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TALKING POINTS FOR AID MISSION CHIEF

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TALKING POINTS

For A.I.D. Mission chief to use in discussions with the President of Honduras.

I. The principal monetary and financial factors limiting economic development are:

1. The government is the dominant factor affecting the market.

   A. Problem. Inflexible reserve requirements equally applied to all classes of deposits, not only, pulls an inordinate amount of money(credit) out of the system (see annex 1) but prevents the development of a term market.

   Suggestion. a. Make reserve requirements flexible so that more or less money(credit) can be pulled out of the system as required.

   b. Set different reserve requirements for deposits of different maturity lengths. Setting requirements high on short maturity deposits and low on long maturity deposits would encourage banks to offer deposit instruments with long maturities. Some of these funds would be lent long.

   B. Problem. Since government bonds are income tax free, inheritance tax free, fixed at rates set by the central bank and are totally liquid, these instruments tend to fix both the minimum and maximum rates (minimum expected return on investments). Consequently, all discretionary investments will be judged against these instruments. (See annex 2)

   Suggestion. a. Eliminate liquidity feature of all government bonds. Allowing cashing only at maturity. Offer bonds with different maturities at different rates. This will produce the beginnings of a secondary market in govt bonds.

   b. Phase out the tax advantage of govt. bonds. Long bonds remain (temporarily) tax free, short bonds are taxed on a sliding scale, depending on maturity. This too would help develop a long term market since holders of long bonds cold use them as collateral for term loans.

cont.

2. With an effective cap on the return of new investments, using government incentives, at 20% there is no incentive to invest long term.

   Suggestion. Remove cap or tax profits on a sliding scale.

II. 1. The above action will permit government to encourage/ discourage economic expansion as it sees fit. With a stimulated money market and investment market, presumably, market forces would encourage govt to make economically correct decisions.

2. The above would produce a positive yield curve, in normal markets, and thus encourage long term investments.

3. With short rated low and term rates high a true money market will develop.

Note: Most financial institutions and instruments exist to deal with these changes.

ANNEX 1

Reserve Requirements

Reserve requirements affect the expansion and contraction of credit through their influence on the multiplier effect. The multiplier effect says that funds lent out will be redeposited in the banking system and available for relending. Reserve requirements take funds out of the system thus reducing the efficiency of the multiplier effect. There are two basic types of reserve requirements, those imposed by banks on themselves to provide immediate liquidity and other contingencies. These normally run from 10 to 15%. The other reserve requirements are those managed by the government to control the creation of credit. These run about 10% in the U.S. and 30% in Honduras. In effect $100 deposited in the U.S. will create $350 in additional credit while the same $100 in Honduras will only create $155 of credit.

ANNEX 2

The disintermediation effect of Honduras' gov't. bond program. A comparison of bond purchase vs lending:

Bond Purchase		Lending	
$100	New deposit	$100	New deposit
- 30	Resv Req	- 30	Resv Req
		- 10	Own Reserves
70	Available to invest	60	Available to invest

note: Since gov't. bonds are totally liquid a bank would not set up additional reserves. It must also be rememberd that bonds are tax exempt.

		(tax)
$70 @ 10% yields $7	$60 @ 17% yields $10.50 -	$5.04 =
		$5.44
$70 @ 11% yields $7.7	$60 @ 18% yields $11.12 -	$5.35 =
		$5.76
$70 @ 12% yields $8.4	$60 @ 19% yields $11.73 -	$5.63 =
		$6.10
$70 @ 13% yields $9.1		

With marginal cost of funds at . 9 to 10% there is little incentive to increase the loan portfolio.