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# THE

# FY 1992 - FY 1996

# COUNTRY DEVELOPMENT STRATEGY STATEMENT

USAID HONDURAS

MAY 1991

# HONDURAS CDSS


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## SUMMARY

This 1992-96 Country Development Strategy Statement (CDSS) demonstrates how the United States Economic Assistance Strategy for Central America, 1991-2000 will be implemented in Honduras. The CDSS is consistent with the Enterprise for the Americas Initiative (EAI), with the Partnership for Democracy and Development (PDD), and with LAC program objectives outlined in 90 State 144647 and 90 State 434641.

This CDSS covers two distinct periods: The 1992-93 period will be the final two years of the Callejas administration, culminating in Honduran National Elections in November 1993. The second period (1994-96) covers most of the term of a new government that will assume office in January 1994. As a result, this CDSS covers a major watershed period both for consolidating Honduran democracy as well as for expanding and deepening the economic reforms that were initiated in 1990 by the Callejas administration. Thus, 1992-96 will be critical years in Honduras for promoting U.S. goals of the evolution of a stable democratic society, broad-based sustainable economic growth, and more effective regional and international cooperation.

The economic reforms of 1990 reflected the conviction of the new Callejas government that export-led growth, based on private investment and an open economy, could reverse a decade of economic stagnation. The lempira was devalued for the first time in more than seventy years. Measures were taken to reduce the fiscal deficit, decrease import tariffs, eliminate price controls and implement other structural reforms. Agreements were reached with the IMF, IBRD and IDB. Large IFI arrears were cleared using a U.S. Treasury bridge loan.

As 1990 progressed, the GOH encountered difficulties in following through with complementary measures needed to keep its program on track. The program was threatened by Honduras' deteriorating economic conditions and growing political resistance to further reforms. It was made even more difficult because Honduras had one of the lowest per capita incomes in the LAC region ($481 according to the World Bank). In that same year GDP declined for the first time since 1983. Inflation of 35 percent was the highest in recent history.

Honduras entered the 1990s with deteriorating economic conditions characterized by a heavy debt burden, negative resource flows from the IFIs, and stagnant exports and investment. These problems were accentuated by the deep but incomplete reform program initiated in 1990. Delays throughout the 1980s in implementing fundamental economic reforms magnified the depth and social costs of the adjustments needed in the 1990s. As a consequence, widespread social and political discontent threatens those very reforms which can eventually ensure higher economic growth.

At a time of declining A.I.D. resources, the challenge for the USG in the 1990s is to keep Honduras moving forward with its macroeconomic and sector reforms, to preserve and strengthen its democracy, and to enhance the country's regional and international cooperation. Such an effort cannot be based on A.I.D. resources alone. It calls for increased support from the IFIs, bilateral donors and other USG agencies.

Over this CDSS period, the Mission's fundamental and overriding objective is to support broad-based, sustainable economic growth. Higher growth is inextricably linked to reduction of the country's widespread poverty, improvement of its social services, preservation of the environment, strengthening democratic institutions, and better regional and international cooperation. The Mission has set six strategic objectives for the CDSS period. These objectives are closely interrelated and mutually reinforcing.

The first strategic objective calls for supporting GOH actions to improve sector policies in agriculture, trade and investment, and finance. We will seek sector policy improvements which permit increased exports, private investment, production and as a result, economic growth and employment. The Mission will support a program of interrelated structural reforms and provide complementary project resources to help the GOH translate reforms into economic growth. This program will be implemented within a multi-donor approach in which we leverage our resources with those of other donors. The IFIs will assume the lead role in supporting GOH macroeconomic stabilization measures and also contribute to key sector reform programs.

The second strategy objective is to increase private investment and trade by encouraging a vigorous response by the private sector to a more favorable

policy environment. This will be achieved by assisting private sector organizations overcome institutional, financial, technological and human resource constraints that are impeding higher levels of investment and exports. As such, this Mission objective complements the first which seeks to overcome the policy constraints to investment and trade.

The third strategic objective is to facilitate implementation of social sector policies that improve the well-being of the historically disadvantaged. They suffer from high fertility, high infant mortality, malnutrition, poor health, lack of jobs and education, and inadequate access to shelter and basic services. Over the past decade, Honduras has been strongly committed to addressing the problems of its poorest citizens. However, implementation of this strong policy commitment has been impeded by institutional, financial, technological and human resource constraints that limited greater coverage of social services. Ongoing USAID projects will help Honduras overcome these constraints and thereby continue its progress in improving the country's social conditions.

The fourth strategic objective calls for supporting Honduran efforts to improve environmental policies and natural resource conservation. Sustainable economic growth requires a halt to the severe deterioration facing Honduran natural resources. It also requires much improved policies and programs to safeguard the environment and conserve the country's vital resources.

The fifth strategic objective is to strengthen democratic institutions and promote a more pluralistic Honduran society. This will be achieved by strengthening the National Electoral Tribunal, the National Congress, the Judicial System and Municipal Governments. We want these to merit greater confidence of the country's leaders, local and foreign investors and most important of all, the Honduran people themselves. Our strategy also will develop democratic leadership and encourage pluralism by strengthening private organizations and facilitating greater citizen participation in democratic processes.

The sixth strategic objective is to promote more effective Honduran regional and international cooperation. Regional cooperation is important to permit improved trade and investment. It also can help reinforce the Honduran

reform process by better coordinating and harmonizing key economic policies among the Central American countries. Increased international cooperation from the IFIs and bilateral donors is required to help Honduras achieve higher economic growth.

Over the CDSS period, the Mission will continue the program consolidation initiated during the past four years. This has been implemented by narrowing the number and scope of USAIDs strategic objectives and reducing those requiring new programs. Of the six strategic objectives, only one (Improving Sector Policies) requires major new funding. Four other strategic objectives (Investment and Trade, Social Sector Programs, Natural Resource Conservation, and Democratic Initiatives) will be supported largely with already approved and ongoing projects and with local currency and regionally-funded activities. The final objective (Regional and International Cooperation) will not require USAID funding. It will be supported through ROCAP programs and our ongoing policy dialogue process.

Even within these six strategic objectives, USAID has further narrowed its focus. For example, we are concentrating only on a few sector policy reforms in agriculture, trade and investment, and finance. USAID will assist far fewer private organizations than we did in the 1980s. There will be a gradual narrowing of our focus in the social sectors. Our environmental and natural resource conservation strategy does not require the initiation of any new dollar-funded projects. In Democratic Initiatives, USAID is directly supporting only five of the ten program objectives included in the U.S. Economic Assistance Strategy for Central America.

This program consolidation brings our strategy in line with what are expected to be reduced USAID funding and staffing levels for the 1990s. Continued GOH economic reforms should permit greater Honduran reliance on financing from export revenues, foreign private investment, domestic savings, and larger IFI and bilateral assistance. A key role for USAID is to help Honduras gain access to these resource flows and use them effectively. To accomplish this, USAID proposes average program funding of $126 million per year from FY-92 to FY-96 or twenty percent less than the levels received by Honduras from 1985 to 1990. These decreases and our program consolidation will permit USAID staffing levels to decline throughout the CDSS period.

## I. OVERVIEW

Honduras is important because of its strategic location in the center of Central America, just two hours south of the United States. Bordering Nicaragua, El Salvador and Guatemala, Honduras traditionally has been a close friend and staunch ally of the United States. Throughout the turbulent 1980s, Honduras supported U.S. foreign policy in Central America and played a key role in promoting the successful democratization of Nicaragua. It remained a center of political stability in a whirlwind of revolution, civil wars, guerilla activity, and deteriorating economic conditions throughout Central America.

In the 1990s the historic ties between Honduras and the United States are of continued importance because of the ongoing civil war in El Salvador, fragile political and social conditions in Nicaragua, guerilla activities and widespread violence in Guatemala, and unknowns surrounding the future of U.S. bases in Panama. These factors highlight the importance of supporting the evolution of a stable Honduran democracy and of continuing efforts to strengthen its economy based on free and open markets.

Despite the turmoil in neighboring countries, Honduras has been a pioneer in the hemispheric democratic revolution of the 1980s. It held three consecutive national elections and began an important process of strengthening its democratic institutions. The successful consolidation of Honduras' still fragile democracy is an important United States foreign policy objective.

Moreover, in 1990, the newly elected government of President Rafael Leonardo Callejas embarked on a historic program of economic reforms and liberalization to promote higher economic growth. The Callejas administration represents the emergence of a group of young Honduran technocrats strongly committed to an export-led growth strategy, based on private investment and an open market economy.

In addition, Callejas inherited a country that had been declared ineligible for new lending from IMF, IBRD, IDB and most bilateral and international credit sources. His administration's herculean efforts in 1990 to clear Honduras' large IFI arrears and to reestablish its creditworthiness are now a

model for other countries such as Nicaragua, Panama and Guatemala. With more LDCs falling into non-eligibility status with the IFIs, the success of this Honduran effort has implications not only for Central America, but also for other developing countries.

Because of these efforts, Callejas emerged as one of Central America's leading spokesmen for regional and international cooperation. His leadership role will directly depend on his success in continuing economic reforms and strengthening Honduran democracy. As a result, Honduras' success has implications for U.S. policy throughout the region. The failure of this country's democracy or economic reforms would represent a major blow to United States policy in Central America.

As a result, this CDSS covers a watershed period both for consolidating Honduran democracy and continuing its economic reforms. Critical milestones will be the national elections scheduled for November 1993 and the economic policies followed by the new government that assumes office in January 1994. These events not only will mark another important step forward in strengthening Honduran democracy, but most likely will be a national referendum on the economic reforms initiated by the Callejas administration. The ultimate outcome of these events will be influenced strongly by actions taken by the USG and by the entire donor community throughout this CDSS period.

In the 1980s Honduras was one of the largest recipients of U.S. economic assistance in the LAC region. This assistance was successful in helping Honduras stabilize its democracy and economy. It also promoted major improvements in the country's social conditions. Although not fully successful in achieving macroeconomic and sector policy reforms, the policy dialogue of the 1980s laid the groundwork for the historic reforms of the 1990s. At a time of declining AID resources for Central America, the challenge for the USG in the 1990s is to keep Honduras on its economic reform process, to strengthen its fragile democracy, and to promote more effective Honduran regional and international cooperation.

## II. PROBLEM ANALYSIS

### A. Economic Performance

Honduras is one of the least developed countries in Latin America and the Caribbean. The World Bank estimates its per capita income at $481 in 1990. Since 1980, gross domestic product (GDP) has been stagnant. It only increased by an average of 2.0 percent per annum in the 1980s -- below the average population growth rate of 2.9 percent in the decade. From 1980 to 1990, GDP per capita fell by 9.0 percent.

In contrast, during the two decades prior to 1980s, the Honduran economy was buoyant. Fueled by rapid industrial growth and a favorable performance in other sectors, GDP advanced by an average of 4.9 percent annually. During the 1960s and the 1970s, average annual manufacturing growth reached 6.7 percent per year. In large part, this impressive performance can be traced to the temporary benefits of import substitution -- a policy which produced some short-term gains but ultimately undermined the ability of the economy to achieve sustainable economic growth. From 1960 to 1980, agricultural growth averaged 3.7 percent per year while services grew at an average of 5.1 percent.

Despite the high growth of the 1960s and 1970s, the underlying structure of the Honduran economy was weak. Exports were dominated by traditional agricultural products, especially bananas and coffee. Although manufacturing prospered and trade with Central America flourished, this took place behind high protective barriers. Much of the industrial growth of this period can be traced to inefficient activities -- incapable of competing in international markets.

Telltale signs of what were later to became major problems were already evident by 1980. After small current account surpluses in the balance of payments in 1960 to 1962 (averaging 1.1 percent of GDP), large and growing deficits were registered in every subsequent year. The current account deficit reached an unprecedented level -- 12.7 percent of GDP -- in 1980. Foreign debt grew from $12 million in 1960 (3.6 percent of GDP) to $541

million in 1980 (21.7 percent of GDP). The public sector and the central government continued to grow. An indicator of the growth of the latter is the participation of government consumption in GDP which increased from 11.0 percent in 1960 to 13.3 percent in 1980 (a 21 percent increase).

In the 1980s Honduras' economic situation deteriorated. Regional instability provoked capital flight and discouraged investment. Economic policies which seemed to work in the 1960s and 1970s proved inappropriate to meet the challenges of the 1980s. The IFIs substantially decreased their support to Honduras. Other sources of external financing also dried up. Trade with Central America plummeted. External indebtedness increased to 80 percent of GDP in 1988. Arrearages grew. Large current account deficits in the balance of payments persisted throughout the 1980s. This deficit was 7.3 percent of GDP in 1989. Government consumption rose to 16.4 percent of GDP in 1989 (a 23 percent increase in its share of GDP since 1980).

In the second half of the 1980s, Honduras began slowly and cautiously shifting its economy away from import substitution. It began a process of developing the laws, institutions and human resources needed to implement an export-led development strategy based on greater private investment. Several private export and investment promotion organizations were established. A privatization program was initiated. Some nontraditional exports were encouraged and began to grow. Nevertheless, these efforts were not adequately supported by improved macroeconomic reforms until the Callejas administration assumed office in 1990.

Honduras' economic problems of the 1980s were exacerbated by poor economic policies. The public sector fiscal deficit remained high throughout the decade. It was 9.2 percent of GDP in 1989. Toward the late 1980s, this deficit was financed through the domestic banking system and through a massive build-up of arrears on external debt. The lempira weakened, but the monetary authorities insisted on maintaining a highly overvalued exchange rate. Nominal import tariffs and surcharges reached 125 percent of the value of imports. Price controls were widespread. The drying up of external credits at the end of the decade -- due to poor GOH economic policies -- along with

heavy deficit financing by the domestic banking system combined to pressure the exchange rate and to fuel inflation.

The Honduran economy relies heavily on agriculture. Although this sector accounts only for 24 percent of GDP, it employs well over half the workforce and supplies over 80 percent of export earnings. The latter are dominated by bananas and coffee which, together, accounted for 55 percent of Honduran exports in 1989. In recent years, Honduras has increased its exports of nontraditional agricultural products, but this growth is far below its potential. Like the rest of the economy, Honduran agricultural growth is stagnant. It only grew by an average of 1.7 percent annually in the 1980s.

Low agricultural growth is primarily a result of poor policies. Honduran agriculture suffers from a heritage of statism and paternalism. Excessive government intervention in pricing, credit, input, trade and land policies have stifled investment and production. Uncertainty concerning land tenure abounds. Fee simple titles are not granted. Land rental is prohibited. There is no formal, market-based mechanism for land transfers. State ownership of forests and the agrarian reform mechanism encourage waste and inefficiency.

The effects of poor agricultural policies are compounded by a deteriorating natural resource base, deficient infrastructure and inadequate human resources. Rural labor suffers from low literacy rates, poor health and malnutrition.

The Honduran financial system is weak, undercapitalized, inefficient, oriented toward short-term commercial transactions and lacks competition. Long-term financial instruments are lacking. Financial institutions have contributed little to domestic resource mobilization, especially in housing. Weak regulation of the banking system has resulted in underreporting of bad loans. Insider loans are common.

Domestic saving is discouraged by poor economic policies -- in particular by cumbersome administrative controls on interest rates, barriers to competition, and widespread Central Bank rediscount operations. In the 1980s a growing

share of savings was channeled toward the public sector through high reserve requirements placed in low-interest government bonds. Until 1990, income tax exemptions on government bonds and their sight redemption made them more attractive than alternative savings instruments.

The Callejas government, which assumed office in January 1990, inherited an economy in a severely deteriorated condition. The foreign exchange regime had broken down. Exporters refused to surrender hard currency at the highly overvalued officially-sanctioned exchange rates. The narrow money supply, M1, increased by more than 20 percent in late 1989 to support year-end spending by the lame duck government. External debt soared past 150 percent of GDP in 1990 -- forty times its level in 1960. Payments were curtailed. Arrearages on external debt were $746 million at the end of 1989. Honduras had been declared ineligible for lending by the IMF, World Bank, IDB and most bilateral donors.

The new government moved quickly and decisively to address the problems it inherited from the past. The Callejas Government initiated a path-breaking program of sweeping economic reforms. These were approved by the National Congress and by the Central Bank Board of Directors in March 1990. They included a comprehensive set of measures designed to liberalize the exchange rate, reduce the fiscal deficit of the public sector and overhaul the trade regime. They also included commitments to move toward the elimination of price controls, accelerate privatization, improve public sector financial accounts and to initiate other major structural reforms.

However, the GOH faltered in implementing some of its reform program. It was reluctant to follow through on initial measures to liberalize the exchange rate. A revenue shortfall coupled with excessive year-end spending resulted in a higher than expected public sector fiscal deficit. The privatization program stalled and little progress was made in improving the investment climate except in the tourist sector.

Nevertheless, the GOH made important achievements in 1990. The first devaluation of the lempira since 1918 was particularly significant. Equally

historic were trade liberalization reforms which compressed the range of customs duties from a spread of 0 to 90 percent in 1989 to 4 to 35 percent in January 1991. The range will automatically adjust to 5 to 20 percent in 1992. Most customs exonerations were eliminated and the maximum customs surcharge was reduced from 35 to 15 percent.

Other reforms included price liberalization for most agricultural inputs and products, removal of the subsidized exchange rate for basic grain imports, and a decrease in the monopoly power of the state grain marketing institute (IHMA). Moreover, the GOH sought a World Bank/IDB-supported comprehensive restructuring of the electricity and water companies (ENEE and SANAA), accompanied by sharp tariff increases. It also announced a possible privatization of the national telephone company (HONDUTEL). The GOH also removed most interest rate ceilings. It enacted legislation permitting foreign ownership of coastal lands in order to stimulate greater investment in tourism.

International donors responded favorably to the GOH reform efforts. A.I.D. disbursed $120 million in FY 1989/90 ESF cash transfer assistance. The IMF, IBRD, IDB and Japan quickly developed programs supporting the GOH reforms. The problem of arrears to the IFIs was overcome in June 1990 through a major financing package led by the U.S. Department of the Treasury. A Paris Club rescheduling provided urgently needed debt relief. In addition, a Consultative Group meeting paved the way for improved multilateral and bilateral financing.

In general, 1990 was a difficult year for the new GOH. Not only did it inherit a deteriorated economic situation, but it suffered from expected delays in donor financing and found the day-to-day management of the economy excruciating. Despite the approval of an IMF Stand-by and disbursement of SAL I and SAL II funds along with cofinancing, GOH resource flows from the IFIs were negative. Payments of arrears and debt service by the GOH to the World Bank exceeded disbursements in 1990 by an amount equivalent to more than 3 percent of Honduran GDP.

In addition, GDP declined by about one percent in 1990, implying a per capita

decrease of 3.6 percent. This was the result of adjustment to the reforms, hesitancy in implementing follow up measures, a protracted banana strike, petroleum price shocks, and major flood damage at the end of 1990.

Moreover, inflation was an especially troublesome problem in 1990. It threatens to further destabilize the economy in 1991. After a surge in the money supply in late 1989, the new GOH experienced difficulties in soaking up the excessive liquidity driving inflation. These inflationary pressures were exacerbated by weak monetary policy and supply side pressures, requiring long overdue increments in the prices of public services and petroleum. As a result inflation was 35.2 percent during 1990. These price increases shocked the people of a nation which rarely experienced double digit inflation.

B. The Private Sector

Honduras has had one of the weakest and least developed private sectors in Latin America. It has operated within a classic mercantilist system that has just recently begun to evolve toward a more open and transparent market economy. Much of the private sector has traditionally been inefficient and inward-looking. This has limited its ability to compete in regional and international markets.

The Honduran private sector is dominated by a few closely held commercial, industrial and banking groups. First and second generation immigrants, multinational corporations, and former military leaders constitute a major part of these groups. Some fear competition from new foreign investors, small and medium-size businesses, and the informal sector. In the past they have avoided risks, shunned long-term investments, and engaged in actions to restrain competition.

While efforts are being made to improve the country's investment climate, more actions are still needed. Foreign and domestic investment has been discouraged by inappropriate macroeconomic and sector policies, complicated laws and regulations, and a weak judicial system. The Constitution requires that foreign investment be "complementary" and not competitive with national investment.

These characteristics were shaped by the Honduran business and political environment. They were promoted by a small internal market, decades of high protective tariffs, an overvalued exchange rate, price controls, subsidies and an onerous system of regulations and controls. To succeed in Honduras, national and foreign businesses often have had to maintain close connections with government and military leaders.

Nevertheless, in recent years, dramatic changes have been occurring as significant segments of the private sector have begun to shift to an export orientation and to adapt to a more open economy. Many of these changes have been promoted by AID-supported policy reforms and private sector programs. New foreign investors are entering the country, especially in the San Pedro Sula area. Small and medium-size businesses are rapidly growing. Each month one hears of another Honduran company that is beginning to export and of new investment plans being formulated. These forces, if continued and reinforced, can lead in the 1990s to a more productive and competitive market economy.

To accelerate this transformation, specific constraints need to be overcome. For example, the private sector's ability to respond to new development opportunities has been limited by a shortage of investment capital. Throughout the 1980s high GOH fiscal deficits squeezed out credit to the private sector. An overvalued exchange rate stimulated capital flight. There has been a severe shortage of long-term credit and equity financing accentuated by the bankruptcy of both the AID-supported Financiera Hondureña and the National Development Corporation (CONADI) in the early 1980s. GOH policies and oligopoly arrangements in the banking system have greatly reduced the financial sector's ability to mobilize savings and to channel them to productive investments.

Private investment in Honduras' largest and most important sector -- agriculture -- has been limited by inadequate policies and price controls that have consistently decapitalized this sector. Insecure land tenure, constant fear of invasions and legal restrictions on the sale, purchase and rental of land have created serious obstacles to increasing private investment in agriculture.

Until recently, in the vital forestry sector, the GOH through its Forestry Development Corporation (COHDEFOR) reserved to the public sector major forest production, marketing and export opportunities. Moreover, there has been a reluctance to modernize Honduras' antiquated mining and petroleum legislation to permit greater private exploration and to facilitate new investments in highly productive areas like shrimp farming, tourism and banking.

Private sector responses to improved policies are also limited by serious human resource, institutional and technological constraints. Honduras has a large pool of low cost labor, but its productivity is low. Small elite groups of organized labor -- the most powerful in Central America -- have institutionalized restrictive labor laws that make it difficult and costly to treat labor as a variable cost. There is also a lack of managerial and entrepreneurial talent with experience dealing in international markets and working with foreign investors.

There is a multiplicity of weak and fragmented private sector organizations. They have difficulties working together and articulating a coherent view of policies and actions needed to promote trade and investment. This is compounded by a deep-seated distrust of free market forces and by strong statist orientations in both the public and private sectors. Until the mid-1980s, there had been no mechanisms for promoting and diversifying Honduran exports and for facilitating new private investment. Likewise, while the agricultural sector offered many new production and export possibilities, there were no effective instruments for disseminating the technologies and information needed to take advantage of these opportunities.

## C. The Disadvantaged

Notwithstanding poor economic performance in the decade of the 1980s, Honduras made significant social sector gains. These were fostered by a consistent policy of reinforcing primary education and primary health services. From 1980 to 1990 infant mortality dropped from 80 to 59 per thousand while life expectancy increased from 58 to 65 years. There was a dramatic increase to 60 percent of those dwellings having access to water and sanitation services.

Contraceptive prevalence increased from 26 percent of couples in union in 1980 to about 46 percent in 1990. The annual average population growth rate declined from more than 3.2 percent in 1980 to 2.8 percent in the late 1980s. At the same time, the literacy rate increased from 55 to 60 percent. Now over 90 percent of Honduran children currently are attending primary school.

Nevertheless, a large proportion of the population suffers from poverty, especially families of landless laborers and small-scale farmers. About 36 percent of Honduran households receive less than 50 dollars in monthly wage earnings and 62 percent receive less than 100 dollars. According to a 1990 UNDP Human Development Report, 55 percent of the rural population and 35 percent of urban population are poverty stricken. This represents approximately 47 percent of the total population or 2.2 million Hondurans.

The economic reforms of 1990-91 have caused great social and political discontent throughout Honduran society. As a result, there has been intense pressure on the GOH to backslide on its reforms. The inflation rate accelerated to one of its highest levels in Honduran history. Nominal wages and salaries lagged behind inflation. There has been a marked deterioration in living standards, especially among the urban middle class -- a politically volatile group. GOH efforts to reduce the real level of public expenditures, decrease government employment and tighten monetary expansion have further deepened an already serious unemployment and underemployment problem.

The effects of the reforms are particularly troublesome in a country with such widespread poverty and fragile social, political and economic structures. Despite the impressive social gains of the 1980s, Honduras still has some of the worst infant mortality and nutrition conditions in the Western Hemisphere. Reductions in the GOH fiscal deficit could easily reverse the country's progress in primary education and primary health care. This is of particular concern because in recent years Honduras has dedicated almost 30 percent of its national budget to the health and education sectors.

## D. The Environment

Honduras is one of the most geographically and biologically diverse countries

in Central America. However, exploitation of the country's extensive forests and other natural resources has been conducted with little or no consideration for sustainability. Many areas have suffered devastating environmental degradation in terms of deforestation, soil erosion, siltation, fertility loss, watershed destruction and pollution.

For example, most of southern Honduras, known little more than a generation ago as a granary of Central America, has experienced widespread deterioration in its resource base. In the past quarter-century, Honduras lost half of its four million hectares of broadleaf forest and the volume of commercial pine timber was reduced by over 40 percent. Due to deforestation on steep and fragile soils, the total area dedicated to agriculture and pastures exceeds by almost 50 percent the land area suited for such production.

In most Honduran cities, raw industrial and residential waste commonly are deposited in rivers. Inadequate sanitation facilities and widespread water pollution are major threats to health conditions throughout the country. Rapid deforestation around Tegucigalpa appears to have produced climatic changes and lower rainfall. Recently attempts were made to utilize remote areas as dumping grounds for toxic wastes from industrialized countries. Pesticide contamination has caused shipments of Honduran meats and produce to be turned back from U.S. markets, a serious threat to export development.

The public sector has not promoted sound development of natural resources. Its ownership of forests contributes to poor management practices. Moreover, the Agrarian Reform Law encourages deforestation and pushes farmers onto fragile hillsides. GOH agencies dealing with natural resources are weak, inefficient and overcentralized. Municipal governments have not had the resources and institutional-technical capacity to deal with local sanitation and pollution problems. All of these factors are exacerbated by an inadequate framework of environmental policies, serious GOH budgetary problems, and lack of private sector concern for improved natural resource management.

## E. Democratic Institutions

Honduras is a pioneer in the hemispheric democratic revolution of the 1980s.

In November 1989, it held its third consecutive free and fair general election for the presidency as well as for legislative and local officials. This marked the first peaceful transition to power by an opposition party in Honduras.

Nevertheless, Honduran democracy is still fragile. It is attempting to make a historic transition from a political system based on personalism, authoritarianism and centralization to one based on more modern forms of democratic participation and decentralization. Yet Honduras' political culture continues to be defined by its authoritarian history and by the dominance of a few special interests. There is a strong tradition of military control and influence over the government. National interests are not always pursued objectively.

After a century and a half of intermittent political and military conflict and regional disputes, the emergence of Honduras as a true nation state is relatively recent. The evolution of universal suffrage; indigenous commercial, financial and industrial sectors; a free labor movement; a government civil service; a court system; a modern armed forces and other basic institutions came about only after World War II. Their development is still incomplete.

The fragility of Honduran democracy is directly related to its history and political culture and to weaknesses in basic democratic institutions. In addition to the Executive, these include: the National Electoral Tribunal (TNE); the National Congress; the Judicial Sector headed by the Supreme Court; municipal governments; two major and two minor political parties; communications media; and hundreds of weak private voluntary organizations, labor unions, cooperatives, and other community and private associations.

The National Electoral Tribunal (TNE) is an autonomous organization created to regulate and implement all procedures related to elections. The TNE, whose members are from each political party, has played a critical role in Honduran elections since its inception in 1978. Its principal functions are registering political parties and candidates, coordinating and supervising

elections, and administering the National Registry of Persons. The latter registers voters and prepares the national civil and electoral census.

Because of party fluidity and personal political ambitions of party leaders, the TNE is a major arena of partisan political conflict. Since party representatives are under constant pressure first to represent the immediate needs of their parties, consensus in TNE decision-making is fragile and subject to intense consultation and compromise. It could easily disrupt national elections. This almost occurred in 1989. The contribution of the TNE to Honduran democracy is further weakened by an outdated civil registry, inefficient administrative services, lack of professionalism and continuity of staff, inadequate equipment and facilities, cumbersome information processing, and poor documentation capability. In the 1980s the TNE was unable to conduct national elections without foreign technical and financial assistance.

The Honduran Congress traditionally has been dominated by the President of the country. Legislative processes are weak, unprofessional and non-transparent. In the 1980s, however, the unicameral Congress became more assertive and began assuming greater initiative in addressing key policy issues. Much more progress is needed in strengthening the Congress.

In particular, Congressional standing committees lack the expertise to staff out issues and prepare legislation. There is little capacity to sustain Congressional debate on major issues. Research and information services are lacking. Administrative and support systems are not staffed with experienced and qualified personnel. The Congress' Comptroller General does not have the technical capacity and trained personnel to do independent audits and reviews of government programs. This is compounded by the lack of a legal and regulatory basis clearly establishing the responsibilities and accountability of public entities and officials.

The Supreme Court is named by the Congress based on the recommendations of the President. It has primary administrative responsibilities over the entire judicial system, including appointment of lower court judges. The four levels

of the Court System (Supreme Court, Appellate Courts, Tribunals of First Instance and Justice of the Peace) require the appointment of about 400 judges every four years. Appointments based on political patronage impede a fair administration of the law and facilitate corrupt practices.

The judicial system does not play a strong independent role in promoting democracy. It suffers from multiple problems. These include underfunding, a high turnover of politically appointed judges and staff, untrained personnel at all levels, a weak administrative system, outdated legal codes, limited systematic planning and a negative public image. Distrust and lack of cooperation among the courts, the police and the Attorney General are also major problems. Weaknesses in the judicial system affect all areas of Honduras' economy and society and threaten to undermine the credibility of its democratic system.

Improvements in the investment climate are closely linked to a better judicial system. Investors are concerned that contract rights will not be respected. They fear disputes will not be settled expeditiously and objectively.

Local governments are some of the weakest elements in the Honduran democratic system. Strengthening their institutional, technical, managerial and financial base is a prerequisite both for consolidating a stronger democracy and for achieving vital development objectives.

Over the decades local governments have been shackled by an anachronistic conception of the municipality as an inherently weak organization needing control from above by a paternalistic national government. They were further weakened by progressively centralizing more responsibilities in ponderous and inefficient central government agencies, increasingly overwhelmed by the problems of rapid urban growth and unresponsive to local needs. This was made worse by fragmenting local government into 290 separate municipalities -- at least two hundred of which are too small to become viable financial and service organizations -- and by severely restricting their taxing and spending authorities. Furthermore, existing law requires mayors to be elected as part

of a national slate which emphasizes the presidential candidate. This further dilutes local control and accountability of municipal officials.

Nevertheless, a landmark Municipal Reform Law was enacted in late 1990 to address many of these deficiencies. It devolves substantial authorities to municipalities. In addition, it commits the country to provide a much improved legal framework for decentralization and for municipal attention to public services and environmental concerns. The law gives municipalities greater financial autonomy, increased taxing authority, ownership of public lands and control of natural resources (see 90 Tegucigalpa 020484 for further details). A new Electoral Reform Law is under consideration that will provide for independent elections of municipal officials.

The full implementation of the changes sought under this new municipal legislation will not come easily and may take years to be fully realized. However, it represents a giant step forward in the decentralization of decision-making and greater local participation and control over resources. As such, this legislation and the attitudinal and policy changes it implies provide a unique opportunity to strengthen a key component of Honduran democracy.

Other fundamental democratic units such as political parties, labor unions, campesino groups, cooperatives and private sector organizations also suffer from institutional and management weaknesses. Honduras has one of Central America's most highly developed system of labor and campesino unions. Nevertheless, the leadership of these groups too often pursues only narrow self-interests and is oblivious to broader national interests.

Democratic pluralism is further weakened by the extreme fragmentation of private groupings, their inability to achieve financial self-sufficiency, and the failure to hold leaders accountable for their official actions. Likewise, while Honduras has one of the most aggressive, uninhibited and unfettered free presses and other communications media, they do not always operate in a responsible and non-partisan manner.

Although Honduras does not have a history of systematic violation of human rights, individual abuses have occurred. These generally can be traced to inadequate training and supervision of lower level police officers. Many do not understand the rights of citizens and rules of evidence. The separate legal system for the military and the police (who are part of the military) has prevented civil authorities from routinely pursuing abuses. Nevertheless, the GOH's persistent emphasis on the importance of democracy and constitutional procedures indicate that there are good prospects for continued improvement of Honduras' human rights record.

Despite problems, the prospects for strengthening Honduran democracy in the 1990s are encouraging. The successful elections of the 1980s, recent interest in improving judicial and congressional performance, the Municipal Reform Law and possible enactment of a new electoral reform law offer a firm basis for further deepening the country's democracy.

## F. Regional and International Cooperation

In principle, Honduras supports Central American regional integration and cooperation. However, this commitment stops short of opening domestic markets to regional competition. Likewise, there is great reluctance to provide financial contributions to regional institutions outside Honduras.

In the 1970s Honduras virtually dropped out of the regional integration process. This coincided with large inflows of cheap goods from El Salvador, Guatemala and Costa Rica. Honduran businesses could not compete efficiently with other regional producers for Central American markets. To compensate for their lack of competitiveness, they sought tariff protection, subsidies and special incentives to invest and produce. This made it virtually impossible for Honduras to join the GATT.

As Central America became embroiled in economic and political crisis in the 1980s, Honduran trade with the rest of the Region declined further. This frustrated Honduras because in the mid-1980s it completed a major energy project, El Cajón Dam, with anticipated sales to the rest of Central America.

Honduras was left with excess capacity, a large external debt and an unrealized hope of participating in regional trade in an area where it had a comparative advantage. Regional cooperation declined along with regional trade during the 1980s.

Regional institutions declined too. Yet Honduras has supported -- rhetorically more than financially -- a few institutions offering benefits to Honduras. These include the Central American Bank for Economic Integration (CABEI) which is located in Tegucigalpa and largely staffed by Hondurans. Honduras has been one of CABEI's primary beneficiaries. Nevertheless, GOH arrearages to CABEI pose a major threat to its solvency. Honduras supports the Pan-American Agricultural School at Zamorano and the National Forestry School (ESNACIFOR). These are located in Honduras and have excellent training programs serving the region.

However, there is less Honduran willingness to support regional institutions located in other countries. For example, CATIE and the EARTH School are seen as largely Costa Rican institutions with little impact in Honduras. Although the Central American Business Administration Institute (INCAE) enjoys widespread support in Honduras, there is a reluctance to make regular contributions to the school. There is a similar pattern with other regional institutions such as SIECA and INCAP.

In addition, Honduras has had difficulty negotiating with the IMF, IBRD, IDB and other international financial institutions. Some prominent Hondurans blame the World Bank and IDB for financing poorly conceived projects, such as the large state-owned CORFINO sawmill, that have produced few benefits while miring the economy in major indebtedness. Until recently, Honduras never participated in Paris Club or Consultative Group meetings. Throughout the 1980s the country had difficulties mobilizing significant development resources from any other donor except the United States. In the 1990s, Honduras will need help to participate fully in new initiatives like EAI and to use more effectively regional and international cooperation.

# III. USAID STRATEGY

## A. Overview

USAID Honduras' goals over this CDSS period coincide with those specified in the United States Economic Assistance Strategy for Central America, 1991-2000. Our strategy will promote broad-based sustainable economic growth, support the evolution of a stable democratic society, and encourage more effective Honduran regional and international cooperation. This USAID Program will also be an essential instrument for facilitating Honduran participation in the Enterprise for the Americas Initiative (EAI), the Partnership for Democracy and Development (PDD) and the Caribbean Basin Initiative (CBI).

This strategy also supports Honduran development objectives specified in the Callejas Administration's Plan de Gobierno and the economic reform process initiated by the GOH in 1990 with international donor support. The key elements of this Plan call for increasing economic growth by restructuring and liberalizing the Honduran economy, reducing the size of the public sector, accelerating and expanding privatization, promoting exports and private investment, and placing greater emphasis on market mechanisms and price incentives rather than state intervention and price controls.

The GOH Plan also proposes employment generation programs, greater efforts to develop the agricultural and forestry sectors, and more effective measures to address the country's serious social, nutrition and environmental problems. Actions to strengthen and modernize the administration of justice, municipal governments and other democratic institutions are also recommended as well as greater Honduran participation in regional and international cooperation mechanisms.

The thrust of this Plan closely parallels the policies outlined in the Economic Assistance Strategy for Central America and in other USG initiatives such as EAI, PDD and CBI. The proposed USAID strategy will help Honduras implement the basic reforms proposed in the Plan de Gobierno during Callejas' final two years in office (1992-93). It will further consolidate Honduran

democracy through the successful completion of the November 1993 national elections. It then will provide support enabling the new government (that will assume office in January 1994) to further deepen policy improvements initiated in the 1990-93 period. Thus, this CDSS covers a watershed period both for consolidating Honduran democracy as well as for deepening the fundamental economic reform process needed for broad-based sustainable growth.

## B. Goals and Objectives

USAID's goals and strategic objectives for the CDSS period are presented below. The indicators that will be used to measure their achievement are outlined in Annex 4.

In the 1990s Honduras cannot achieve its major economic, social and political development goals without higher economic growth. High growth is inextricably linked to reduction of the country's widespread poverty, improvements of its social services, preservation of the environment and strengthening its democratic institutions. Indeed, continued economic stagnation would push even more Hondurans into poverty, worsen environmental deterioration, and impede regional and international cooperation. This could reverse the democratic and social sector gains of the 1980s. For these reasons, the fundamental and overriding goal of the USAID strategy is to support Honduran efforts to achieve broad-based sustainable economic growth.

The scenarios presented in Annex 3 indicate that it is feasible to increase the country's economic growth. To achieve this goal, Honduras must make substantial improvements in its economic policies, promote higher agricultural growth, significantly expand private investment and exports, and mobilize additional donor resources through more effective international cooperation. The interrelationships between economic variables are explained in Annex 3.

The needs of the disadvantaged must be better addressed to make economic growth "broad-based". This means not only generating more employment and incomes, but also expanding the coverage and impact of basic social services. To make economic and social gains sustainable, environmental policies and

programs must be improved. Efforts must be continued to strengthen Honduran democratic institutions and promote a more pluralistic Honduran society.

USAID has set six strategic objectives for the CDSS period. These objectives are closely interrelated and mutually reinforcing as follows:

1. Improve Sector Policies in Agriculture, Trade and Investment, and Finance: USAID will support sector policy reforms that increase the growth of agricultural GDP, exports and private investment. Domestic savings will be increased and more efficiently channeled to productive investments.

2. Increase Private Investment and Trade: USAID will encourage a vigorous response by the private sector to a more favorable policy environment. This will be achieved by assisting private sector organizations overcome institutional, financial, technological and human resource constraints that are impeding higher levels of investment and exports.

3. Facilitate Implementation of Social Sector Policies: Actions will be supported that decrease infant mortality and malnutrition, increase contraceptive prevalence, and expand vaccination, water supply and sanitation coverage. The average number of years required to complete primary school will be decreased, thereby increasing the primary school completion rate. Additional employment opportunities will be generated and access to shelter and basic urban services will be expanded.

4. Improve Environmental Policies and Natural Resource Conservation: Support will be provided to improve environmental policies. Programs will be assisted that better protect Honduras' vital forest, soil, water and other natural resources.

5. Strengthen Democratic Institutions and Promote a More Pluralistic Honduran Society: USAID will continue its efforts to strengthen Honduran democratic institutions with primary emphasis directed to the National Electoral Tribunal, the National Congress, the Judiciary and Municipal Governments. Pluralism will be encouraged by developing democratic leadership,

strengthening private organizations and facilitating greater citizen participation in democratic processes.

6. Promote Effective Honduran Regional and International Cooperation: Actions will be supported to encourage Honduras to better coordinate and harmonize its economic policies with those of other Central American countries and with international initiatives for the region. Higher levels of economic growth will require increased international cooperation from the IFIs and bilateral donors.

## C. Strategy

### 1. Broad-Based Sustainable Economic Growth

USAID's strategy for helping Honduras achieve broad-based sustainable economic growth is presented below. It will be implemented by: encouraging GOH adoption and adherence to sounder economic growth policies, promoting a more vigorous private sector response to policy reforms, accelerating opportunities for increased participation of the historically disadvantaged, and encouraging the preservation and sustainable use of Honduras' natural resources.

#### a. Policies for Economic Growth

USAID's first strategic objective is to improve sector policies in agriculture, trade and investment, and finance.

Inadequate macroeconomic and sectoral policies were major causes for Honduras' poor economic performance in the 1980s. The only way for Honduras to achieve large increases in GDP growth in the 1990s is to continue to deepen those macroeconomic reforms initiated in 1990-91 and, at the same time, to accelerate structural changes in key sectors of the economy.

As further discussed in Annex 3, USAID believes that it is feasible for Honduras to increase its GDP growth rate to 3.8 percent in 1993 and to 5.3 percent in 1996. To achieve these targets the GOH must implement stronger

stabilization measures and deepen sector policy reforms. Because of the country's large debt overhang, especially to the IFIs, Honduras must also continue to receive positive net flows from the IMF, World Bank, IDB and bilateral donors. The urgency of increased donor flows is underscored by the large financing gaps discussed in Annex 3.

As a result, Honduras' major requirements will be for fast-disbursing policy-based balance of payments and sector assistance. A large number of interrelated reforms must be implemented. These include stabilization measures, fiscal reforms, public enterprise improvements, and structural changes in energy, agriculture, finance, and trade and investment. In the 1990s, no one donor will have sufficient resources to support simultaneously all of the needed policy changes. Thus, a multi-donor approach must be followed with a division of labor among donor agencies.

In the 1980s USAID attempted to support GOH reforms in many areas because we were the only active donor in Honduras with a large balance of payments program. In the 1990s, the IFIs are returning to their traditional lead role. Honduras will probably receive lower levels of ESF than in the 1980s. As a result, USAID has consolidated and narrowed the scope of its policy reform agenda for this CDSS period. We will support selected policy reforms only in three areas that:

- -- increase agricultural production and exports;
- -- promote increased private investment and trade; and
- -- strengthen the ability of the financial system to mobilize domestic resources and channel them efficiently to the most productive sectors of the economy.

Even within these three areas, USAID will further narrow its policy agenda by only supporting a few key reforms and by implementing them whenever possible within a multi-donor sector approach. This will further leverage our resources and allow USAID to concentrate on those most critical policy and structural changes that cannot adequately be addressed by other donors. This approach, however, will continue to require aggressive USG actions (through

PDD and Consultative Group mechanisms) to help Honduras mobilize increased donor assistance to support complementary stabilization and sector reforms.

In 1990-91 USAID was successful in helping the GOH develop economic reform programs that merited support from the IFIs and bilateral donors. These represented landmark achievements in weaning Honduras from its unhealthy dependence on ESF cash transfers that had developed in the 1980s. USAID will continue to encourage the IMF and World Bank to assume the leadership role in supporting GOH stabilization measures. We also will encourage the World Bank and IDB to continue their policy-based support for the energy sector and for reforming and scaling down Honduran public enterprises. We will urge the World Bank to exercise even more leadership in helping Honduras increase overall donor flows that further reinforce GOH stabilization and sector reforms.

This USAID shift to a sector-based structural reform program assumes that the GOH maintains and deepens stabilization policies that merit ongoing support from IMF and World Bank. To the contrary, it would be difficult to achieve the full benefits from sector reforms. Past experience indicates that the Honduran reform process may not be as smooth as USAID and other donors would prefer. It, therefore, may prove necessary to incorporate some macroeconomic stabilization objectives into our sector program as was done in FY-90 and FY-91. However, USAID's goal during 1992-96 is to move to a policy-based sector approach while leaving stabilization objectives to IMF and World Bank.

In developing its strategy, USAID searched for a scenario which could lead to strong and sustained GDP growth through 1996 and beyond. Our analyses concluded that agriculture is the one sector which can most bolster economic growth in the 1992-96 period. It requires less investment and imported inputs (a severe constraint on the Honduran economy) than other major sectors. It also can respond quickly to improved policies. As described earlier, agricultural policy weaknesses are a severe impediment to better performance of the entire economy. Improved agricultural policies offer the best opportunities for significantly increasing growth, exports, employment and

income and nutrition throughout the economy.

Our target is to increase the agricultural sector growth rate to 4.9 percent in 1993 and to 7.5 percent in 1996. This will be achieved by supporting a few key sector reforms to improve land security and land markets, price and trade policies, and promote greater access to credit, inputs and technology. The specific policies to be supported are outlined in Annex 2. These are based on the Mission's Agricultural Sector Strategy approved in 1990 in State 164131.

The World Bank and the IDB also are developing policy-based agricultural sector reform programs for implementation during this CDSS period. There already has been extensive donor coordination and discussions on these programs. Tentative agreements have been reached on how best to approach the sector reform program and focus our conditionality in a mutually reinforcing manner. Given the number and complexity of the constraints limiting agricultural sector growth -- and the importance of addressing them as quickly as possible -- USAID believes that a multi-donor effort is particularly appropriate. This is the model for the approach the Mission expects to follow in other sectors.

Although agricultural sector reforms are necessary, they alone are not sufficient to attain higher economic growth rates. Additional closely related reforms also are needed in the trade, investment and financial areas. Policy improvements in these sectors are vitally needed to spur investment and efficiency in all of Honduras' productive activities. Therefore, USAID's strategy will support further GOH actions to liberalize its trade regime; to improve the country's investment climate by adopting a better investment code and legal, regulatory and judicial reforms; to accelerate privatization of state-owned enterprises and to adopt key financial sector reforms.

The Mission is completing a Financial Sector Assessment that should provide the analytic base for a multi-donor reform effort similar to the one being used in agriculture. Both World Bank and IDB have expressed interest in supporting reforms in this important sector, although some IDB officials seem to be defining their participation as providing Honduras with more directed

lines of credit. (Annex 5 contains USAID's strategy for dealing with directed lines of credit.) Given the importance of deep reforms in this sector to generate far higher levels of domestic savings and to improve the allocation of financial reources, USAID will continue its leadership and encourage the World Bank and the IDB to follow through on their interest in supporting a financial sector program.

Implementation of the policy reforms outlined above will be supported through the development of one multi-year Structural Adjustment Program (SAP) to be initiated in FY-1992. It will support a series of sharply focused but interrelated reforms in the three sectors described above. This Program will be supported by ESF Cash Transfers and PL-480 Title III resources. Ongoing and new Mission projects (e.g., Policy Analysis and Implementation, Small Farmer Organization Strengthening, Investment and Export Development, Privatization II) will provide complementary resources to help the GOH translate its reforms into action. These will facilitate a vigorous private sector response to the liberalization of the Honduran economy.

In addition, given the overwhelming debt burden confronting Honduras during this CDSS period, a final critical action for achieving higher economic growth must involve debt relief and reduction. As a result, USAID will continue to support GOH efforts seeking debt relief and ample grant and concessionary financing from the USG and other donors. We will encourage continued Paris Club debt reschedulings and Consultative Group assistance. Moreover, we will urge the GOH to take full advantage of debt relief provisions of the EAI, the FY 1990 Food Aid Legislation and the Foreign Assistance Act (providing reductions for countries meeting relatively least developed country status). The moderate scenario in Annex 3 projects that the burden of external debt will decline during this period and that Honduras will progress toward creditworthiness.

b. Private Sector Response

USAID's second strategic objective is to increase private investment and trade.

Honduras through its private sector has ample potential to improve its economic performance. It has underutilized agricultural and industrial resources which could greatly increase their contribution to the country's production as economic policies are improved. With close proximity to United States, Mexican and Caribbean Basin markets, Honduras is well positioned geographically to take full advantage of the trade and investment incentives contained in EAI and CBI.

The country has a large pool of low cost labor and some of the most extensive forest and agricultural resources in Central America. Key investments were made in the El Cajón Dam, in modern telecommunications, in an extensive road network, and in Puerto Cortés -- the largest, most modern port facility on Central America's Caribbean coast. These investments provide some of the basic infrastructure needed to increase private investment and trade.

There also are bright prospects for increasing Honduras' traditional banana exports, especially to Europe. Foreign exchange earnings are being increased by improving the quality of Honduras' coffee exports. Shrimp farming has a large yet relatively untapped potential for growth. There are growing opportunities in other nontraditional export areas such as melons, cacao, textiles, wood and furniture products, ornamental plants, and fruits and vegetables.

Honduras also offers other investment opportunities. Five privately financed Export Processing Zones (EPZs) are currently under construction. They are attracting major new foreign investors. As many as 100 EPZ factory shells are likely to be in operation by 1996. Recent GOH legal changes should help stimulate greater investment in Honduras' infant tourist sector. Moreover, the country may have off-shore petroleum deposits. Additional investment opportunities may exist in Honduras' small mining sector.

To facilitate a more vigorous private sector response to these opportunities, USAID will continue supporting GOH implementation of the macroeconomic and sector reforms needed to improve the country's overall investment climate. Our target is to increase gross private investment to 15.6 percent of GDP by

private sector to take fuller advantage of investment opportunities and the country's comparative advantages. Funding for these organizations will be provided through already approved and ongoing projects.

Private organizations such as FIDE, FPX and FHIA are key to achieving the private investment and export targets outlined in Annex 4. USAID's Privatization II Project will produce additional investment by completing the divestiture of most remaining state-owned enterprises under the control of GOH holding companies. Export-oriented agribusiness cooperatives and the International Executive Service Corps will also receive USAID support.

Through the ongoing Policy Analysis and Implementation Project, USAID will continue to assist the Honduran Confederation of Private Sector Organizations (COHEP) as an instrument for promoting GOH economic reforms, modernizing the private sector and accelerating Honduras' transition to a more open and transparent market economy. COHEP was highly effective in using international advisors in 1989-90 to formulate the economic liberalization program that was ultimately adopted and implemented by the Callejas administration.

Likewise, we will assist the Honduran Banker's Association (AHIBA) and Credit Union Federation (FACACH) adjust to liberalization measures, improve financial intermediation capacity and lobby for further financial sector reforms. Additional actions will be supported to develop and deepen Honduran capital markets and to strengthen incentives for attracting and efficiently allocating financial resources in both the formal and informal sectors.

USAID will continue its highly successful small business development program throughout this CDSS period. It is one of the most cost effective means of expanding productive employment. Equally important, it increases the numbers of entrepreneurs and creates a larger pool of potential businesses that can grow and compete with some of Honduras' larger companies. This program -- plus our efforts to facilitate greater flows of foreign private investment -- are key instruments for promoting a more competitive Honduran economy. It will produce a more pluralistic and open private sector that can better respond to the investment opportunities of the 1990s.

1996 and to increase export growth by an average annual rate of 7.2 percent over the CDSS period.

While policy reforms are necessary to achieve these targets, they alone are not sufficient. There also are institutional, technological and human resource constraints impeding higher levels of investment and exports. These must be overcome to achieve a more modern and competitive free-enterprise economy. As a result, USAID will continue to support a limited number of private organizations that address these constraints. This will facilite the country's transition to an export-led private investment strategy based on transparent market mechanisms.

In the 1980s USAID supported a wide array of NGOs and PVOs. During the past four years the Mission phased out or terminated funding to many of these organizations as part of our ongoing program consolidation effort. This will continue during the CDSS period. We will concentrate our funding on fewer NGOs/PVOs than we did in the 1980s. We will only support groups with a proven track record of achieving specific investment, export and policy reform objectives.

As such, USAID will continue to support the Foundation for Investment and Export Development (FIDE) through an already approved project. FIDE has been a leader in promoting foreign investment and lobbying for legislative and other changes that promote exports. It is also a vital support mechanism for Honduras' Export Processing Zones (EPZs) and for improving the country's overall investment climate. Honduras cannot achieve an increase in foreign investment and exports -- nor actively participate in EAI or CBI -- without an entity like FIDE.

Likewise, USAID will continue to support the Federation of Agricultural Exporters and Producers (FPX) together with the Honduran Foundation for Agricultural Research (FHIA). These private organizations, established in the 1980s with USAID assistance, have now developed into highly effective tools for promoting investment in the agricultural sector. They open markets for Honduran nontraditional exports and generate new technologies that allow the

c. Increased Well-Being of the Disadvantaged

USAID's third strategic objective is to facilitate implementation of social sector policies that improve the well-being of the historically disadvantaged.

The major problems of the disadvantaged are high fertility, high infant mortality, malnutrition, poor health, lack of jobs and education, and inadequate access to basic services (e.g., water, sanitation) and shelter. These problems are compounded by an over-centralization of government services in Tegucigalpa and San Pedro Sula while the most severe poverty problems are in rural areas and smaller towns. Poverty is made even worse by the poor utilization of social sector resources and by the economic adjustment process that the GOH must implement throughout this CDSS period. These could limit further social gains in the 1990s and even reverse some of the gains of the 1980s.

It is vital to continue the process of improving the lives of those Hondurans who have been disfranchised from the economic system and those adversely affected by economic reforms. Not only is this needed to make economic growth broad-based, but also to encourage acceptance of macroeconomic and sector reforms and to strengthen the commitment to a democratic system. If this acceptance is not achieved, GOH economic reforms could be repudiated in the 1993 national elections. Inadequate social gains could also undermine Honduras' fragile democracy.

Over the past decade Honduras has been strongly committed to addressing the problems of its poorest citizens. However, full implementation of this policy has been impeded by institutional, financial, technological and human resource constraints that have limited greater coverage of social services. Ongoing USAID projects will help Honduras overcome these constraints and thereby continue its progress in improving the country's social conditions.

USAID's strategy focuses on key constraints preventing families from improving their well-being and taking advantage of enhanced economic opportunities. This stresses expanding contraceptive coverage, primary health care and water

and sanitation coverage. It will also improve nutrition, basic education and housing and generate more employment opportunities.

Our strategy will continue to emphasize policy dialogue to improve resource allocations within the social sectors. We will promote efficiency of delivery systems thereby reaching more beneficiaries with fewer resources. This also calls for greater decentralization and more community responsibility for controlling, supervising and financing service delivery. Community participation will be emphasized at all levels of program implementation.

USAID will move away from supporting the construction of health and education infrastructure, leaving this to other donors. Likewise, we will urge other donors to assume the lead role that USAID played in the 1980s in basic health and education. Throughout this CDSS period, USAID will gradually narrow the focus of its social sector program by only initiating new projects to fill gaps not addressed by other donors. We expect these gaps to be in family planning, nutrition, vocational education and shelter.

As a result, USAID will continue its ongoing and highly successful Population II Project that is implemented through Honduras' largest provider of family planning services (ASHONPLAFA) and through other PVOs. We will continue to seek even more cost-effective ways of expanding family planning services and developing the financial self-sufficiency of PVO delivery systems. This effort is critical not only for achieving our CDSS target of increasing contraceptive prevalence to 52 percent of couples in union by 1996 but also for increasing per capita income.

To reduce high infant mortality, USAID will complete its ongoing Health Sector II Project. This supports primary care through the expansion of child survival technologies such as oral rehydration salts, vaccinations, health education, family planning, growth monitoring and better access to potable water and sanitation. It helps the GOH translate into action its strong policy of expanding primary care, decentralizing services and making the health sector more cost-effective and financially self-sufficient.

As part of USAID's efforts to encourage other donors to assume a lead role in primary health, the planned Health Sector III Project scheduled to be implemented near the end of this CDSS period will not be undertaken. Instead, we will work with the GOH to present this project to another donor. We will concentrate USAID activities on a more narrowly focused and less costly nutrition improvement strategy that emphasizes diagnosis, education, income enhancement, and targeted food aid using a larger PL-480 Title II program.

The Health Sector II Project is also playing a major role in expanding the coverage of water and sanitation in rural areas with extremely low coverage. Ongoing Housing Guaranty, Municipal Development and employment generation activities are expanding the coverage of water and sanitation systems in secondary cities and smaller towns. Our Municipal Development Project is supporting GOH policies of cost recovery and decentralization of responsibilities for maintaining and expanding potable water and sanitation facilities. By the end of this CDSS period, at least 70 percent of Honduran dwellings should have access to potable water and sanitation services provided largely through municipal governments and local community water boards.

Improved access to low cost shelter for the disadvantaged is another development challenge for Honduras and the donors during this CDSS period. No donor currently has plans to support shelter sector reforms that address the needs of the lowest income groups. USAID, through its Housing Guaranty (HG) program, has been a unique leader in this area. As Honduras regains its creditworthiness and re-enters international capital markets, USAID may propose a HG Program that will support sector reforms to expand financing of low cost housing, especially through private banks, PVOs and informal sector organizations.

USAID also will complete its ongoing Primary Education Project that is aimed at improving the efficiency and cost effectiveness of primary education. As a result, the primary school completion rate will increase and the time required to complete six years of primary education will decrease. A World Bank/IDB Social Sector Program to be initiated in 1992 or 1993 will address broader problems related to resource allocation among universities, secondary and

primary education. It may be able to provide follow-on assistance to this USAID Project. We will encourage other donors to assume a lead role in primary education. USAID will concentrate its efforts in technical vocational education to increase the productivity and employment of Honduras' labor force. This will be done through cost-effective private organizations such as the USAID-supported Human Resources Development Center (CADERH) and its network of PVOs and in-plant training programs.

The disadvantaged also suffer from widespread unemployment and underemployment. In the short run these have been made even worse by GOH economic reforms. To cushion the impact of the adjustment process among the most vulnerable groups, USAID will continue to provide local currency to the Honduran Social Investment Fund (FHIS) and to other similar programs to finance labor-intensive community-based infrastructure activities. This will be complemented by ongoing USAID projects to increase employment by improving small farmer and labor productivity, developing small and microenterprises, promoting export processing zones, and increasing investment and exports. During this CDSS period, the USAID program should generate a significant increase in job opportunities, including 25,000 in the five EPZs now under construction. Higher levels of private investment, exports and economic growth, however, are the only long-term solution to Honduras' serious employment problems.

### d. Preservation and Sustainable Use of Natural Resources

USAID's fourth strategic objective is to improve environmental policies and natural resource conservation.

USAID has been one of the leading donors in supporting environmental protection and natural resource conservation in Honduras. The major initiatives of the Central American Environmental Strategy are reflected throughout the ongoing USAID program. We plan to continue our leadership in this vital area largely through already approved bilateral and regional projects and local currency.

To encourage the preservation and sustainable use of natural resources, USAID will continue to implement a four part strategy of: 1) helping Honduras better understand and analyze its serious environmental and natural resource problems; 2) undertaking policy dialogues to develop more adequate environmental policies, laws and regulations; 3) improving institutional and technical capacity for environmental protection and natural resource management; and 4) supporting specific impact-oriented initiatives to improve conservation of key resources such as forests, soils and critical watersheds.

USAID will finance this strategy largely through already ongoing projects for Forestry Development, Land Use and Productivity Enhancement (LUPE), Irrigation Development and Municipal Development. We will also continue to use local currency and regional support such as ROCAP's Regional Environment and Natural Resources Management (RENARM) Project. The GOH expects to create an Environmental Fund to manage local currency generated through various bilateral debt forgiveness and reduction schemes such as EAI and from other sources. As a result, no new USAID dollar-funded environmental projects will be proposed during this CDSS period.

A comprehensive Environmental Profile was financed by USAID in 1989-90. It is being used to formulate policy reforms and new environmental initiatives. In 1990 USAID used RENARM technical resources to help the GOH develop an Environmental Policy Inventory and related diagnostic studies. (Issues related to tropical deforestation and biological diversity are addressed in Annex 6 and are based on the aforementioned documents). The GOH has established a new National Environmental Commission (CONAMA) with representatives from various GOH agencies and the Honduran Congress. CONAMA is using the Environmental Profile and Policy Inventory to formulate new initiatives and to prepare a National Environmental Action Plan.

USAID expects that GOH and private organizations will implement actions to carry out the major recommendations contained in the Environmental Profile. Through CONAMA and other agencies Honduras should make significant progress in improving its environmental policies, laws and regulations including enactment

of comprehensive Environmental and Water Resources Laws, establishment of an Environmental Action Plan, and adoption of other reforms and measures outlined below and in USAID's 1992-96 Policy Dialogue Agenda shown in Annex 2. To translate these new measures into action, a GOH Environmental Fund will be made operational. It will finance projects through both public and private entities. USAID will use RENARM-financed technical experts and local currency to assist this effort.

With support from the ongoing USAID Forestry Development Project, by 1996 almost all vital commercial pine resources will be managed on a sustainable yield basis. Pine harvests will be in accordance with improved forest management systems. The GOH's Forestry Development Corporation (COHDEFOR) will have divested itself of all commercial production, marketing and export activities. It will assume a role similar to that of the U.S. Forest Service. COHDEFOR will concentrate on creating incentives that encourage the private sector to implement sustainable yield forest management practices. Progress will also be made in privatizing standing timber ownership, moving toward timber price liberalization and providing greater private control over timber harvests.

Moreover, through USAID's Land Use and Productivity Enhancement Project, twenty-five percent of the 200,000 Honduran small farmers will no longer practice destructive slash and burn agriculture by 1996. Instead, they will use sustainable agricultural technologies (e.g., improved production practices, soil and water conservation, agroforestry) and integrated pest and range management techniques. They will be receiving these technologies and greater environmental education through both GOH and NGO entities. Field level efforts will be supported by sector policy reforms that remove restrictions related to land titling and agricultural prices that have discouraged investment in on-farm soil conservation.

The ongoing USAID Irrigation Project will help the GOH improve water resource utilization, prepare the technical studies for a new Water Resources Law and implement complementary efforts to protect critical watersheds. Technical

assistance from the RENARM Project will assist the GOH rationalize coastal zone resource management and encourage mariculture development. It will also help the GOH develop and enforce better regulations for pesticide use and for reducing chemical contamination.

USAID also will support a possible OFDA project to help Honduras better undertake disaster preparedness in the Sula Valley watershed. Rapid deforestation and soil erosion contribute to regular Sula Valley flooding that damages infrastructure and produces losses in agricultural production and exports. The U.S. Corps of Engineers may be the implementing agency for this OFDA project with the GOH providing some local currency generated from USAID programs. Local currency may also be made available to COHDEFOR for supporting a GOH-Embassy initiative to use U.S. military training exercises for developing Honduran military capacity to fight forest fires and carry out reforestation (the "green brigades").

Three major reserve areas (Rio Platano, La Muralla, El Armado) will also be protected and placed under management plans that contribute to making these reserves self-financing. A network of stronger NGOs, including the Honduran Ecological Association and the Pan-American Agricultural School at Zamorano, will be operating in support of environmental actions and education as well as channeling resources to high priority projects. Appropriate mechanisms will be developed to promote coordination between international and local environmental NGOs and to support debt-for-nature swaps and other innovative ways of financing private environmental initiatives.

Finally, USAID's ongoing Municipal Development Project will assist local governments address their water pollution and sanitation problems and help them redress past abuses. Through this Project, municipalities will also make progress in developing their capacity to protect public lands and natural resources as called for by the 1990 Municipal Reform Law.

### 2. Stable Democratic Society

USAID's fifth strategic objective is to strengthen democratic institutions and

promote a more pluralistic Honduran society. This will support the evolution of a stronger and more stable democratic society.

The Mission's strategy will continue to strengthen some of Honduras' most important democratic institutions. These include the National Electoral Tribunal (TNE), the National Congress, the Judiciary and Municipal Governments. We want these to merit greater confidence of the country's leaders, local and foreign investors and, most important of all, the Honduran people themselves. Our strategy also will develop democratic leadership and encourage pluralism by facilitating greater citizen participation in government and non-government organizations.

More specifically, this strategy will be implemented through our ongoing Strengthening Democratic Institutions (SDI), Municipal Development, Honduran Peace Scholarship (HOPS) and other related projects. It will be carried out within a coordinated Country Team approach of participation and funding from various USG agencies (State, DOD, DOJ, USIS, NED) and by using regional and centrally funded AID projects whenever appropriate.

The successful completion of the November 1993 national elections will be a key output of this strategy. We will continue to support efforts to improve TNEs institutional, managerial and technical capacity to carry out open and fraud-free elections. As a result, the TNE should be able to organize and conduct 1997 national elections without major foreign technical and financial assistance. By that date Honduras should have in place an independent and professional Electoral Tribunal capable of organizing and managing free and fair elections. This should allow the completion of USAID's electoral assistance by the end of this CDSS period.

In order to enable TNE to achieve this objective, the Honduran Congress must enact an Electoral Reform Law that permits TNE and its National Registry of Persons (RNP) to develop a career staff of professional managers and technicians. They must be protected by civil service regulations from partisan political pressures. USAID will support this legislation through

policy dialogue. Moreover, USAID will continue to assist the professionalization and training of TNE/RNP staff. We will support efforts to update the Honduran civil registry, improve administrative and electoral information systems, and upgrade equipment and facilities so that elections can be carried out more smoothly and professionally than in the 1980s.

USAID will continue to support efforts by the National Congress to improve its legislative processes and develop an institution that inspires greater public confidence. This will be achieved by making operational a new Center for Legislative Research and Studies (CIEL) managed by a professional career staff. The CIEL will improve the Congress' analytic, research and management capacity. It will provide standing committees with legal, economic and technical expertise to upgrade Congressional debate and improve the preparation and processing of legislation. Efforts will also be made to strengthen administrative and support systems and professionalize Congressional staff.

Moreover, we will continue to strengthen the technical capacity of the Congress' Comptroller General to do independent audits and reviews of government programs. This will be complemented by improvements in standards of public sector accountability and responsibility that can help inspire greater confidence in a democratically-elected government. Institutional and technical improvements in the Comptroller General may require modest USAID assistance throughout the 1990s. However, we expect to complete our major assistance to the National Congress during this CDSS period. By 1996 Honduras should have in place a stronger legislature that can better address the country's most fundamental problems.

Another vital element for strengthening Honduran democracy is improvements in the administration of justice. USAID will continue to help the Supreme Court increase the effectiveness of the Judiciary through implementation of its Career Judicial Law. This will promote professionalism, independence and fewer partisan interests in the judicial system. We will support efforts to upgrade judicial personnel including judges, prosecutors, public defenders,

clerks and court administrators through objective selection and promotion standards and in-service training implemented through a new Judicial School. Upgrading the Supreme Court's administrative, budgeting and planning systems will also be a high priority as well as continuing efforts to improve coordination among the courts, the police and the Attorney General.

USAID will also support simplification of legal codes and modernization of case tracking and management techniques. The highly successful experimental Justice of the Peace and Public Defenders and Prosecutors Programs will be expanded. More coherent management of property registries and other judicial reforms needed to improve the country's investment climate will be implemented.

This strategy will make important progress developing a more professional, effective and less partisan judiciary during the CDSS period. However, problems in the Honduran court system are deeply rooted. They cannot be totally overcome in the next five years. Continued assistance beyond 1996 will be required to consolidate and further deepen reforms and new procedures. Thus, USAID believes that this initial effort should be seen as the first phase of a longer-term strategy that will have to extend throughout the 1990s to be fully successful. Such a commitment is particularly appropriate because of the Judiciary's role in strengthening Honduran democracy and improving the country's investment climate.

Honduran efforts to strengthen municipal governments and promote decentralization took a major step forward with the enactment in late 1990 of the historic Municipal Reform Law. In most cases, however, local governments are ill-prepared to assume their new responsibilities. This significant decentralization legislation could easily fail if efforts are not made throughout this CDSS period and beyond to upgrade the technical, managerial and planning skills of municipal officials. USAID will continue to strengthen municipal capabilities in management, financial administration, service delivery, community involvement and project planning and implementation. This will facilitate the historic devolution of power and responsibilities to local governments, thereby ensuring that a major policy breakthrough does in fact

succeed in strengthening Honduran democracy.

Equally important, through neighborhood associations and other community groups, USAID will continue supporting mechanisms that facilitate greater local participation in municipal decision-making. This will be mirrored at the national level by a stronger Honduran Association of Municipalities (AHOM). It will be better able to present municipal concerns to the national government and provide a forum for mutual self-help activities independent of central government control. The enactment of an Electoral Reform Law will further promote greater local control over municipal officials. This law offers a significant opportunity for modernizing Honduras' highly centralized political system.

To promote democratic leadership and values, USAID will continue to implement its Honduran Peace Scholarship Program (HOPS) that allows low income persons to study in the United States. We also will support leadership training programs among labor unions, campesino groups, cooperatives, community associations and other private organizations. This will be complemented by USAID efforts to strengthen private development organizations, improve the well-being of the disadvantaged and promote a more open, transparent and competitive market economy.

Other USG agencies are also contributing to the Country Team's overall strategy for strengthening democratic institutions. For example, the U.S. Military Assistance Group is professionalizing the Honduran military by assisting a new civilian-oriented Defense College and improving the military justice system by upgrading the Adjutant General's Office. The Embassy's Political Section addresses human rights issues. It oversees efforts to modernize political parties and labor unions and to professionalize the police (FUSEP) using ICITAP and other assistance. The Embassy also addresses issues related to military influence in Honduran society, the size of the military budget, the need to separate FUSEP from military control, and drug awareness and public education. Likewise, USIS has the lead role in working with the press and has been coordinating with LACs Central American Journalism Project.

This coordinated Country Team approach allows different USG agencies to pursue actions in their areas of expertise. It permits USAID to narrow the focus of its strategy and concentrate on a limited number of program objectives in the Central America Strategy. It also better reflects the funding and staffing realities of this CDSS period.

### 3. Regional and International Cooperation

To obtain broad-based sustainable economic growth and a stronger democracy, Honduras needs more effective regional and international cooperation. As a result, improved regional and international cooperation is our final strategic objective during this CDSS period. It takes on even greater importance in the 1990s as bilateral USG assistance declines and as new trade and investment opportunities open up for Honduras through EAI and CBI.

On the regional level, our strategy supports greater horizontal cooperation between Honduras and its Central American neighbors. The meeting of Central American Presidents at Puntarenas to discuss the unification of customs duties is just one example of how regional policy harmonization can help reinforce key GOH reforms. Other examples include the Central American Commission on Environment and Development, the Regional Council for Agricultural Cooperation (CORECA), and other regional mechanisms that support Honduran efforts to implement sounder economic and development policies.

We will continue to encourage Honduran participation in ROCAP-sponsored projects, meetings and seminars on key policy topics of regional interest ("the horizontal response"). USAID will assist Honduras in implementing policies adopted by the regional community ("the vertical response"). The Mission anticipates that ROCAP will refocus its resources away from weak regional institutions and toward more intensive and less costly efforts to encourage greater harmonization of national policies and to promote intraregional trade and improved interchanges of development experience.

Although Honduras is unlikely to be a major financial contributor to regional

institutions, USAID will encourage the GOH to take full advantage of regional opportunities. This means clearing its arrearages to CABEI and utilizing CABEI resources to finance projects which benefit Honduras. We also will support ROCAP efforts to work through those regional institutions which can attain financial self-sufficiency without continuous injections of AID resources.

USAID's policy dialogue will encourage greater Honduran participation in intraregional trade. Dismantling protective barriers and realigning exchange rates on market terms will encourage trade on mutually beneficial terms. Likewise, we will continue our work to help the GOH streamline its custom procedures, thereby reducing arbitrary actions and cumbersome border crossings.

On the international level, USAID will encourage Honduras to take full advantage of opportunities for enhancing trade, investment and increasing donor flows. This means promoting full Honduran participation in EAI, PDD, CBI and regional consultative group mechanisms. It also means supporting Honduran efforts to join GATT thereby gaining access to markets and benefiting from its improved trade policies. Of critical importance will be continuous and aggressive USG leadership at both the field and Washington levels to help Honduras better mobilize increased assistance from IMF, IBRD, IDB and bilateral donors. Furthermore, Honduran participation in Paris Club debt reschedulings and Consultative Group meetings will be indispensable for achieving higher economic growth.

The strategy outlined above will not require AID financial resources. It will require, however, substantial staff time and USG leadership. As such, USAID does not intend to develop new projects or programs in support of this objective. Instead, the Mission will ensure that its policy dialogue and bilateral projects adequately promote more effective Honduran regional and international cooperation.

D. Program Consolidation

In the 1980s Honduras had one of the largest USAID programs in the world. For the past four years, USAID has been consolidating its program and reducing the number of its projects. The 1992-96 strategy will further accelerate this consolidation while refocusing resources only on those most critical objectives contained in the U.S. Economic Assistance Strategy for Central America, 1991 to 2000. This represents a substantial narrowing of the scope of our program when compared to the one implemented in the 1980s. It brings our strategy in line with what are expected to be reduced USAID funding and staffing levels for the 1990s.

Program consolidation is being implemented in a number of different ways. First, it is reflected by narrowing the number and scope of USAID's strategic objectives and reducing those requiring new USAID program initiatives and funding. Of our six strategic objectives, only one (Improving Sector Policies) requires major new program funding during this CDSS period. Four other strategic objectives (Investment and Trade, Social Sector Programs, Natural Resource Conservation, and Democratic Initiatives) will be supported largely with already approved and ongoing projects and with local currency and regionally-funded activities. The final objective (Regional and International Cooperation) will not require USAID funding. It will be supported through ROCAP programs and our ongoing policy dialogue process.

Even within these six strategic objectives, USAID has further narrowed its focus. For example, we are concentrating only on a few sector policy reforms in agriculture, trade and investment, and finance while implementing our strategy within a multi-donor approach that will further leverage our resources. Support of stabilization measures and important reforms in key sectors such as energy and public enterprises are being left to other donors. This represents a substantial narrowing of our policy dialogue when compared to the much broader approach included in programs of the 1980s.

Likewise, USAID will assist far fewer private sector organizations than we did

in the 1980s. We will work only with those NGOs that have a proven track record in supporting our strategic objectives and in mobilizing non-AID sources of funding. There will be a gradual narrowing of our focus in the social sectors. We will phase out major AID funding in primary health and primary education as other donors prove willing to pick up these programs. Our Environmental and Natural Resource Conservation strategy does not require the initiation of any new dollar-funded projects. It will be supported by ongoing DA projects, local currency and regionally-funded activities.

In Democratic Initiatives, USAID is supporting only five of the ten program objectives included in the U.S. Strategy for Central America. Those objectives not included in USAID's program will be pursued by other USG agencies within a coordinated Country Team approach to strengthening democratic institutions. We also expect to complete most of our assistance to the National Electoral Tribunal and to the National Congress by the end of the CDSS period.

Program consolidation also is reflected in those sectors USAID has chosen not to address. Although there are potential development opportunities in energy, mining, tourism and infrastructure financing, we are leaving these areas to other donors. Likewise, there are serious problems in Honduras' public enterprises and in modernizing its public administration. We expect that these areas will be addressed by other donors.

In the social sectors, USAID will not have the resources to address the serious problems in Honduran universities and in secondary education. We will greatly limit the numbers of PVOs we support. New development projects will only be initiated when they are reinforced by sound sector policies. We will continue to reduce the number of projects in our portfolio. USAID will encourage other donors to replace our funding in certain key areas like stabilization assistance and in primary health and primary education. To further complement our resources, we will encourage other USG agencies and other donors to increase assistance to Honduras in their areas of expertise.

# IV. RESOURCES

## A. Overview

After years of heavy dependence on U.S. economic assistance, Honduras moved to diversify its access to external resources in 1990. From 1985 to 1990, AID inflows averaged $158 million per year. The GOH reform program, initiated in 1990, opened the way to renewed flows from multilateral and bilateral donors. This program will permit increased reliance on financing through export revenues, foreign private investment and domestic saving.

During the CDSS period, total Honduran exports are projected to grow from $1.2 billion in 1991 to $1.9 billion in 1996. Unlike other Central American countries, traditional exports (bananas and coffee) will be largely responsible for the growth in export receipts. These two crops will account for one-half the increase in export revenues from 1991 to 1996. Honduras enjoys excellent prospects for expanding banana sales abroad, especially to European markets. Coffee export revenues could rise through processing improvements. Nontraditional exports -- especially cultivated shrimp -- are also expected to increase. The share of nontraditionals in total exports is projected to grow from 26.2 percent in 1990 to 30.1 percent in 1996. Exports from EPZs (registered as current account transfers, not as "exports" in the balance of payments) are projected to surge from $38 million in 1991 to $77 million in 1996.

As Honduras continues to improve its investment climate, private capital will be another important source of financing. In response to more favorable policies, USAID projects net direct investment from abroad to rise from $48 million in 1991 to $123 million in 1996. In addition, large foreign investment flows are expected to enter the EPZ's (these flows are recorded as off-shore activities). Through 1990, there were substantial capital outflows from Honduras. If these are reversed, the country will have another important source of financing.

In addition, the Inter-American Development Bank (IDB) and the World Bank are expected to respond to improved GOH economic policies with substantial net positive resource flows (net of debt service). IDB flows alone could exceed $1.0 billion during this CDSS period. The GOH should also be able to mobilize additional bilateral assistance from Japan, Germany, Taiwan, Venezuela, Mexico, Canada and other European donors. While Honduras may not qualify for renewed commercial bank lending by 1996, bilateral credit programs such as the U.S. Export-Import Bank and CCC should become a growing source of short-term commercial credits.

However, all of these resource flows need to be placed in the context of Honduras' high debt service burden. A large percentage of IFI and other donor flows will be needed just to service World Bank, IDB, IMF and CABEI loans that alone will average about $150 million per year (over 6 percent of GDP) during this CDSS period. Some progress will have to be made in reducing the country's bilateral debt (especially to Mexico and Venezuela) and cleaning up its commercial payments to international private banks. This effort to better manage Honduras' debt problems and to make the country creditworthy will reduce the overall short-term resource flows available to promote Honduras' economic growth.

### B. Program Funding

A key role for USAID assistance is to help Honduras maximize the resource flows described above as well as to achieve the strategic objectives outlined in this CDSS. To accomplish this, USAID must have available a level of resources that can influence the policy and structural reform process in Honduras. This means providing a significant level of fast-disbursing sector assistance and complementary project resources that can influence both GOH decision-making as well as other donors.

In arriving at the program funding level for the CDSS period, the Mission took into consideration the following factors:

-- In order to achieve the economic growth targets proposed in this CDSS, the simulation model shown in Annex 3 estimates an average annual financing requirement from official donors of about $550 million. The Mission believes that an appropriate USG level is to finance 20 to 25 percent of this amount or an average of $126 million per year. Such a level is consistent with our strategy of encouraging the IFIs and other bilateral donors to expand their assistance to Honduras while providing sufficient USAID resources to influence the GOH and other donors. This level represents a substantial reduction in the USGs share of official development assistance compared to the 1985-90 period. Any further reductions would endanger Honduras' ability to achieve CDSS targets and weaken USAIDs impact on the policy reform process.

-- Throughout the CDSS period, Honduras will confront a crushing IFI debt burden. In effect, this requires that the first $150 million of IFI disbursements be "round-tripped" back to the IFIs each year. While the GOH anticipates large IFI and other donor assistance in the coming years, the heavy IFI debt burden will reduce substantially the impact that this assistance will have on Honduras' overall economic growth.

-- Honduras remains one of the poorest countries in Latin America. It is one of the few IDA-eligible countries in the region. There is a strong U.S. foreign policy rationale for continuing a large USAID program here.

-- Finally, during the 1985-90 period, Honduras received approximately 10.4 percent of the LAC budget. Even though a new GOH implemented historic economic reforms in 1990-91, Honduras' share of the LAC budget dropped to 8 percent in FY-91/92. The current GOH continues to make valient efforts to improve Honduras' macroeconomic and sector policies. The country continues to rank high within most other LAC performance indicators. To reduce even further Honduras' share of the LAC budget would be inconsistent with performance based budgetary criteria and would cast doubt on the USGs ability to support necessary but politically difficult changes.

As a result, USAID proposes the following level of resources for this CDSS period:

| Source | Fiscal Year in Millions of US$ | | | | |
|---|---|---|---|---|---|
| | FY 92 | FY 93 | FY 94 | FY 95 | FY 96 |
| Economic Support Funds (ESF) | 50 | 50 | 85 | 65 | 50 |
| Development Assistance (DA) | 41 | 41 | 48 | 50 | 51 |
| PL-480 Food Aid | 20 | 20 | 20 | 20 | 20 |
| TOTAL | 111 | 111 | 153* | 135* | 121 |

In addition, USAID assistance should be complemented by U.S. debt reductions and additional resources provided by other USG agencies. For example, Honduras should receive increased assistance from the U.S. Export-Import Bank, the Overseas Private Investment Corporation, the USDAs Commodity Credit Corporation, and the Department of Commerce Latin American Trade Center. The U.S. Peace Corps should continue to have one of its largest programs in Honduras. The Inter-American Foundation will continue to provide small grants to PVOs and other community groups.

Honduras also should continue to be a major recipient of U.S. military assistance (MAP). These resources are being used to professionalize the Honduran military, develop a National Defense College, improve the military justice system and finance civic action. Funds from MAP and the Departments of State and Justice are also being used to professionalize the police force (FUSEP). USIS will continue its international visitors and scholarship

* Program funding levels are increased in FY-94 and FY-95 in order to better support a new democratically-elected government that will take office in January 1994. This will provide positive incentives to encourage the continuation and deepening of the economic reforms initiated in the 1990-93 period.

programs. The National Endowment for Democracy (NED) should continue to provide assistance to help modernize Honduran political parties. Regionally-funded AID projects such as AIFLD, LAAD, RENARM and others will also continue to be important sources of support for Honduras.

C. Staffing and Operating Expenses

In response to our consolidation efforts and a decline in program funds, USAID anticipates that its overall staffing levels can be reduced by 25 percent during the CDSS period. This means a decline from 238 FTEs (USDHs, PASAs, FSNs, PSCs) in FY-91 to 178 in FY-96. Total U.S. citizen employment will be cut by 34 percent and FSN employment by 22 percent. There will be decreases in USAID's Operating Expenses. However, the dollar component of our OE budget should be increased to reduce our current heavy dependency on local currency Trust Funds. Annex 7 contains USAID's detailed plan for reducing staffing and OE levels.

USAID believes that further cuts in staffing and OE resources would be inappropriate and inconsistent with meeting our accountability responsibilities. The strategy proposed in this CDSS will continue to require substantial USAID leadership and intensive staff support. In recent years, USAID has had to play a major leadership role in helping the GOH formulate and implement its macroeconomic and sector reforms and in mobilizing IFI and other donor assistance. Much work was required to get Honduras to understand and better utilize Paris Club and Consultative Group mechanisms. A substantial amount of USAID staff time (both in Tegucigalpa and Washington) has had to be dedicated to helping the GOH better manage its debt problems, especially with the IFIs. This type of intensive USAID leadership and staff support will have to continue throughout the CDSS period if Honduras is to achieve higher economic growth and effectively participate in new initiatives like EAI and PDD.

Likewise, USAID has been the recognized leader among donors in promoting trade, investment and privatization and in helping Honduras take advantage of

the Caribbean Basin Initiative. USAID continues to be the lead donor in financing primary health, family planning, primary education, training, housing, microenterprises and food aid programs. Many of Honduras' environmental protection and natural resource conservation programs were pioneered with USAID technical assistance. No other donor is providing assistance to strengthen democratic institutions.

These programs cannot be effectively implemented without intensive USAID staff support, monitoring and supervision. This is particularly important because Honduras has such a weak institutional and human resource base. It is made even more difficult by the country's inadequate management and accountability systems, poor policy planning and implementation mechanisms, difficulties in dealing with the IFIs and a history of poorly utilizing resources that are not properly supervised.

During the past decade LAC had the foresight to establish a well-staffed USAID Mission that could maintain adequate supervision and accountability systems. As a result, in the 1980s over one billion dollars of U.S. economic assistance was provided to Honduras without major scandals or misuse of funds. This represented a significant achievement that could not have happened without a properly staffed USAID Mission.

While USAID has been encouraging Honduras to broaden and diversify its international cooperation, such an effort will take time and will be ongoing throughout the CDSS period. We are hopeful that the IMF and the World Bank will assume an even greater leadership role and that the IDB will gradually become the single largest funding source for economic and development programs. USAID also expects to gradually phase-out its assistance in some areas as other donors expand their programs. However, for this to happen, USAID must continue to have a well-staffed Mission that can exercise strong policy and programmatic leadership.

Honduras 92-96

# CDSS ANNEXES


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ANNEX 1

## CDSS ISSUES

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# CDSS ISSUES

## 1. Scope of the Proposed Strategy

The strategy proposed in this CDSS is narrowly focused. Major new program initiatives during FY-92 to FY-96 are largely directed to only one strategic objective (Improving Sector Policies) while other strategic objectives will be supported through already approved and ongoing projects and with regional projects, local currency and policy dialogues. Other donors will assume the lead role in supporting GOH macroeconomic stabilization programs. As other donors expand their programs, USAID will phase-out of primary education and primary health. By the end of the CDSS period, USAID will complete its assistance to the National Electoral Tribunal and to the National Congress and thereby narrow its DI assistance. It is expected that the Inter-American Development Bank and World Bank will become the largest donors in Honduras. Other bilateral donors will increase their support to Honduras. USAID will continue to reduce the number of projects in its portfolio, support far fewer PVOs/NGOs, not enter new sectors like energy or mining nor finance capital projects, and reduce overall staffing levels by 25 percent.

Is this strategy too narrowly focused? Should AID budget planning levels be increased? Should greater flexibility be introduced into this strategy?

Honduras remains one of the poorest LAC countries and one of the few IDA-eligible countries in the region. The current GOH is improving the country's macroeconomic and sector policies when compared to the 1980s. The country continues to rank high within all other LAC performance indicators. It has a crushing IFI debt burden requiring that the first $150 million of IFI disbursements each year be "round-tripped" back to the IFIs. There is a strong U.S. foreign policy rationale for continuing a large USAID program in Honduras. Several high priority development projects could benefit from USAID assistance if additional funds were made available above the budget levels proposed in this CDSS.

Furthermore, it is possible that IMF/IBRD will not alone be able to assume the leadership role we are anticipating during this CDSS period. In FY-90 and FY-91 the Fund encountered difficulties in negotiating stabilization programs with realistic targets (See FY-91 ESF PAAD for further details). There have been disagreements between the Fund and Bank over stabilization and structural adjustment objectives. These have threatened to disrupt GOH-IFI relations. On occasion the GOH has called upon USAID to arbitrate these disagreements. The Fund also has called upon USAID for help in negotiating and implementing its Stand-by, in part because of its lack of in-country presence, GOH inexperience in dealing with the IFIs, and the expertise USAID has gained over the past ten years in analyzing and supporting Honduran stabilization programs. USAID will continue to encourage the IMF/IBRD to assume the leadership role in the stabilization area. We are hopeful that as the Fund and Bank gain additional experience working with the GOH that some of these problems can be overcome. However, it is quite possible that USAID will have to continue to play a close supporting role if IMF/IBRD assistance is to be continued.

The World Bank and the IDB told the GOH that they will expand substantially

their fast-disbursing sector and other programs if the GOH sticks to its macroeconomic and sector reform programs. The IDB President has announced that Honduras could receive $1.0 billion in new IDB assistance over the next several years. In 1991 the World Bank is implementing a large SAL II program, and a multi-donor project for the FHIS. Moreover, it is developing new Energy Sector and Agricultural Sector Programs, and has under consideration a Social Sector Reform Program. Despite these efforts the GOH believes that both Banks are moving too slowly to disburse funds and to replace the leadership and funding that USAID has provided. There are growing concerns that 1991 may again be the second year of negative net IFI disbursements to Honduras.

There are also concerns about whether the World Bank, IDB or other donors will be prepared to assume an aggressive leadership role in primary education and primary health and thereby replace USAID assistance. Both Banks are currently developing a fast-disbursing Social Sector Reform Program that will support GOH efforts to improve further its policies in education, health and nutrition. However, this Program does not specifically address some of the institutional, managerial and technological constraints limiting GOH expansion of social sector coverage. These are being addressed in USAID projects. USAID will continue its dialogue with the IFIs on these issues. We also will help the GOH address these constraints by developing primary education and primary health project proposals for presentation to the IFIs and other donors.

In addition, the proposed strategy anticipates a narrowing of USAIDs DI program through completion of assistance to the TNE and National Congress. This assumes that the National Congress approves the electoral reform legislation needed to strengthen the TNE and that AID-financed institution building efforts in both the TNE and National Congress stay on track. It also assumes that the TNE will be able to organize and carry out the November 1993 national elections better than it did in the 1980s.

Finally, Honduras is a disaster-prone country. Almost every year it experiences some type of flooding or drought. Over this century its North Coast agricultural production areas were devastated by a major hurricane every 15 to 20 years. The last such disaster was in 1975. While such incidents cannot be predicted, they could have a significant impact on the proposed strategy.

While USAID has recommended a narrowly focused strategy for FY-92 to FY-96 unexpected events could require broadening this strategy. Any such broadening would require additional resources. Given expected funding and staffing levels for the 1990s, we believe that the proposed strategy directs limited USAID resources to the highest priority development areas.

## 2. IFI and Bilateral Donor Flows

In accordance with the Economic Assistance Strategy for Central America 1991-2000, this CDSS anticipates that the IFIs will expand their programs in Honduras in the 1990s and that the GOH will be more successful mobilizing additional assistance from countries such as Japan, Germany, Mexico, Venezuela and other bilateral donors. In addition, it is expected that a growing

proportion of donor flows during this CDSS period will be provided in the form of fast disbursing balance of payments and sector assistance rather than slower disbursing project assistance that often requires high levels of GOH counterpart contributions.

In 1990-91 the IFIs have attempted to respond more favorably than in the 1980s. The IMF has agreed to Stand-by arrangements in both 1990 and 1991. It supported GOH efforts to reschedule bilateral debts in the Paris Club. The World Bank has taken the lead in developing a large SAL II program with complementary cofinancing from IDB and bilateral donors. The World Bank and IDB also are finalizing large fast-disbursing Energy Sector and Agricultural Sector loans. They have under consideration a new Social Sector Reform Program and various new project loans. The IDB President recently announced in Tegucigalpa that Honduras could receive $1.0 billion in new IDB assistance over the next three years. In December 1990 the World Bank organized a Honduras Consultative Group (CG) meeting to urge expansion of donor assistance to Honduras. The Bank indicated that the country's highest priority need was for policy-based fast-disbursing balance of payments and sector assistance.

Nevertheless, the GOH has been critical of both the World Bank and IDB. During 1990, a year of historic Honduran economic reforms, the World Bank received in GOH loan repayments more than 3 percent of GDP over what it provided in new disbursements. These GOH repayments virtually neutralized all of our 1990 ESF disbursements. In 1991, the Bank may not be able to deliver on its commitment to the GOH of providing Honduras with positive net flows.

In addition, the World Bank has been unable to define to the GOH or the USG what its overall flows to Honduras might be during the CDSS period. It continues to project an ambivalent attitude of whether its primary objective is reducing the Bank's Honduran credit exposure or helping Honduras implement major economic reforms. Rightly or wrongly many Hondurans believe that the World Bank's principal objective is to attract ESF, Japanese and other donor disbursements so as to help the GOH reduce its World Bank debt rather than to promote higher levels of economic growth.

In addition, the GOH has been critical of the slow IDB response. Since the IDB's fast-disbursing sector loans cofinance World Bank programs, IDB disbursements are subject to the same delays characterizing World Bank programs. The IDB also has been slow in developing new project loans. Furthermore, disbursements from ongoing IDB projects have been delayed because the GOH could not keep current on its IDB debt service payments.

Moreover, there have also been unexpected problems with some bilateral donors. While the Japanese were forthcoming in providing cofinancing to the World Bank SAL I program in 1990, they have proven reluctant to follow through with similar assistance in 1991 for SAL II. The German government has offered to cofinance a part of the SAL II, but this assistance has not as yet been finalized. At the December 1990 Consultative Group meeting many bilateral donors appeared more comfortable providing traditional project assistance rather than fast-disbursing balance of payments and sector assistance. Nevertheless, some donors such as Spain, Venezuela and Mexico are following

through with long-term commercial and other credits with a balance of payments impact.

What this means is that high level GOH and USG officials will have to continue lobbying other donors aggressively to increase their flows to Honduras. Otherwise the proposed CDSS growth targets cannot be achieved. High level USG officials have already been involved in such an effort throughout 1990-91. This must continue throughout much of this CDSS period. High level talks are needed with the IFIs and other donors such as the Japanese. Aggressive USG use of PDD and Consultative Group meetings is also important.

The USG dialogue with the donors must emphasize: (1) the urgent need of supporting GOH macroeconomic and sector policy improvements that can produce higher levels of economic growth, (2) the critical GOH need for fast-disbursing balance of payments and sector assistance rather than a proliferation of new projects that require large GOH counterpart contributions, (3) the serious GOH debt problem and the need for debt reduction and relief and (4) the need to help Honduras obtain larger flows of foreign private investment. It is these types of donor actions that can help the GOH achieve the economic growth targets specified in this CDSS and in the Economic Assistance Strategy for Central America, 1991-2000.

## 3. Stabilization Assistance

This CDSS assumes that the IMF/IBRD will play the lead role in supporting stabilization programs while USAID focuses on supporting structural reforms in key sectors of the economy. The IMF and World Bank have assumed this lead role and we expect to phase-out our support for stabilization objectives over the CDSS period. Nevertheless we need flexibility. As indicated in this CDSS, at times it may prove necessary for USAID to incorporate some stabilization type conditionality in its sector reform programs in order to further reinforce IMF/IBRD programs. We have followed this approach in both FY-90 and FY-91. Future USAID support of stabilization objectives (e.g., lower fiscal deficits, exchange rate flexibility) would be pursued not as ends in themselves -- as is done in a classic Fund program -- but as means of achieving specific sector reforms.

For example, high fiscal deficits throughout the 1980s squeezed out credit to the private sector and choked off private investment. Lower fiscal deficits are needed not just to stabilize the Honduran economy but also to achieve GOH/USAID sector objectives of increasing private investment. Likewise, Honduras' unwillingness to devalue in the 1980s limited the country's capacity to export and to maintain its international competitiveness. Exchange rate flexibility is not only needed to stabilize the economy but to achieve GOH/USAID objectives of increasing Honduran exports and promoting agricultural development.

Throughout the 1980s and early 1990s stabilization objectives (e.g., fiscal deficit reduction, exchange rate adjustments, debt service problems) dominated the GOH-USAID policy dialogue process. While important structural adjustments were also included in ESF and other programs, they were often overwhelmed by

problems in achieving stabilization objectives. As a result, in the 1990s we hope to concentrate far more USAID policy dialoguing on sector-based structural reforms while leaving stabilization programs to the IMF and IBRD.

4. Honduran Debt Service Problems

Honduras is confronting major debt service problems that can be addressed only in part through Paris Club debt reschedulings. There is a large IFI debt service burden that cannot be rescheduled and must be managed throughout this CDSS period. The country's most significant debt service problems are with the World Bank, IDB, CABEI and with non-Paris Club bilateral donors like Mexico and Venezuela. Honduras may not be able to grow out of its heavy debt burden without debt forgiveness and reduction especially by the bilateral donors. The country's large debt service burden, especially to the IFIs, will be a major drag on its economic growth unless more innovative and longer term solutions can be found.

In the Mission's last CDSS the importance of the Honduran debt problem was not fully appreciated nor recognized as a major constraint to economic growth. Large ESF cash transfers were provided in the 1980s that directly or indirectly were "round tripped" to the IFIs which limited their impact on Honduran economic growth. In 1990-91 ESF and a Treasury bridge loan along with other donor resources were used to get the IFIs back engaged with Honduras. It was fully expected that this action would lead to positive net flows of international assistance.

GOH debt service payments to the World Bank, IDB, IMF and CABEI alone will average about $150 million per year (or 6 percent of GDP) during the 1992-96 CDSS period. Over the past several years, problems related to Honduras' ability to generate sufficient foreign exchange to service its IFI debts have consumed an inordinate amount of GOH and donor time. They have often diverted attention away from implementing stabilization and structural reforms. These problems will continue to require high level GOH, USG and donor attention unless some better solutions can be found.

To date the only solution to the IFI debt service problem has involved the provision of fast-disbursing World Bank SAL and Sector Loans along with cofinancing from the IDB and bilateral donors like the Japanese. These new IFI loans have included a large component of highly concessionary IDA/FSO financing. In effect, this replaces older, higher interest IFI debt with softer terms. Almost all of these new IFI disbursements are returned to the IFIs along with some ESF and other bilateral assistance. These operations are in effect a form of IFI debt refinancing.

However, these World Bank/IDB operations have turned into extremely complex and time-consuming undertakings. They have required ESF and other bilateral donor funding to make them work. There is growing GOH frustration with these operations and with the IFIs. Many Hondurans cannot see "light at the end of this debt tunnel". They believe the World Bank is using these operations to reduce its own exposure in Honduras rather than to promote the country's economic growth. Unless a simpler and better solution is found to Honduras'

IFI debt service problems, financial shortfalls and stagnant economic growth may lead to the defeat of current GOH economic reforms in the November 1993 national elections. (See attached from one of Honduras' leading newspapers).

5. U.S. Debt Relief

As part of a comprehensive resolution of Honduras' debt service problems this CDSS proposes that actions be initiated to forgive all of the country's prior PL-480 Title I and Development Assistance Loans. We also recommend that this be used to encourage other bilateral donors to take similar action.

Honduras almost qualifies as an RLDC. It is one of the few IDA-eligible countries in Latin America. Given declining ESF levels, EAI debt reduction provisions, Honduras' weak balance of payments position and GOH efforts to regain creditworthiness in the international financial community, the Mission recomends that PL-480 and DA loans be forgiven as has been done for RLDCs.

Based on the FY-1990 Food Aid Legislation, USAID understands that consideration is already underway for forgiving previous PL-480 Title I loans which total $105 million. (In the 1990s Honduras will be a PL-480 Title III country in part because of its debt service problems.) USAID believes that similar consideration should be given to forgiving (as opposed to reducing) previous AID Development Assistance Loans which total $339 million. Through the EAI and other legislation, debt relief should be used as an additional instrument for supporting GOH efforts to implement its macroeconomic and sector policy reforms.

6. Investment and Export Promotion

Improving Honduras' investment climate and export performance remain two of the critical issues for increasing the country's growth rate in the 1990s. Over the past six years some important progress was made with USAID support. For example, Honduras cautiously adopted a series of new policies and laws that are now shifting the country to an export-led private sector development strategy. This transformation has been accelerated over the past eighteen months by the macroeconomic and sector policy reforms implemented by the new Callejas government.

In the 1980s new private institutions were made operational to promote investment and exports such as the Foundation for Investment and Export Development (FIDE), the Federation of Agricultural Producers and Exporters (FPX) and the Honduran Foundation for Agricultural Research (FHIA). These institutions should have even greater impact in the 1990s now that the GOH is moving more aggressively to remove policy constraints that have hindered investment and exports. In addition, with USAID support, Honduras' leading private sector organizations such as the Confederation of Private Sector Organizations (COHEP) and the Chamber of Commerce and Industry of Cortes (CCIC) are now engaged in lobbying the GOH and the private sector itself for new policies, laws and attitudes to encourage investment, exports and an open and transparent market economy.

Attachment to Issue 4.

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In addition, the Honduran Congress passed legislation encouraging exports and authorizing the development of privately financed Export Processing Zones (EPZs). In the past four years twelve state-owned enterprises were privatized generating $15 million in private investment. GOH macroeconomic and sector reforms in 1990-91, especially devaluation and agricultural price liberalization, provided important policy stimulus to exporters and to investors. In 1990 the Honduran Congress passed a new law that allows foreign investors to own land within 40 kilometers of the Honduran coast. This removed one of the key legal constraints to the development of the country's tourist industry and to foreign investment in tourism. Some efforts have been made to encourage petroleum exploration and to promote increased banana production. Nontraditional agricultural exports such as cultivated shrimp and melons are rapidly increasing.

Five privately financed Export Processing Zones (EPZs) are currently under construction. They are attracting major new foreign investors. While these EPZs are not the solution to Honduras' investment problems, they serve as highly effective demonstration models of what greater liberalization and openness to foreign investment can mean to the rest of the Honduran economy. As many as 100 EPZ factory shells could be in operation by 1996.

However, while significant progress has been made, much more needs to be done. Constant IFI debt service crises in 1990-91 and political difficulties in managing stabilization measures and price liberalization actions have not allowed the Economic Cabinet to focus sufficient time on modifying Honduras' inadequate investment code and laws, accelerate privatization or promote more investment in key areas like bananas, petroleum exploration or shrimp farming. Policy changes are still needed to support announcements by both of Honduras' large multinational banana producers (Standard, Chiquita) to expand their production. This is particularly important because expanded banana production and exports may be the single most important short-run private sector action to raise Honduras' growth rate to 3.8 percent by 1993. In addition, fundamental legal changes are still needed in Honduras' investment law to stimulate much higher flows of foreign investment. Our policy dialogue in these areas will be intensified throughout the CDSS period. They are a major focus of our FY-91 ESF conditionality (see FY-91 PAAD for further details). They will continue to be of high priority during the 1992-96 CDSS period.

## 7. Traditional Versus Nontraditional Exports

In the 1980s the LAC Bureau supported an export development strategy that emphasized the promotion of nontraditional exports. This was particularly appropriate for an advanced developing country like Costa Rica with a much more diversified economic base and a larger entrepreneurial class. While this strategy produced some important gains for Honduras, especially in shrimp farming and melon production, it was far less relevant for Honduras in the short-term because the country's nontraditional export base is relatively small.

An effective export development strategy for Honduras must focus on both traditionals and nontraditionals to significantly increase foreign exchange earnings and economic growth. This means that USAID and other donors must direct more attention to helping Honduras promote its traditional exports (bananas, coffee) as well as nontraditionals.

Over the past decade banana production in Honduras has been stagnant. An overvalued exchange rate and inadequate access to securely titled land have hindered the expansion of foreign investment in the banana industry. During the same time period exports from other major banana producing countries in the region (Colombia, Ecuador, Costa Rica, Guatemala, Panama) increased by approximately 42 percent. While Honduras slipped in terms of policy performance, its competitors enacted special incentives designed to encourage increased investment in banana production.

In response to GOH exchange rate adjustments in 1990 and the rapidly growing worldwide demand for bananas, especially in Europe and Asia, both of Honduras' major multinational banana companies (Standard, Chiquita) have announced major expansion plans. European and other foreign investors have also expressed interest in initiating new banana investments in Honduras. President Callejas has publicly expressed his support for making Honduras into the "most progressive banana producing country in the world". He clearly recognizes that his country has a strong comparative advantage in this product that was eroded throughout the 1980s by poor macroeconomic and sector policies.

Callejas has committed his government to create incentives that can increase banana exports from 45 million boxes in 1989 to 70 million boxes in 1993 which at current prices would increase foreign exchange generations from $343 million to over $500 million annually. This can be achieved by a relatively small (5,000 to 10,000 hectare) increase in land under banana cultivation which was estimated at 39,000 hectares in 1989 (1.1 percent of arable land). An increase in banana production and exports may be the single most important private sector action to help Honduras significantly increase its economic growth over this CDSS period.

The exchange rate reforms enacted by the GOH in 1990 represented a major step in the right direction in promoting Honduran banana production. However, the GOH has not as yet completely followed through on other needed reforms especially those related to access to land (see 91 Tegucigalpa 5257 for further details). Through USAID's policy dialogue and agricultural sector program we will continue to support changes in land tenure provisions and encourage other incentives that can facilitate a significant expansion of foreign and local investment in banana production.

Likewise, Honduras' other traditional export -- coffee -- also offers the country opportunities for increasing export earnings. This is particularly important because coffee is a small farmer crop that employs large numbers of Hondurans. There are 60,000 small coffee producers. It is estimated that nearly 435,000 people depend upon coffee for their livelihood.

Honduran coffee is sold in international markets at a substantial discount because of poor processing. It averages nearly $10 less per bag of export

coffee than the average New York price. By comparison, Costa Rica receives nearly $10 more per bag than the New York price. Processing improvements in the Honduran coffee sector could produce new foreign exchange earnings. These improvements include small on-farm wet processing plants and a revitalization of larger processing plants.

In the 1980s the Mission successfully financed a Small Farmer Coffee Project that helped Honduras increase small farmer coffee productivity and employment and initiate a quality enhancement program. While this project is ending in FY-91, the coffee processing improvement program will be continued within the Mission's new Small Farmer Organization Strengthening Project.

As indicated above, there are significant opportunities for increasing foreign exchange earnings from Honduras' traditional export crops. They require more USAID and donor attention than they received in the 1980s. While nontraditionals still merit support, USAID's export development strategy in the 1990s will be more balanced than it was in the 1980s.

## 8. Economic Growth Targets

From 1980 to 1990, the annual increase in Honduran GDP growth averaged 2.0 percent. We project a 1.7 percent increase in 1991, followed by an average increase of 4.3 percent over the CDSS period. Two annual GDP growth rates are especially important CDSS goal indicators -- the 3.8 percent increase in 1993 and the 5.3 percent increase in 1996. The former growth rate is possible if the GOH sticks to its stabilization program and implements the deep agricultural sector reforms supported by ESF and PL 480 programs in FY 91 and later years. The 1996 growth rate requires the continuation of comprehensive macroeconomic and sector reforms.

Thus, a key underlying factor behind the projected sharp improvement in GDP growth over the CDSS period is straightforward -- better economic policies. As explained in the CDSS, the GOH followed poor economic policies in the 1980s. These were corrected in March 1990 through deep and comprehensive measures to liberalize the exchange rate, cut the fiscal deficit, reduce effective protection and undertake deep structural reforms.

Once these measures take hold, the Mission expects a favorable private sector response. It is projected to begin in 1991 and 1992 and grow through the years spanned by the CDSS. As simulated in the CDSS scenarios in Annex 3, the Mission believes that strong export-led growth is indeed possible for Honduras. The Mission projected growth rates for all major agricultural commodities on a crop-by-crop basis. We believe that the private sector response to good policies is conservative and indeed possible. Export-led growth will be bolstered by large private sector investment, financed by a combination of domestic and external savings.

## 9. Policy Dialogue Agenda

To achieve the objectives specified in this CDSS will require supporting

changes in highly sensitive Honduran policies. These include, among others, further liberalization of the foreign exchange and trade regimes, removal of remaining price controls, reduction in the size of the public sector, modifications of the Agrarian Reform Law to permit operation of land markets and land rentals, improvements in the investment climate that may eventually require changes in the Honduran Constitution, breaking down oligopoly arrangements that allow more competition in the Honduran banking system, implementation of career civil service systems in the Judiciary and TNE, and election reforms.

Some of the proposed changes will be resisted by powerful vested interests. These extend from leftist and campesino groups who oppose bitterly any changes in the current Agrarian Reform Law to some private banks that may resist actions to make the financial system more open and competitive. The policy dialogue agenda outlined in this CDSS is limited in scope but ambitious. The policy dialogue process will have to be implemented with great care and sophistication. While USAID will vigorously promote policy changes, it may not be possible to obtain breakthroughs in all areas.

It must be remembered that it took USAID many years of highly contentious and difficult policy dialoguing to finally convince Honduran society of the benefits of devaluation and price liberalization. Even today the reform process in these areas is much improved but still incomplete. The lesson of this experience is that the policy reform process is lengthy. Clearcut breakthroughs that produce immediate benefits are rare. Most policy changes must be accompanied by complementary measures that help translate reforms into favorable results. If such measures are not provided, the impact of policy changes may be dampened.

It also needs to be recognized that fundamental policy and structural change is difficult in Honduras because of this country's historic commitment to democratic and popular participation. Campesino groups, labor unions, private sector associations, the press, the GOH bureaucracy and the Honduran Congress and military all have significant influence over the GOH decision-making process. There is a Honduran tendency to make decisions by consensus after lengthy public debate and dialogue rather than to mandate decisions from the top down. Small groups of opponents to policy change can often stop or delay needed reforms. While these factors can neutralize and dilute even the best policy reform package, they also clearly reflect Honduras' strong commitment to democratic procedures that incorporate views from many disparate groups.

USAID now has almost a decade of experience in high level policy dialoguing in Honduras. This effort produced major breakthroughs (e.g., devaluation, tariff reform, agricultural price liberalization, implementation of a judicial career law, adoption of a new Municipal Reform Law, etc.) All of these efforts took years to get adopted. They required intensive technical assistance to be implemented. This experience clearly demonstrates that if USAID and the donor community persevere, policy change can indeed be brought about in Honduras. We must not, however, underestimate the difficulty.

10. Primary Education and Primary Health

As part of its program consolidation strategy, USAID proposes to complete its large ongoing Primary Education Efficiency and Health Sector II Projects during this CDSS period. Attempts will be made to graduate follow-on projects to other donors and to terminate USAID funding in primary education and primary health. These USAID projects have been highly successful in helping to expand the coverage of basic social services and reducing the country's high infant mortality. The success that Honduras achieved in the 1980s in improving its social indicators was due in large part to the highly effective technical and financial assistance provided by USAID. These USAID projects also enjoy widespread GOH and private sector support. There are repeated requests for more USAID assistance in these sectors.

Honduras has been reported to the U.S. Congress as a child survival target country with one of AID's largest primary health programs. It has also had one of the Bureau's largest and most successful primary education programs that has been used to meet Congressional earmarks. Significant segments of the U.S. Congress continue to encourage AID to allocate more funding to primary education, primary health and child survival especially in those poorest countries like Honduras.

Most donors continue to look to USAID for advice and guidance in these sectors. USAID is the recognized technical leader and this gap may be difficult for other donors to fill. While Honduras has made great strides in improving social conditions, it still has some of the worst health and nutrition indicators in Latin America. Much remains to be done.

Nevertheless, USAID believes that after 15 years of intensive USAID support it is time to begin a process of graduating primary education and primary health to other donors. With declining USAID funding and staff resources, other donors should be able to move more aggressively into these sectors. We plan to implement this graduation in an orderly and systematic way. USAID will complete its ongoing projects and work with both the Ministries of Education and Health to develop follow-on project proposals for presentation to other donors. We will then work to encourage other donors to expand their funding in these areas.

11. HG Funding

Honduras is struggling to reduce its onerous debt burden and to reestablish its international creditworthiness. The GOH took a giant step forward toward this objective in 1990 by reducing its arrears to the IFIs and rescheduling its bilateral loans in the Paris Club. Honduras has signed Stand-by agreements with the IMF in both 1990 and again in 1991. These measures, plus the macroeconomic reforms initiated in 1990-91, should help generate higher rates of economic growth by 1993-94. USAID expects Honduras to progress toward creditworthiness throughout the CDSS period and hopefully re-enter some international capital markets through EXIM, CCC and HG-type guarantee programs.

USAID believes, therefore, that it is reasonable to leave open the possibility of a new HG program beginning in FY-94 or FY-95. Such a program can support implementation of important financial sector reforms for shelter as well as facilitate Honduras' reentry into international private capital markets. It should also be noted that HG loans are more concessional than are ordinary capital loans from IBRD and IDB that are currently being provided to Honduras. Thus, because of potentially declining AID resources for Central America, a HG loan in the second half of this CDSS period could provide a valuable source of funding for achieving important CDSS objectives. However, before any such program is initiated, an indepth Country Risk Analysis will be undertaken. Because of the HG's lengthy repayment period and its potential importance in helping Honduras improve its shelter sector policies, USAID recommends that potential HG funding be included in this CDSS provided Honduras continues to make acceptable progress toward international creditworthiness.

ANNEX 2

## POLICY DIALOGUE AGENDA

This annex summarizes the major areas where policy changes are needed to achieve the growth targets set out in this CDSS. The USAID program will not be targeted at all these areas. As explained in the text of this document, we expect other donors to assume sole responsibility for supporting some of the required policy reforms. In other areas, we expect to join with other donors in promoting improved policies. The major policy dialogue areas are listed below, along with a brief explanation of their importance and the Mission's role -- if any -- in supporting these reforms.

### 1. Stabilization

Throughout the CDSS period, the GOH must implement sound stabilization policies. This means a low and declining public sector fiscal deficit. Internal financing of the public sector deficit must be very low or negative. Without a low public sector fiscal déficit, insufficient credit and resources would be available to the private sector. Sound stabilization policies also call for a uniform, market-determined exchange rate and the careful use of monetary policies to control inflation.

Sound exchange rate policies are needed to bolster exports.

During the CDSS period, GOH stabilization policies are expected to merit IMF and World Bank support. Given the importance of these policies for achieving the objectives of Mission programs, we will monitor GOH performance in this area and discuss this performance with other donors and the GOH. However, with a firm GOH commitment to design and implement sound stabilization programs supported by the IMF, we believe our efforts could be better focused on the sectoral policies needed to achieve broad-based, sustainable economic growth. The Mission will only use its resources to support stabilization objectives to further sectoral objectives.

### 2. Agriculture

As brought out in the text of the CDSS and in Annex 3, we premise our targets of strong overall economic performance on large increases in agricultural investment, production and exports. This calls for substantial improvements in agricultural policies. Over the CDSS period, better agricultural sector performance, requires policy improvements in three areas which will form the centerpiece of the Mission's agricultural sector program:

- Improved land security and markets. Encouraging the reallocation of land resources to more intensive and productive uses. This means permitting fee simple titles to land removing the risks inherent in land tenure due to state- defined land use criteria and the threat of expropriation. Land owners must have clear and secure property and investment rights and be free to mortgage their land, rent it or sell it. Mission field work indicates that improved land security and

transfer mechanisms are basic to create the conditions needed for a surge in agricultural investment, production and exports. This encompasses one of the most important sets of measures the Mission will encourage prior to and during the CDSS scenario. Once improved land policies are implemented, we will collaborate with the GOH in carrying out better land titling and market-based land transfer mechanisms.

- Improved pricing and trade policies. The elimination of all price controls on agricultural products is another key agricultural sector priority of the policy dialogue. The Mission will also encourage the elimination of price controls on agricultural inputs. In coordination with trade sector policies, the Mission will support the end of quantitative restrictions and other trade barriers which impede agricultural exports and imports.

- Improved access. Honduran agriculture suffers from restricted access to credit, technology and inputs. Improved credit policies are needed to bolster farm productivity and investment as well as to set up an effective land transfer mechanism. The Mission will work with the GOH to liberalize credit markets, enabling an improved flow of resources to efficient farms. Our program also calls for the privatization of public sector activities, such as seed production and marketing, which currently impede rather than promote the transfer of more productive technologies and an efficient use of resources in the countryside.

The World Bank and the IDB are also developing agricultural sector programs. USAID is closely coordinating the design of its agriculture sector program with these entities. Although the World Bank and IDB agricultural programs are still in the design stage, we expect them to place considerable emphasis on reform of BANADESA, the public sector agriculture development bank. BANADESA is technically bankrupt and has long suffered from mismanagement. The World Bank and IDB are examining alternatives for liquidating or privatizing its assets and functions. USAID does not intend to actively participate in the resolution of the problems facing BANADESA. The Mission also expects the World Bank and the IDB to work closely with the Ministry of Natural Resources to better support agricultural extension and research.

3. Trade

The Mission will support the GOH commitment to liberalize its trade regime. During the CDSS period the policy dialogue calls for continuation toward a uniform and low nominal tariff on imports with no exonerations, except those required by international agreements. In 1991 the maximum dispersion in the import tariff is 31 percent with another 15 percentage points in surcharges -- a total dispersion of 46 percent. Legislation has already been fully approved to reduce the total dispersion to 30 percent in January 1991. The policy dialogue will call for a further reduction in this dispersion to no more than 25 percent by 1994 and 20 percent by 1996.

We will also encourage the elimination of all administrative barriers to trade such as quantitative restrictions, licensing, trade monopolies and cumbersome regulatory procedures. We will cooperate with the GOH in simplifying and streamlining customs procedures through the Policy Analysis and Implementation Project.

The World Bank's SAL II also calls for measures to reduce effective protection. However, once the conditions of the SAL II are satisfied, continued World Bank participation in the improvement of the trade regime is uncertain. We believe this area merits continued World Bank support.

4. Investment

During the CDSS period, the Mission will support GOH policies to encourage private investment. These call for:

- An improved investment code. We will support legislation to streamline investment procedures and to eliminate barriers against the entry of foreign and domestic investment. We expect new investment to be treated on an equal footing with existing ventures, without special priviledges or impediments.

- Improvements in legal, regulatory and judicial systems. The Mission will encourage the GOH to strengthen enforcement of contracts and to promote fair, impartial treatment by the judicial system. Legal and regulatory improvements are being sought to enable businesses to carry out their day to day operations without harassment.

- Acceleration of the privatization program. The Mission will support the GOH commitment to accelerate the privatization of state owned enterprises.

We do not expect other donors to play an active role in seeking improvements in the investment climate.

5. Finance

Rapid and deep improvements in the financial system are urgently needed to more than double the proportion of gross domestic savings in GDP between 1990 and 1996. Financial sector reforms are also urgently needed to improve the allocation of resources among productive activities and to provide long term financing for housing and efficient long term business ventures. Our policy dialogue activities in support of these objectives will call for the following measures:

- the complete elimination of all administrative controls on interest rates.

- effective regulation of banking system activities, designed to strengthen bank solvency, promote competition among banks, and encourage an efficient allocation of credit among competing demands.

- a phase-out of directed lines of credit. This will emphasize the elimination of all subsidies on central bank rediscounting operations. The effective cost of these credits should be higher to the banking system than the utilization of deposits. The Mission plan to phase out its directed credit lines is presented in Annex 4.

- the creation of instruments to permit long-term lending. This could be greatly enhanced through the determination of interest rates according to a market index, permitting the investment of pension, insurance and other funds in long-term ventures.

- the gradual reduction of excessively high reserve requirements (coordinated with the phase-out of directed credits) and increases in the interest rates paid on legal reserves of the banking system.

Through its SAL II loan, the World Bank is presently participating in a program to strengthen the financial system. Once the SAL II is concluded, World Bank participation in this area is uncertain. We believe the Bank should develop a financial sector program to complement the Mission program.

6. Energy

The Mission is cognizant of the need to make effective use of Honduras' energy resources and to improve the management of these resources. Regional energy sales offer an important possibility of increasing exports. In addition, the GOH must soon begin to plan for long-term improvements in its electrical generating capacity to accomodate the demand at the end of this century. However, both increased energy sales and long-term programs are hampered by poor management of the electricity company (ENEE). It has an overstaffed workforce. Electricity rates are too low to cover costs, and ENEE has deep arrearages on its external debt.

The Mission also realizes the importance of reducing the role of the state in controlling the importation, distribution and sale of petroleum products. Moreover, the country's prospects for producing petroleum remain uncertain due to highly complex rules and regulations impeding exploration.

The World Bank and IDB are developing an energy sector program to address the above problems. These entities are especially concerned about energy sector policies because they hold a substantial part of the debt used to finance the El Cajón Dam Project. The Mission agrees with the thrust of the World Bank and IDB energy programs. However, we foresee no need for our direct involvement in an energy sector program.

7. Public Sector Enterprises

Through the SAL II, the World Bank is seeking to scale down and improve efficiency in the GOH decentralized enterprises. The Bank is focusing on improving the allocation of public investments and allowing public enterprises more autonomy in setting rates.

While the Mission is complementing the World Bank program -- through the privatization project and the Policy Analysis and Implementation Project which is improving public sector financial accounts -- we prefer that the

World Bank take primary responsibility in this area. After the SAL II, we would like to see the World Bank, possibly with IDB support, continue its leadership in this area.

8. Social Services

We will continue to support the government's primary health care priority in the face of overall government austerity and pressures to expand hospital and curative health care, especially in the cities where voters are concentrated. We will encourage liberalization of the import regime to permit the free importation of pharmaceuticals outside the monopolistic control of the Honduran Pharmaceutical Organization. Over this period, the role of the Ministry of Health in developing and coordinating a National Nutrition Policy will be strengthened, we will encourage a more aggressive and comprehensive public approach to family planning services. We will support other donor efforts to expand support of primary health care and hospital expansion costs are reduced (thus reducing their relative share of the budget) through improved management and efficiency.

Education policy dialogue will continue to emphasize the efficient delivery of primary education services. We will stress the importance of maintaining the proportion of the national budget for primary education, increasing the secondary school proportion, and decreasing the university proportion. This focus will form the basis for our support of other donor projects, particularly those of the World Bank who we expect to provide financing and technical assistance for primary education. In the area of vocational and technical training efficiency also will continue to be emphasized, both in instruction and in the relevance of the education to the productive development sectors.

9. Democratic Initiatives

Policy dialogue in the four main components of Honduras' democratic system (legislative, judicial, electoral, and local governments) will focus on the professionalization of activities with the depoliticization receiving an equal emphasis for judicial and electoral activities. Efforts to inform the public about their rights and responsibilities will be encouraged. Dialogue at all levels will support an effective transfer of power from the central government to the municipalities. Policy dialogue in all Mission areas of activity will be supported by the training to expose current and potential leaders to democratic ideas and information.

10. The Environment

As articulated in the text and Annex 6 of the CDSS, management of the natural resource base and the environment is a high priority area. Honduras must reverse the rapid deterioration of its natural resources if sustained economic growth is to be achieved for future generations. Fundamental changes in the way resources are perceived and managed are required, this implies policy change in several areas, all of which will be pursued during the CDSS period:

- Development and implementation of a comprehensive water law to make allocation and use of water resources more efficient.

- Further clarification of timber resource rights and establishment of incentives to make individuals communities, the forestry industry and COHDEFOR more efficient in managing these resources. Full divestiture by COHDEFOR of all production and marketing interventions.

- Removal of restrictions relating to land titling and agricultural prices that discourage on-farm investment in soil and water conservation.

- Rationalization of coastal zone resource management relating to mariculture development.

- Improved regulation of agricultural, industrial, mining, and municipal pollution.

- Enactment of a comprehensive environmental law, and development and implementation of a related environmental action plan.

ANNEX 3

## SIMULATIONS OF THE HONDURAN ECONOMY THROUGH 1996

The CDSS assumes that the GOH will maintain and deepen strong macroeconomic policies in the decade of the 1990s. In order to project the effects of these policies on the overall performance of the Honduran economy, USAID/Honduras made use of a simulation model constructed by the World Bank.

The model projects visions of the Honduran economy, reflecting the simulated effects of economic policy and exogenous variables (such as export prices) on key macroeconomic variables. These visions, or scenarios, are not forecasts. Instead, they provide a framework for analyzing the consequences of the interrelations between economic policies and exogenous factors in the context of a model based on national accounts and the balance of payments.

The model and the scenarios it generates are based on many assumptions. In the course of adapting the model to the needs of the Mission, these assumptions as well as the underlying structure of the model were subject to numerous changes. The basic conclusions concerning the growth prospects of the Honduran economy and its requirements to achieve increased growth over the next six years, however, remain virtually identical across the diversity of assumptions and structures.

Three simulations -- each generating its respective scenario -- of the Honduran economy through 1996 are summarized for the CDSS. The presentation of the simulations is divided into three parts: (1) assumptions underlying the model; (2) how the model works; and (3) characteristics of the scenarios utilized for the CDSS. The latter section examines the relation between the vision presented in the scenarios and the policy thrusts and major program themes over the CDSS period.

The three simulations assume that the GOH continues implementing a strong and comprehensive macroeconomic program. All three simulations also assume generally strong sectoral policies. However, they differ in the nature and speed of GOH implementation of major reforms affecting the performance of the agricultural sector.

### 1. Assumptions Underlying the Model

Good economic policy is the most important assumption behind all the simulations of this model. This means a low (and declining) public sector fiscal deficit, low domestic banking system finance of the public sector deficit, a market-determined exchange rate regime, interest rates determined by market forces, transparent and streamlined government operations, and deep sectoral reforms. Good policies are required in all the scenarios to ensure favorable performance of key macroeconomic variables simulated by the model, including increased GDP growth, high export growth, substantial donor inflows on concessional terms, and ample debt rescheduling. All the simulations run on the basis of this model assume that much-needed improvements are made in the investment climate, the external debt burden, the financial system and the trade regime.

Other assumptions incorporated in all the scenarios are the following:

- Tight monetary and fiscal policies are assumed. These will lower inflation from 23 percent in 1991 to 10 percent in 1992, 8 percent in 1993, 5 percent in 1994, and 4 percent annually during the 1995-96 period.

- Population growth is projected to decline gradually from 2.7 percent in 1991 to 2.6 percent in 1996.

- The growth rate of public consumption is held low. It stays constant in real terms in 1991 and then gradually increases to 1.7 percent in 1996.

- Imports of durable and nondurable consumer goods, petroleum, intermediate goods, and nonfactor services are determined by their estimated elasticities to GDP (using 1989 data as a basis for the calculations). Imports of capital goods are determined by their estimated elasticity to investment (also using 1989 data as a basis for calculations). The import content of gross investment is between 50 and 60 percent.

- Investment growth is determined exogenously; however, a lagged incremental capital output ratio (ICOR) is examined to ensure avoidance of an overly optimistic relation between GDP growth and the need for new capital stock. In the base scenario (moderate agricultural growth) the ICOR is 5.0 in 1992, declining gradually to 2.9 in 1996. The latter represents a very efficient utilization of capital. This is consistent with a scenario of good economic policies and growth being propelled by improved agricultural performance. The agricultural sector requires less capital investment per unit of increased output than growth in the industrial sector.

- Export growth by industries in export processing zones (EPZs) is projected to surge. This is spurred on by good macroeconomic policies and favorable investment conditions. The value added by these industries averages a growth rate of 16.4 percent from 1990 to 1996 (increasing from $31 million to $77 million over this period). It should be noted that the production and exports of EPZs are registered as an offshore activity in the Honduran national accounts. Since the simulation model is based on the GOH national accounts and balance of payments, the production and exports by these export processing zones are treated as current transfers on the balance of payments. Even though these transfers are not registered in GDP or exports, they are vital for financing imports over the CDSS period. They improve the country's balance of payments position through large current account inflows.

- All arrears to the IMF, World Bank and the IDB are eliminated in 1990. However, arrearages remain on debts to commercial banks, suppliers, CABEI, non-Paris Club bilateral donors, and several minor lenders.

- Two-thirds of these remaining arrearages are assumed to be cleared in 1991. Most of these are refinanced by the lending institutions. Commercial bank arrears are reduced by $100 million in 1991 and again by the same amount in 1992. This is in the form of elimination of interest arrears and debt conversion of the principal at a fraction of its face value (about 30 cents on the dollar).

- Honduras will remain creditworthy for assistance from international financial institutions throughout the 1991 to 1996 period. It is further assumed that Honduras will find financing to fill any "unfinanced gap" that may temporarily appear in the scenario. This figure is important in assessing the consistency of the scenario with reality. If an "unfinanced gap" appears and there is no realistic chance of obtaining the necessary financing, the scenario should be rerun -- probably with lower growth rates.

- Gap financing is provided in the model at concessional terms, probably from bilateral donors and from concessional financing by the IDB and IDA. The terms of these loans are assumed to average 10 years, including four of grace and six of amortization, with an interest rate of 7 percent per annum. Even though the model always assumes this financing is available, it should be underscored that too high an "unfinanced gap" implies an inconsistency in the scenario.

- Export and import prices use World Bank projections of January 1991. The model does not explicitly consider price elasticities of supply or demand. They are implicitly assumed to be highly inelastic. This is a shortcoming of the model.

- Gross international reserves are projected to rise to the equivalent of one half month of imports in 1991. These reserves will further increase annually by one quarter month of imports from 1992 to 1996. This will permit gross reserves to reach 1.75 months of imports in 1996.

- Real net direct foreign investment will respond to improved economic policies with a growth rate of 10 percent in 1991, 15 percent in 1992 and 20 percent from 1993 to 1996.

## 2. How the Model Works

The model allows the user to arbitrarily assign real growth rates to three sectors (agriculture, industry and others), net indirect taxes and major exports. However, overly high growth rates would quickly cause inconsistencies with reality for two reasons:

- Excessively ambitious GDP growth would strain the balance of payments by requiring high levels of imports which are linked to GDP. High GDP growth requires much higher investment growth to sustain the increased production. More than one half of the value of investment is assumed

to be imported. Consequently, with other factors remaining unchanged, increased imports associated with excessive economic growth would lead to a deteriorated current account performance in the balance of payments. This, in turn, would require more financing and would lead to a deterioration in indicators relating to gap financing, the stock of debt and debt service to GDP and exports.

- Projecting high GDP growth would also strain private consumption by channeling a larger portion of GDP to investment. GDP by expenditures has three main components: consumption, investment and the difference between exports and imports. Any acceleration of growth must be accompanied by an increase in investment which squeezes consumption directly (through the increase in investment) and indirectly (through the increase in imports needed to sustain more investment). It is likely that private per capita consumption cannot fall precipitously without causing social discontent.

The model requires savings to finance investment. Savings may be domestic (the difference between GDP and consumption) or external (the difference between imports and exports corrected for other current account items in the balance of payments).

The model contains a balance of payments table. Imports and exports are the same as those used in the national accounts. Interest payments and amortizations were originally estimated by the World Bank but were changed by USAID to take into consideration updated information on likely donor disbursements and the financing requirements of the scenarios. The debt service projections reflect the effects of debt rescheduling and increased donor assistance.

The growth rates of all major agricultural commodity exports were projected on a product-by-product basis and then aggregated. Underlying these projections is a favorable private sector response to improved macroeconomic and sectoral policies.

The simulations present major macroeconomic indicators. These serve to assess the consistency of the scenario with reality. They also facilitate assessment of the degree to which the scenario may constitute an acceptable path for the economic growth and development of Honduras.

## 3. Characteristics of the Scenarios Utilized for the CDSS

In general, the scenarios envisage a continuation through the 1990s of the GOH's stabilization program, initiated in March 1990. Sluggish economic performance in 1990 reflects difficult adjustments to improved economic policies, exacerbated by a rise in petroleum prices, a lengthy banana strike, and flooding due to heavy rains late in the year.

The simulations assume that GOH economic policy will emphasize economic growth. At the same time the GOH will seek to strengthen its balance of payments position by bolstering exports and by reducing the burden -- but not necessarily the dollar amount -- of its foreign debt obligations. It is further assumed that the GOH will seek to balance its growth objectives with efforts to cushion the impact of the adjustment measures on low-income groups. As described below, the moderate agricultural growth scenario is consistent with the objectives stated in the CDSS.

In the three scenarios industrial production is projected to rise gradually. Its GDP growth increases from 1.0 percent in 1991 to 4.2 percent in 1996. Due to the need for heavy investments in this sector and the length of time required to adapt an inefficient structure to improved market signals, industrial growth rates are likely to lag behind those of agriculture. It should be noted, that for reasons mentioned previously, the output of the rapidly growing export processing zones is not registered in GDP.

As explained in the text of the CDSS, the Mission believes that rapid agricultural growth is key to improving the performance of the Honduran economy in the CDSS period. However, to attain this growth, deep sectoral reforms must be implemented. The three scenarios presented in this section simulate the results of variations in the speed and degree in implementing these reforms.

The first scenario -- the moderate agricultural growth scenario -- posits strong agricultural reform policies which are introduced gradually over the first half of the 1990s (see Table 1). This scenario serves as the basis for the CDSS analysis. After analyzing the principal characteristics of this scenario, its results will be compared with those of the high and low agricultural growth scenarios.

The moderate agricultural growth scenario projects a leading role for agriculture from 1991 to 1996. During this period, agricultural investment, exports and production surge in response to better macroeconomic and sectoral policies. In this same scenario, overall annual GDP growth averages 4.3 percent. It increases from 1.7 percent in 1991 to 5.3 percent in 1996. This permits real per capita GDP growth to reach 2.7 percent by 1996.

Bolstered by the effects of major macroeconomic and sectoral reforms, agricultural GDP growth is simulated to grow by an average of 6.1 percent per annum in the CDSS period. It grows by 7.5 percent in 1996. This will be accomplished primarily through increased output of traditional and nontraditional export crops. Bananas and coffee will lead the way in the overall rise of export revenues with average annual growth rates of, respectively, 6.0 and 7.6 percent from 1991 to 1996. Cultivated shrimp exports will grow by almost 25 percent annually over the same period. Large increases are also projected for selected fruits, vegetables and ornamental plants. However, this growth will be over a much smaller base than of that bananas, coffee and shrimp. All together, exports are

projected to grow by an annual average of 7.2 percent over the CDSS period. Nontraditionals are projected to grow by an average of 9.0 percent.

The projections of nontraditional exports are based on FPX projections for agricultural products. It is assumed that other nontraditional exports will grow in the same proportion. FPX projected the growth rates of individual export commodities under an ideal policy environment (up front policy reforms in all major areas as presented in the second scenario depicting high agricultural growth). These projections were divided in half for the base scenario (moderate agricultural growth) and by four for the low agricultural growth scenario. In addition, it is assumed that nontraditional industrial exports will contribute an additional five percentage point gain in the total growth of nontraditionals in 1996.

Agricultural production for the domestic market is also expected to increase substantially through 1996. The removal of price controls in 1990-91 will result in an average annual increase in basic grains production of more than 7 percent during the CDSS period. This, along with increased rural income will raise caloric consumption. The agrarian reform law, will be modified to permit fee simple titles, land rentals and sales. Arbitrary expropriations will be curbed. The improved economic policy environment will lead to more intensive land use and, consequently, higher productivity. An improvement in livestock productivity will be an important result of agricultural sector reforms. This will not only increase the availability of dairy and beef products to satisfy the increased demand, but will also make high quality land available for the expansion of crop agriculture.

In the lumber sub-sector, the nationwide implementation of the stumpage valuation method of forest management will decrease total lumber exports to a sustainable level. As a consequence, lumber exports in 1996 are projected to be 6 percent below the level of 1990. Improved forestry management will sharply slow the degradation of the environment and protect the watersheds which are vital to continued expansion of agricultural production. The new graduated tax on lumber exports will decrease the exports of raw and semi-processed lumber while stimulating exports of finished wood products. This will create substantial new employment opportunities and increase foreign exchange earnings.

The government's role in the agricultural sector will change during the CDSS period. Its focus will evolve from interventions and implicit subsidies to transparent economic policies and promotion of efficient production and exports in a competitive environment. The principal functions of the Ministry of Natural Resources (MNR) will be of a normative nature. With World Bank and USAID support, MNR will advocate a much greater allocation of the national budget to investment in productive infrastructure.

Resources for this increased level of investment will become available as the GOH sells state owned enterprises and reduces personnel levels commensurate with the reduction in activities such as grain marketing, seed production, extension services, agricultural laboratories, marketing lumber, retailing fertilizer, agricultural credit programs and many

others. In addition, it is expected that international donors will assist with the development of critical infrastructure. The GOH will increase the effectiveness of its normative activities designed to regulate the import, packaging and use of agricultural chemicals, certify the locally produced seed and plant material and disseminating market and sectoral information. However, the importation and distribution of agricultural inputs will be strictly a private sector activity.

Along with improved economic policies, the scenario assumes a much more efficient utilization of capital stock. Notwithstanding efficiency improvements, increased GDP growth must be accompanied by more capital. As a result, investment is projected to increase its participation in GDP. Gross investment rapidly rises from 13.0 percent of GDP in 1990 to an average of 19.5 percent during the CDSS period. Likewise private investment increases its share of GDP from 11.4 percent in 1990 to 15.6 percent in 1996. During the CDSS private investment averages 14.3 percent of GDP.

Investment capital will shift to the agricultural sector as a result of policy improvements. A major revamping of the financial sector in 1992-1996 will increase the amount of capital available for new investments. In particular, the removal of all administrative controls over interest rates will make lending to the agricultural sector viable for the banks. The new investment code, expected in 1991, along with the improved and stable economic and political environment will also attract foreign investment and Honduran capital which had been held off-shore.

The GOH must find savings to finance increased investment. Savings come from two sources: external and domestic. External savings, defined as the deficit in the balance of payments on current account, are limited by GOH access to external financing. If -- as is assumed in the scenarios -- the GOH strives to reduce the burden of its external debt service obligations, it may try to control current account deficits in its balance of payments. This is because current account deficits have to be financed -- probably (but not necessarily) by incurring debt. Domestic savings, on the other hand, are constrained by the need to ensure minimum levels of domestic consumption.

In the base scenario total Honduran debt, including arrears, is projected to increase in nominal terms from $3,609 million in 1990 to $5,359 million in 1996 -- a total increase of 48.5 percent (at an annual average growth rate of 6.8 percent). Despite this large increase in nominal (uncorrected for world inflation which is projected at about 3.2 percent annually over the same period) debt, the burden of indebtedness declines somewhat during the CDSS period. Total external debt (including arrears) is close to 150 percent of GDP in 1991 and 1996, after climbing to 162 percent in 1994. Debt/exports, debt service/GDP, and debt service/exports all improve somewhat during the 1991-1996 interval. Overall, Honduras' large external indebtedness and the relatively small decrease in its burden -- even with a large increase in exports and debt conversion of obligations to commercial banks at a deep discount -- underscore the need for further debt reduction and concessionary financing, including financing through grants.

The scenario projects large financing gaps. In 1990, the gap (which cannot exist ex post) is shown as $100 million in Table 1. It was probably financed by a further drawdown of reserves (of which liquid reserves are already close to zero), two bridging operations, a postponement into 1991 of the last payment due Mexico as part of its participation in the June 1990 bridge, and somewhat lower imports than estimated in the scenario. Final 1990 figures are not yet available. From 1992 to 1996, the gaps vary from a high of $272 million in 1996 to a low of $164 million in 1993.

It is believed possible that these gaps could be financed by increased donor inflows. However, their large size poses a threat to the Honduran economic reform program. High levels of balance of payments support -- in particular greater IFI disbursements and continued large ESF cash grants -- are key to attain an adequate flow of external financing on favorable terms.

A large part of the gap should be filled by new World Bank and IDB programs and projects. However, the scenarios do not project disbursements by the World Bank and IDB for programs and projects which have not yet been designed. We understand that ample new IFI disbursements, in particular by the IDB, can fill much of the large gap. New bilateral support should also decrease the unfinanced gap. Once new credits are entered in the scenarios, this gap should be narrowed and, hopefully, eliminated. Without financing to close the gap, the scenario would not be viable.

In order to support the investment projected in the scenario without increasing the burden of external debt, the GOH must take decisive measures to increase the generation of domestic savings. Gross domestic savings (GDS) must triple its share of GDP from 6.0 percent in 1990 to 18.0 percent in 1996. This is considered possible (the average GDS/GDP ratio reported by the World Bank for 37 lower middle income economies in 1987 was 21 percent). Gross national savings (equal to GDS minus the outflow of net factor services plus net current transfers) must increase its share of GDP from minus 8.0 percent in 1990 to 10.2 percent in 1996. An increase in the share of savings (both of GDS and GNS) in GDP of this size will require deep financial sector reforms. In particular, these should include higher real rediscount and interest rates, a phase-out of directed credit lines, increased competition among banks, and improved regulation of the banking system (see the text of the CDSS and Annex 2).

The sharp decline in private per capita consumption is arrested in the CDSS period in this scenario. It decreases abruptly in 1990 and 1991, by respectively 5.6 and 4.8 percent, due to a fall in real wages accompanying lower GDP. The latter declines are due to short-term adjustments to improved economic policies, exacerbated by a banana strike, higher petroleum prices and flooding due to heavy rains. After declining slightly in 1992, per capita private consumption growth increases modestly over the rest of the CDSS period, averaging an annual gain of 1.1 percent. In this scenario private consumption per capita in 1996 is 96.4 percent of its value in 1988 (after dipping as low as 90.8 percent in 1991).

The second scenario depicts an even higher agricultural growth rate (see Table 2). It projects the implementation of deep agricultural reforms in the first half of 1991. These reforms encompass improved land security through rapid changes in land reform laws and regulations, liberalized pricing and trade policies, and reforms permitting improved access to credit, inputs and markets. This scenario allows virtually no slippages in the expeditious implementation of improved sectoral policies. The simulation of the results of this scenario is impressive. Real agricultural GDP growth averages 9.0 percent from 1991 to 1996 while overall GDP growth averages 5.7 percent. The latter climbs from minus 1.0 percent in 1990 to 7.2 percent in 1996 and, on a per capita basis, reaches 4.5 percent in 1996. Exports surge in this scenario, led by shrimp, bananas and nontraditionals. Over the 1991 to 1996 period, total exports grow by an annual average of 11.2 percent. The attainment of the results of this scenario would greatly strengthen the GOH balance of payments and permit it to reduce its dependence on donor assistance during the latter part of the CDSS period.

The second scenario contrasts with the first in several other ways. The high agricultural growth scenario is assumed to spur on higher growth in the service sectors. Higher overall GDP growth also increases the need for more investment, and of course, savings to finance the increased investment.

However, nominal external indebtedness, and its burden, are lower in the high growth scenario because the surge in export earnings pays some of the cost of increased imports caused by more growth. In fact, in the high growth scenario the financing gap disappears in 1995 and subsequent years. This same scenario also shows a rapid reduction in the balance of payments deficit -- it is only 0.4 percent of GDP in 1996. In the high growth scenario, debt to GDP is 115 percent in 1996 (compared to 150 percent in the moderate scenario). Debt service to exports is 21.3 percent in the high growth scenario in 1996 (compared to 30.3 percent in the moderate scenario).

The high growth scenario requires much greater domestic savings than the moderate scenario. In the former, GDS must reach 27.8 percent of GDP in 1996. This may be possible, but the share is probably near or above the upper limit of what is politically and socially feasible. Despite this increase in domestic saving, the high growth scenario permits private per capita consumption to increase by 1.7 percent in 1996.

Perhaps the greatest practical impediment to achieving the high growth scenario is its requirement for deep and comprehensive agricultural reforms in the first half of 1991. These may be difficult, but not impossible, from a political perspective. The Mission will use this scenario as an example of what we would like the GOH to achieve; however, we believe the first scenario or perhaps something between the two scenarios is more consonant with political realities.

In contrast to the first two scenarios, the third assumes that agricultural growth is restrained by hesitancy on the part of the GOH to implement fundamental sectoral reforms (see Table 3). Some agricultural policy improvements are made, but progress is erratic with frequent backtracking. As a result the agricultural sector growth rate averages only 3.2 percent over the 1990 to 1996 period. This still represents an improvement over the 2.4 percent average of the last 40 years. The improvement is due more to better macroeconomic, than sector, policies. In this scenario overall GDP growth averages 3.3 percent in the CDSS period. It increases from minus 1.0 percent in 1990 to 3.7 percent in 1996. In the latter year GDP per capita grows by 1.0 percent. Export growth during the 1992-96 period averages 3.9 percent. This scenario is characterized by a weak balance of payments, large external financing gaps and lower increments in private per capita consumption than in the other two scenarios. The growing financing gap makes the scenario unviable and underscores the gravity of a failure of the Honduran economy to improve its overall economic performance. The third scenario also has a greater debt burden than the other two scenarios.

This is clearly the least desirable of the three scenarios. It demonstrates the importance of strong sectoral, as well as macroeconomic, policies which spur agricultural investment, production and exports. In fact, the last scenario suggests that the Honduran economy may be stagnant over the CDSS period -- even with good macroeconomic policies -- if it does not put in place the sector improvements needed to bolster agricultural investment, exports and production.

## 4. Program Funding

A key role for USAID assistance is to help Honduras maximize the resource flows described above as well as to achieve the strategic objectives outlined in this CDSS. The type of program described in this document calls for two essential inputs — GOH courage in implementing far reaching policy reforms and ample donor support for these reforms.

During the CDSS period, the Mission will continue to play a leadership role in the policy dialogue as well as in encouraging ample donor support of sound GOH policies. In support of sound economic policies, we will collaborate in performing technical analyses with the IMF, World Bank, IDB and other donors. We will develop joint programs with the World Bank and IDB in the agriculture sector and will explore additional joint programs in the financial and trade sectors. This collaboration is key to achieving the donor funding levels needed to finance the program outlined in this CDSS.

TABLE 1

HONDURAS: SIMULATION OF ECONOMIC PERFORMANCE THROUGH 1996

MODERATE AGRICULTURAL GROWTH SCENARIO

| | 1990 | 1991 | CDSS Period 1992 | 1993 | 1994 | 1995 | 1996 | CDSS Period (Annual Average) |
|---|---|---|---|---|---|---|---|---|
| GDP growth rate | -1.0% | 1.7% | 3.2% | 3.8% | 4.3% | 5.0% | 5.3% | 4.3% |
| Agriculture | 0.2% | 1.2% | 5.4% | 4.9% | 5.4% | 7.2% | 7.5% | 6.1% |
| Industry | 0.0% | 1.0% | 1.6% | 2.2% | 2.8% | 3.6% | 4.2% | 2.9% |
| Other | -3.8% | 2.0% | 3.0% | 4.0% | 4.4% | 4.8% | 5.0% | 4.2% |
| GDP per capita growth | -3.6% | -1.0% | 0.5% | 1.1% | 1.6% | 2.3% | 2.7% | 1.6% |
| Gross reserves (Months of imports) | 0.37 | 0.50 | 0.75 | 1.00 | 1.25 | 1.50 | 1.75 | 1.25 |
| ESF disbursements ($ millions)* | $135 | $50 | $50 | $50 | $50 | $50 | $50 | $50 |
| Financing gap ($ millions) | $100 | $28 | $202 | $164 | $212 | $193 | $272 | $209 |
| Balance of payments | | | | | | | | |
| Current account balance/GDP | -17.3% | -20.5% | -17.4% | -14.2% | -13.2% | -11.3% | -10.1% | -13.2% |
| Export growth rate (G&NFS) | 2.4% | 5.2% | 7.3% | 5.8% | 6.3% | 8.3% | 8.0% | 7.2% |
| Nontraditionals, growth rate | -2.9% | 10.1% | 8.5% | 8.5% | 8.0% | 11.2% | 8.6% | 9.0% |
| Import growth rate(G&NFS) | -3.6% | 7.7% | 3.5% | 2.4% | 4.9% | 5.3% | 6.0% | 4.4% |
| Gross investment/GDP | 13.0% | 20.0% | 20.0% | 18.6% | 19.1% | 19.5% | 20.3% | 19.5% |
| Private investment/GDP | 11.4% | 11.3% | 12.5% | 13.8% | 14.4% | 15.0% | 15.6% | 14.3% |
| Gross saving/GDP | | | | | | | | |
| GDS/GDP | 6.0% | 9.7% | 12.7% | 13.8% | 14.7% | 16.6% | 18.0% | 15.2% |
| GNS/GDP | -8.0% | -0.5% | 2.5% | 4.5% | 5.9% | 8.3% | 10.2% | 6.3% |
| Private consumption per capita growth rate | -5.6% | -4.8% | -0.3% | 1.9% | 1.1% | 1.4% | 1.7% | 1.1% |
| External debt: | | | | | | | | |
| Debt (including arrears)/GDP | 157% | 151% | 155% | 161% | 162% | 157% | 150% | 157% |
| Debt (including arrears)/exports | 328% | 328% | 321% | 323% | 318% | 297% | 277% | 307% |
| Debt service/GDP | 12.4% | 16.8% | 17.3% | 12.8% | 13.6% | 14.0% | 16.4% | 14.8% |
| Debt service/exports | 25.9% | 36.6% | 35.7% | 25.7% | 26.8% | 26.5% | 30.3% | 29.0% |

* These levels are more conservative than the budget levels proposed in the body of this CDSS and in the FY-1993 ABS.

NOTE: The 1990 figures were the best estimates available to the Mission on April 15, 1991. More recent estimates are included in Annex 3.

TABLE 2

HONDURAS: SIMULATION OF ECONOMIC PERFORMANCE THROUGH 1996

HIGH AGRICULTURAL GROWTH SCENARIO

| | 1990 | 1991 | CDSS Period 1992 | 1993 | 1994 | 1995 | 1996 | CDSS Period (Annual Average) |
|---|---|---|---|---|---|---|---|---|
| GDP growth rate | -1.0% | 2.4% | 4.3% | 4.8% | 5.4% | 6.7% | 7.2% | 5.7% |
| Agriculture | 0.2% | 4.0% | 7.3% | 7.2% | 8.1% | 11.2% | 11.4% | 9.0% |
| Industry | 0.0% | 1.0% | 1.6% | 2.2% | 2.8% | 3.6% | 4.2% | 2.9% |
| Other | -3.8% | 2.3% | 4.3% | 5.0% | 5.5% | 6.5% | 7.0% | 5.7% |
| GDP per capita growth | -3.6% | -0.3% | 1.5% | 2.1% | 2.7% | 4.0% | 4.5% | 2.9% |
| Gross reserves (months of imports) | 0.37 | 0.50 | 0.75 | 1.00 | 1.25 | 1.50 | 1.75 | 1.25 |
| ESF disbursements ($ millions)* | $120 | $50 | $50 | $50 | $50 | $50 | $50 | $50 |
| Financing gap ($ millions) | $102 | ($3) | $130 | $53 | $41 | ($48) | ($93) | $16 |
| Balance of payments | | | | | | | | |
| Current account balance/GDP | -17.3% | -19.2% | -14.7% | -9.9% | -7.2% | -3.9% | -0.4% | -7.2% |
| Export growth rate (G&NFS) | 2.4% | 9.0% | 10.2% | 9.3% | 9.9% | 13.4% | 13.2% | 11.2% |
| Nontraditionals, growth rate | -2.9% | 20.7% | 16.6% | 16.0% | 14.3% | 19.7% | 16.4% | 16.6% |
| Import growth rate (G&NFS) | -3.8% | 8.7% | 5.8% | 2.9% | 5.3% | 9.0% | 8.4% | 6.2% |
| Gross investment/GDP | 13.0% | 20.0% | 21.0% | 19.1% | 18.9% | 21.1% | 22.3% | 20.5% |
| Private investment/GDP | 11.4% | 11.3% | 12.5% | 13.8% | 13.8% | 15.6% | 16.3% | 14.4% |
| Gross saving/GDP | | | | | | | | |
| GDS/GDP | 6.0% | 11.1% | 15.4% | 17.8% | 19.8% | 24.2% | 27.8% | 21.0% |
| GNS/GDP | -7.9% | 0.8% | 6.2% | 9.2% | 11.7% | 17.2% | 21.9% | 13.3% |
| Private consumption per capita growth rate | -5.5% | -5.1% | -0.5% | 2.4% | 1.9% | 0.4% | 1.7% | 1.2% |
| External debt: | | | | | | | | |
| Debt (including arrears)/GDP | 157% | 149% | 149% | 150% | 144% | 131% | 115% | 138% |
| Debt (including arrears)/exports | 328% | 314% | 293% | 278% | 256% | 219% | 182% | 246% |
| Debt service/GDP | 12.5% | 16.8% | 16.2% | 12.0% | 12.7% | 12.3% | 13.5% | 13.3% |
| Debt service/exports | 26.2% | 35.6% | 31.8% | 22.3% | 22.6% | 20.5% | 21.3% | 23.7% |

* These levels are more conservative than the budget levels proposed in the body of this CDSS and in the FY-1993 ABS.

NOTE: The 1990 figures were the best estimates available to the Mission on April 15, 1991. More recent estimates are included in Annex 3.

TABLE 3

HONDURAS: SIMULATION OF ECONOMIC PERFORMANCE THROUGH 1996

LOW AGRICULTURAL GROWTH SCENARIO

| | 1990 | 1991 | CDSS Period 1992 | 1993 | 1994 | 1995 | 1996 | CDSS Period (Annual Average) |
|---|---|---|---|---|---|---|---|---|
| GDP growth rate | -1.0% | 1.1% | 2.6% | 3.3% | 3.2% | 3.7% | 3.7% | 3.3% |
| Agriculture | 0.2% | -1.1% | 3.6% | 4.5% | 2.7% | 2.9% | 2.1% | 3.2% |
| Industry | 0.0% | 1.0% | 1.6% | 2.2% | 2.8% | 3.6% | 4.2% | 2.9% |
| Other | -3.8% | 1.8% | 2.6% | 3.2% | 3.6% | 4.0% | 4.0% | 3.5% |
| GDP per capita growth | -3.6% | -1.5% | -0.1% | 0.6% | 0.6% | 1.1% | 1.0% | 0.6% |
| Gross reserves (months of imports) | 0.37 | 0.50 | 0.75 | 1.00 | 1.25 | 1.50 | 1.75 | 1.25 |
| ESF disbursements ($ millions)* | $120 | $50 | $50 | $50 | $50 | $50 | $50 | $50 |
| Financing gap ($ millions) | $100 | $45 | $239 | $227 | $303 | $346 | $502 | $323 |
| Balance of payments | | | | | | | | |
| Current account balance/GDP | -17.3% | -21.2% | -19.0% | -16.6% | -16.6% | -16.5% | -17.2% | -17.2% |
| Export growth rate (G&NFS) | 2.4% | 2.8% | 5.4% | 4.6% | 3.2% | 3.6% | 2.8% | 3.9% |
| Nontraditionals, growth rate | -2.9% | 5.2% | 4.5% | 4.6% | 4.5% | 6.3% | 4.5% | 4.9% |
| Import growth rate (G&NFS) | -3.6% | 6.8% | 2.7% | 1.9% | 3.7% | 3.8% | 4.1% | 3.2% |
| Gross investment/GDP | 13.0% | 19.8% | 19.7% | 18.4% | 18.7% | 18.9% | 19.4% | 19.0% |
| Private investment/GDP | 11.4% | 11.3% | 12.5% | 13.8% | 14.4% | 15.0% | 15.6% | 14.3% |
| Gross saving/GDP | | | | | | | | |
| GDS/GDP | 6.0% | 9.0% | 11.1% | 11.5% | 11.5% | 11.7% | 11.4% | 11.4% |
| GNS/GDP | -8.0% | -1.3% | 0.7% | 1.8% | 2.0% | 2.5% | 2.1% | 1.8% |
| Private comsumption per capita growth rate | -5.6% | -4.8% | -0.4% | 1.5% | 0.8% | 1.3% | 1.4% | 0.9% |
| External debt: | | | | | | | | |
| Debt (including arrears)/GDP | 157% | 152% | 159% | 167% | 173% | 174% | 175% | 170% |
| Debt (including arrears)/exports | 328% | 337% | 339% | 353% | 363% | 362% | 366% | 356% |
| Debt service/GDP | 12.4% | 16.9% | 17.6% | 13.2% | 14.4% | 15.2% | 18.5% | 15.8% |
| Debt service/exports | 25.9% | 37.5% | 37.6% | 27.8% | 30.1% | 31.7% | 38.7% | 33.2% |

* These levels are more conservative than the budget levels proposed in the body of this CI and in the FY-1993 ABS.

NOTE: The 1990 figures were the best estimates available to the Mission on April 15, 1991. More recent estimates are included in Annex 3.

ANNEX 4

CDSS GOALS, OBJECTIVES, AND INDICATORS

USAID/HONDURAS

GOALS, SUBGOALS, AND STRATEGIC OBJECTIVES

1992-1996

| GOALS and SUBGOALS | STRATEGIC OBJECTIVES |
|---|---|
| I. BROAD-BASED, SUSTAINABLE ECONOMIC GROWTH | |
| A. Policy Reforms for Economic Growth. | 1. Improve Sector Policies in: Agriculture; Trade and Investment; and, Finance. |
| B. Private Sector Response. | 2. Increase Private Investment and Trade. |
| C. Increased Well-Being of the Disadvantaged. | 3. Facilitate Implementation of Social Sector Policies. |
| D. Preservation and Sustainable Use of Natural Resources. | 4. Improve Environmental Policies and Natural Resource Conservation Programs. |
| II. STABLE, PARTICIPATORY DEMOCRACY | |
| A. Responsive Government Institutions. | 5a. Strengthen Democratic Institutions. |
| B. Democratic Pluralism and Values. | 5b. Promote a More Pluralistic Honduran Society. |
| III. EFFECTIVE REGIONAL COOPERATION | |
| Honduran Regional Cooperation. | 6. Promote More Effective Honduran Regional and International Cooperation. |
| IV. OTHER | |
| None. | None. |

TABLE 4A:

USAID/HONDURAS GOALS, SUBGOALS, STRATEGIC OBJECTIVES, and PERFORMANCE INDICATORS
1992 - 1996

| GOALS and SUBGOALS | GOAL and SUBGOAL INDICATORS | Estimated 1990 | Target 1993 | Target 1996 | STRATEGIC OBJECTIVES | STRATEGIC OBJECTIVE PERFORMANCE INDICATORS | Estimated 1990 | Target 1993 | Targ 199 |
|---|---|---|---|---|---|---|---|---|---|
| **I. BROAD-BASED, SUSTAINABLE ECONOMIC GROWTH** | | | | | | | | | |
| A. Policy Reforms for Economic Growth. | GDP Growth: | -1.0% | 3.8% | 5.3% | 1. Improve Sector Policies in Agriculture, Trade and Investment, and Finance. | Agricultural GDP Growth: | 0.2% | 4.9% | 7. |
| | Per Capita GDP Growth: | -3.6% | 1.1% | 2.7% | | Nontraditional Export Growth, volume: | -7.8% | 8.5% | 8. |
| (Encourage the adoption of, and continued adherence to, economic policies that promote investments, productive employment, and export-led economic diversification.) | Per Capita Private Consumption Growth: | -5.8% | 1.9% | 1.7% | | Gross Domestic Savings/GDP: | 5.9% | 13.8% | 18. |
| | Debt/GDP: | 157.0% | 161.0% | 150.0% | | Private Investment Growth: | -11.2% | 14.2% | 9. |
| | Debt Service/GDP: | 12.4% | 12.8% | 16.4% | | | | | |
| | Debt Service/exports: | 25.9% | 25.7% | 30.3% | | | | | |
| | Bal. of Payments Current Account/GDP | -17.3% | -14.2% | -10.1% | | | | | |
| | Children Under 5 Malnourished: | 31.0% | 28.0% | 25.0% | | | | | |
| B. Private Sector Response. | Industrial GDP Growth: | 0.0% | 2.2% | 4.2% | 2. Increase Private Investment and Trade. | Gross Private Investment/GDP: | 7.0% | 13.8% | 15. |
| | Direct Foreign Investment, $ millions | 44 | 66 | 71 | | Export Growth (volume): | 0.7% | 5.8% | 8. |
| (Encourage vigorous response by the private sector to a favorable policy environment.) | | | | | | AID-Supported Export Sales, $ millions: | | | |
| | | | | | | Agriculture | 20.0 | 76.0 | 130. |
| | | | | | | Manufacturing | 4.0 | 8.4 | 13. |
| | | | | | | AID-Supported EPZ/FTZs Transfers, $ millions: | 0.5 | 12.1 | 35. |
| C. Increased Well-Being of the Disadvantaged. | Population Growth Rate: | 2.8% | 2.7% | 2.6% | 3. Facilitate Implementation of Social Sector Policies. | Contraceptive Prevalence: | 46.0% | 49.0% | 52. |
| | Infant Mortality (per 1000): | 59 | 52 | 46 | | Vaccination Coverage: | 75.0% | 80.0% | 85. |
| (Encourage accelerated opportunities for increased participation in the economy by the historically disadvantaged.) | Water Supply Coverage: | 62.5% | 69.1% | 71.9% | | | | | |
| | Sanitation Coverage: | 63.6% | 69.4% | 73.1% | | | | | |
| | Primary School Completion Rate:: | 50.0% | 54.0% | 57.0% | | Years to Complete Primary School: | 9.6 | 9.2 | 8.8 |
| | Unemployment Rate: | 13.8% | 13.9% | 10.0% | | AID-Supported Job Creation, 000s person-yr.: | 14.1 | 22.9 | 28.3 |

TABLE 4A:

USAID/HONDURAS GOALS, SUBGOALS, STRATEGIC OBJECTIVES, and PERFORMANCE INDICATORS
1992 - 1996

| GOALS and SUBGOALS | GOAL and SUBGOAL INDICATORS | Estimated 1990 | Target 1993 | Target 1996 | STRATEGIC OBJECTIVES | STRATEGIC OBJECTIVE PERFORMANCE INDICATORS | Estimated 1990 | Target 1993 | Target 1996 |
|---|---|---|---|---|---|---|---|---|---|
| I. BROAD-BASED, SUSTAINABLE ECONOMIC GROWTH (continued) | | | | | | | | | |
| D. Preservation and Sustainable Use of Natural Resources. | Implementation of environmental, water quality, and chemical and waste contamination laws. | Qualitative target | | | 4. Improve Environmental Policies and Natural Resource Conservations Programs. | Enactment of regulations to implement: | | | |
| (Encourage preservation and sustainable use of the natural resource base.) | People abandoning slash-and-burn farming, thousands | 34 | 35 | 40 | | Environmental Laws | | X | |
| | Ecologically sound management of mangrove forests. | | X | | | Water Quality Laws | | X | |
| | Operational Environmental Fund. | | X | | | Chemical and Waste Contamination Laws | | X | |
| | Functioning financially self-sufficient environmental NGO. | | X | | | Establishment of standards for cultivation in mangrove forests and coastal zones. | | X | |
| | Expanded contacts with international conservation foundations. | | X | | | Privatization of wood processing. | | X | |
| | | | | | | Private ownership of natural forests on private land. | | X | |
| | | | | | | Honduran strategy for environmentally sound development. | | X | |
| | | | | | | Reorganization of government agencies managing natural resources. | | X | |
| | | | | | | Debt-for Nature Swaps | | | |

TABLE 4A:

USAID/HONDURAS GOALS, SUBGOALS, STRATEGIC OBJECTIVES, and PERFORMANCE INDICATORS
1992 - 1996

| GOALS and SUBGOALS | GOAL and SUBGOAL INDICATORS | Estimated 1990 | Target 1993 | Target 1996 | STRATEGIC OBJECTIVES | STRATEGIC OBJECTIVE PERFORMANCE INDICATORS | Estimated 1990 | Target 1993 | Target 1996 |
|---|---|---|---|---|---|---|---|---|---|
| II. STABLE, PARTICIPATORY DEMOCRACY | | | | | | | | | |
| A. Responsive Government Institutions. | Electoral Reform Law | | | | 5a. Strengthen Democratic Institutions. | Improved Judicial System. | Qualitative target. | | |
| | Career Judicial Law | | | | | Improved Local Government. | Qualitative target. | | |
| (Encourage the strengthening of competent, civilian government institutions that will merit the confidence of political and military leaders, citizens, and investors.) | National Elections | | X | | | Improved Legislative System. | Qualitative target. | | |
| | Peaceful transition of democratically elected civilian administrations. | X | | | | Improved Election System. | Qualitative target. | | |
| | | | | | | Strengthened Controller General. | Qualitative target. | | |
| | Public confidence in the ability of the judiciary to provide timely, independent, and objective due process. | Qualitative target | | | | Judicial School | | | |
| | | | | | | Center for Legislative Research and Studies | | | |
| | Public reliance initially on local governments to meet urban service needs. | Qualitative target | | | | | | | |
| | Legislative independence from the executive branch and equal, open access to the legislative branch. | Qualitative target | | | | | | | |
| | Domestically and internationally recognized free and open local and national elections. | Qualitative target | | | | | | | |
| B. Democratic Pluralism and Values. | Stronger NGOs and Community Organizations. | Qualitative target. | | | 5b. Promote a More Pluralistic Honduran Society. | Increased citizen understanding of democracy. | Qualitative target. | | |
| (Encourage pluralism, tolerance of opposing views, and support for democratic values on the part of nongovernment bodies, including the press, community organizations, labor unions, and business associations.) | | | | | | Stronger NGOs and community organizations. | Qualitative target. | | |

TABLE 4A:

USAID/HONDURAS GOALS, SUBGOALS, STRATEGIC OBJECTIVES, and PERFORMANCE INDICATORS
1992 - 1996

| GOALS and SUBGOALS | GOAL and SUBGOAL INDICATORS | Estimated 1990 | Target 1993 | Target 1996 | STRATEGIC OBJECTIVES | STRATEGIC OBJECTIVE PERFORMANCE INDICATORS | Estimated 1990 | Target 1993 | Target 1996 |
|---|---|---|---|---|---|---|---|---|---|
| III. EFFECTIVE REGIONAL COOPERATION | | | | | | | | | |
| Honduran Regional Cooperation. | Net Positive IFI Financial Flows | | X | X | 6. Promote More Effective Honduran Regional and International Cooperation. | Effective Honduran Participation in Regional Cooperation Mechanisms and Institutions: PDD, CGs, CABEI, CA Parliament, etc. | | | |
| | IFI and Bilateral Donor Support for Honduras: | | | | | Effective Honduran Participation in International Cooperation Mechanisms and Institutions, EAI, CBI, GATT, CGs, etc. | | | |
| | IMF Agreements and SAFs/ESAFs: | X | X | X | | Reduced PL 480 Debt: | | | |
| | World Bank SALs and SECALs: | X | X | X | | principle, $ millions | -12 | 0.8 | 2.1 |
| | IDB Sector and Investment Loans: | X | X | X | | interest, $ millions | -2 | 2.1 | 2.2 |
| | Transparent and Streamlined Government Operations: | | X | | | Reduced AID Debt: | | | |
| | Open, transparent, and competitive market economy. | Qualitative target. | | | | principle, $ millions | -3.7 | 6.9 | 10.1 |
| | World Bank and IDB financed social sector programs. | | | X | | interest, $ millions | -7.7 | 8.2 | 8.4 |
| | World Bank and IDB support for: | | | | | | | | |
| | agricultural sector reforms | X | X | X | | | | | |
| | financial sector reforms | X | X | X | | | | | |
| | improving efficiency of decentralized enterprises | X | X | | | | | | |
| | reform of BANADESA | | X | | | | | | |
| | energy system | X | | | | | | | |
| | World Bank support for Honduran financial system. | | X | | | | | | |
| | Increased National Budget for Infrastructure: | | | X | | | | | |
| | Improved Primary Road System: | | | X | | | | | |
| | Expanded Electrical Grid: | | | X | | | | | |
| | Participation in CA Summit Meetings: | 2 | 2 | 2 | | | | | |
| | Signature of EAI Agreements: | X | NA | NA | | | | | |

TABLE 4B:

| GOALS and SUBGOALS | STRATEGIC OBJECTIVES | Projects Directly Supporting Strategic Objective | | Projects Indirectly Supporting Strategic Objective | |
|---|---|---|---|---|---|
| I. BROAD-BASED, SUSTAINABLE ECONOMIC GROWTH | | | | | |
| A. Policy Reforms for Economic Growth. (Encourage the adoption of, and continued adherence to, economic policies that promote investments, productive employment, and export-led economic diversification.) | 1. Improve Sector Policies in Agriculture, Trade and Investment, and Finance. | Small Farmer Organization Strengthening | 522-0252 | Forestry Development | 522-0246 |
| | | Strategic Planning and Technical Support | 522-0269 | Land Use and Productivity Enhancement | 522-0292 |
| | | Privatization of State-Owned Enterprises | 522-0289 | Strengthening Democratic Institutions | 522-0296 |
| | | Shelter Sector Program | 522-0324 | Chamber of Commerce - Cortes | 522-0363 |
| | | Policy Analysis and Implementation | 522-0325 | Housing Guarantee 008 | |
| | | Economic Support Program | 522-0331 | | |
| | | Rural Roads Maintenance | 522-0334 | | |
| | | Economic Stabilization and Recovery III | 522-0358 | | |
| | | Structural Adjustment Program | 522-0365 | | |
| | | Privatization of State-Owned Enterprises II | 522-0367 | | |
| | | Economic Stabilization and Recovery IV | 522-0375 | | |
| | | Small Farmer Organization Strengthening II | 522-0383 | | |
| | | PL 480 Title I | | | |
| | | PL 480 Title III | | | |
| | | Housing Guarantee 009 | | | |
| B. Private Sector Response. (Encourage vigorous response by the private sector to a favorable policy environment.) | 2. Increase Private Investment and Trade. | Small Farmer Coffee Improvement | 522-0176 | Small Business Development II | 522-0241 |
| | | Export Development and Services | 522-0207 | Small Farmer Organization Strengthening | 522-0252 |
| | | Small Farmer Livestock | 522-0209 | Privatization of State-Owned Enterprises | 522-0289 |
| | | Rural Trails and Access Roads II | 522-0214 | Strengthening Democratic Institutions | 522-0296 |
| | | Human Resources Development Council (CADERH) | 522-0257 | Policy Analysis and Implementation | 522-0325 |
| | | Irrigation Development | 522-0268 | International Executive Services Corps (IESC) | 522-0361 |
| | | Investment and Export Development | 522-0312 | Chamber of Commerce - Cortes | 522-0363 |
| | | | | Structural Adjustment Program | 522-0365 |
| | | | | Privatization of State-Owned Enterprises II | 522-0367 |
| | | | | Small Farmer Organization Strengthening II | 522-0383 |
| | | | | Housing Guarantee 008 | |
| | | | | Housing Guarantee 009 | |

TABLE 4B:

| GOALS and SUBGOALS | STRATEGIC OBJECTIVES | Projects Directly Supporting Strategic Objective | | Projects Indirectly Supporting Strategic Objective | |
|---|---|---|---|---|---|
| I. BROAD-BASED, SUSTAINABLE ECONOMIC GROWTH (continued) | | | | | |
| C. Increased Well-Being of the Disadvantaged.<br><br>(Encourage accelerated opportunities for increased participation in the economy by the historically disadvantaged.) | 3. Facilitate Implementation of Social Sector Policies. | Health Sector II | 522-0216 | Small Farmer Coffee Improvement | 522-0176 |
| | | Small Business Development II | 522-0241 | Rural Trails and Access Roads II | 522-0214 |
| | | Primary Education Efficiency | 522-0273 | Small Farmer Organization Strengthening | 522-0252 |
| | | International Executive Services Corps (IESC) | 522-0361 | Human Resources Development Council (CADERH) | 522-0257 |
| | | Private Sector Population Program II | 522-0369 | Land Use and Productivity Enhancement | 522-0292 |
| | | Housing Guarantee 008 | | Strengthening Democratic Institutions | 522-0296 |
| | | PL 480 Title II | | Shelter Sector Program | 522-0324 |
| | | | | Rural Roads Maintenance | 522-0334 |
| | | | | Municipal Development | 522-0340 |
| | | | | Small Farmer Organization Strengthening II | 522-0383 |
| | | | | Housing Guarantee 009 | |
| D. Preservation and Sustainable Use of Natural Resources.<br><br>(Encourage preservation and sustainable use of the natural resource base.) | 4. Improve Environmental Policies and Natural Resource Conservations Programs. | Forestry Development | 522-0246 | Health Sector II | 522-0216 |
| | | Land Use and Productivity Enhancement | 522-0292 | Agricultural Research Foundation | 522-0249 |
| | | Integrated Pest Management | 522-0362 | Policy Analysis and Implementation | 522-0325 |
| | | Central America Energy Conservation | 522-0998 | Municipal Development | 522-0340 |
| | | | | Structural Adjustment Program | 522-0365 |
| | | | | Housing Guarantee 008 | |
| | | | | Housing Guarantee 009 | |

TABLE 4B:

| GOALS and SUBGOALS | STRATEGIC OBJECTIVES | Projects Directly Supporting Strategic Objective | | Projects Indirectly Supporting Strategic Objective | |
|---|---|---|---|---|---|
| II. STABLE, PARTICIPATORY DEMOCRACY | | | | | |
| A. Responsive Government Institutions. (Encourage the strengthening of competent, civilian government institutions that will merit the confidence of political and military leaders, citizens, and investors.) | 5a. Strengthen Democratic Institutions. | Strengthening Democratic Institutions | 522-0296 | Health Sector II | 522-0216 |
| | | Controller General | 522-0338 | Primary Education Efficiency | 522-0273 |
| | | Municipal Development | 522-0340 | Investment and Export Development | 522-0312 |
| | | Strengthening Accountability Systems | 522-0381 | Policy Analysis and Implementation | 522-0325 |
| | | | | Structural Adjustment Program | 522-0365 |
| B. Democratic Pluralism and Values. (Encourage pluralism, tolerance of opposing views, and support for democratic values on the part of nongovernment bodies, including the press, community organizations, labor unions, and business associations.) | 5b. Promote a More Pluralistic Honduran Society. | Small Farmer Titling and Services | 522-0173 | Export Development and Services | 522-0207 |
| | | Agricultural Research Foundation | 522-0249 | Small Farmer Organization Strengthening | 522-0252 |
| | | FOPRIDEH Institutional Strengthening | 522-0266 | Strengthening Democratic Institutions | 522-0296 |
| | | Honduras Peace Scholarships | 522-0329 | Investment and Export Development | 522-0312 |
| | | Chamber of Commerce - Cortes | 522-0363 | Municipal Development | 522-0340 |
| | | Honduras Peace Scholarships II | 522-0364 | Small Farmer Organization Strengthening II | 522-0383 |

TABLE 4B:

| GOALS and SUBGOALS | STRATEGIC OBJECTIVES | Projects Directly Supporting Strategic Objective | Projects Indirectly Supporting Strategic Objective | |
|---|---|---|---|---|
| **III. EFFECTIVE REGIONAL COOPERATION** | | | | |
| Honduran Regional Cooperation. | 6. Promote More Effective Honduran Regional and International Cooperation. | | Export Development and Services | 522-0207 |
| | | | Rural Trails and Access Roads II | 522-0214 |
| | | | Forestry Development | 522-0246 |
| | | | Agricultural Research Foundation | 522-0249 |
| | | | Small Farmer Organization Strengthening | 522-0252 |
| | | | Irrigation Development | 522-0268 |
| | | | Strategic Planning and Technical Support | 522-0269 |
| | | | Privatization of State-Owned Enterprises | 522-0289 |
| | | | Land Use and Productivity Enhancement | 522-0292 |
| | | | Strengthening Democratic Institutions | 522-0296 |
| | | | Investment and Export Development | 522-0312 |
| | | | Policy Analysis and Implementation | 522-0325 |
| | | | Rural Roads Maintenance | 522-0334 |
| | | | Municipal Development | 522-0340 |
| | | | Chamber of Commerce - Cortes | 522-0363 |
| | | | Structural Adjustment Program | 522-0365 |
| | | | Privatization of State-Owned Enterprises II | 522-0367 |
| | | | Economic Stabilization and Recovery IV | 522-0375 |
| | | | Small Farmer Organization Strengthening II | 522-0383 |
| | | | Central America Energy Conservation | 522-0998 |
| **IV. OTHER** | | | | |
| None. | None. | | | |

TABLE 4C: USAID/HONDURAS GOALS, SUBGOALS, STRATEGIC OBJECTIVES, and PERFORMANCE AND PROGRAM INDICATORS
1992 - 1996

| GOALS and STRATEGIC OBJECTIVES | STRATEGIC OBJECTIVE PERFORMANCE INDICATORS | Estimated 1990 | Target 1993 | Target 1996 | PROGRAM INDICATORS | Estimated 1990 | Target 1993 | Target 1996 |
|---|---|---|---|---|---|---|---|---|
| I. BROAD-BASED, SUSTAINABLE ECONOMIC GROWTH | | | | | | | | |
| 1. Improve Sector Policies in Agriculture, Trade and Investment, and Finance. | Agricultural GDP Growth: | 0.2% | 4.9% | 7.5% | Fiscal Reforms: | | | |
| | Nontraditional Export Growth, volume: | -7.8% | 8.5% | 8.6% | fiscal deficit as a percent of GDP | 8.9% | 4.0% | 2.4% |
| | Gross Domestic Savings/GDP: | 5.9% | 13.8% | 18.0% | domestic bank finance of public sector deficit: | 5.5% | 0.0% | 0.0% |
| | Private Investment Growth: | -11.2% | 14.2% | 9.7% | inflation | 35.2% | 8.0% | 4.0% |
| | | | | | Low Public Consumption Growth: | -6.0% | 1.5% | 1.7% |
| | | | | | Market-determined exchange rate: | | X | |
| | | | | | Gross International Reserves, months of imports: | 1.0 | 1.0 | 1.8 |
| | | | | | Structural Changes in: | | | |
| | | | | | Agriculture: | | | |
| | | | | | improved land markets: | | | |
| | | | | | land mortgage system established, | | | |
| | | | | | land rental system established, | | | |
| | | | | | land sale system established; | | X | |
| | | | | | improve pricing and trade policies: | | | |
| | | | | | elimination of price controls on ag. products; | | | |
| | | | | | elimination of price controls on ag. inputs; | | | |
| | | | | | end quantitative restrictions on ag.: | | | |
| | | | | | exports, | | | |
| | | | | | imports; | | | |
| | | | | | privatize seed production and marketing | | | |
| | | | | | Finance: | | | |
| | | | | | liberalize credit markets | | X | |
| | | | | | removal of interest rate ceilings | | X | |
| | | | | | high real rediscount rates | | X | |
| | | | | | effective regulation of banking system | | | X |
| | | | | | phase-out directed lines of credit | | X | |
| | | | | | reduced reserve requirements | | X | |
| | | | | | long-term lending instruments created | | | X |
| | | | | | strengthened Honduran Bankers' Association (AHIBA) | | | X |

TABLE 4C: USAID/HONDURAS GOALS, SUBGOALS, STRATEGIC OBJECTIVES, and PERFORMANCE AND PROGRAM INDICATORS
1992 - 1996

| GOALS and STRATEGIC OBJECTIVES | STRATEGIC OBJECTIVE PERFORMANCE INDICATORS | Estimated 1990 | Target 1993 | Target 1996 | PROGRAM INDICATORS | Estimated 1990 | Target 1993 | Target 1996 |
|---|---|---|---|---|---|---|---|---|
| 1. Improve Sector Policies in Agriculture, Trade and Investment, and Finance. (continued) | | | | | low-income shelter credit (percent of households below median income with access to credit): | 19.1% | 23.5% | 28.5% |
| | | | | | Trade: | | | |
| | | | | | maximum nominal import tariff: | 40.0% | 20.0% | 20.0% |
| | | | | | eliminate quantitative restrictions | | X | |
| | | | | | eliminate licensing | | X | |
| | | | | | eliminate trade monopolies | | X | |
| | | | | | simplify regulatory procedures | | | |
| | | | | | simplify customs procedures | | | |
| | | | | | value added by EPZs, $ millions | 31 | 53 | 77 |
| | | | | | Investment: | | | |
| | | | | | eliminate barriers to entry of foreign investment | | X | |
| | | | | | improve legal, regulatory, and judicial systems | | | |
| | | | | | enforcement of contracts | | X | |
| | | | | | privatizations: | 1 | 5 | 5 |
| | | | | | reduced capital flight | | | |
| | | | | | return of flight capital | | | X |
| | | | | | Narrowed USAID Policy Agenda: | | | |
| | | | | | Value of coffee exports, $ millions | 170 | 185 | 306 |
| | | | | | Value of banana exports, $ millions | 194 | 248 | 300 |
| | | | | | Increased value nontraditional agricultural exports: | 19.5% | 11.2% | 4.8% |
| | | | | | pineapples | 79.2% | 4.4% | 10.0% |
| | | | | | cultivated shrimp | 7.8% | 32.5% | 0.9% |
| | | | | | melons | 23.0% | 20.6% | 16.7% |
| | | | | | ornamental plants | 22.0% | 22.5% | 15.5% |
| | | | | | Value Added to Ag. by AID-Supported Programs, $ millions | 46.1 | 62.5 | 80.0 |
| | | | | | Growth in basic grains production, percent | 11.3% | 4.5% | 4.5% |

TABLE 4C: USAID/HONDURAS GOALS, SUBGOALS, STRATEGIC OBJECTIVES, and PERFORMANCE AND PROGRAM INDICATORS
1992 - 1996

| GOALS and STRATEGIC OBJECTIVES | STRATEGIC OBJECTIVE PERFORMANCE INDICATORS | Estimated 1990 | Target 1993 | Target 1996 | PROGRAM INDICATORS | Estimated 1990 | Target 1993 | Target 1996 |
|---|---|---|---|---|---|---|---|---|
| 2. Increase Private Investment and Trade. | Gross Private Investment/GDP: | 7.0% | 13.8% | 15.6% | Structural Changes in Investment: | | | |
| | Export Growth (volume): | 0.7% | 5.8% | 8.0% | new investment code | | | |
| | AID-Supported Export Sales, $ millions: | | | | streamline investment procedures | | X | |
| | Agriculture | 20.0 | 76.0 | 130.0 | Private Sector Gross Fixed Capital Formation/GDP | 7.0% | 13.8% | 15.6% |
| | Manufacturing | 4.0 | 8.4 | 13.2 | Additional Investment in Manufacturing, $ millions | 6.0 | 19.2 | 32.3 |
| | AID-Supported EPZ/FTZs Transfers, $ millions: | 0.5 | 12.1 | 35.0 | | | | |
| 3. Facilitate Implementation of Social Sector Policies. | Contraceptive Prevalence: | 46.0% | 49.0% | 52.0% | Number of NGOs providing family planning services | 1 | 4 | 6 |
| | Vaccination Coverage: | 75.0% | 80.0% | 85.0% | Share GOH Budget going to Health | 12.3% | 13.0% | 13.0% |
| | | | | | Share Health Budget going to Primary Health | 21.8% | 23.0% | 23.0% |
| | | | | | Share of Health Budget Collected at Health Centers and Hospitals | 2.3% | 3.0% | 5.0% |
| | | | | | Diarrhea Cases Treated with ORT | 17.3% | 24.0% | 30.0% |
| | | | | | Number of Municipalities Managing Water Systems | 2 | 2 | 1 |
| | Years to Complete Primary School: | 9.6 | 9.2 | 8.8 | Primary School Enrollment Ratio | 102.0% | 101.0% | 100.0% |
| | | | | | First graders Going to Second, thousands | 59.6 | 62.0 | 64.0 |
| | | | | | Share GOH Budget going to Education | 18.3% | 18.8% | 20.0% |
| | | | | | Share of Education Budget going to Primary Education | 48.0% | 49.5% | 50.0% |
| | AID-Supported Job Creation, 000s person-yr.: | 14.1 | 22.9 | 28.3 | Additional People Employed in Nontraditional Agricultural Exports, thousands | 14.6 | 25.6 | 18.3 |
| | | | | | Additional People Employed in Manufacturing for Export, thousands | 2.5 | 5.4 | 7.9 |
| | | | | | Increased Employment due to AID support of micro & small enterprises, thousands | 5.6 | 6.0 | 7.0 |

TABLE 4C: USAID/HONDURAS GOALS, SUBGOALS, STRATEGIC OBJECTIVES, and PERFORMANCE AND PROGRAM INDICATORS
1992 - 1996

| GOALS and STRATEGIC OBJECTIVES | STRATEGIC OBJECTIVE PERFORMANCE INDICATORS | Estimated 1990 | Target 1993 | Target 1996 | PROGRAM INDICATORS | Estimated 1990 | Target 1993 | Target 1996 |
|---|---|---|---|---|---|---|---|---|
| 4. Improve Environmental Policies and Natural Resource Conservations Programs. | Enactment of regulations to implement: | | | | Pine Forest Managed for Sustainable Yield, cumulative thousands of hectares: | 68 | 160 | 300 |
| | Environmental Laws | | X | | Trees Planted in AID-Supported Activities, thousands per year: | 429 | 700 | 700 |
| | Water Quality Laws | | X | | Forests protected, thousands of hectares | 90 | 200 | 300 |
| | Chemical and Waste Contamination Laws | | X | | Reserves Protected, cumulative | | 1 | 3 |
| | Establishment of standards for cultivation in mangrove forests and coastal zones. | | X | | Standards for pesticide use and chemical contamination | | X | |
| | Privatization of wood processing. | | X | | | | | |
| | Private ownership of natural forests on private land. | | X | | | | | |
| | Honduran strategy for environmentally sound development. | | X | | | | | |
| | Reorganization of government agencies managing natural resources. | | X | | | | | |
| | Debt-for Nature Swaps | | | | | | | |

TABLE 4C: USAID/HONDURAS GOALS, SUBGOALS, STRATEGIC OBJECTIVES, and PERFORMANCE AND PROGRAM INDICATORS
1992 - 1996

| GOALS and STRATEGIC OBJECTIVES | STRATEGIC OBJECTIVE PERFORMANCE INDICATORS | Estimated 1990 | Target 1993 | Target 1996 | PROGRAM INDICATORS | Estimated 1990 | Target 1993 | Target 1996 |
|---|---|---|---|---|---|---|---|---|
| II. STABLE, PARTICIPATORY DEMOCRACY | | | | | | | | |
| 5a. Strengthen Democratic Institutions. | Improved Judicial System. | Qualitative target. | | | Career Justices of the Peace | 25% | 75% | 100% |
| | Improved Local Government. | Qualitative target. | | | Merit Selection of New Judges | NA | 100% | 100% |
| | Improved Legislative System. | Qualitative target. | | | Career Judicial Administrative Staff | NA | 100% | 100% |
| | Improved Election System. | Qualitative target. | | | Strengthened Municipal Governments | NA | 2 | 3 |
| | Strengthened Controller General. | Qualitative target. | | | Separate Municipal Elections | | | X |
| | Judicial School | | | | Deputies Receiving Training | 71% | 10% | ? |
| | Center for Legislative Research and Studies | | | | Newly Elected Deputies Receiving Training | - | 100% | NA |
| | | | | | Career CIEL Staff | NA | 100% | NA |
| | | | | | Primary Elections | NA | NA | X |
| | | | | | National Election | X | X | NA |
| | | | | | Merit Selection of Registry Personnel | NA | 100% | 100% |
| | | | | | Poll Workers Trained, thousands | NA | 64 | NA |
| 5b. Promote a More Pluralistic Honduran Society. | Increased citizen understanding of democracy. | Qualitative target. | | | Also See Indicators Under I.1. | | | |
| | Stronger NGOs and community organizations. | Qualitative target. | | | Democratic Leadership Training Courses | 12 | 15 | 15 |
| | | | | | Peace Scholarship training in U.S. | | | |
| | | | | | Long-Term | 64 | 58 | 20 |
| | | | | | Short-Term | 159 | 90 | 0 |
| | | | | | Municipalities consulting community based groups | NA | 2 | 3 |
| | | | | | Functioning, Financially Self-Sufficient: | | | |
| | | | | | Honduran Foundation for Agricultural Research | | X | |
| | | | | | Foundation for Investment and Export Development | | | X |
| | | | | | Federation of Agricultural Exporters and Producers | | | X |
| | | | | | Confederation of Private Sector Organizations | | | X |
| | | | | | Honduran Family Planning Association | | | X |
| | | | | | Human Resources Development Council | | | X |

TABLE 4C: USAID/HONDURAS GOALS, SUBGOALS, STRATEGIC OBJECTIVES, and PERFORMANCE AND PROGRAM INDICATORS
1992 - 1996

| GOALS and STRATEGIC OBJECTIVES | STRATEGIC OBJECTIVE PERFORMANCE INDICATORS | Estimated 1990 | Target 1993 | Target 1996 | PROGRAM INDICATORS | Estimated 1990 | Target 1993 | Target 1996 |
|---|---|---|---|---|---|---|---|---|
| III. EFFECTIVE REGIONAL COOPERATION | | | | | | | | |
| 6. Promote More Effective Honduran Regional and International Cooperation. | Effective Honduran Participation in Regional Cooperation Mechanisms and Institutions: PDD, CGs, CABEI, CA Parliament, etc. | | | | Secretariat for CA Summit | | X | |
| | | | | | Participation in CA Summit Meeting | 2 | 2 | 2 |
| | | | | | Regional Consultative Group (IDB) | | X | X |
| | Effective Honduran Participation in International Cooperation Mechanisms and Institutions, EAI, CBI, GATT, CGs, etc. | | | | Signature of EAI Trade and Investment Agreement | X | | |
| | | | | | US debt Reduction/Rescheduling | X | X | X |
| | | | | | Bilateral Consultative Group (World Bank) | X | X | X |
| | | | | | Paris Club Reschedulings | X | X | X |
| | Reduced PL 480 Debt: | | | | | | | |
| | principle, $ millions | -12 | 0.8 | 2.1 | Implementation of and IMF, World Bank and IDB Support for Strong Macroeconomic Stabilization Measures: | X | X | X |
| | interest, $ millions | -2 | 2.1 | 2.2 | | | | |
| | Reduced AID Debt: | | | | | | | |
| | principle, $ millions | -3.7 | 6.9 | 10.1 | | | | |
| | interest, $ millions | -7.7 | 8.2 | 8.4 | | | | |

ANNEX 5

## DIRECTED LINES OF CREDIT

The Mission's Directed Lines of Credit Strategy responds to cable guidance (90 STATE 164131) which requested a strategy for phasing out directed lines of credit. The same cable approved the Mission's Agricultural Sector Strategy Document.

The Mission's strategy is based on its experience with directed credit in the 1980s, conclusions of a Credit Dilemma Study for Honduras, and current donor policy with regard to targeted credit. The strategy redirects Mission actions in the financial sector from a focus on provision of credit to one of reducing structural impediments to more efficient financial markets.

### Rationale

The widespread support of directed credits by the Mission in recent years is a response to Honduras' weak financial system. Honduran banks generally serve only a limited client group. The flaws of this system are exacerbated by an excessive public sector fiscal deficit and attempts by the government to obtain subsidized banking system credit to finance this deficit. Other sources of credit were further reduced in the 1980s as commercial lenders lost confidence in the region. Capital flight increased dramatically during the same period. The result was ever increasing conservatism in the allocation of resources by formal sector lenders. Consequently, many sectors such as agriculture, small business, housing and new export industries found their growth potential constrained by limited access to credit. USAID/Honduras and other donors addressed the problem by including credit components in projects designed to increase production and promote exports.

A Credit Dilemma Study financed by USAID/Honduras in 1988 and a Financial Sector Assessment being prepared in 1991 point out that the targeted credit approach has not been successful in alleviating the problem. The study revealed that constraints to delivering credit in Honduras are institutional and structural and that very little of an expansion in the aggregate supply of credit would reach the target group. World Bank studies and A.I.D.'s Financial Markets Policy note the pitfalls of reliance on directed lines of credit. International donor experience confirms that countries should work to remove obstacles to more efficient financial markets rather than circumvent the underlying weaknesses by targeting credit. Given this overwhelming evidence that directed credit is not the best solution to limited access to resources, USAID/Honduras has developed this strategy which changes our focus from provision of credit to one of improving financial market conditions.

The disadvantages of directed lines of credit are well-known. They discourage the generation of domestic savings. They often rely on artificially low rediscount and interest rates. Administrative costs

associated with the program are excessive. And because money is fungible, directed credits often do not finance the activities they are intended to support. Solutions to the problem of increased access to credit in Honduras lie in changing lender practices, removal of all interest rate ceilings, removal of disincentives to savings mobilization such as excessive reserve requirements, and development of new financial instruments which respond to market conditions.

Policy Environment

Honduras made historic progress on improving economic policies in March 1990. Financial liberalization is a part of this movement. In June 1990, the Central Bank of Honduras announced an increase in the interest rate ceiling and in rediscount rates. Further reforms were implemented in October and November when the Central Bank lifted the interest rate ceiling for all lending using resources owned by the commercial banks in areas other than housing and agriculture. And in late March 1991, the GOH took another positive step by increasing the rediscount rate on all directed lines of credit to 19 percent.

Acting on these unprecedented changes in the policy environment, USAID/Honduras is pursuing a strategy to extend the liberalized interest rate structure to project-financed lines of credit. The World Bank and the Inter-American Development Bank are partners in this effort and are supporting the same policy reforms in their programs.

Planned Actions

Based on the positive movement of the GOH in recent months, the Mission will implement a strategy to phase out directed lines of credit. This will be carried out in conjunction with our financial sector reforms, supported by the Mission's Structural Adjustment Program (SAP) beginning in 1992. This strategy will employ an integrated policy/implementation approach to the dual problem of access to credit and the distortionary effects of directed lines of credit.

The most important element of this strategy will be to remove the subsidies inherent in lines of credit. The effective cost to financial intermediaries of using directed credits will be more expensive than paying interest on savings. Our objective is to create an environment that discourages reliance on targeted credit while increasing incentives for the financial sector to mobilize domestic resources.

Phasing out directed lines of credit is part of a comprehensive strategy to deepen financial markets. Continuous policy dialogue will be an essential element in bringing about necessary reforms of the formal financial sector. In complementary efforts, the Mission will use project interventions to address noninterest rate questions such as lack of competitive behavior among lenders, nonresponsive lender practices, and concentration of lending to vested interest groups. These issues are being further analyzed in USAID's Financial Sector Assessment.

Policy dialogue will be carried out through the SAP, and the Policy Analysis and Implementation Project will be the main implementation channel for this program. These actions will be supplemented by activities with the Superintendent of Banks under the Investment and Export Promotion Project, and by interventions with the informal financial sector through the Small Farmer Organization Strengthening and Small Business II projects.

These Mission initiatives will work to create the following conditions which are required for a complete phase out of directed lines of credit:

- Interest rate determination by market forces;

- effective supervision and regulation of the banking system to improve solvency and efficiency and to promote competition;

- establishment of medium and long term nondonor financing for all activities of the financial system; and

- rediscount rates high enough to make savings generations more attractive than directed credits for financing bank lending activities.

It is anticipated that these conditions can be met within a three to five year time frame, which is consonant with the planned period of implementation of the SAP and the Policy Analysis and Implementation Project.

Until these conditions are met, the Mission will implement a policy that all new or expanded directed lines of credit must be justified in accordance with A.I.D.'s current Financial Markets Policy.

ANNEX 6

# TROPICAL DEFORESTATION AND BIOLOGICAL DIVERSITY

## A. BACKGROUND

Sections 118 and 119A of the FAA require that every CDSS and Action Plan address the issues of Tropical Deforestation and Biological Diversity, to include analyses of (1) actions necessary in the host country to achieve sustainable management of tropical forests and conserve biological diversity, and (2) the extent to which actions proposed for Mission support meet these needs.

Honduras is one of the most geographically and biologically diverse countries in the Central American region, possessing a very wide variety of ecosystems. From coral reefs to cloud forests, from rich mangrove estuaries to pine covered highlands, Honduras was richly endowed with tropical flora and fauna. Indeed, rational utilization of a rich natural resource base would appear to be Honduras' most promising development strategy. Historically, however, development of these resources has followed an explotative or "mining" approach with little or no consideration for sustainability. This approach, coupled with rapidly increasing population pressures on the land, has placed the future of Honduras' natural resource based economy in jeopardy. Recognition of this most basic problem has grown slowly within both public and private sectors, but is beginning to take root. This recognition has been hampered by budgetary limitations and political will in the public sector, and by the immediate subsistence needs and the "common property" nature of resource utilization in the private sector, and, in society as a whole, by a lack of awareness of the seriousness of the issue.

Due to the leadership of enlightened Hondurans and the increasing support of AID and other donors, significant steps are being taken to reverse the trend toward deterioration of forests and to preserve biological diversity.

The following sections identify major problems and enumerate USAID initiatives associated with their solution. For the sake of brevity in presenting the analyses, the following acronyms are used:

| | |
|---|---|
| AHE | Honduran Ecological Association |
| AMADHO | Association of Sawmill Operators of Honduras |
| CAPS | Central American Peace Scholarships |
| COHDEFOR | Honduran Forestry Development Corporation |
| CONAMA | National Commission on the Environment |
| DA | Development Assistance |
| EA | Environmental Assessment |
| FDP | Forestry Development Project |
| FPX | Federation of Agricultural Producers and Exporters |
| HCEP | Honduras Country Environmental Profile |
| IPM | Integrated Pest Management |
| LC | Local Currency |
| LUPE | Land Use and Productivity Enhancement (Project) |
| MNR | Ministry of Natural Resources |

| | |
|---|---|
| NRMP | Natural Resources Management Project |
| RPBR | Plátano River Biosphere Reserve |
| RTP | Rural Technologies Project |
| WWF | World Wildlife Fund |
| RENARM | ROCAP's Regional Environmental and Natural Resources Management Project. |
| E/NR | Environment/Natural Resources |

## B. TROPICAL DEFORESTATION

According to available data, 7.4 million hectares (about 65 percent of the country's land area of 11.2 million hectares) is classified as land whose proper use should be forest. Only about 5.0 million hectares actually are covered by broadleaf or pine forests. Broadlead forests account for about 2.0 million hectares of this total, and are made up primarily of mahogany, cedar, San Juan, Sangre, oak, granadillo, liquidambar, and mangrove. Principal conifers are pitch pine (pinus oocarpa), Caribbean pine (P. caribea), and white pine (P. pseudostrobus). Over 95 percent of lumber exports are pine.

These forest resources have declined rapidly in the past quarter-century. For example, the area of broadleaf forest has declined from around 4 million to about 2 million hectares since 1964. One reason for this is that broadleaf forest soils are much preferred to typically poorer, steeper, and more acid pine forest soils for agricultural purposes. While the area of pine forest has not declined nearly as dramatically, the volume of standing pine timber has been reduced dangerously due to overutilization and slow reforestation (primarily via natural regeneration from standing seed trees). Pine lumber exports continue to decline because of the "mining" nature of lumber production in Honduras. Consequently, the volume of pine resources has fallen from 48 to 28 million cubic meters since 1964.

The harvesting of wood for fuel is another factor in the decline of forest resources -- both broadleaf and pine. Overall, the current rate of forest land loss is estimated at around 80,000 hectares per year.

The following analysis indicates principal actions necessary to achieve conservation and sustainable management of tropical forests in Honduras, and the extent to which Mission supported actions meet these needs.

| Actions Necessary | Related USAID Actions |
|---|---|
| 1. Modify GOH policies regarding: | 1. |
| a. ownership of trees | a. 1982 NRMP/COHDEFOR agreement granting farmers ownership rights to trees they plant has been extended nationally. (However, natural forests on private lands remain under state control.) |

| Actions Necessary | Related USAID Actions |
|---|---|
| b. public sector participation in lumber production. | b. USAID-supported policy change toward divestiture of public industries. This divestiture is almost 100% complete. |
| c. standing timber valuation and granting of timber concessions. | c. FDP/COHDEFOR effort to enhance pine forest management, install stumpage valuation system, and revise concessions system has reached over 60% of pine forests, will be 100% by end of 1991. |
| d. deemphasize public (COHDEFOR) role of production and marketing. | d. FDP effort to reorient COHDEFOR toward forest management role is almost complete. |
| e. rationalize commercial development in mangrove forest. | e. USAID has provided support via RTP, AHE, and FPX to contribute to environmentally and economically sound development of shrimp and salt production. |
| f. encourage sustainable development of broadleaf forests. | f. Other donors are involved in this sector. (FDP has delineated broadleaf forest reserves.) |
| g. enforcement of regulations regarding use of fires, land clearing, use of forest reserves. | g. Limited USAID participation through localized interventions under NRMP, FDP, LUPE. RENARM will contribute. See 3.a below. |
| 2. Increase awareness of and interest in forest protection via: | |
| a. educational/promotional campaigns | a. USAID support to AHE. LUPE rural schools and extension activities. FDP environmental education component. Planned LUPE/WWF activity, and environmental education activities. |
| b. training at technical and academic levels, for GOH and Mission staff. | b. CAPS and Project-funded scholarships for forestry related applicants. FDP, NRMP, and LUPE training programs. E/NR training planned for two USDH employees in FY 1991. |

| Actions Necessary | Related USAID Actions |
|---|---|
| c. articulation and analysis of environmental issues. | c. HCEP and 1989 update, detailed project EA's. RENARM studies. |
| 3. Improve Honduran efforts for: | 3. |
| a. forest protection (existing forests) | a. NRMP/LUPE forest protection and agroforestry efforts (90,000 ha. under protection), and FDP forest protection/fire detection-control activities, both of which are primarily in pine areas. |
| b. reforestation | b. NRMP has produced and planted 6,000,000 trees. LUPE will plant 9-10 million additional trees. FDP promotes reforestation as part of sustained forest management. |
| c. long-term sustained forest management | c. FDP will make large contribution for pine resources. Broadleaf areas being assisted by other donors. |
| d. management of forest watersheds, reduction of slash and burn agriculture, etc. | d. NRMP/FDP/LUPE watershed management initiatives. USAID support to improved management of coffee lands. |
| e. controlling development for agriculture on forest lands, including reserve buffer zones. | e. Support under LUPE and FDP in selected areas. |
| f. improving the efficiency of lumbering activities. | f. FDP/COHDEFOR efforts in support of forest industry (AMADHO). |
| g. mitigating demand for fuelwood cutting. | g. RTP/NRMP/LUPE promotion of improved stoves. FDP promotion of alternative energy. NRMP/LUPE fuelwood plantations and agroforestry activities. ROCAP/RENARM renewable energy activities. |
| 4. Limited GOH budget for forestry activities. | 4. DA and LC support. Potential availability of funds via debt forgiveness and debt-for-nature swaps. |

## C. BIOLOGICAL DIVERSITY

As indicated in Section A, Honduras was richly endowed with biological diversity. The wide variety of ecosystems in Honduras provide environments for myriad plant and animal species. However, much of this diversity is in danger and large areas of cloud forest have been lost.

Half of the original broadleaf forest has been converted to other land uses. Mangrove forests have been disturbed for fuelwood, salt, and mariculture production. Pollution threatens surface water systems, estuaries, coral reefs, and other plant and animal systems. However, incredible diversity still remains, and must be preserved. This diversity represents an important natural legacy for future generations of Hondurans, as well as a potential economic resource that can support increased tourism and scientific study.

The Plátano River watershed on the north coast is an example of existing biological diversity in Honduras. This watershed contains a wide range of ecosystems, from relatively high altitude moist tropical forests inland (one of the four largest such forests remaining in Central America), through lower altitude hardwood forests to the coastal wetlands and coral reefs of the Caribbean shore. This single watershed contains around 85 percent of the species of flora and fauna found in Honduras. The area has been declared a biosphere reserve by the GOH Protection is almost nonexistent, however, and logging and slash and burn agriculture are beginning to cause problems. Efforts involving the AHE, COHDEFOR, WWF, MNR and other entities towards developing and implementing a management plan for the reserve were supported by $100,000 made available through the NRMP. Significant future support from the GOH and donor community will be required if this resource is to be maintained. The following analysis identifies principal actions necessary to conserve biological diversity in Honduras, and the extent to which USAID support meets these needs.

| Actions Necessary | Related USAID Actions |
|---|---|
| 1. Modify GOH policies regarding: | 1. |
| a. private conversion of biologically diverse areas to other land uses. | a. USAID supports (1) rationalization of shrimp mariculture concessions/development, (2) establishment of forest reserves under FDP, and (3) support for management plan for RPBR. RENARM will contribute in policy area. |
| b. regulation and enforcement of pesticide/ fungicide use and other pollutants. | b. USAID support to IPM activities and Project EA provisions. RENARM. |
| c. harvest of wildlife through commercial or sport hunting and fishing. | c. No direct USAID activities. Some local currency support for related activities of RENARE. |

| Actions Necessary | Related USAID Actions |
|---|---|
| d. incentives for maintenance of diversity. | d. No current USAID activities. Potential LUPE and RENARM support via buffer zone management activities. |
| 2. Increase awareness of and interest in biological diversity via: | 2. |
| a. public education | a. USAID support to AHE, FDP, NRMP, LUPE activities in environmental education. Rural primary education textbooks. |
| b. training at technical and academic levels. | b. support to AHE, CAPS and Project funded scholarships and training courses. |
| c. analysis of environmental issues. | c. RTP studies of coastal zone. USAID funded shrimp study, HCEP and 1989 update. Project EAs. RENARM Policy Inventory. |
| 3. Improve Honduran efforts for: | 3. |
| a. official delineation of and practical management of reserve areas. | a. GOH has proposed 60, delineated and declared 30; AID has directly supported six (Parque Nacional La Tigra, RPBR, two in Olancho under FDP, two in Choluteca R. watershed under NRMP/LUPE). |
| b. enhanced monitoring and control of farming systems, including chemical use, in agricultural areas in context of biodiversity maintenance. | b. USAID IPM activities. FDP, NRMP, and especially LUPE activities in environmental monitoring. Project EA conditions. Proposed RENARM activities in Honduras. |
| c. establishment and utilization of contacts with international conservation foundations to assist Honduran organizations in biodiversity conservation. | c. USAID support to AHE. Proposed initiatives under LUPE, and RENARM. Potential use of debt-for-nature or debt forgiveness funds, possibly via CONAMA. |
| d. environmentally sound tourism development. | d. Limited USAID activities. |

| Actions Necessary | Related USAID Actions |
|---|---|
| e. developing local capacities in technical and financial aspects of biodiversity management. | e. USAID support to AHE, MNR. RENARM program. |
| 4. Increase GOH budget resources for biodiversity. | 4. DA and LC support for various activities. Potential debt-for-nature resources. |

D. SUMMARY

Although the situation in Honduras with respect to Tropical Deforestation and Biological Diversity is critical, encouraging steps are being taken -- many of them due in large part to USAID leadership. Indeed, USAID/Honduras has a long history of involvement in activities relating to forestry, conservation, and environmental concerns. The Mission recognizes the importance of addressing these issues as an integral part of the overall development picture. USAID/Honduras consistently places high priority on the development of in-depth environmental assessments wherever the need for such analyses is indicated, typically with the valued assistance of AID environmental specialists from LAC and ROCAP.

As example, the EA for the FDP includes a series of recommendations for environmental planning and mitigative measures which are now included in COHDEFOR forest management plans. These recommendations were backed up by three conditions precedent and once covenant in the Project Agreement. Under the LUPE Project, almost $1.5 million in grant funds are budgeted for direct support of environmental management activities in addition to substantial expenditures for such environmentally sound interventions as soil conservation and agroforestry. These activities include full time technical specialists in environemntal monitoring and education, monitoring equipment, training, and establishment of agreements to provide project personnel with assistance in IPM, management of buffer zones for biological reserves, etcetera. The Health Sector II Project provides support for safe water and sanitation systems. The new Municipal Development Project includes environmentally related activities with respect to providing participating municipalities with the capability to manage wastes and protect local environments. The contribution of RENARM activities in Honduras are also expected to be substantial.

These developments have taken place since the Mission's last analysis of Tropical Deforestation and Biological Diversity was submitted. In addition, further assistance has been provided to AHE, an environmental education study was funded by NRMP, the 1989 Environmental Profile update was completed, a study of the southern mangroves was carried out under RTP, and Mission personnel participated in a variety of workshops related to environmental issues, including one organized by ROCAP for the development of a regional strategy for AID assistance for environmental and natural resources management in Central America.

The result of the latter, a ROCAP Strategy Paper, articulates five priority areas for the region:

1. Sustainable Agriculture;
2. Production from Natural Forests;
3. Management of Wildlands and Protection of Biological Diversity;
4. Management of Critical Watersheds; and
5. Policy Formulation, Institutional Strengthening, and Environmental Education.

It is a reflection of the historical concern of USAID that all of these priority areas for the region are already receiving attention and support within the mission's development portfolio.

ANNEX 7

STAFFING AND OE LEVELS

OVERVIEW

Over the CDSS period we propose reducing overall USAID staffing by 25 percent from current levels. Total U.S. citizen employment will be cut by 34 percent and FN employment by 22 percent. The Operating Expense (OE) funds required to support the levels of staffing we have proposed will also be substantially reduced. The total OE levels will be reduced gradually over the CDSS period to a level of 34 percent below current levels in real terms.

We have proposed a strategy for the USAID program in Honduras for 1992-96 which continues our efforts to operate with a smaller staff. We are in accord with the "Economic Assistance Strategy for Central America, 1991-2000". From 1985-90 the USAID Program averaged $158 million in new funding with an authorized LOP of close to $627 million in ongoing projects by FY-91. Nevertheless, during the past four years the Mission made a concerted effort to consolidate its program. We reduced the number of project and nonproject management units from 62 in 1986 to 35 in 1991.

Our program consolidation effort will continue throughout the 1992-96 period. Program funding will decline from an average of $158 million per fiscal year in 1985-90 period to $126 million in the 1992-96 period. There will continue to be a large pipeline of ongoing projects that will be gradually reduced. The number of ongoing project and nonproject management units will also decline from 35 in 1991 to about 25 in 1996.

The process of reducing management workload is gradual, as is the process of consolidation of our portfolio. We are currently operating at a level of 39 USDH employees; 19 USDH for mission management and staff functions, 17 USDH for technical and line functions, 1 USDH regional legal advisor and 2 trainee positions. Illustratively, we project dropping 2 staff positions, 3 line positions and the 2 trainee positions in order to reach our proposed level of 32 USDH FTE by 1996. We expect our consolidation efforts also to reduce our reliance on US and FN PSCs as illustrated in the charts in the next section.

Another AID/W initiative with which we are in complete agreement is the reduction of our dependence on trust funds for our operating expense needs. Our current percentage of trust funds to total operating expense requirements is approximately 80 percent. If AID/W is successful in obtaining dollar funds to replace trust fund reductions at the rate of 80 cents to the dollar, we plan to reduce our dependence on trust funds to 25 percent of total operating expense requirements. The 20 cents per dollar shortfall will be offset by reducing our total operating expense requirements, mainly by reducing personnel.

That being said, we believe further cuts in personnel and OE resources will be inappropriate. The strategy proposed in this CDSS will continue to require substantial USAID leadership and intensive staff support. In recent years, USAID has had to play a major leadership role in helping the GOH formulate and implement

its macroeconomic and sector reforms and in mobilizing IFI and other donor assistance. Much work was required to get this country to understand and better utilize Paris Club and Consultative Group Mechanisms. A substantial amount of USAID staff time (both in Tegucigalpa and Washington) has had to be dedicated to helping the GOH better manage its debt problems especially with the IFIs. This type of intensive USAID leadership and staff support will have to continue throughout the CDSS period if Honduras is to achieve higher economic growth and effectively participate in new initiatives like EAI and PDD.

Likewise, USAID has been the recognized leader among donors in promoting trade, investment and privatization and in helping Honduras take advantage of the Caribbean Basin Initiative. USAID continues to be the lead donor in financing primary health, family planning, primary education, training, housing, microenterprises and food aid programs. Many of Honduras' environmental protection and natural resource conservation programs were pioneered with USAID technical assistance. No other major donor is providing assistance to strengthen democratic institutions.

These programs cannot be effectively implemented without intensive USAID staff support, monitoring and supervision. This is particularly important because Honduras has such a weak institutional and human resource base. It is made even more difficult by the country's inadequate management and accountability systems, poor policy planning and implementation mechanisms, difficulties in dealing with the IFIs and history of poorly utilizing resources that are not properly supervised.

While USAID has been encouraging Honduras to broaden and diversify its international cooperation, such an effort will take time and will be ongoing throughout the CDSS period. We are hopeful that the IMF and the World Bank will assume an even greater leadership role and that the IDB will gradually become the single largest funding source of economic and development programs. USAID also expects to gradually phase-out its assistance in some areas as other donors expand their programs. However, for all of this to fall into place during this CDSS period, USAID will continue to require an adequately staffed Mission.

STAFFING

In view of the limited availability of dollar operating expense resources over the CDSS period and the OMB requirement that we reduce our dependence on trust funds, we have undertaken a process of reducing Mission staff to a bare minimum. The continuing consolidation of our program has helped us in the staff reduction exercise.

The basic theme justifying the levels we are proposing is that we will continue to exercise a high level of accountability for our entire program. Additionally, although the program level for ESF in FYs 91-93 has been reduced to $50 million, the effort involved in economic analysis, financial analysis and policy dialogue related to this program has not changed. Rather, there is an increase of effort required in coordinating with the other donor institutions in order to obtain increases in the levels of their programs as we reduce ours.

In order to determine who qualifies as USAID staff, as opposed to U.S. technical assistance to the Honduran public and private sectors, we defined USAID staff as

those employees whose workplace is primarily the USAID offices. Office-by-office staffing reviews divided the staff into three major categories according to the type of responsibilities performed. These categories cut across organizational lines. As a result, some offices (e.g. Engineering) had employees in all three categories. The categories are: Core Management, Indirect Variable Support staff and Direct Variable staff. The idea behind this exercise was that certain positions will vary according to the program make-up and size and others will not. Core Management is expected to stay constant, assuming that there will be no dramatic change in program size from that projected in this CDSS. Indirect variable support staff will vary with program size and make-up but not in direct relationship to the changes. Direct variable staff are those employees whose positions relate directly to specific projects or programs and, as we further consolidate our program, will be reduced accordingly. The following table outlines, by employee category, the total USAID/Honduras FTE employment levels for each of the fiscal years of the CDSS.

| | FTE | | | | | | |
|---|---|---|---|---|---|---|---|
| | FY91 | FY92 | FY93 | FY94 | FY95 | FY96 | Overall Reduction |
| USDH | 39 | 36 | 35 | 33 | 33 | 32 | 7 |
| USPSC | 23 | 20 | 16 | 14 | 13 | 13 | 10 |
| PASA | 9 | 4 | 2 | 2 | 2 | 2 | 7 |
| FNDH | 33 | 32 | 31 | 30 | 30 | 30 | 3 |
| FNPSC | 134 | 122 | 119 | 114 | 110 | 101 | 33 |
| TOTAL | 238 | 214 | 203 | 193 | 188 | 178 | 60 |

In determining the ultimate make-up of the Mission staff we split the positions into three general categories as follows:

| | FTE | |
|---|---|---|
| | FY91 | FY96 |
| Core Management | 93 | 93 |
| Indirect Variable Support | 58 | 34 |
| Direct Variable Staff | 87 | 51 |
| Total | 238 | 178 |

Core Management Staff are those employees who will be required for overall program management within any likely annual program level. Included in this category are:

| | FTE | | |
|---|---|---|---|
| | USDH | OTHER | TOTAL |
| Mission Direction | 3 | 3 | 6 |
| Office Directors | 9 | 9 | 18 |
| Regional Legal Advisor | 1 | 1 | 2 |
| Other Program Management* | 6 | 61 | 67 |
| Total | 19 | 74 | 93 |

*B&A Officer, Project Development Officer, Program Officer, Contracts Officer, Econ. Officer.

We have projected that these positions will remain constant throughout the CDSS period.

Indirect Variable Support are those employees who provide overall Mission support but whose positions may vary indirectly according to program size and makeup. The reduction of 24 FTEs in this category result in the following levels by the end of the CDSS period:

| | FTE | |
|---|---|---|
| | FY91 | FY96 |
| Mission Direction | 1 | 0 |
| Executive Management | 26 | 18 |
| Controller | 16 | 11 |
| Project Development | 5 | 2 |
| Program | 2 | 0 |
| Economic Analysis | 2 | 0 |
| Engineering | 6 | 3 |
| Total | 58 | 34 |

Direct Variable Staff are those employees directly responsible for project management and whose position levels vary directly with project requirements and the number of project management units in the portfolio. The following is the level of employment in each of the line functions after a reduction of 36 FTEs:

| | FTE | |
|---|---|---|
| | FY91 | FY96 |
| Engineering | 2 | 0 |
| Private Sector | 13 | 13 |
| Rural Development | 33 | 18 |
| Human Resources and Democratic Initiatives | 39 | 20 |
| Total | 87 | 51 |

Our Municipal Development project, an important component of the Democratic Initiatives portfolio, is being managed by RHUDO. If RHUDO staffing is reduced, the Mission will have to absorb the management responsibility and the personnel currently in RHUDO directly related to the project. Our projections of Mission staffing do not include the effects of this transfer, possibly to be effective in FY93. RHUDO's projections for staffing its continuing regional operations are as follows:

| | FY91 | FY92 | FY93 | FY94 | FY95 | FY96 |
|---|---|---|---|---|---|---|
| DHs | 4.0 | 4.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| PSCs | 3.5 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Support Staff | 4.5 | 5.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| Total | 12.0 | 11.0 | 8.0 | 8.0 | 8.0 | 8.0 |

The RHUDO staff responsible for the Municipal Development Project are projected to be as follows:

| | FY91 | FY92 | FY93 | FY94 | FY95 | FY96 |
|---|---|---|---|---|---|---|
| USPSCs | 1.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| TCN | 0.2 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| FSNPSCs | 0.5 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Total | 1.7 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |

If we are to absorb the project management responsibilities for the Municipal Development project in FY93, the transfer of one of the RHUDO USDH positions will be required.

## OPERATING EXPENSES

The following chart indicates total levels required and the appropriated dollar and trust fund split. The split proposed is dependent on the success of the recently announced AID/W plan to provide dollar appropriated funds by 80 percent of the reductions in trust funds.

OPERATING EXPENSES ($ MILLIONS)

| | FY92 | FY93 | FY94 | FY95 | FY96 |
|---|---|---|---|---|---|
| Dollar OE | 1.0 | 2.2 | 3.0 | 3.0 | 3.0 |
| Trust Funds | 3.5 | 2.1 | 1.1 | 1.0 | 1.0 |
| Total | 4.5 | 4.3 | 4.1 | 4.0 | 4.0 |

If the Agency is not successful in obtaining dollar appropriated OE funds to help reduce our dependence on trust funds, we will need to continue to rely heavily on trust funds. Our "worst case" scenario in such a circumstance is as follows:

OPERATING EXPENSES ($ MILLIONS)

| | FY92 | FY93 | FY94 | FY95 | FY96 |
|---|---|---|---|---|---|
| Dollar OE | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| Trust Funds | 3.5 | 3.3 | 3.1 | 3.0 | 3.0 |
| Total | 4.5 | 4.3 | 4.1 | 4.0 | 4.0 |

The reductions represented in the tables assume we will absorb inflation to the extent that it does not exceed 5 percent per year.

Of the staff reductions of 60 FTEs, 27 are project funded. Of the OE funded reductions in staff of 33, 7 are USDHs and 3 are USPSCs. Our ability to absorb the 34 percent reduction in OE is made possible by this large reduction in expensive U.S. citizen employment.

We reiterate, further cuts in either staffing or total OE resources will severely curtail our ability to provide adequate accountability for our program and appropriate leadership in assisting the GOH and other donors in developing the economic measures necessary for growth. Our proposed reductions in both staffing and OE funding resulted from a detailed analysis of the requirements of our program in a position-by-position review and justification process.