping producer associations to tap sources of technical information for their growers, such as FHIA, established Honduran firms, MRN, and off-shore firms.

2. Basic market information for growers: Provide associations with information on current prices, grades, and standards in off-shore markets, and standard practices in these markets (e.g., accepted brokerage fees), and Honduran export regulations and incentives; facilitate contacts between associations, on the one hand, and Honduran exporters and American/European importers on the other (but leave actual negotiations to these parties themselves); provide information on Honduran costs of production and growing conditions to potential off-shore agribusiness firms (on request only).

3. Input supply to growers: Arrange bulk importation of inputs for associations on a commission basis; help associations resolve member problems regarding quality or availability of specialized inputs (e.g., importation of seed stock).

4. Grower contact with potential processors and packers: Assist associations or association members in making contact with

Honduran and off-shore firms potentially interested in purchasing their products for processing or packing and serve as a point of contact for such firms (in cooperation with FIDE and others) in their efforts to assess the supply situation and make connections with supply sources, i.e., associations and their members.

5. Development of export-product associations: Arrange training and technical assistance for the associations in membership development, fund raising and financial management, cooperative marketing (as appropriate), staff development, design and implementation of training programs for their members, etc.

6. Transport coordination: Serve as a point of coordination to help associations, their members, and others (particularly small exporting firms) schedule their shipments so as to minimize delay and ensure the availability of containers and space on reefer vessels (if the system is introduced in Honduras).

7. Credit support: Assist association members in qualifying for commercial credit or in locating other credit sources by helping them to (1) prepare financial and other analyses needed for loan appraisal; (2) determine their potential eligibility for credit (i.e., collateral); and (3) identify alternative sources of credit by restructuring "unbankable" projects to bring in "bankable" partners such as processing firms, exporters, and U.S./European importers (assistance to associations in titling their members might be an appropriate adjunct to the credit function to improve credit access over time).

In all of these functions, FEPRO's role is limited to coordination, support, provision of information and other activities with a relatively low resource requirement. Consequently, they meet the first criterion defined above. In each case, FEPRO's primary clients are its member associations, and its central role is to help the associations in providing services to their members that enable the latter to negotiate the export labyrinth more successfully with higher volumes at a greater profit. Consequently, these functions meet the other criteria defined above.

They are also focused on the problems outlined above. Points 1, 2, 4, and 5 facilitate marketing; point 6 is aimed at reducing transport cost and is directed to improving access to credit. The proposal is ambitious and will probably require management assistance from A.I.D. to carry out.

Finally in the matter of self support, A.I.D. should consider whether it is an appropriate goal for an organization of this kind. FEBRO is being asked to provide many of the services that a Ministry of Agriculture normally undertakes on the ground that low salaries make it impossible to find qualified personnel to carry them out in a ministry. The evaluation team and the Mission recognize that FEPRO must be restructured to make it more self supporting. Both consider that financial independence is unlikely.

The evaluation team believes that greater reliance on and support for producer associations would increase FEPRO's income and make it a more effective organization. The Mission disagrees with our point about associations but insists that a FEBRO reduced in scope must remain independent. It is not clear to us how independence without reliance on the associations and without income from the certificates of loan eligibility is possible unless it implies that A.I.D. should provide a subsidy indefinitely. We believe that the project objective to provide seed money is the correct one. Although the Mission might choose to provide technical assistance as part of other program objectives, it should gradually reduce its support for operating expenses to zero. If the organization is a success, it could perhaps be turned into an autonomous agency supported by producer associations and a subsidy from the GOH. If it is not, it should be allowed to sink.

RECOMMENDATIONS:

1. The Mission should consider the reorganization of FEPRO in accordance with the proposal above as being one of best courses oı action to make it both more effective and self supporting.

2. Once FEPRO has been restructured, the Mission should set up a transitional funding plan which will give it an incentive to improve its financial condition by developing a closer relation to its producer association members and to seek eventually help from the GOH.

FIDE and the Problem of Industrial Export Promotion

FIDE (Fundacion para la Investigation y Desarollo Empresarial) has already been the subject of a thorough and well written evaluation by the International Science and Technology Institute (ISTI). The evaluation team was able to study both the preliminary draft and the final report which was received just before our departure from Tegucigalpa. In this section we will define the problem of industrial export promotion, summarize ISTI's conclusions and recommendations, state to what extent we accept them, and discuss the relationship between FIDE, FEPRO and DGPEI.

Honduras has a relatively brief history of industrial exporting and much of that concerned shipments to other parts of Central America. Since 1981-82, the overvaluation of the exchange rate, stagnation in Central American economies, and the breakdown of the inter-country payments mechanism has reduced industrial exports, particularly those not based on local agricultural products. Overvaluation has, of course, made Honduran products less price competitive.

The disruption of some of Honduras's markets has made its other problem -- poor marketing -- more acute. The marketing is composed of several parts: understanding what foreign markets want, making contact with buyers, and finding the assistance and finance necessary to redesign product and produce in the quantities needed. FIDE's principal functions were established to help solve the marketing issue. But it had other purposes as well:

1. To assist individual Honduran enterprises to increase nontraditional exports through technical assistance, training, or provision of marketing contacts and information

2. To serve as a facilitator of foreign investment in Honduras

3. To assist in the development of at least two export processing zones

4. To provide technical assistance to existing or new producer associations, particularly in the wood products group

5. To serve as the technical support arm of the private sector to analyze policy issues that affect efforts to increase nontraditional exports

ISTI's basic premises in evaluating FIDE are

1. Most Honduran industrial products are not exportable without a good deal of assistance.

2. FIDE has already addressed the easier cases.

3. Therefore, bringing in foreign investors who would have commercial reasons to assist in adaptation and expansion of production, would be the most efficient way to promote exports; and

4. Medium-term project finance based on an analysis of cash flows is essential for the expansion of industrial exporting but very scarce in Honduras.

ISTI sees FIDE's main strengths as its ability to deliver technical assistance to a number of firms, its knowledge of project finance, and the success of its targeted marketing efforts. The report cites a number of cases in which technical assistance has turned a local firm into an effective exporter. It criticizes the organization, however, for undertaking very difficult cases where the risk of failure is great. It also states that technical assistance is undertaken without setting up a framework agreement which would make clear to the recipient what its obligations to pay and cooperate are.

ISTI believes the staff has been rather effective in managing the lines of credit assigned to it. Its certificates of eligibility needed to apply for the A.I.D.-sponsored loans are regarded by the banks as based on good analyses of creditworthiness. Its analysts understand project finance based on projected cash flows in a country in which banks depend mainly on collateral as a guarantee of repayment. Where establishing contacts between local producers and foreign buyers is concerned, the evaluation believes that FIDE has been effective when it has hired industry specialists rather than relying on non-specific channels like trade fairs.

The major criticism concerns the relative merits of trade over export promotion. As noted above, ISTI argues that given the weaknesses of most Honduran industrial exporters, it would be more cost effective to promote investment in Honduras in the form of a joint venture, or an independent foreign investment in an export processing zone. Honduras would benefit through employment, training, and the induced demand for local products. In either case, the evaluation concludes that more employment and foreign exchange will be generated by the investment than the firm-by-firm trade promotion that FIDE has been undertaking.

Its basic recommendation then is a partial reconversion of FIDE to greater emphasis on investment and away from trade promotion. Second, it believes that the financial staff should be increased and given greater control over project follow-up. To economize on management time and redirect resources, it would also reduce technical assistance, keeping a smaller number of clients who were better able to absorb its help; and drop its role as a technical advisor to the private sector in which it has been quite active and its work assisting producer associations.

The evaluation is skeptical that FIDE can ever be self-sustaining, although it could do a better job than it has so far. Its own recommendations might help a bit in that direction but that would depend on how ambitious the investment program turns out to be.

The ISTI evaluation covers all the relevant subjects and on the whole makes good recommendations. We will comment on it from the perspective of the larger issue of export strategy, but first we would like to comment on the question of whether FIDE can or should be self-sustaining.

Our general point is the same one expressed earlier in the cases of DGPEI and FEPRO, i.e., that these organizations are being asked to produce public goods and services that by their nature benefit the whole community indirectly as well as certain firms and individuals directly. The latter should not and cannot be asked to pay for the whole cost. Therefore, while all of them can be partially sustaining by the collection of fees for services, their operating costs will have to be subsidized. Second, it would not be appropriate for A.I.D. to be in this position indefinitely, because it permits the GOH to go on ignoring the problem of export promotion as a potential claim on its own resources.

The ISTI evaluation suffers from the fact that it was carried out in a macroeconomic vacuum. It takes no notice of the fact that the exchange rate is overvalued and that industrial exports, especially of the kind that FIDE has been helping, have suffered the most. It then observes that "one primary constraint to increased financing of exporters...[is] the relative dearth of export projects of even minimally sufficient quality....FIDE has limited ability to create [them]....[There] has to be a hard working entrepreneur who is willing to take risk and accept assistance." We believe that the "dearth" may be the result of Honduras's incentive structure, in which exchange rate overvaluation combined with high levels of protection make investments to serve the domestic market far less risky and much more profitable than export projects.

Based on this conclusion the team feels that the relative value of investment over trade promotion is exaggerated. Unless one assumes that overvaluation can last indefinitely, i.e., that someone will always be around to finance the gap, it will come to an end. Although foreign investment may provide a quicker pay-off, eventually Honduras is going to have to rely on its own businessmen. Only by a well-organized and sustained export effort will they be able to carry out that task.

The central recommendation, i.e., a greater emphasis on investment and less on trade promotion, is still valid but for different reasons. The establishment of the DGPEI (the main function of which is trade promotion) at the beginning of 1988 has changed the situation. We understand that both parties recognize this fact and have reached a tentative agreement in which FIDE will take a greater role in investment while retaining trade promotion responsibilities in sectors like wood manufacturing where it has built up expertise. A corollary is that, as ISTI recommends, FIDE should take a leading role in promoting the Export Processing Zones. The export strategy for industrial exports should proceed on two tracks: trade promotion and technical assistance for Honduran manufacturers for the long run and the attraction of foreign investors for the medium term.

RECOMMENDATIONS:

1. ISTI's recommendations to reduce and tighten the scope of activities should be accepted.

2. Trade promotion gradually should be cut back as DGPEI establishes its own programs.

3. FIDE should give more explicit recognition to the obstacles to exporting and investing posed by Honduras's macroeconomic policy, which would require that some projects be postponed until the exchange rate is more competitive.

4. On the basis of a new projection of FIDE's earnings, A.I.D. should establish a plan to phase out support for operating expenditures.

Export Promotion in the Mission's Agricultural Portfolio

The Mission's agricultural portfolio is balanced between two competing objectives: (1) increasing production of basic food crops to raise small farmer income and supply the needs of the Honduran population and (2) increasing export-oriented production to generate employment and foreign exchange in the Honduran economy as a whole.

Excluding the agricultural activities in the EDSP and policy dialogue activities discussed elsewhere in this report, the Mission's agricultural projects can be divided into four categories with respect to their impact on exports:

1. Projects that support production of traditional exports: Small Farmer Coffee Improvement, Small Farmer Livestock, and Forestry Development.

2. Projects that support production of nontraditional exports: Agriculture Research Foundation and Agribusiness Development (proposed as an FY 1989 start).

3. Projects that support input provision and marketing systems for both export and non-export production: Titling, Irrigation Development, Rural Technologies, and Rural Trails and Access Roads I and II.

4. Projects with limited impact on exports: Natural Resource Management, Small Farmer Organizational Strength, Mosquitia Relief, and Agricultural Productivity Enhancement (proposed as a new start for FY 1988).

The portfolio also includes several local currency-funded activities, including the Agricultural Land Sale Fund, Agricultural and Cooperative Credit, and budget support for the agricultural sector. With the exception of the last, these programs are not currently active. The Mission also recently made a $1.5-million local currency grant to APROCACAHO, the cacao producers association, for development of an extension and marketing program.

Funding for Export and Non-Export Projects
in the Agricultural Portfolio
($ millions)

	Grant	Loan	L/C	Total
1. Traditional Exports	15.2	38.0	29.6	82.8
Small Farmer Coffee Improvement	4.2	16.0	29.3	49.5
Small Farmer Livestock	3.0	10.0	0.3	13.3
Forestry Development	8.0	12.0		20.0
2. Nontraditional Exports	30.5	9.5		40.0
Agriculture Research Foundation	23.0	6.5		29.5
Agribusiness Development	7.5	3.0		10.5
3. Inputs and Marketing (partially related to export dev't)	19.0	54.2	40.6	113.8
Titling Irrigation Development	8.0	14.5	8.7	31.2
Rural Technologies	9.0	8.6		17.6
Rural Trails and Access Roads I and II	2.0	39.7	23.3	65.0
4. Not Export Related	32.0	32.8	45.2	110.0
Natural Resource Mgt.	3.9	12.3	5.6	21.8
Small Farmer Organiz. Strength	7.5	8.5	19.8	35.8
Mosquitia Relief		2.6		2.6
Agricultural Productivity Enhancement	18.0	12.0	19.8	49.8
TOTAL				

The priorities implicit in the Mission's composition of funding place export development in second place behind activities oriented primarily to production for the domestic market. Within the export sector, traditional exports receive approximately twice as much support from A.I.D. as nontraditional exports.

This pattern is consistent with the overall goals of the GOH and A.I.D. The GOH's priorities for the agricultural sector continue to place meeting the nation's food needs above any other goals. Given A.I.D.'s agency-wide exclusive emphasis on export development would be inappropriate in a situation where production for the domestic market (maize, beans, meat, etc.) continues to account for more than half (an estimated 53 percent of the farm-gate value of agricultural production) and a much higher (but not quantifiable) share of small farmer income.

The balance between traditional and nontraditional exports is also generally appropriate and responsive to the country's needs. Although the potential for expansion in traditional exports is limited in the long term by international demand constraints, substantial short-term potential exists for raising income (at both the national and farmer level) through measures such as improving the quality, and therefore the price, of coffee and beef exports. Development of nontraditional exports will be a long process, as the disappointing results achieved to date indicate, and traditional exports offer much greater potential for generating foreign exchange in the immediate future.

A.I.D.'s commodity emphasis within the TAE subsector is also appropriate, given the constraints on A.I.D. commodity programs. Coffee, livestock, and forest-based products together account for half of traditional export value and will continue to play an important role in Honduran exports for the foreseeable future.

Assessment of the Mission's Strategy for Promoting Agricultural Exports

The Mission's strategy for promoting agricultural exports, like its strategy for the agricultural sector overall, is heavily oriented toward operations on the farm. The strategy focuses on increasing production through two broad tactical approaches:

1. Raising the productivity of farmer-owned resources

2. Improving farmer access to improved technologies

While raising farmers' production and incomes is clearly an appropriate aim for A.I.D.'s export promotion strategy, the current tactical approaches chosen to achieve the aim focus too narrowly on the farmers themselves (and farmer associations) to the virtual exclusion of the off-farm parts of the export system.

The current strategy therefore makes two implicit assumptions, neither one of which is necessarily valid for the Honduran situation. First, it assumes that the most effective way to improve farmer access to technologies, credit, and markets is by working with the farmers themselves or with non-profit entities of one sort or another (FHIA, FEPRO, etc.), rather than with private sector firms for which the supply of technologies and the purchase of farmers' products are integral elements of their own profit-making activities. Second, it assumes that increased production can be translated into increased sales and income without explicit attention to the other elements of the system, that is, that private firms will either fall automatically in place as production develops or, if not, that their function can be filled effectively and efficiently by farmer-based and non-profit organizations.

These assumptions are particularly open to challenge in the area of nontraditional exports, for two reasons:

1. Processing and marketing channels for these products are not well developed in Honduras, by definition, and the availability of markets for farmers' products cannot therefore by assumed to exist (whereas channels can be assumed to exist for coffee production, for example).

b. Small farmers can market perishable products on the domestic market but they simply are not in a position to export such products to overseas markets themselves; they require functioning intermediaries to assemble, pack, process, and export their products if they are to realize the income potential of high-value products.

Private input suppliers, packers, processors, and exporters also deserve serious consideration as a potential source of farmer credit. These firms generally have better access to bank credit (including that provided by donor-supported projects) and have an interest in increasing farmer output, either as a market for their products or as a source of supply for their own products. Unlike the banks, processors and packers are also in a position to accept perishables and other export crops as chattel collateral. The team has not had the resources to explore whether the private firms could serve as credit intermediaries or would be willing to do so. Given the central importance of the credit function and the need to explore alternatives to approaches that have been tried to date, the possibility of channeling credit through such firms deserves serious consideration in the context of a broader Mission strategy for promotion of agricultural exports. (See comments on agribusiness project in Chapter VI.)

Our conclusion is that much of the agricultural portfolio benefits the production of exportable products but not necessarily exports. A foundation is being laid, but not much work is being done on the superstructure. Until more attention is paid to effective and inexpensive marketing and until a devaluation in some form takes place, the payoff in foreign sales will be a long time coming.

Assessment of AID's Implicit Export Strategy

The problem is that the strategy is implicit, not explicit. There is no export plan that year by year lists export objectives and means of arriving at them. The various activities, fortunately, do not work at cross purposes but neither do they reinforce each other to any appreciable degree. There is a tendency to concentrate on programs that have a very long range pay-off as far as actual exporting is concerned. Only the production programs for perishable agricultural products have borne fruit by the end of 1987.

With respect to financial measures, those promoting the return to nontraditional exports produced nothing of substance until 1988. The reduction in the marginal export tax on bananas may have been the most effective foreign exchange earner that the Mission helped to bring about.

Because the program has been so diffuse, it has been ineffective in bringing about results. Exporting may theoretically have a high priority but nowhere is there a piece of paper that states what its relative priority is.

The lesson to be learned is to produce an initial plan that cuts across project activities each year and concentrates on a few easily monitored measures. For example, the most important decision the Mission made in this area was in 1985, when it decided not to pursue devaluation as a condition for ESF. Instead of concentrating on a substitute that would be an effective functional equivalent for at least some of Honduras's exports, effort was diffused into tariff reform, customs administration, etc., none of which had any measurable effect on increasing the financial reward to exporting.

The CETRA as the only promising equivalent of the exchange rate should have been emphasized as the heart of the program at the outset. Marketing could have been made a more prominent activity in FEPRO and in the coffee, livestock, and forestry projects.

The keys to successful exporting for a fairly backward country like Honduras are competitive prices and effective marketing. We have made a number of recommendations in the sections pertaining to each activity based on those guidelines. The main ones are

- The rapid broadening of the CETRA market
- The efficient functioning of CEFEX reimbursement
- The restructuring of FEBRO so that it more effectively tackles the problems of marketing, high transport costs, and access to credit
- Strong support to export promotion in the Ministry of Economy
- The creation by CONAFEXI of a list of export products, not restricted to nontraditionals, with priorities set by estimates of their market prospects

A program of this kind would create a more focused export strategy. It would not be too early to consider further measures along the same lines proposed in the following section for future fiscal years.

Planning for this year and next would benefit from an export strategy paper building on this evaluation. There ought to be a paper in the Mission in which the whole portfolio of activities is viewed from the angle of export promotion. It would bring together and compare the annual program targets of ESF, the EDSP, and the half dozen agricultural projects, all of which relate to exporting. For example deciding explicitly on an export commodity list rather than having one de facto would be a good starting point (see next section). It could then be matched to Mission activities to determine how they need to be modified. That might serve to give more of a marketing/export focus to projects concentrating on production problems.

VI. THE EXPORT STRATEGY: OPTIONS FOR THE FUTURE

This section examines export strategy issues for FY 1989 and beyond such as the overvalued exchange rate; the lack of consensus, either in the Honduran government or the Mission, on what products have the highest priorities for export promotion; a more market-oriented approach to agricultural projects; and the need for tariff reform if the industrial sector is to be given serious incentives to export.

Past A.I.D. export strategy has been a combination of measures that increase the return to foreign sales, assistance to the production of exportable commodities, and help in marketing. In Chapter V we have made a number of specific recommendations to modify ESF conditionality, and the various components of the EDSP. In this chapter, we examine several general issues that were brought to light by the evaluation. Mission strategy in the future should depend on the choices it makes in each of these areas:

1. Export promotion when the effective exchange rate is seriously overvalued
2. Comparative advantage -- what Honduras's and the Mission's export target should be
3. Devaluation and other forms of exchange rate depreciation
4. New means of promoting agricultural exports
5. Tariff reform and industrial exports

Export Promotion When the Effective Exchange Rate is Seriously Overvalued

For the next year or two general export promotion is still worthwhile because (1) we can still hope that devaluation in some form must take place; (2) the promotional apparatus in Honduras is extremely weak at present; and (3) it will take several more years of sustained effort to create the kind of institutions the country will need.

In other words, Honduras will need a strong trade promotion unit in the Ministry of Economy that knows local exporters; can supply them with information; can organize trade fairs; can help foreign buyers and investors to make contacts and understand the local environment; and so forth. CONAFEXI, if it is prepared to tackle difficult issues like transport and the effect of protection on exports, and has a competent technical staff, would be highly useful regardless of Honduras's competitive status. But before FIDE or FEBRO become involved in helping a particular industry or project in a period of overvaluation, it ought to be clear that sales can be made profitably at the current effective exchange rate. If not it would simply be a waste of resources. If by the end of FY 1989 there is no prospect of a basic change in the exchange rate situation (section 3), then export promotion should be phased out as a component of the A.I.D. program.

Comparative Advantage - What Honduras's Export Target Should Be

In terms of explicit special incentives (CEFEX, CETRA), the official goal, and the one supported by EDSP, is the promotion of nontraditional exports. In practice, as was already pointed out, the traditional exports have received far more help from the GOH and in the Mission's portfolio of activities. The general argument for concentrating on nontraditional exports is the need to diversify exports so that as the older products run into demand restraints abroad, new markets will be opened up, maintaining overall growth. The argument for diversification is certainly valid and supported by the experience of most successful exporters. The error is in assuming that the dividing line between traditional and nontraditional corresponds to those products that do not have long-term growth prospects and those that do.

The overvaluation of the exchange rate gives us some interesting insights into the problem. The volume of some traditional exports, such as coffee, has grown in spite of apparently less remunerative prices. New agricultural exports, such as melons and pineapple in the nontraditional sector, have established markets for themselves in spite of the obstacles. Industrial exports have stagnated or declined.

Over the long run, there is little doubt that bananas and coffee have poor prospects for rapid growth. In the medium term, the outlook could be quite different. Coffee in particular, where Honduras is relatively inefficient but has still sold at a profit even in the non-quota market, seems to be a good candidate. Wood is probably more a victim of the poor management of domestic resources than of a lack of foreign demand.

For FY 1989, the Mission ought to review, with CONAFEXI and the Central Bank if possible, all traditional exports and the more important categories of the nontraditional sector to identify first where foreign demand prospects are good and second, if Honduras could be a competitive producer. Studies of market demand for the major commodities are already available from international agencies. The difficult part is finding reliable local cost data. Moreover, costs would have to be considered not only in terms of a lempira price calculated at 2/1 but first, at the effective return, after promotional incentives are calculated; and at rates of devaluation that make the lempira more realistic. On the basis of these studies, a list of export priorities can be drawn up, showing where the efforts of both the Mission and the Honduran authorities could be directed.

The next step would be to establish a time framework: what will pay off in five years, in ten years, and so on. If the GOH wishes to increase exports by "x" million dollars cumulatively between now and 1993 it needs to know what commodities offer the best chances of succeeding. Second, it needs to know what products, even if collectively small in value, would probably have the highest rates of growth. These will bulk progressively larger over time. If the Council were limited to nontraditional exports, it would ignore all the more interesting near term problems and concentrate on products that are only likely to become important in absolute dollar terms far down the road. Conversely, a concentration on traditional exports would be beneficial in the medium term but would ignore the spade work that has to be done now for the future.

This could give more specific quantitative goals to an export campaign that is mostly concerned with institution building. This does not necessarily mean an expansion of Mission activities that already are concerned in one way or another with more than 50 percent of Honduran exports. It could lead, however, to a greater emphasis on marketing and quality instead of production alone.

Alternatives to a Low Key Approach to Devaluation

Because the GOH has made devaluation a major political issue, the Mission has eliminated it as an option in its policy dialogue and ESF conditionality. The development of the CETRA market will probably lead to some growth in nontraditional exports, and some traditional exports are doing fairly well. Sustained export growth, however, is going to take more decisive measures. There are two options:

- A devaluation to a new fixed rate
- Widening the CETRA or some similar arrangement to include more than half of trade and invisible transactions

Devaluation to a New Fixed Rate

Devaluation has several advantages over other courses of action:

- It is a clear and unequivocal signal to exporters that the government seriously wishes to increase foreign sales.
- It is comprehensive, covering all invisible and capital transactions as well as trade.
- It can produce large quantities of budget revenue.

On the import side, tariff surcharges and the monopoly profits created by the exchange control system have already devalued the lempira but Honduran export incentives have been selective, arbitrary, and not very effective to date. They may have offset some of the overvaluation but it is doubtful that a firm would base any medium-term plans on them. Rhetoric and institutions are components of an export objective but the foundation is a realistic legal exchange rate. Second, policy has entirely been concerned with merchandise exports, paying no attention to the leakage of foreign exchange through invisible transactions covering tourism, payment of salaries to foreigners, or remittances by Hondurans abroad, or by capital flight that may be equally important. On the contrary, the market is encouraged by permitting imports to be financed with unrecorded holdings of dollars.

Finally, a substantial proportion of budget revenue is effected by the exchange rate applied to imports. The income collected by means of tariffs, surcharges, and counterpart funds would all change in proportion to a devaluation. Export taxes are levied in lempira but they could be substantially increased while still permitting the return to the exporter to rise. In practice, tariffs would probably be adjusted to offset the impact on the cost of living. The tariff surcharges, for example, are actually a form of devaluation restricted to imports. There would still be a net, substantial revenue increase available to reduce the deficit if expenditures could be kept under control.

A devaluation would have to be accompanied by the appropriate fiscal and credit measures and new foreign credits to increase imports, all designed to stop an inflationary spiral from taking off. Because Honduras is a country with a taste and experience of stability, the new parity should be fixed at a level that could be held indefinitely. In Chapter IV E., we suggested that the current exchange rate should be between 2.5 and 2.7/1. Given the one-time price increase, inherent in a devaluation, and the need to convince the market that other changes are not in the offing in a year's time, a rate of 3/1 would be appropriate.

Widening the CETRA Market

The possible extension of the CETRA market to all nontraditional exports in and of itself would produce an effective exchange rate of 2.15/1 as long as certificates issued were only equal to 30 percent of earnings. If devaluation continues to be ruled out, a more powerful intermediate measure than the CETRA as presently conceived would be necessary to stimulate exports. Goods in addition to those in the nontraditional sector would have to be included as well as some services. Some of the smaller traditional exports like shrimp, meat, sugar, and wood could be added to the list. At a minimum, the associated freight and insurance costs would be included. Certificates would have to be issued for higher percentages, at least to 75 percent to achieve a 2.37/1 exchange rate or about an additional 10 percent devaluation.

This CETRA continues to be the proxy for the black market and its effective rate depends on that market. As in the earlier calculations, we have assumed an exchange rate of 2.5/1. There would be no revenue increases because the official parity would be unchanged and continue to be used for other transactions.

The other drawbacks of this plan are that it still leaves large parts of the export spectrum at overvalued exchange rates; and that, as in any multiple rate scheme, there is a tendency for arbitrage to take place from the less depreciated to the more depreciated rate. For example, manufacturers will seek to import their raw materials at 2/1 while exporting the finished product at 2.37/1. The advantage is that the authorities could still maintain the fiction that the exchange rate had not been devalued.

<u>As noted above, if neither one of these plans is adopted by the end of FY 1989, other forms of export promotion should be phased out as a waste of resources.</u>

New Means of Promoting Agricultural Exports

The Mission has taken the first steps toward expanding its production-oriented strategy by identifying the agribusiness development project as a new start for FY 1989. The design of this project is still at too early a stage for comment, although the proposed focus on secondary cities may be too narrow to capitalize fully on the potential for export-oriented development. It does provide an opportunity to consider expanding the Mission's strategy to address the needs of the off-farm components of the export system. Issues that could be addressed during the design process and in the project itself include

1. The feasibility of providing credit through input suppliers, packers, processors, and exporters for on-lending to farmers

2. The credit needs of these groups themselves and alternative ways to open up the system to them where access is inadequate

3. The current strength of agribusiness organizations and measures to improve their services to their members

4. Linkages between development of indigenous agribusiness firms and U.S. investors, including technology transfer and market access as well as investment promotion

5. Support available to agribusiness firms from the GOH and non-profit organizations in such areas as work force training, management, and financial systems

Two other areas can be identified as deserving greater attention in the Mission's agricultural export promotion strategy. Depending on Mission resources and GOH support, one or both of these areas could be tackled as the export portfolio develops:

1. Production information for export crops

2. Agricultural sector policies affecting nontraditional exports

Production Information for Export Crops

For a variety of reasons, the quality of the information available on nontraditional agricultural export production has deteriorated sharply in the past four years. It has now reached a point where the information available is totally inadequate for either public sector planners or private sector investors. It is difficult or impossible to obtain consistent or reliable information on two key factors:

1. The level of production of important nontraditional exports such as melons, pineapple, and cucumbers (in total or by variety)

2. The cost of production for these products in Honduras, either under current conditions or using improved technologies (national averages or region-specific values)

As a result, potential investors interested in producing exportable produce in Honduras or purchasing Honduran products for export, and Honduran officials charged with monitoring and supporting export performance do not have the basic information needed for decision-making. In particular, the lack of information makes it impossible to identify accurately the factors constraining export of particular products. For example, planners need to know whether pineapple exports can be increased from the current production base (raising yields and diverting production from the domestic market) or whether the level of production and varieties produced are such that expanded exports can only be achieved by expanding or restructuring production.

Previous efforts to upgrade the national agricultural data collection and analysis system have been disappointing (and may even have contributed to the current problem). In the current context of severely limited budgetary resources, a large-scale program to improve data on nontraditional production would be difficult to justify. A smaller program targeted on the dozen or so products with the greatest potential would pay high dividends, however. If resource availability and institutional priorities are not consistent with an effort to upgrade ongoing data collection, then, at a minimum, a survey of production, costs, and returns for selected products in the main producing regions should be undertaken on a one-time basis.

Tariff Reform and Industrial Exports

Tariff reform is essential to make industrial exports on any scale possible. As noted in Chapter IV, Honduran industry has grown up behind high tariff barriers. The temporary import law permits local industry to procure inputs at world prices, but the high degree of protection makes it much more profitable to sell internally than abroad even when foreign sales yield profits at the margin. In Chapter II, the decline of industrial exports since the period of overvaluation began was examined. They are now well below their 1980 levels.

Yet the authorities have provided very little to manufactured exports, apparently because they are more concerned that local industrialists will take advantage of the system and receive subsidies in return for very little value-added domestically than they are for promoting industrial exports. For example, most products eligible for CEFEX reimbursement and CETRA certificates are agricultural commodities that undergo little processing in Honduras.

Although devaluing to a more realistic rate and eliminating tariff surcharges, which represent a de facto import devaluation, would sharply reduce the relative profit margin on domestic sales, exporting would still remain a second best form of sales. Tariff protection would still have to be reduced. As a practical proposition that is probably impossible on any scale. One way that might be feasible would be to concentrate on a few industries, offering them adjustment assistance for good export performance.

One final observation: the Honduran tariff system is a crazy patchwork of rates and exemptions that turn on who is doing the importing. The usual reaction is to do away with them but that could consume a lot of time and simply leave the economy with a higher average rate of protection. It would be more effective, in our opinion, to limit the objective of tariff reform to export promotion.

ANNEX I. METHODOLOGY

The basic material for an evaluation is the documentation produced by the Mission. This consists of the PAADs, background studies, compliance reports, the action program, reports of negotiations, and so forth. The second element of documentation is Honduran legislation, regulations, and statistics. The third element is World Bank and IMF reports and studies and other relevant consultant reports, commissioned by the Mission. Interpretation is based on interviews with Mission personnel at all levels, senior and junior officials in the Banco Central, Economia, Hacienda and Planificacion and with private businessmen, bankers, and other experts. Wherever possible, we have sought to quantify the effects of various measures and sum up problems by quantitative means. This is not always possible and can be counterproductive when formulas obscure real issues.