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Honduras

Economic Performance Assessment



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Honduras

Economic Performance

Assessment

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Sponsored by the Economic Growth office of USAID's Bureau of Economic Growth, Agriculture and Trade (EGAT), and implemented by Nathan Associates Inc. under Contract No. PCE-I-00-00-00013-00, Task Order 004, the Country Analytical Support (CAS) Project, 2004-2006, has developed a standard methodology for producing analytical reports to provide a clear and concise evaluation of economic growth performance in designated host countries. These reports are tailored to meet the needs of USAID missions and regional bureaus for country specific analysis. Each report contains:

- A synthesis of data drawn from numerous sources, including World Bank publications and other international data sets currently used by USAID for economic growth analysis, as well as accessible host-country data sources;
- International benchmarking to assess country performance in comparison to similar countries and groups of countries;
- An easy-to-read analytic narrative that highlights areas in which a country's performance is particularly strong or weak, thereby assisting in the identification of future programming priorities.

Under the CAS Project, Nathan Associates will also respond to mission requests for in-depth sector studies to examine more thoroughly particular issues identified by the data analysis in these country reports.

The authors of this report are Eric Miller, Colleen Morton, and Maureen Hinman. Bruce Bolnick provided technical supervision.

The CTO for this project is Yoon Lee. USAID missions and bureaus may seek assistance and funding for CAS studies by contacting Rita Aggarwal, USAID/EGAT/EG Activity Manager for the CAS project, at raggarwal@usaid.gov.

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Bruce Bolnick
Chief of Party, CAS Project
Nathan Associates Inc.
Bbolnick@nathaninc.com

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HIGHLIGHTS OF HONDURAS'S PERFORMANCE

Economic Growth	Honduras has had strong real GDP growth in 2004 and 2005. However, its investment and labor productivity numbers have declined over time. Significant competitiveness challenges remain.
Poverty	Honduras has very high levels of poverty and inequality.
Economic Structure	Honduras has a mismatch between the number of people employed in agriculture and the productivity of the agricultural sector. Industrial and service sector workers are very productive relative to their size.
Demography and Environment	Honduras has a young population that continues to grow quickly, creating ever more pressure on job creation. Despite improvements in environmental management, Honduras's Environmental Sustainability Index score has declined in recent years.
Gender	Honduras has more men than women enrolled in school. The ratio of male to female literacy is roughly equal at 0.99.
Fiscal and Monetary Policy	Fiscal and monetary management have tended to be good in recent years. Honduras' fiscal deficit has declined steadily. However, the government still faces a variety of spending pressures, notably from wages and salaries.
Business Environment	Honduras faces significant problems with corruption and rule of law. Although Honduras does relatively fine with respect to its business procedures, the cost of starting a business is significantly out of line with its comparators.
Financial Sector	Honduras has a significant quantity of credit available to the private sector. However, the cost to create collateral is high and those puts standard financial instruments out of reach for many small and medium size enterprises.
External Sector	CAFTA-DR offers tremendous opportunities and challenges to Honduras in the years ahead. Debt relief has helped Honduras by providing greater space for social spending over the medium term. Remittances will continue being an important source of income for the country and its population.
Economic Infrastructure	Honduras's Puerto Cortes is now part of the U.S. Container Security Initiative. Investment in airport infrastructure continues apace.
Health	Honduras has had great success in reducing maternal mortality rates. More investment in health, especially to reduce child malnutrition, is essential.
Education	Honduras has further to go in increasing its youth literacy rate. Its rates of student persistence to grade 5, while better than expected, need to improve.
Employment and Workforce	In Honduras, men have a relatively high rate of participation in the labor force while women have a very low rate of participation.
Agriculture	Growth in value-added per worker remains low by regional standards as does Honduras' cereal yield.

Note: The methodology used for comparative benchmarking is explained in the Appendix.

HONDURAS: NOTABLE STRENGTHS AND WEAKNESSES— SELECTED INDICATORS

Indicator	Strength	Weakness
Growth Performance		
Real GDP growth	✓	
Growth of labor productivity		✓
Poverty and Inequality		
Income share accruing to poorest 20%		✓
Poverty headcount (%), by national poverty line		✓
Economic Structure		
Output structure (agriculture, value-added, % GDP)		✓
Output structure (industry, value-added, % GDP)	✓	
Demography and Environment		
Age dependency rate		✓
Environmental sustainability index		✓
Gender		
Ratio of male to female—adult literacy rate	✓	
Fiscal and Monetary Policy		
Cash Surplus/Deficit (% of GDP)	✓	
Composition of government expense (wages and salaries)		✓
Business Environment		
Rule of law index		✓
Cost of starting a business, % GNI per capita		✓
Financial Sector		
Domestic credit to private sector, % GDP	✓	
Interest rate spread, lending rate minus deposit rate	✓	
External Sector		
Private capital inflows, % GDP		✓
Gross international reserves, months of imports	✓	
Debt service ratio, % exports	✓	
Time to trade (average import and export days)		✓
Economic Infrastructure		
Quality of infrastructure - ports	✓	

Indicator	Strength	Weakness
Health		
Maternal mortality rate, per 100,000 live births	✓	
Prevalence of child malnutrition (weight for age)		✓
Education		
Persistence in school to grade 5 (total)	✓	
Employment and Workforce		
Labor force participation rate (female)		✓

Note: The chart identifies selective indicators for which Honduras's performance is particularly strong or weak relative to the benchmark standards; details are discussed in the text. The separate Data Supplement presents a full tabulation of the data examined for this report, including the international benchmark data, along with technical notes on the data sources and definitions.

1. Introduction

This paper is one of a series of economic performance assessments prepared for the EGAT Bureau to provide USAID missions and regional bureaus with a concise evaluation of a broad range of indicators relating to economic growth performance in designated host countries. The report draws on a variety of international data sources¹ and uses international benchmarking against reference group averages and comparator countries (Chile and Costa Rica²) to identify major constraints, trends, and opportunities for strengthening growth and reducing poverty.

The methodology used is analogous to examining an automobile dashboard to see which gauges are signaling problems. Sometimes a blinking light has obvious implications—such as the need to fill the fuel tank. In other cases, it may be necessary to have a mechanic probe more deeply to assess the source of the trouble and determine the best course of action.³ Similarly, economic performance assessments are based on an examination of key economic and social indicators, to see which ones are signaling problems. In some cases a “blinking” indicator has clear implications, while in others a detailed study may be needed to investigate the problems more fully and identify an appropriate course for programmatic action.

The analysis is organized around two mutually supportive goals: transformational growth and poverty reduction.⁴ Rapid and broad-based growth is the most powerful instrument for poverty reduction. At the same time, measures aimed at reducing poverty and lessening inequality can help to underpin rapid and sustainable growth. These interactions create the potential for stimulating a virtuous cycle of economic transformation and human development.

Transformational growth requires a high level of investment and rising productivity. This is achieved by establishing a strong enabling environment for private sector development involving multiple elements: macroeconomic stability; a sound legal and regulatory system, including secure contract and property rights; effective control of corruption; a sound and efficient financial

¹ Sources include the latest data from USAID’s internal Economic and Social Database (ESDB), and from readily accessible public information sources. The ESDB is compiled and maintained by the Development Information Service, under PPC/CDIE. It is accessible to staff through the USAID intranet.

² These two countries were selected at the request of the LAC Bureau as comparators for all of the CAS reports on the CAFTA countries.

³ Sometimes, too, the problem is faulty wiring to the indicator—analogue here to faulty data.

⁴ In USAID’s White Paper on *U.S. Foreign Aid: Meeting the Challenges of the Twenty-first Century* (January 2004), transformational growth is a central strategic objective, both for its innate importance as a development goal, and because growth is the most powerful engine for poverty reduction.

system; openness to trade and investment; sustainable debt management; investment in education, health, and workforce skills; infrastructure development; and sustainable use of natural resources.

In turn, the impact of growth on poverty depends on policies and programs that create opportunities and build capabilities for the poor. We call this the pro-poor growth environment.⁵ Here too, many elements are involved, including effective education and health systems, policies facilitating job creation, agricultural development (in countries where the poor depend predominantly on farming), dismantling barriers to micro and small enterprise development, and progress toward gender equity.

The present evaluation of these conditions must be interpreted with caution, because a concise analysis of this sort cannot provide a definitive diagnosis of economic problems or simple answers to questions about programmatic priorities. Instead, the aim of the analysis is to spot signs of serious problems for economic growth, on the basis of a review of selected indicators, subject to limits of data availability and quality. The results should provide insight about potential paths for USAID intervention, to complement on-the-ground knowledge and further in-depth studies.

The report discusses the most important results of the diagnostic analysis in three sections: Overview of the Economy; Private Sector Enabling Environment; and Pro-Poor Growth Environment. Table 1-1 summarizes the topic coverage. The Appendix provides a brief explanation of the criteria used for selecting indicators, the benchmarking methodology, and a table showing the full set of indicators examined for this report.

Table 1-1
Topic Coverage

Overview of the Economy	Private Sector Enabling Environment	Pro-Poor Growth Environment
<ul style="list-style-type: none"> • Growth Performance • Poverty and Inequality • Economic Structure • Demographic and Environmental Conditions • Gender 	<ul style="list-style-type: none"> • Fiscal and Monetary Policy • Business Environment • Financial Sector • External Sector • Economic Infrastructure • Science and Technology 	<ul style="list-style-type: none"> • Health • Education • Employment and Workforce • Agriculture

⁵ A comprehensive poverty reduction strategy also requires programs to reduce the *vulnerability* of the poor to natural and economic shocks. This aspect is not covered in the template since the focus is economic growth programs. In addition, it is difficult to find meaningful and readily available indicators of vulnerability to use in the template

2. Overview of the Economy

This section reviews some basic information on Honduras's macroeconomic performance, poverty and inequality, economic structure, demographic and environmental conditions, and indicators of gender equity.⁶ Some indicators are descriptive rather than analytical and are included to provide context for the performance analysis.

Honduras has spent much of the past seven years recovering from Hurricane Mitch, which struck the country in 1998. Mitch caused such massive and widespread damage that President Carlos Roberto Flores claimed it destroyed 50 years of progress in the country. Mitch destroyed about 70 percent of crops, totaling about \$900 million (1998 dollars) in losses. An estimated 70–80 percent of the transportation infrastructure of the entire country was wiped out, including nearly all bridges and secondary roads. Damages to the transportation and communication network totaled \$529 million in 1998 dollars (or \$671 million in 2005 dollars). Across the country, the storm destroyed 33,000 houses and damaged 50,000 others.

In the past eight years Honduras has made great strides in rebuilding its infrastructure and industry. It has also begun to move in a new direction that holds tremendous promise for generating economic growth and reducing poverty. This fresh departure has three central components. First, Honduras has received significant debt relief under the International Monetary Fund (IMF)-World Bank Heavily Indebted Poor Country (HIPC) initiative as well as under various bilateral initiatives. Second, on April 1, 2006, the United States–Central America/Dominican Republic Free Trade Agreement (CAFTA-DR) entered into force for Honduras, opening significant trade opportunities for the country's exporters. Third, on June 13, 2005, Honduras signed a \$215 million Millennium Challenge Account compact to finance activities to strengthen the productivity of the rural economy and reduce transport costs between production centers and rural markets.

On January 27, 2006, Manuel Zelaya Rosales of the Partido Liberal was sworn in for a four-year term as president of Honduras. The Zelaya administration appears to support basic policy continuity on the economic front—prudent, market-oriented policies with a strong trading relationship with the United States.⁷

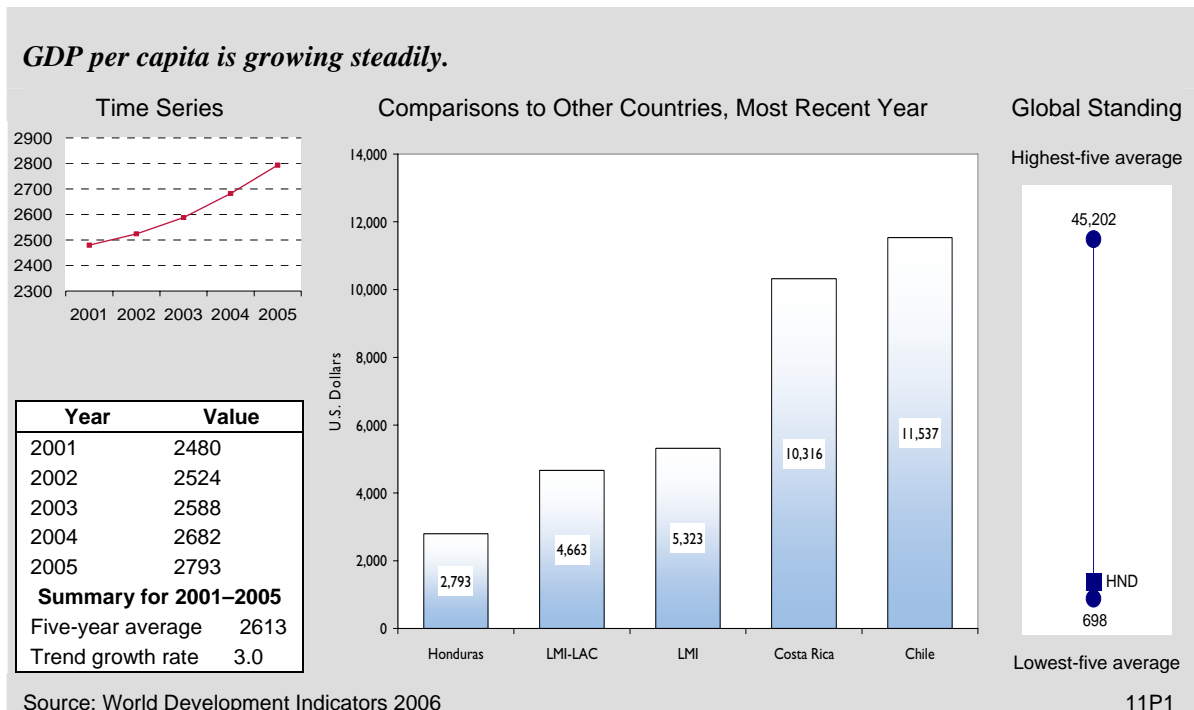
⁶ The separate Data Supplement provides a full tabulation of the data for Honduras and the international benchmarks, including indicators not discussed in the text, as well as technical notes for each indicator.

⁷ *Country Report: Honduras*. The Economist Intelligence Unit, January 2006, p. 3.

GROWTH PERFORMANCE

With an estimated per capita income in 2005 of \$2,793 in PPP U.S. dollars (and \$1,069 in current dollars), Honduras is one of the poorest countries in the Western Hemisphere. Honduras's GDP per capita is still significantly below the average for lower-middle-income Latin American and Caribbean countries (LMI-LAC). It is also less than a quarter of Chile's GDP (\$11,537) and only slightly more than a quarter of Costa Rica's GDP (\$10,316).

Figure 2-1
Per Capita GDP, PPP Dollars



To raise its per capita income, Honduras needs robust, real GDP growth sustained over a period of years. In the past five years, the Honduran economy has performed steadily better. Although real GDP growth grew by a paltry 2.6 percent in 2001, by 2004, the Honduran economy grew by 4.6 percent. In 2005, real GDP growth tapered off slightly to 4.2 percent, but this is still better than the growth levels of the early part of the decade. Honduras's 2005 growth performance compares favorably to the statistically estimated benchmark level⁸ and the LMI-LAC level, both 3.7 percent. Although Costa Rica's 2005 performance was below the level of Honduras at 3.2 percent, the other comparator country, Chile, was the star performer, with real GDP growth of 6.1 percent.

The last available investment and productivity indicators in Honduras are from 2003 and thus do not capture the most recent years of 4 percent real GDP growth. By contrast, real GDP growth

⁸ A detailed description of the methodology used to determine the regression benchmark can be found in the Appendix.

between 2001 and 2003 averaged just 2.9 percent. Therefore, the investment and productivity indicators may have improved somewhat in the past two years.

The 1999–2003 investment and productivity data reveal a steadily declining economic situation. Gross fixed investment fell from 36.1 percent of GDP at the beginning of the period to 24.0 percent of GDP at the end of the period. The 2003 score for Honduras came in near the statistically predicted benchmark (23.5 percent) and the level of Chile (22.8 percent) but was higher than the LMI-LAC average (18.5 percent) and the level of Costa Rica (19.7 percent). Nongovernment gross fixed investment in Honduras showed the same trend, falling from 22.6 percent of GDP in 1999 to just 15.7 of GDP in 2003. Honduras experienced negative growth in the productivity of its labor force in the five years to 2003, averaging -0.9 percent. In 2003, Honduras, with a score of -0.2 percent on this indicator compared unfavorably to Chile, which saw a 1.6 percent growth in labor productivity, and Costa Rica, which turned in a score of 3.7 percent. Finally, a full five-year time series is not available for the incremental capital output ratio (ICOR). However, this indicator declined from 8.7 in 2000 to 10.8 in 2003, meaning that Honduras required \$10.8 in gross investment for every \$1 of extra output, compared to \$8.7 in 2000. By contrast, in 2003 regional competitor Costa Rica required only \$4.5 for every \$1 of extra output.

Although the economy has turned the corner in the past two years, Honduras needs sustained real growth well above 4 percent if it is to make significant inroads in reducing poverty. If Honduras is to achieve a significant acceleration of its growth rate, it will have to improve productivity. The analysis below will highlight some of the causes of low productivity with a view to flagging areas in which donor intervention may be appropriate.

POVERTY AND INEQUALITY

Honduras is one of the poorest and most unequal countries in Latin America. In 2004, 64.0 percent of Hondurans lived below the national poverty line, significantly higher than the statistically predicted level of 46.2 percent. In 1999, the last year for which data are available, some 20.7 percent of Hondurans were living on less than \$1 PPP per day. By contrast, in 2000 (latest year), only 2 percent of the population of Chile and 2 percent of the population of Costa Rica were living on less than \$1 PPP per day. The LMI-LAC average in this category is 17.0 percent, well below the level of Honduras.

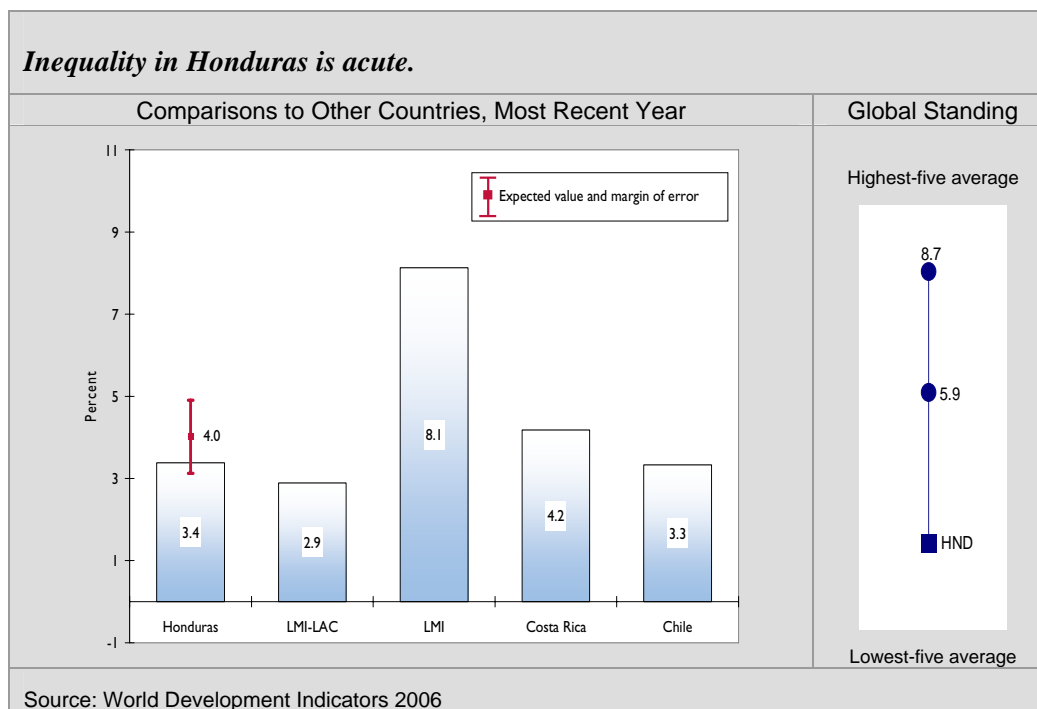
Another key indicator of poverty is the percentage of the population living on less than the minimum dietary energy consumption. In 2003, 22 percent of the Honduran population lived in this manner. Lower than the statistically predicted benchmark of 24.2 percent, this rate is nonetheless well above the LMI-LAC average of 13.0 percent, six times the level of Chile (4.0 percent), and four times the level of Costa Rica (6.0 percent).

The UNDP Human Poverty Index (HPI) provides a broader gauge of poverty that takes into account deprivation in health and education as well as income. On a scale of 0 (no deprivation) to 100 (maximum deprivation), Honduras scored a 16.9 in 2005, an improvement over the 19.9 in 2003. Notably, this score is better than the regression benchmark of 21.1, indicating that on this count the country is doing better than expected. Be that as it may, Honduras's HPI score is still

worse than the LMI-LAC average (11.4) and much worse than the scores of Chile (3.7) and Costa Rica (4.0).

On a global level, Latin America has one of the most unequal distributions of income. And in Honduras, in 2003, 60.2 percent of income accrued to the richest 20 percent of Hondurans, while only 3.4 percent accrued to the poorest 20 percent. In 1999, the last year for which data are available, the share of income accruing to the richest 20 percent of Hondurans was 21.5 times higher than the share accruing to the poorest 20 percent. Interestingly, Chile has both a similar share of income accruing to the richest 20 percent of the population (62.2 percent in 2000) and a similar share accruing to the poorest 20 percent (3.3 percent). The ratio of the income accruing to the richest 20 percent of Chileans to that of the poorest was 18.7. By contrast, Costa Rica saw 51.5 percent of income in 2000 accrue to the richest 20 percent while 4.2 percent accrued to the poorest 20 percent. Costa Rica's rich-to-poor income ratio was 12.3 in 2000 (Figure 2-2).

Figure 2-2
Income Share Accruing to the Poorest 20 percent



Honduras is implementing its August 2001 Poverty Reduction Strategy Paper (PRSP). PRSPs describe a country's macroeconomic, structural, and social policies and programs to promote growth and reduce poverty, as well as associated external financing needs. These documents are required for countries wishing to receive World Bank and International Monetary Fund concessional assistance and serve as the basis for debt relief. The January 2005 PRSP Progress Report notes that Honduras has achieved approximately 18 percent of the PRSP indicator improvements necessary to reach the Millennium Development Goals by 2015. The PRSP indicators that have improved the most are macroeconomic indicators, the extreme poverty index, education coverage, electricity coverage, telecommunications coverage, and human development.

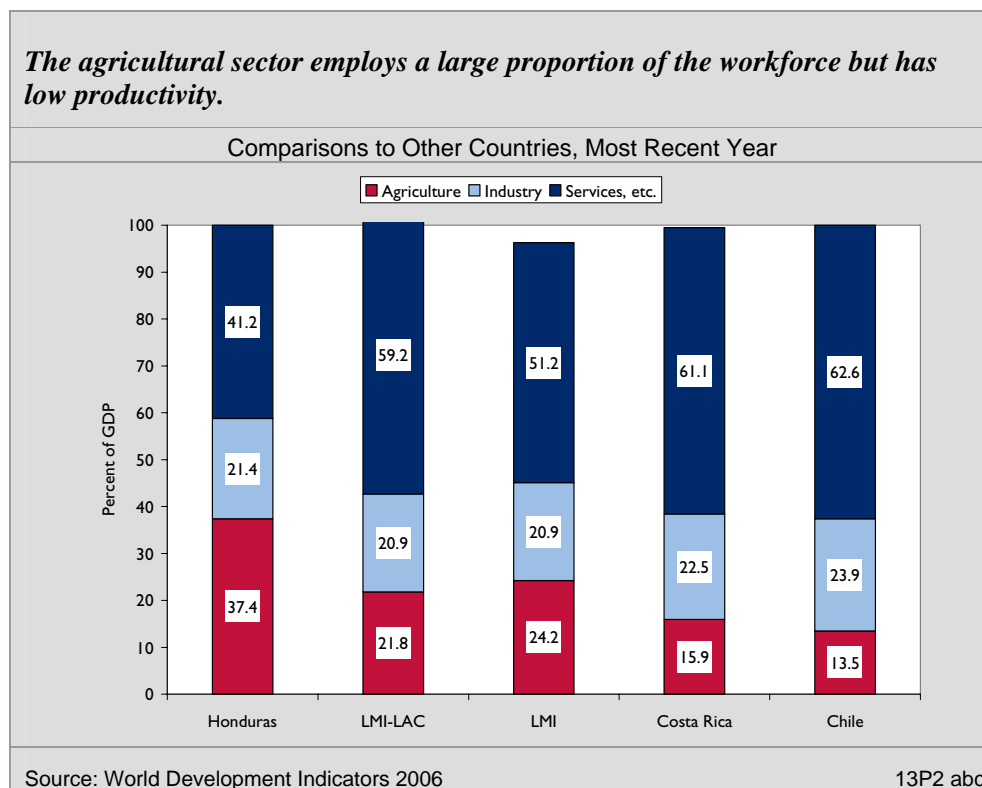
Indicators that have evolved more slowly include the poverty headcount index, health outcomes, and access to water and sanitation.⁹

Donors and policymakers need to work together in a variety of areas if Honduras is to succeed in reducing poverty and inequality. Investments need to focus on the social sector (education, health, and nutrition) and economic development (productivity enhancements at the firm level, infrastructure investments, and specialized training).

ECONOMIC STRUCTURE

Honduras’s labor force is divided between the services sector, with 41.2 percent, agriculture, with 37.4 percent, and industry, with 21.4 percent. Chile and Costa Rica, in contrast, share the employment patterns of virtually all developed countries: the largest number of workers by far is employed in the services sector (62.6 percent and 61.1 percent respectively), followed by industry (23.9 percent and 22.5 percent respectively), and then agriculture (13.5 percent and 15.9 percent respectively). The LMI-LAC average falls in the middle of these two points: services is the most important source of employment, at 59.2 percent, followed by agriculture at 21.8 percent, and finally industry, at 20.9 percent (Figure 2-3).

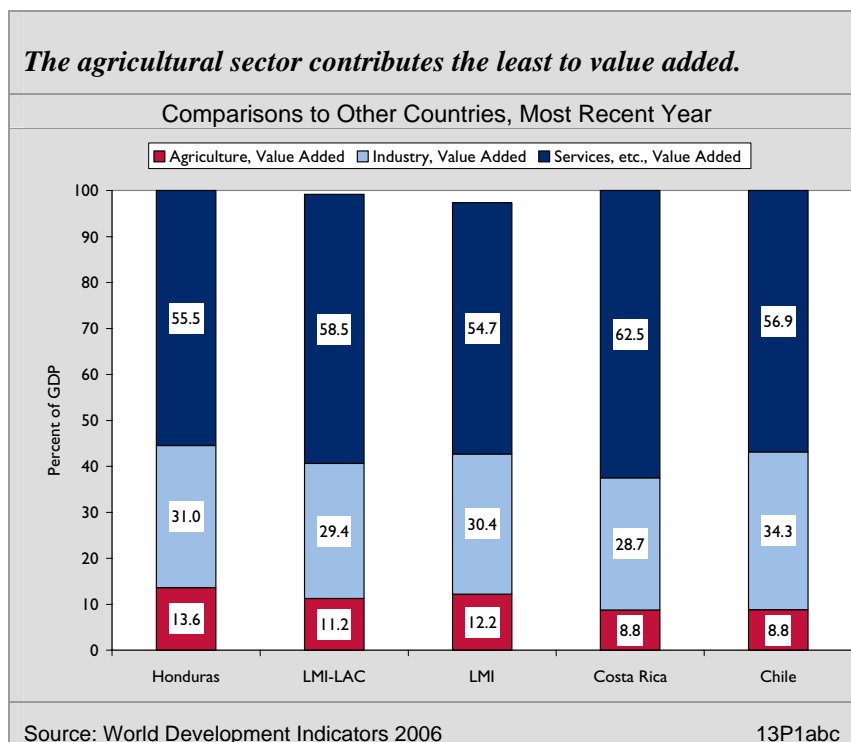
Figure 2-3
Labor Force Structure, Percent Total



⁹ See Poverty Reduction Strategy: Progress Report 2004. Tegucigalpa, January 2005. [http://siteresources.worldbank.org/INTPRS1/Resources/Honduras-PRSP\(Feb2005\).pdf](http://siteresources.worldbank.org/INTPRS1/Resources/Honduras-PRSP(Feb2005).pdf).

Productivity in Honduras's agricultural sector is low relative to other sectors of the economy. Its share of value added to GDP is only 13.6 percent. In both Chile and Costa Rica, agriculture's share is 8.8 percent. Honduras's industrial sector has relatively high labor productivity, accounting for 31.0 percent of value-added as a percentage of GDP. This high level of productivity is undoubtedly linked to Honduras's large *maquila* industry. In Chile, industry's share of value added to GDP is 34.3 percent and in Costa Rica, 28.7 percent. Finally, the service sector has a 55.5 percent share of value added to GDP, compared with 56.9 percent in Chile and 62.5 percent in Costa Rica (Figure 2-4). The Honduran services sector is expected to increase output in the coming years as international telecommunications are liberalized and the government participates in the expansion of tourism.¹⁰

Figure 2-4
Output Structure, Value Added, Percent GDP



Agricultural workers, despite their number (37.4 percent), produce a relatively low percentage of the country's output (13.6 percent as measured by value added as a share of GDP). This contrast is particularly striking because between 1999 and 2003 agricultural value added per worker grew by 4.6 percent over the period. (See Agriculture, p. 37). Despite success in improving productivity, there remains a fundamental mismatch between the sector's share of value added to GDP and the proportion of the total labor force that it employs. This mismatch is of great concern because low productivity in agriculture translates into low income for agricultural workers. In fact, many agricultural workers in Honduras are stuck in a "poverty trap." For workers to escape this trap, two concurrent developments are required. First, Honduras needs to continue to

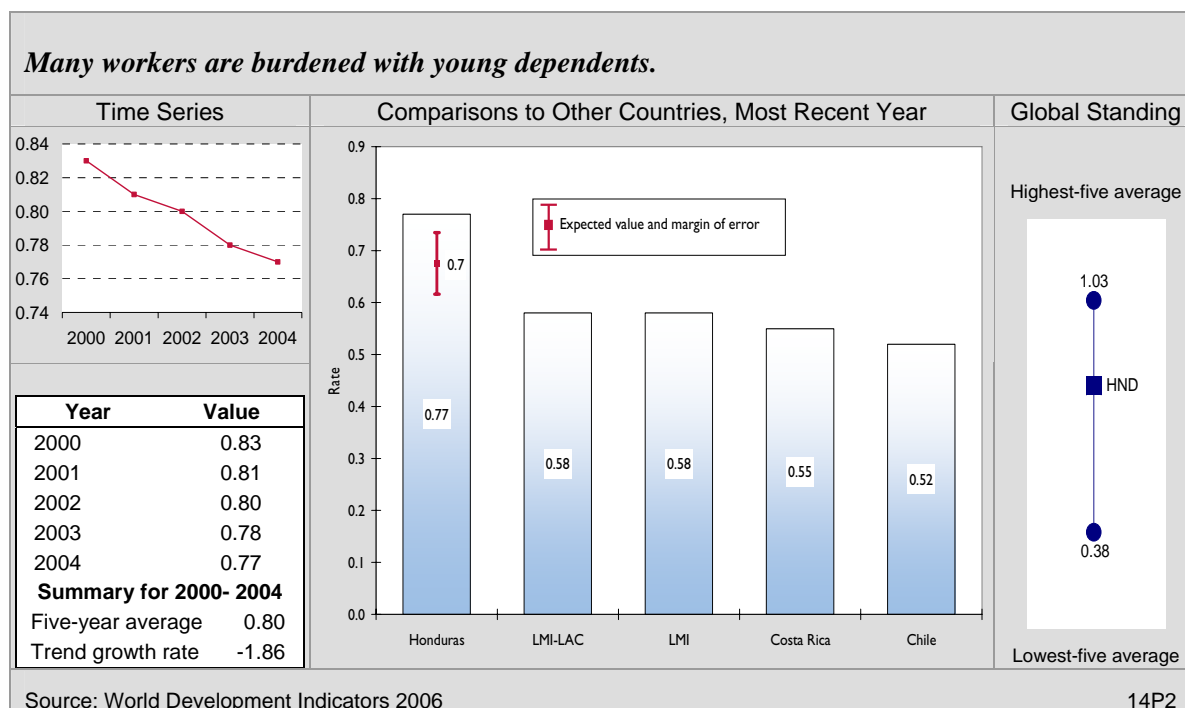
¹⁰ *Country Report: Honduras*. The Economist Intelligence Unit, January 2006, p.24.

emphasize the diversification of its agricultural sector into higher-value-added and niche products that offer a higher return to their producers. Second, Honduras needs to focus on reducing obstacles—structural and regulatory—to the movement of agricultural workers into nonagricultural activities. The improvement of secondary roads, for example, can have the dual effect of helping to move people to jobs and agricultural products to market.

DEMOGRAPHY AND ENVIRONMENT

Honduras is a mid-sized country by Central American standards, with a population of 7 million in 2003, compared with 4 million in Costa Rica and 12 million in Guatemala. But population size is less important than the population growth rate and the age dependency rate. In the 2000–2004 period, Honduras had a stable average annual population growth rate of 2.3 percent. This is significantly higher than the statistically predicted level (1.9 percent) and the LMI-LAC average (1.5 percent). It is also double the rate of Chile (1.2 percent) and a full percentage point higher than the rate found in Costa Rica (1.6 percent). Honduras also has a high age dependency rate, which is the number of dependents that each income earner supports. Although this rate fell steadily from 0.83 in 2000 to 0.77 in 2003, Honduras’s score still compares poorly to all the benchmarks. The statistically predicted age dependency rate for a country of Honduras’s characteristics is 0.70, and this is still significantly above the LMI-LAC average of 0.58. A high age dependency rate in Honduras is a consequence of the number of young dependents rather than a large elderly population. The high age dependency rate translates into a growing need for job creation as the younger generation enters the labor force (Figure 2-5).

Figure 2-5
Age Dependency Rate



In 2004, some 46.0 percent of Honduras's population lived in urban areas. Moreover, the growth of the country's urban population has continued at a steady clip, averaging 0.9 percent per year from 2000 to 2004. Honduras's urban population is on par with statistically predicted (47.2 percent) but still lower than the LMI-LAC average (64.2 percent).

An important population characteristic is the adult literacy rate. In 2004, the adult literacy rate was 80.0 percent. Honduras's adult literacy rate is well below the LMI-LAC average (85.0 percent) and significantly below the near-universal levels of Chile (95.7 percent) and Costa Rica (95.8 percent). Increasing adult literacy to Chilean and Costa Rican levels should be a high priority for Honduras.

Rapid population growth often creates significant environmental stress. The best indicator available is the Environmental Sustainability Index (ESI), which ranges from 0 (poor) to 100 (excellent). In 2005, Honduras scored a 47.4, down significantly from 53.1 in 2002, although still slightly above the regression benchmark (45.0). Honduras's ESI score is also below the LMI-LAC average (52.4) and Chile's score (53.6). Meanwhile, Costa Rica scored a very good 59.6 on the ESI, in large part thanks to a long-term effort to give environmental stewardship a central place in the country's development strategy.

Key factors that are driving Honduras's ESI include insufficient efforts to reduce the environmental effects of natural disasters, poor air quality, and weak private sector responsiveness to environmental challenges. Yet Honduras has made large strides in stopping the degradation of its natural capital in areas that have been severely damaged in the past few decades, particularly in the southern and Caribbean regions.

Perhaps the single most complex environmental challenge facing Honduras is illegal logging.¹¹ In a 2005 report by the conservationist NGO the Environment Investigation Agency detailed a web of corruption that is resulting in large-scale deforestation in Honduras.¹² The report estimates that 80 percent of the mahogany and up to 50 percent of the pine are produced in violation of government regulations. At the current loss rate, mahogany could disappear as a native species within 10 to 15 years. The massive scale of illegal logging not only encourages a broader culture of corruption but is devastating to the economic and social lives of a whole series of communities in the affected areas. In addition, illegal logging is undermining potentially lucrative ecotourism possibilities created by the internationally recognized Río Plátano Biosphere Reserve. Donors, policymakers, and civil society groups need to work together to reverse the alarming rate of deforestation.

GENDER

Honduras performs well on indicators of gender equality. The male-to-female adult literacy ratio rate was 0.99 in 2004. This is consistent with figures for Chile and Costa Rica (also at 1.00) and

¹¹ The ESI subcomponent indicator that relates to forestry ("Percentage of forest area that is certified for sustainable management") does not capture deforestation or illegal logging in national parks and other sanctuaries.

¹² *The Illegal Logging Crisis in Honduras*. Environmental Investigation Agency, 2005. <http://www.eia-international.org/files/reports112-1.pdf>.

slightly better than the LMI-LAC average of 1.02. Equality in literacy corresponds with a ratio of male-to-female gross enrollment rate of 1.05 for 2002, indicating that slightly more boys than girls attend school. This is a manifestation of broader gender equality in society.

Gender-differentiated life expectancy at birth reveals that women live longer on average than men, with a male-to-female life expectancy ratio of 0.94 for 2004. This is in line with the LMI-LAC average of 0.92 and ratios for Chile (0.92) and Costa Rica (0.94). Women tend to live longer than men throughout the world; the Honduran data are in line with this tendency, indicating that there are no fundamental problems pushing the country away from the global norm.

Gender equity is a key component of the development process. Women generally raise the children and see that their children's basic needs are met, and healthy, educated women tend to ensure that their own children are healthy and educated. This creates a virtuous cycle of intergenerational development.

3. Private Sector Enabling Environment

This section reviews indicators for key components of the enabling environment for encouraging rapid and efficient growth of the private sector. Sound fiscal and monetary policies are essential for macroeconomic stability, which is a necessary (though not sufficient) condition for sustained growth. A dynamic market economy also depends on basic institutional foundations, including secure property rights, an effective system for enforcing contracts, and an efficient regulatory environment that does not impose undue barriers on business activities. Financial institutions play a major role in mobilizing and allocating saving, facilitating transactions, and creating instruments for risk management. Access to the global economy is another pillar of a good enabling environment, because the external sector is a central source of potential markets, modern inputs, technology, and finance, as well as competitive pressure for efficiency and rising productivity. Equally important is development of the physical infrastructure to support production and trade. Finally, developing countries need to adapt and apply science and technology as a basis for attracting efficient investment, improving competitiveness, and stimulating productivity growth.

FISCAL AND MONETARY POLICY

Honduras has made notable improvements in its fiscal and monetary policies in recent years. The central government deficit fell to 3.0 percent of GDP in 2005, down from 6.1 percent in 2003. This decrease is welcome and brings Honduras more in line with the regional average deficit of 2.5 percent as well as expectations set forth by the regression benchmark, at 2.6 percent (Figure 3-1).¹³ The IMF reports that Honduras's success with reducing fiscal deficits is attributable to a policy package that includes the tax reforms enacted in 2002 and 2003, subsequent improvements in tax administration, and fiscal austerity.¹⁴ On the revenue side,

IMF Program Status

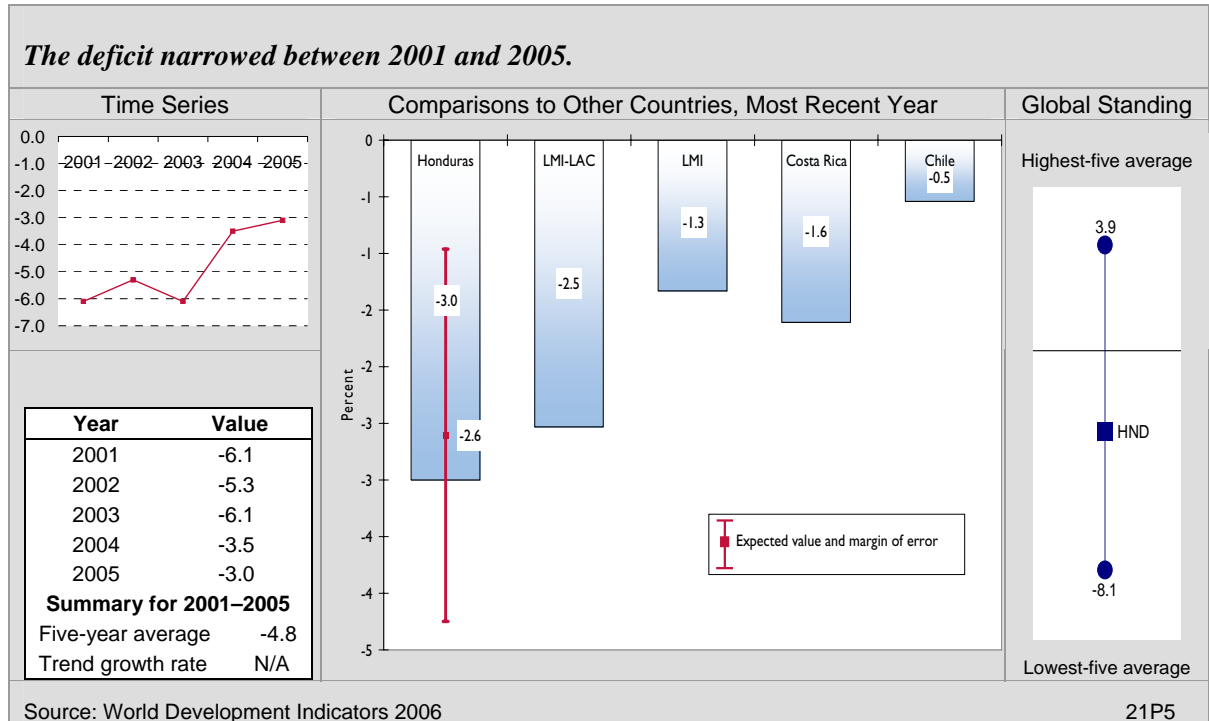
On February 27, 2004 the IMF approved a three-year Poverty Reduction and Growth Fund for Honduras. In December 2005 the IMF Executive Board completed the third review of the fund and approved a waiver for nonobservance of performance criterion.

¹³ In 2005, the World Development Indicators (WDI) adopted a new system for classifying fiscal data, although most developing countries still use the old classification. The WDI database therefore has fiscal data for very few developing countries; because of the limited sample size, most of the group averages derived from WDI are not meaningful. In this section, comparisons are based on absolute standards or benchmarks derived from 2004 WDI data, as well as figures for Chile and Costa Rica.

¹⁴ *Honduras: 2005 Article IV Consultation*. IMF Country Report No. 06/35, January 2006.

improved collections have translated into increased revenue, although growth has been limited. In 2005, the ratio of government revenue to GDP was 19.3 percent, compared with 18.2 percent in 2001. On the expenditure side, the Honduran government cut its ratio of government expense to GDP, from 26.1 percent in 2001 to 24.1 percent in 2005. These efforts on both the revenue and expenditure sides reflect the authorities' desire to reduce the country's fiscal deficit.

Figure 3-1
Cash Deficit, Percent GDP



Despite the trend toward fiscal consolidation, the size of the government in relation to output remains disproportionately large. In many developing countries a large public sector effectively crowds out the private sector. Although Honduras's large public sector may be compensating for gaps in the private sector (particularly in the area of services) the government should seek ways to transfer functions that would be better suited to the private sector. For example, the elimination of the monopoly on telecommunications held by Hondutel in December 2005 seems to be a step in the right direction.¹⁵

The central government is also burdened with a high wage bill. In the five years to 2005, wages and salaries accounted for an average of 51.5 percent of government expenditure, compared to the LMI-LAC average of 25.7 percent. The current program that the government has with the IMF includes a prudent wage policy that in 2004 began to reduce the wage bill, from 52.6 percent in 2004 to 46.7 percent in 2005.

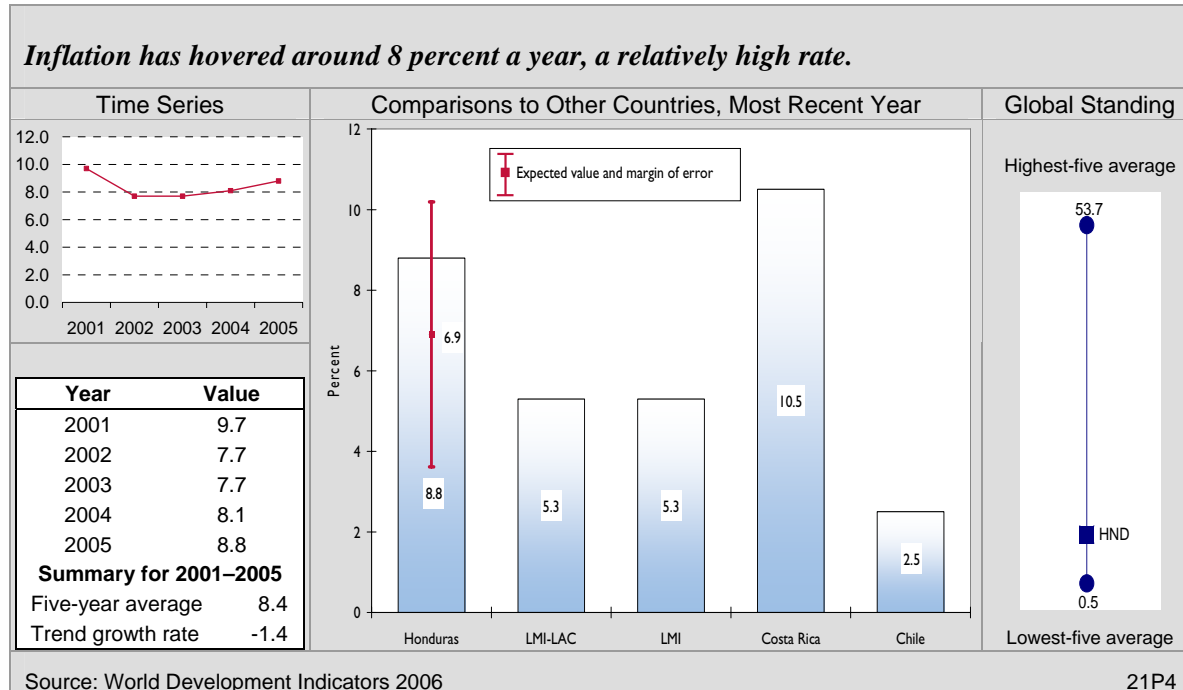
Honduras has also benefited from several debt relief initiatives:

¹⁵ Article IV Consultation, p. 14.

- In February 2005, after a review of economic progress, the IMF agreed to grant Honduras US\$1.2 billion in debt relief under the HIPC initiative, equivalent to a 25 percent cut in Honduras's foreign public debt.
- In May 2005, the Paris Club agreed to grant Honduras \$1.1 billion in debt relief—equivalent to almost 72 percent of bilateral debt.
- In June 2005, G8 finance ministers agreed to write off 100 percent of the debt of the poorest countries, including Honduras—an additional US\$1.25 billion reduction of Honduras's bilateral and multilateral debt¹⁶
- In December 2005, the IMF announced plans to extend Honduras 100 percent debt relief for all debt incurred before January 1, 2005, amounting to approximately US\$154 million.¹⁷

Inflation management has been reasonable but not great in Honduras in the past five years, with rates hovering near 8 percent (Figure 3-2). In 2005, inflation edged up to 8.8 percent, which is mildly preoccupying because it is 1.3 percent above the high end of the Central Bank's target range (6.5–7.5 percent). Inflation appears to have been driven in no small measure by higher prices for petroleum. Other factors appear to be contributing to inflation, however, including significant growth in the broad money supply from 15.8 percent in 2003 to 20.7 percent in 2004 (latest available data). With real GDP growth of only about 4 percent per year, the result is undoubtedly inflationary.

Figure 3-2
Inflation Rate



¹⁶ *Country Report: Honduras*. The Economist Intelligence Unit, January 2006, pp. 8–9.

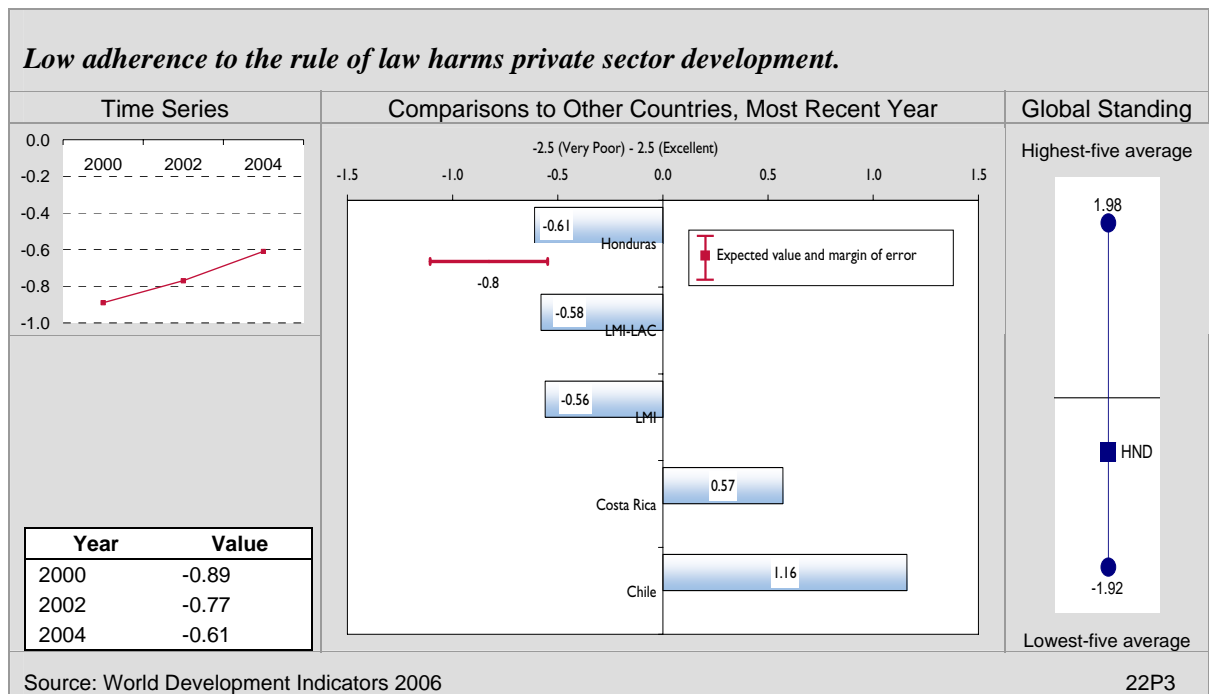
¹⁷“IMF to Extend 100 Percent Debt Relief to Honduras Under the Multilateral Debt Relief Initiative,” IMF Press Release No 05/295, December 23, 2005.

BUSINESS ENVIRONMENT

Institutional barriers to doing business, including corruption and violence, are critical determinants of private sector development and prospects for sustainable growth. Honduras clearly has room for significant improvements in its business environment

Honduras, like certain of its neighboring countries, faces significant challenges in the related issues of rule of law and crime and violence. In the World Bank Institute's Rule of Law Index, which ranges from -2.5 (poor) to +2.5 (excellent), Honduras scored a -0.61 in 2004, much improved over the -0.89 it scored in 2000. The 2004 result is also better than the statistically predicted benchmark (-0.80) and not far from the LMI-LAC average (-0.58). Unsurprisingly, the scores for the wealthier Chile and Costa Rica are much higher (+1.16 and +0.57, respectively) (Figure 3-3).

Figure 3-3
Rule of Law Index



Reliable data on crime and violence are often difficult to obtain, and measuring the impact of crime and violence on the business climate and economic growth is even harder. Nevertheless, Honduras clearly has undergone an upsurge in violent crime in recent years. Honduras had one of the world's highest murder rates in 2004—45.9 per 100,000 people.¹⁸ The perpetrators of many of these murders are transnational gangs (known as *maras*) that are reportedly involved in kidnapping, extortion, human trafficking, and smuggling of autos, drugs, and weapons. Such activities imply both direct costs, such as increased security, and indirect costs, such as higher insurance premiums, for the local productive sector as well as for foreign investors.

¹⁸ Clare Ribando. *Gangs in Central America*. Congressional Research Service. May 10, 2005: <http://fpc.state.gov/documents/organization/47140.pdf>.

Another large challenge facing Honduras is corruption. In the 2005 Transparency International Corruption Perceptions Index, Honduras scored a 2.6 of a possible 10 (10 being the lowest level of corruption).¹⁹ By contrast, Chile scored a 7.3 and Costa Rica a 4.2.²⁰

Rule of law and corruption challenges certainly contribute to Honduras' poor performance in the World Bank's Ease of Doing Business ranking. Honduras finished in 112th position out of 155 countries ranked in the 2005 survey. By contrast, Chile finished 25th and Costa Rica in 89th position. Neither did Honduras score particularly well on the Regulatory Quality Index, which ranges from -2.5 (poor) to +2.5 (excellent), turning in a score of -0.33 in 2004. Once again, Chile (+1.62) and Costa Rica (+0.67) are well ahead of Honduras.

On the transaction side of doing business, Honduras is average, with definite room to improve. According to the 2005 Doing Business data, starting a business in Honduras requires 13 procedures, on par with the LMI-LAC average of 12.5 but slightly more than in Chile (9) or Costa Rica (11). The average length of time required to start a business in Honduras is 62 days—less time than in Costa Rica (77 days) but slightly more than the LMI-LAC average (56 days), and more than twice the time required in Chile (27 days). More problematic is the cost of starting a business (as a percent of GNI per capita). The cost in Honduras (64.1 percent) greatly exceeds the cost in Chile (10.3 percent) and Costa Rica (23.8 percent) and is 25 percentage points higher than the LMI-LAC average (48.3 percent) (Figure 3-4).

Seven steps are required for registering property in Honduras, the same as the LMI-LAC average and slightly more than the six procedures required in both Chile and Costa Rica. Completing the property registration process in Honduras takes an average of 36 days, 25 percent less than the LMI-LAC average (48 days) yet more than the time required in Chile (31 days) or Costa Rica (21 days). Enforcing a contract takes 36 procedures, slightly below the LMI-LAC average (37 procedures) yet still above number of procedures required in Chile (28 procedures) and Costa Rica (34 procedures). In terms of the time required to enforce a contract, the completion of the required procedures in Honduras took an average of 545 days, just less than the time required in Costa Rica (550 days), but more than the LMI-LAC average (457 days) and much more than the time required in Chile (305 days).

It therefore appears that Honduras could benefit greatly from improving the business environment, and donor assistance might target such interventions. Foreign investors and traders will compare the business climates of the CAFTA-DR countries carefully when deciding where to locate and expand businesses. Donors could help Honduras improve its competitiveness and attractiveness as an investment location if they considered (1) anticorruption programs,

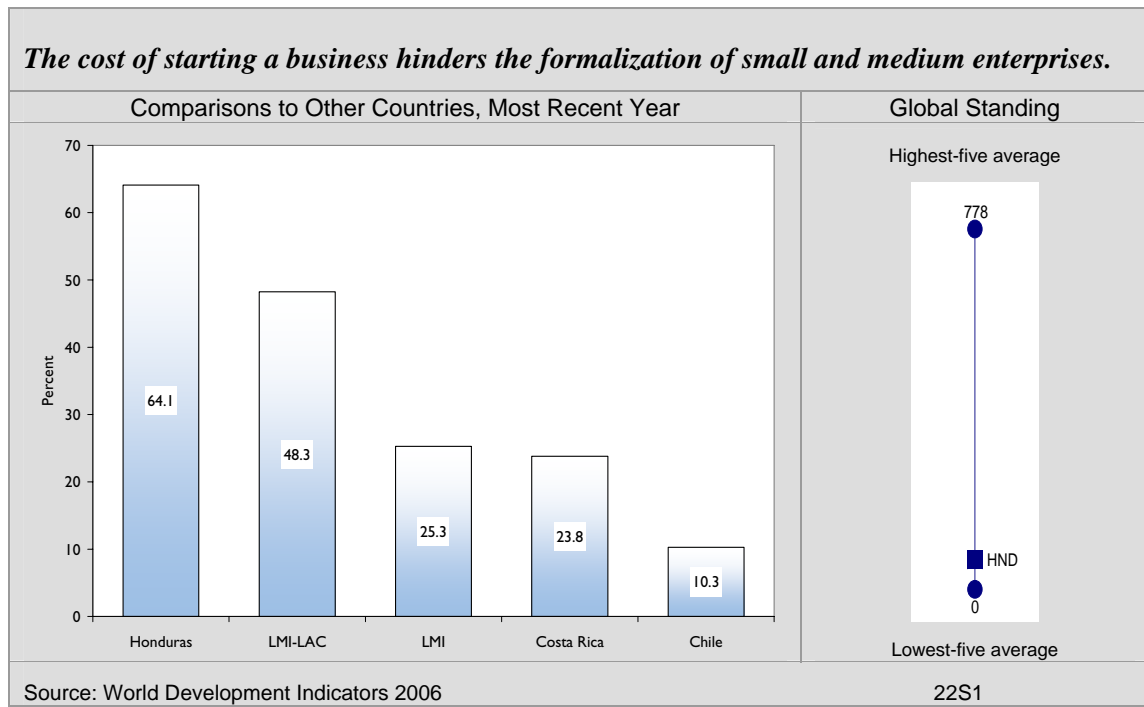
¹⁹ The Corruption Perceptions Index ranks countries from least to most corrupt. Honduras's score makes it the 107th least-corrupt country in the world. http://www.transparency.org/policy_research/surveys_indices/cpi/2005.

²⁰ Quantitative and anecdotal evidence suggests that Costa Rica's score may not be accurate. When the survey data were being gathered, Costa Rica was in the midst of a major corruption scandal that resulted in the jailing of two former presidents and the disgracing of a number of senior officials. The data indicate that it is easier to do business in Mexico, Argentina, and Russia, than in Costa Rica, which appears unlikely to those with country-specific knowledge. This year of data therefore may be an outlier.

particularly for customs administration;²¹ (2) strengthening regulatory performance; and (3) coordinated regional approaches to addressing violent crime and gang issues.

Figure 3-4

Cost of Starting a Business, Percent of GNI Per Capita



FINANCIAL SECTOR

A sound and efficient financial sector is important for mobilizing savings, fostering productive investment, and improving risk management. The banking sector in Honduras, as the prime financial intermediary, has seen substantial growth over the past few years. In 2005, domestic credit to the private sector was valued at 40.0 percent of GDP, indicating that a substantial portion of credit is mobilized for private sector interests. This is impressive when compared to the statistical prediction of 26.5 percent, Costa Rica's 31.3 percent,²² and especially the LMI-LAC average of 23.4 percent (Figure 3-5). Furthermore, a relatively low interest rate spread of 7.3 percent in 2004 indicates that Honduran banks are more efficient than other systems in the region. The LMI-LAC average interest rate spread is 10.4 percent, while the regression benchmark is similar, at 11.6 percent.

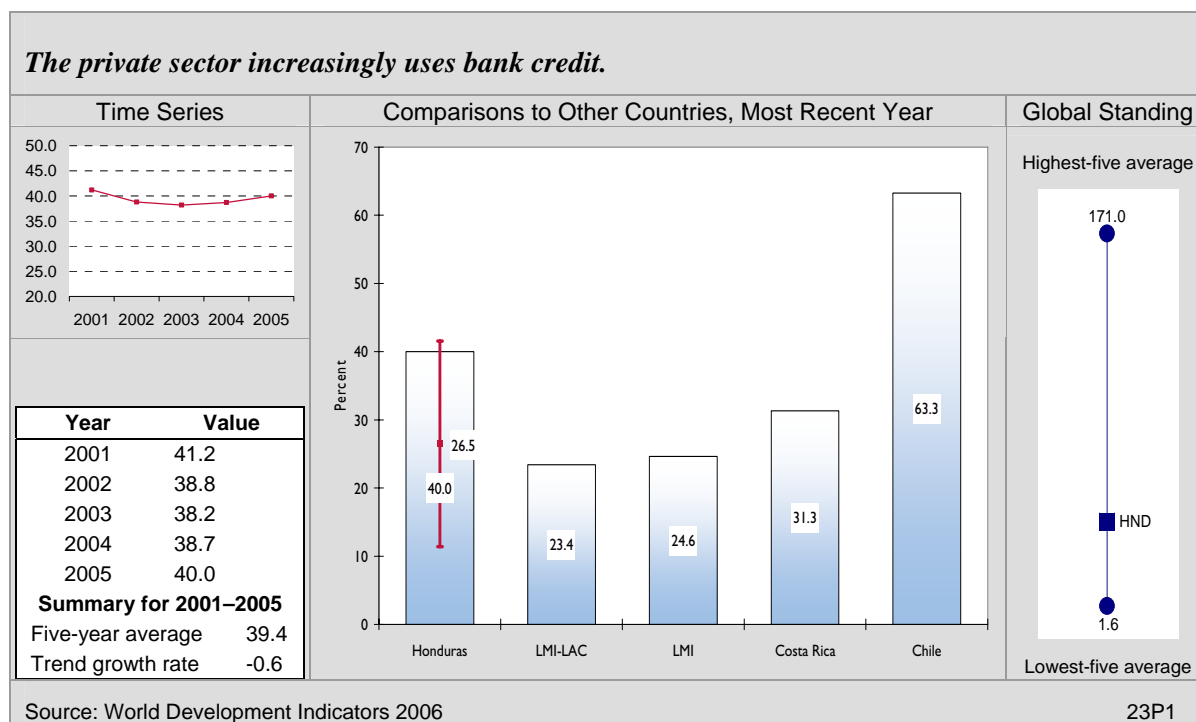
The relative efficiency of the banking sector translates into a significant use of banks as financial conduits for storing wealth and infusing credit into the economy. The predominance of banks is evident through money supply as a percent of GDP at 53.8 percent of GDP compared to a value

²¹ An excellent diagnostic of the challenges facing Honduran customs can be found in *Trade and Commercial Law Assessment—Honduras*. USAID, January 2005, P.XI-4-XI-11.

²² Chile's value, at 63.3 percent, exceeded that of Honduras.

of 35.8 percent suggested by the regression benchmark and the LMI-LAC regional average of 30.1 percent.

Figure 3-5
Domestic Credit to the Private Sector, Percent GDP



However, the banking sector still needs to improve significantly, particularly in its capacity to provide credit to small and medium enterprises. For example, the cost to create collateral (as a percentage of per capita income) remains high, at 36.6 percent, inhibiting those seeking credit to set up or expand their business. These costs are high relative to the LMI-LAC average (23.7 percent) and costs in Costa Rica (16.2 percent) and astronomical compared to those of Chile (5.3 percent).

Finding solutions to barriers to obtaining credit will be an essential component to a pro-poor growth strategy that seeks to include small and medium-sized producers in the export opportunities afforded by CAFTA-DR. One option may be to help Honduras to establish a stock market, which could contribute to broadening access to finance for investors.

In addition to focusing on industry and services firms, the private financial sector also needs to develop some financial instruments that will reduce the risk of investing in agriculture through instruments such as area crop insurance. Given the uncertainties of climate and the range of risks in the production process, private financial institutions have tended to shy away from investing in agriculture. However, if donors form partnerships with local financial institutions, lending and providing insurance for agricultural production will become more attractive. This, in turn, would assist Honduras in overcoming some productivity constraints in the sector.

EXTERNAL SECTOR

Fundamental changes in international commerce and finance, including reduced transport costs, advances in telecommunications technology, and lower policy barriers, have fueled a rapid increase in global integration over the past 25 years. The international flow of goods and services, capital, technology, ideas, and people offers great opportunities for Honduras to boost growth and reduce poverty by stimulating productivity and efficiency, providing access to new markets and ideas, and expanding the range of consumer choice. Globalization also creates new challenges in the need for institutions, policies, and regulations to take full advantage of international markets, develop cost-effective approaches to cope with adjustment costs, and establish systems for monitoring and mitigating the associated risks.

CAFTA-DR

The most significant manifestation of the integration process for Honduras is CAFTA-DR. CAFTA-DR entered into force for Honduras on April 1, 2006, and provides Honduras with secure access to the largest consumer market in the world. However, this access requires that Honduras provide reciprocity by reducing its barriers to goods and services originating in the United States and other CAFTA-DR countries. In addition, Honduras and its CAFTA-DR partners agreed to common measures covering a whole range of at-the-border and behind-the-border activities, from procedures for determining the origin of goods to the enforcement of copyrights and the treatment of foreign direct investment. The opportunities are great for Honduras, but so are the challenges, including the loss of government revenue from import duties. CAFTA-DR also serves as a tool for regime building by establishing common anticorruption commitments similar to those in the Foreign Corrupt Practices Act and by establishing a methodology for enhancing labor rights in Central America and the Dominican Republic. In short, CAFTA-DR is a multifaceted agreement that establishes a comprehensive regime that will govern most aspects of commerce among the six signatory countries.²³

The entry into force of CAFTA-DR and, by extension, the reduction of barriers to trade and investment pose tremendous challenges for Honduras. CAFTA-DR will not only result in more imports of goods and services from the United States, but also more competition among the Central American countries in trade and attracting investment. International firms are likely to consolidate their regional presence and will place a premium on the domestic investment climate.

An important innovation in the CAFTA-DR agreement is the inclusion of a trade capacity building process. Before negotiations for the agreement, Honduras and its fellow CAFTA²⁴ countries each developed national trade capacity building strategies specifying their needs for negotiating, implementing, and adjusting to the agreement. USTR and USAID led the process of

²³ The full text and more complete summaries of CAFTA/DR are available at http://www.ustr.gov/Trade_Agreements/Bilateral/CAFTA/Section_Index.html.

²⁴ When referring to the negotiating period, it is more accurate to refer to the agreement as simply CAFTA. The agreement was originally negotiated by the five Central American Common Market countries (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua) and the United States between January and December 2003 (through January 2004 in the case of Costa Rica). The Dominican Republic negotiated its own agreement with the United States in early 2004 and the two agreements were integrated into the CAFTA-DR in August 2004.

mobilizing assistance to meet these needs. Donors included U.S. government agencies and departments, international financial institutions, nongovernmental organizations, and private sector firms and organizations.²⁵ Chapter 19 of CAFTA-DR mandates that the trade capacity building process continue throughout the life of the agreement. Donors should continue to use this channel to assist countries in implementing and adjusting to CAFTA-DR.²⁶

International Trade Performance

So where does Honduras stand in international and regional trade with the entry into force of the CAFTA-DR? A precise assessment is made difficult by large discrepancies in the trade data among various sources, primarily because of the way that *maquila* exports are counted.²⁷ Discrepancies are particularly visible between data reported by Honduras and data reported by the United States. The discrepancies are no doubt largely accounted for by the absence in the Honduran statistics of apparel exports from the *maquilas* (See Table 3-1).²⁸

The most common indicator for determining the openness of a country to international trade is the ratio of trade—exports plus imports—to GDP. In 2003, the year that Honduras negotiated CAFTA, Honduras's trade as a percentage of GDP was 64.1 percent; it rose to 68.8 percent in 2005 (according to Honduran data reported to COMTRADE and the IMF). These figures put Honduras very close to the regression benchmark of 66.4 percent and above the LMI-LAC average level of 52.6 percent. Chile, a country that has placed trade at the center of its growth strategy, has a trade-to-GDP ratio of 68.3 percent. Costa Rica, by contrast, has a trade-to-GDP ratio of 95.4 percent, typical of a small, relatively prosperous country.

The ratio of foreign direct investment to GDP tells a markedly different story. In 2005, Honduras had a ratio of 2.4 percent, down from 3.9 percent in 2004, and below the benchmark of 3.3 percent. However, the five-year average was 3.1 percent, closer to the benchmark. Chile

²⁵ For a detailed description of the successes and challenges of the CAFTA trade capacity building process, see Eric T. Miller, *Achievements and Challenges of Trade Capacity Building: A Practitioner's Analysis of the CAFTA Process and its Lessons for the Multilateral System*. ITD-INTAL Occasional Paper 32. Inter-American Development Bank, October 2005.

http://www.iadb.org/intal/aplicaciones/uploads/publicaciones/i_INTALITD_OP_32_2005_Miller.pdf.

²⁶ CAFTA-DR entered into force for El Salvador on March 1, 2006 and in Nicaragua and Honduras on April 1, 2006. Costa Rica has yet to ratify the agreement and legislative and regulatory work is continuing with Guatemala and Dominican Republic to permit its entry into force in the near future.

²⁷ "Net exports (i.e., value added) of the maquila industry are recorded as net services rather than as exports and imports of goods for processing. Non recording of profits of foreign enterprises operating in the maquila industry likely understates the external current account deficit, while direct investment in this industry is excluded from the financial account." *Honduras: Report on the Observance of Standards and Codes—Data Module, Response by the Authorities, and Detailed Assessments Using the Data Quality Assessment Framework*. IMF Country Report No. 05/230, July 2005, p. 14.

²⁸ Even when Honduras claims that it is including *maquila* exports, the country's reported total global exports are still smaller than U.S. imports from Honduras alone, as reported by the United States. Generally speaking, Honduras has dramatically undervalued both exports and imports, but particularly exports, by understating the very large *maquila* sector contribution. Neither are Honduran data internally consistent, with the Central Bank of Honduras reporting different figures to COMTRADE than the data used in other reports. Where these discrepancies are easily highlighted, we do so.

posted a somewhat better result at 4.1 percent for 2003 (the latest available data year) and while Costa Rica had an investment to GDP ratio of 3.3 percent for the same year.

Table 3-1

Trade with United States in Selected Apparel and Textiles for HTS Categories Usually Processed in Maquilas

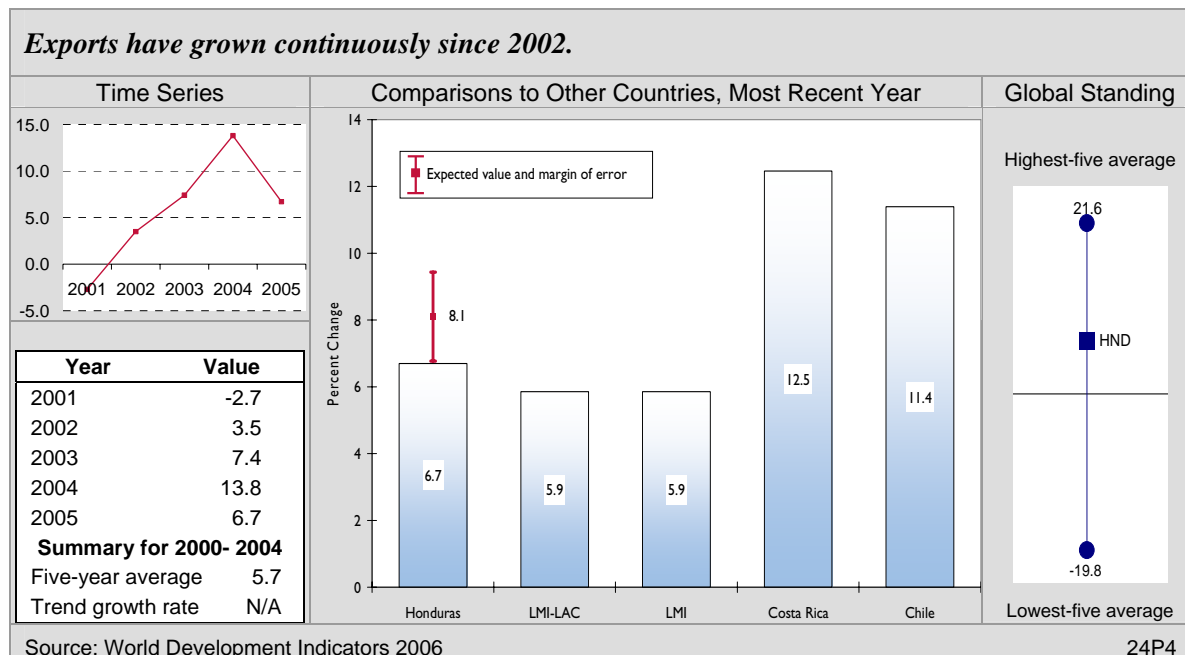
Selected HTS Categories	2002	2003	2004	2005
EXPORTS TO U.S.				
61—Apparel articles and accessories, knit or crochet	\$1,801,375	\$1,887,090	\$2,013,307	\$2,016,210
62—Apparel articles and accessories, not knit etc.	\$702,117	\$680,064	\$729,343	\$668,583
Subtotal	\$2,503,492	\$2,567,154	\$2,742,650	\$2,684,793
Total Imports	\$3,264,037	\$3,311,550	\$3,641,067	\$3,750,200
Exports to U.S.	\$645,413	\$415,306		
IMPORTS FROM U.S.				
52—Cotton, including yarn and woven fabric thereof	\$207,278	\$307,130	\$411,638	\$410,243
60—Knitted or crocheted fabrics	\$243,754	\$339,708	\$351,125	\$379,901
61—Apparel articles and accessories, knit or crochet	\$519,881	\$422,583	\$312,306	\$240,167
62—Apparel articles and accessories, not knit etc.	\$259,607	\$253,998	\$210,567	\$177,399
Subtotal	\$1,230,520	\$1,323,419	\$1,285,636	\$1,207,710
Total Exports	\$2,564,589	\$2,844,902	\$3,076,512	\$3,243,920
Imports from U.S.	\$1,251,715	\$1,326,570		

Honduras's export growth in goods and services with the world between 2001 and 2005 varied widely from year to year—declining in 2001 (-2.7 percent), probably because of the recession in the United States, rebounding, peaking in 2004 (13.8 percent), then growing more slowly in 2005 (6.7 percent) (Figure 3-6).

Exports of services have a reasonably important place among Honduras's total exports. In 2003, 21.7 percent of its exports were in services.²⁹ According to the IMF International Financial Statistics, this percentage has remained essentially the same since 1999. Honduras ranks midway between Chile, with services comprising 18.6 percent of total exports, and Costa Rica, with services making up 24.9 percent of total exports. The LMI-LAC average for the share of services in total exports is 16.5 percent.

²⁹ The IMF's data review of Honduras states that the net *maquila* exports are recorded in the balance of payments as a net service, but we cannot determine the size of this net on the basis of the categories of services imports and exports used by Honduras and the IMF. See IMF Balance of Payments Statistics, Part I—Country Tables, Honduras, p. 268.

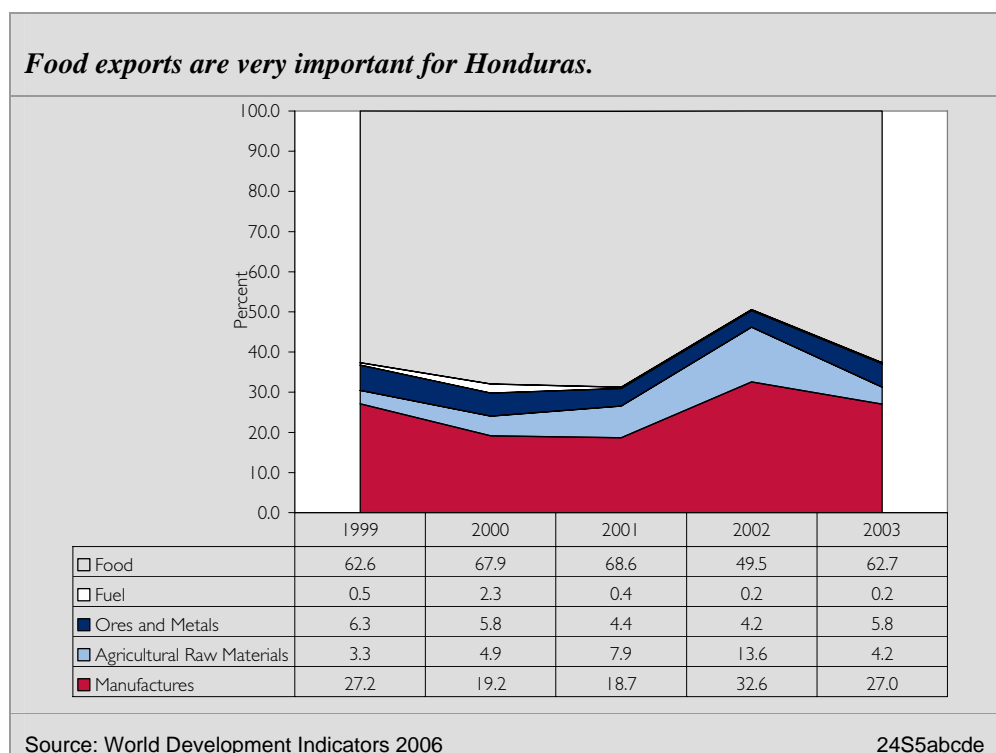
Figure 3-6
Export Growth, Goods and Services



Goods make up the remaining 78.3 percent of Honduras’s exports. Food products (including coffee, bananas, and sugar) made up 62.7 percent of that trade in 2003; manufactured goods made up 27.0 percent, agricultural raw materials 4.2 percent, ores and metals 5.8 percent, and fuel 0.2 percent. In 1999, the shares of food and manufactured products in Honduras’s export basket were almost identical (62.6 percent and 27.2 percent respectively) (Figure 3-7).

In contrast, two-thirds of Costa Rica’s exports are in manufactured products and less than one-third in food products. In Chile, 41.7 percent of exports are in ores and metals (especially copper) and 28.2 percent in food products. Furthermore, Chile tends to export higher-value food products (such as wine, grapes, apples, and asparagus) than Honduras—products that command a premium for the extent of their processing or are off season in northern markets.

Figure 3-7
Structure of Merchandise Exports



In terms of the geographical distribution of its merchandise trade, in 2004 Honduras sent 38.7 percent of its exports to and received 34.6 percent of its imports from the United States.³⁰ In 2003 Honduras sent 19.3 percent of its exports to and received 12 percent of its imports from Central American Common Market countries. El Salvador and Guatemala are Honduras's most prominent CAFTA-DR trading partners after the United States. Honduras sends 6 percent of exports and receives 5 percent of its imports from El Salvador while it sends 4 percent of its exports to and receives 8 percent of its imports from Guatemala (Figures 3-8 and 3-9).³¹

Merchandise trade between Honduras and other CAFTA-DR countries in the past five years, both exports and imports, has varied significantly year to year. Honduras is running a persistent trade deficit vis-à-vis other CAFTA-DR countries, especially with the United States (again excluding *maquila* exports). In 2003, Honduras sent \$670.5 million in merchandise exports to its CAFTA-DR partners. This is a worrisome decline from 1999 levels, when the country exported \$963 million worth of goods to other CAFTA-DR countries. Honduras imported \$1.9 billion of merchandise from these countries in 2003, only slightly more than the \$1.75 billion worth of goods imported in 1999 from the same countries, at a time when trade among these countries could have been expected to grow much faster.

³⁰ *Honduras: Statistical Annex*. IMF Country Report No. 05/385, p. 51. According to the Central Bank of Honduras, however, 41.5 percent of Honduran exports went to the United States in 2004 (see Banco Central de Honduras, *Exportaciones de Bienes de Honduras, 2000–2004*, April 2005, p. 6).

³¹ IMF Country Report No. 05/385,

Figure 3-8
 Merchandise Imports from Other CAFTA Countries, Excluding United States

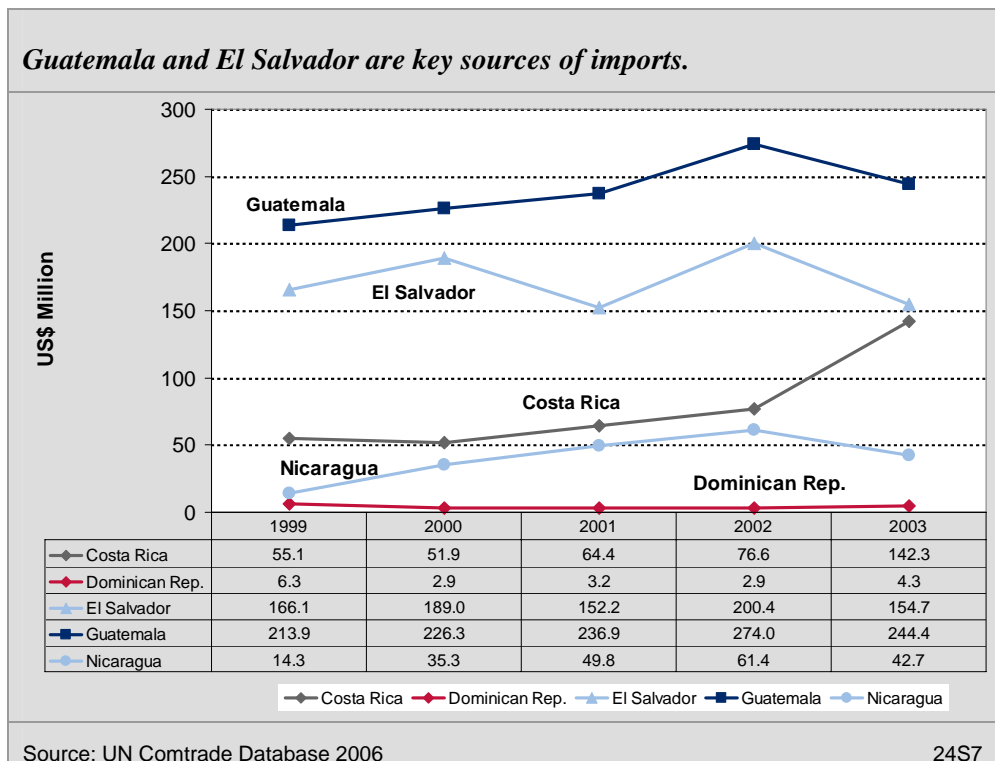
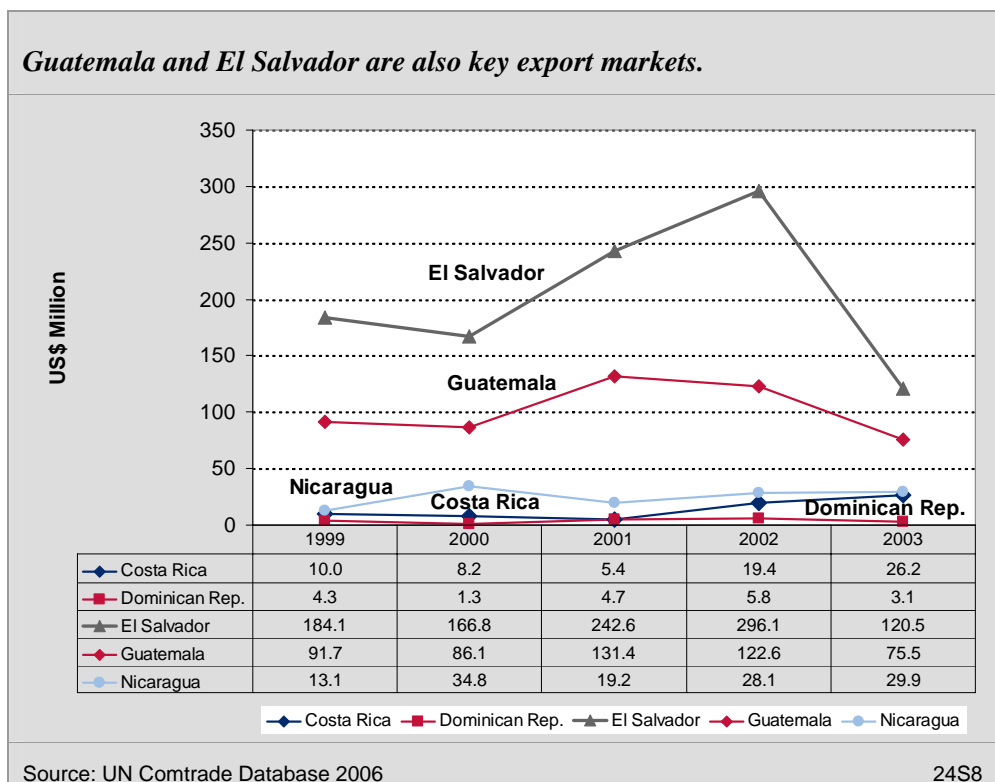


Figure 3-9
 Merchandise Exports from Other CAFTA Countries, Excluding United States



Some significant patterns emerge from the data disaggregated by country. First, the United States accounts for more than 69 percent of Honduras's imports from CAFTA-DR countries. Second, although the United States is the largest export market for Honduras among CAFTA-DR countries, the Salvadoran and Guatemalan markets are by no means insignificant. Third, Honduras has consistently run a trade deficit with all CAFTA-DR countries except El Salvador, with which Honduras enjoyed a trade surplus in two of the past five years.

The real effective exchange rate index has followed a trend of depreciation in the years to 2003, declining from 104.7 to 98.3.³² Although more recent data have not become available in standard sources, the IMF reports that the trend towards real depreciation has continued. The IMF has cautioned, however, that pressure for real appreciation has increased, fueled in large part by remittances and strong capital inflow.³³ In 2004 the government was able to neutralize these pressures through an accumulation of reserves and sterilization efforts. But if these pressures persist the government will have to protect the competitiveness of the export sector by maintaining the real exchange rate. The IMF suggests a policy package that includes fiscal discipline and rational wage policies. Fluctuations in the currency in recent years have not been sufficiently pronounced to have a significant impact on trade and competitiveness.

The key performance measures of Honduras's trade and investment progress present a mixed picture. In the Heritage Foundation trade policy index, which ranges between 1 (excellent) and 5 (poor), Honduras comes out average, with a 3. Costa Rica also scored a 3, while free market trailblazer Chile received top marks, a 1. Honduras's results on the Actual and Expected Trade Size index,³⁴ which ranges from 0 (poor) to 10 (excellent), declined slightly between 2000 and 2003, falling from 6.5 to 5.8. Nevertheless, Honduras compares well with Costa Rica, which posted a 2003 result of 5.5, but is somewhat behind Chile, which had a 6.7 in the same year. On the Inward FDI Potential index,³⁵ which ranges from 0 (poor) to 1 (excellent), Honduras posted a 0.11 for the 2001–2003 period, a result that deteriorated only slightly from a high of 0.16 in 1997–1999. Chile and Costa Rica achieved results of 0.23 and 0.18, respectively, for the same period. Finally, in terms of the actual average time required to complete import and export processes, Honduras performs relatively poorly. The average time to complete the importing and exporting process in Chile is 23.5 days, the LMI-LAC average is 34.7 days, and the average for Costa Rica is 39.0 days, while in Honduras the process takes an average of 40.0 days—a particularly negative result given the importance of Puerto Cortés (near San Pedro Sula) to regional commerce.

The government of Honduras, with the help of USAID, the IDB, and the World Bank, has carried out a number of economic and poverty reduction initiatives, in conjunction with its National Competitiveness Plan, aimed at addressing regulatory, administrative, legal, and infrastructure

³² The data on the real effective exchange rate index used for Honduras differ from those in the technical notes because the base year used is 2000 rather than 1995.

³³ IMF Article IV Consultation, p. 21.

³⁴ The index, prepared by the Fraser Institute, estimates the degree to which an economy's actual share of trade (as percent of GDP) deviates from its expected trade share.

³⁵ The index, prepared by UNCTAD, measures an economy's attractiveness to foreign investors, capturing factors other than market size that have an index.

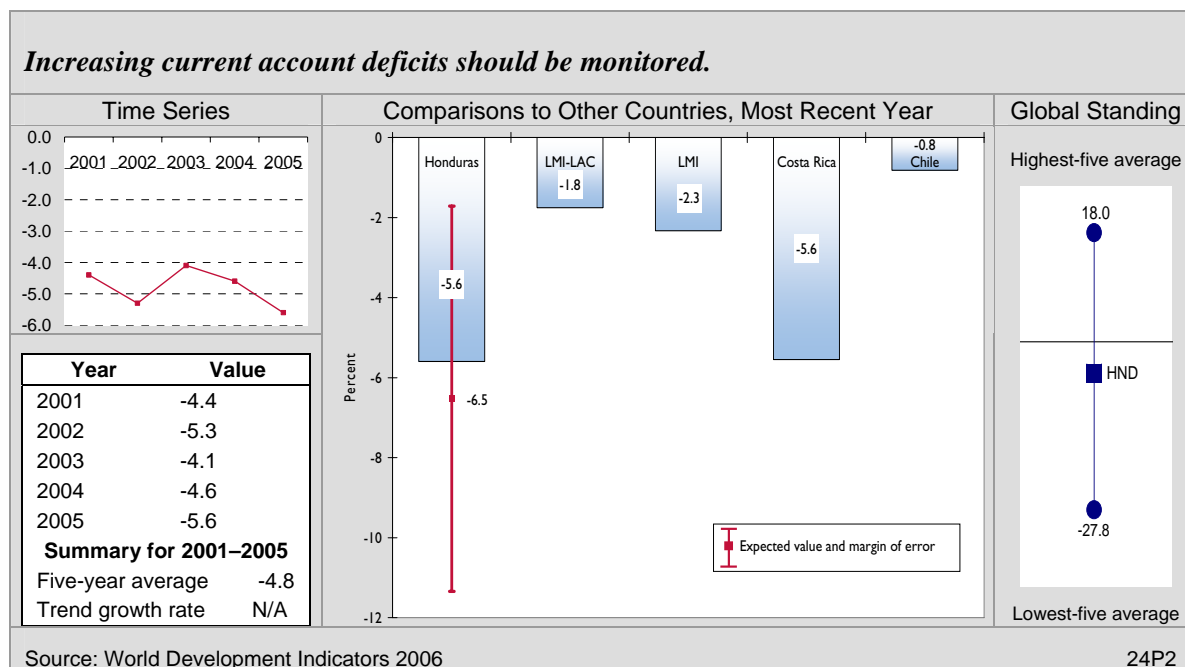
weaknesses: reduce export delays and onerous bureaucratic procedures, improve macroeconomic management, encourage domestic and foreign investment, reform political institutions and processes, and improve the education and health system.

Specific activities that donors may wish to consider financing include (1) a comprehensive trade facilitation audit to identify the impediments to reducing the time required to trade; (2) technical assistance to the apparel sector in adjusting to new competitive challenges from East Asian producers; (3) assistance in implementing and administering CAFTA-DR, including rules of origin, intellectual property rights, and trade in services; (4) development of a strategy to enhance the value-added share of Honduras’s food and agricultural exports; and (5) assistance in resolving some of the data issues discussed in this report.

Current Account

Honduras’s current account deficit averaged 4.8 percent of GDP in the period 2000–2004 but grew in 2004 to 5.6 percent. The IMF attributes the widening of the current account deficit to higher oil prices and large private investments in energy and telecommunications, which were only partly offset by growth in the *maquila* sector and remittances (Figure 3-10).³⁶ The overall external picture improved despite the deficit thanks to higher official and private capital inflows.

Figure 3-10
Current Account Balance, Percent GDP



Worker remittances are estimated to have grown by 30 percent in 2004 and now total more than 15.5 percent of GDP, up 3 percent from 2003. Remittances have become the second most

³⁶ IMF Article IV Consultation.

important source of foreign exchange inflows, after exports of goods. They far exceed official disbursements of loans and grants as well as net maquila exports and FDI.

Although the overall effects on the Honduran economy of strong growth in remittances are positive, and remittances generally are a stable source of foreign exchange inflows with important economic benefits, remittances can create difficulties for macroeconomic management. Although perhaps unavoidable in the long term, further increases could create real appreciation pressure and crowd out the export sector (maquila, tourism, and agriculture), which play an important role in growth and employment. Fostering financial services that could help channel more remittances into productive use will be important for promoting growth in the future.³⁷

International Financing

Honduras's public debt service ratio as a percent of exports has been improving, declining to 7.8 percent of exports in 2004 from 12.9 percent in 2000. Honduras's debt service ratio is very low and will fall further as a result of debt relief.

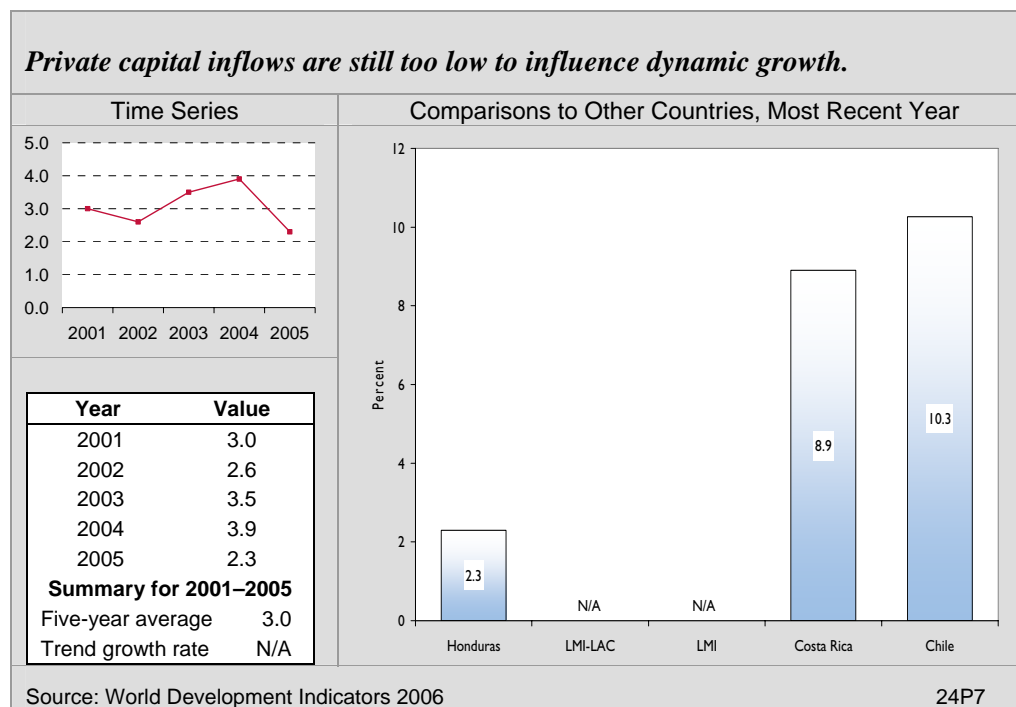
Honduras also has a healthy situation with respect to international reserves, with reserves covering 4.9 months of imports in 2005. This provides an extra level of stability over the 3.7 months that Honduras had in 2003. Honduras's virtuous situation exceeds both the benchmark (3.9) and the LMI-LAC average (4.0). Costa Rica's gross international reserves are at 2.3 months—uncomfortably low for a central bank concerned about medium-term stability.

International aid flows are relatively important to Honduras. In 2003, aid was equal to 9.1 percent of Honduras's GNI, significantly higher than the LMI-LAC average of 1.0 percent. The \$215 million Millennium Challenge Corporation compact is an important aid instrument for the country. The aid-to-GNI ratio is negligible for Chile and Costa Rica because neither country is eligible for non-reimbursable assistance because of their higher per capita income levels.

Finally, Honduras has significant room for improvement of private capital inflows (measured as a percentage of GDP). Private capital inflows in 2005 were 2.3 percent, down from 3.9 percent in 2004. Private capital flows have been affected by lumpy investments in privatized companies and infrastructure. When Honduras's 2003 performance is compared with that of Chile, at 10.3 percent and Costa Rica, at 8.9 percent, it is clear that the country needs to do more (Figure 3-11). In the medium term, Honduras should work to increase FDI inflows, which would mitigate the country's growing dependence on remittances (and the accompanying current account pressures) and support domestic capital formation.

³⁷ Article IV Consultation, p. 9.

Figure 3-11
Private Capital Inflows, Percent of GDP



ECONOMIC INFRASTRUCTURE

A country's physical infrastructure—for transportation, communications, power, and information technology—is the backbone for strengthening competitiveness and expanding productive capacity. Honduras' rugged geographic setting makes any nationwide infrastructure program more complicated and costly, all other things being equal, than a similar program in a temperate climate with a gentle landscape.

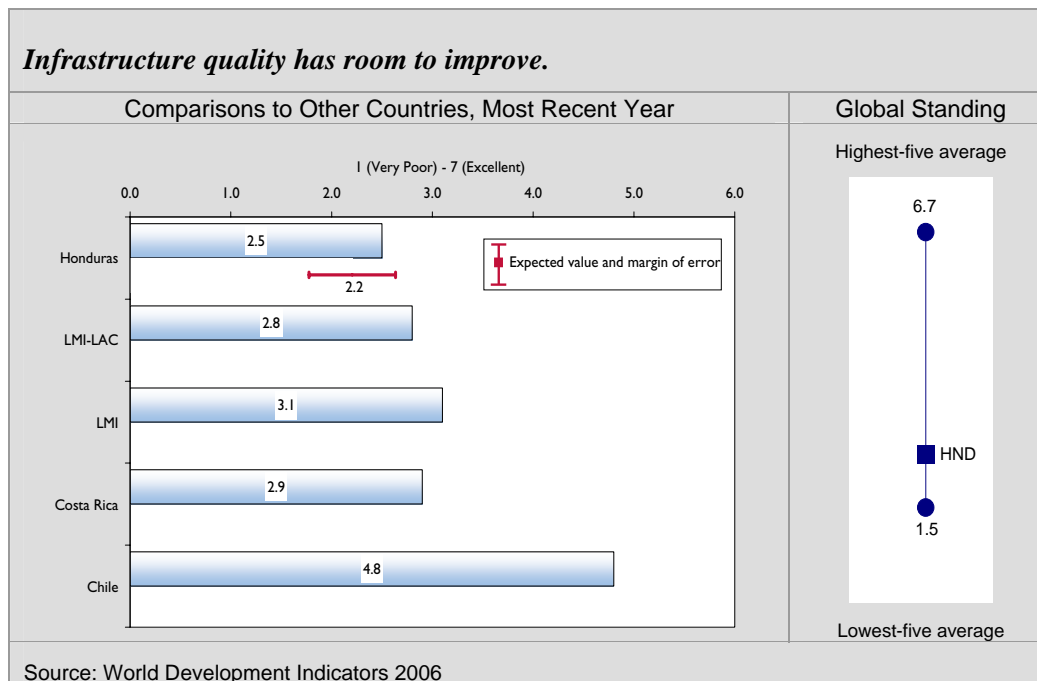
The broad measure of a country's infrastructure is the Quality of Infrastructure index prepared by the World Economic Forum. Honduras scored a 2.5 out of a possible 7.0, above the regression benchmark (2.2) but somewhat below the LMI-LAC average (2.8) and Costa Rica's score (2.9) and well below Chile's score (4.8). When this index is disaggregated by type of infrastructure, rail is clearly the spoiler, with a score of 1.3 out of 7. Rail has not been an important transport mode for some time in Central America—the Costa Rican aggregate infrastructure score is also dragged down to a significant degree by its railroad score (1.2) (Figure 3-12).

Honduras' highest-scoring type of infrastructure is ports—specifically, Puerto Cortes, which is arguably the most important port in Central America. Although Honduras scored 3.4 out of 7 in terms of quality, this actually understates the advances that Puerto Cortes has made in preparing itself for expanded CAFTA-DR and global trade. In March 2006, Puerto Cortes became the first port in Central America to join the Container Security Initiative (CSI).³⁸ CSI is a joint initiative of U.S. Customs and Border Protection and foreign governments that aims to secure the supply

³⁸ See http://www.cbp.gov/xp/cgov/newsroom/news_releases/032006/03252006.xml.

chain by screening U.S.-bound containers at their port of embarkation, using smarter, more secure containers and identifying high-risk containers. With the CSI seal of approval, Honduran (and Central American) trade originating at Puerto Cortes will be handled more efficiently on arrival in the United States. Puerto Cortes will receive sophisticated equipment to identify nuclear materials and a multidisciplinary team of officers from U.S. Customs and Border Protection will work on site with Honduran officials on screening containers bound for the United States.

Figure 3-12
Overall Infrastructure Quality Index



Honduras scored 3.0 out of 7 on the quality of electricity infrastructure, notably worse than the comparator countries: the LMI-LAC average for quality of electricity infrastructure is 4.0 and Chile's and Costa Rica's scores are 5.5 and 4.6, respectively.

In terms of airports, Honduras received 2.9 out of 7. Honduras's four international airports have undergone upgrades in recent years as a result of long-term concession agreements negotiated with experienced international operators in the late 1990s. Steady efficiency improvements therefore can be expected in the years ahead.³⁹ By contrast, the quality of airports in Costa Rica, with a score of 4.1, and Chile, with a score of 5.4, is already first-rate.

Data on telecommunications in Honduras are incomplete. Nevertheless, the data available do indicate that the average cost of a three-minute, peak-rate, fixed-line local phone call is the same as the LMI-LAC average (\$0.06), which is cheaper than in Chile (\$0.10) yet more expensive than in Costa Rica (\$0.02). The other telecommunications indicator, the number of Internet users per 1,000 people, rose steadily from 9 to 32 in the five years to 2004. But Honduras underperforms

³⁹ For a November 2004 progress report, see <http://www.iadb.org/exr/doc98/pro/rho0201.pdf>.

compared to the statistically predicted benchmark (42) and is well below the LMI-LAC average (74). Chile and Costa Rica are advanced in this category, with 279 and 235 users per 1,000 people, respectively. Honduras's telecommunications performance can be expected to improve significantly in the years ahead since Hondutel, the state telecoms company, lost its monopoly on long-distance and local service in December 2005.⁴⁰

Honduras recognizes the importance of an efficient, competitive infrastructure. It has a first-rate port, is upgrading its airports, is opening its telecommunications system to competition, and is continuing to work with neighbors on developing a regional electrical grid. Although Honduras will receive financing for infrastructure projects from official lenders or private investors, donors such as USAID can provide financing for complementary activities such as feasibility studies and efficiency assessments. Honduras would undoubtedly benefit from this type of assistance.

SCIENCE AND TECHNOLOGY

Science and technology are central elements of a dynamic growth process, because technical knowledge is a driving force for rising productivity and competitiveness. Even for low-income countries such as Honduras, transformational development increasingly depends on acquiring and adapting technology from the global economy and applying it in ways that are appropriate to their level of development. A lack of capacity to access and utilize technology prevents an economy from leveraging the benefits of globalization.

Honduras scores relatively well on the FDI Technology Transfer index, which ranges from 1 (FDI bringing little new technology) to 7 (FDI bringing much new technology). Its score of 4.6 is equal to the regression benchmark and the LMI-LAC average while Chile scored 5.3 and Costa Rica scored 5.5.

In 2000 (most recent data available), Honduras spent 0.1 percent of its GDP on research and development. This is in line with the LMI-LAC average, yet lower than Chile's (0.5) and Costa Rica's spending (0.4). In 2002, Honduran residents filed seven patent applications; although below the LMI-LAC average of 13 patents filed, this figure is nonetheless impressive for a country of the size and level of development of Honduras, especially considering that Costa Rica residents filed zero patent applications in the same year. Some of the explanation undoubtedly arises from the excellent work done through Zamorano University—an academic institution recognized as a leader throughout Central America.⁴¹ Donors may wish to partner with and help to strengthen this and other recognized institutional leaders when implementing projects.

⁴⁰ See *Analysis: Uncertain Future for Hondutel*: <http://www.tmcnet.com/scripts/print-page.aspx?PagePrint=http%3A%2F%2Fwww.tmcnet.com%2Fsubmit%2F2006%2Fjan%2F1272133.htm>.

⁴¹ See <http://www.zamorano.edu/>.

4. Pro-Poor Growth Environment

Rapid growth is the most powerful and dependable instrument for poverty reduction, yet the link from growth to poverty reduction is not mechanical. In some cases, income growth for poor households exceeds the overall rise in per capita income, while in other conditions growth benefits the non-poor far more than the poor. A pro-poor growth environment stems from policies and institutions that improve opportunities and capabilities for the poor while reducing their vulnerability. Pro-poor growth is associated with improvement in primary health and education, the creation of jobs and income opportunities, the development of skills, microfinance, agricultural development, and gender equality.⁴² This section focuses on four of these issues: health, education, employment and the workforce, and agricultural development.

HEALTH

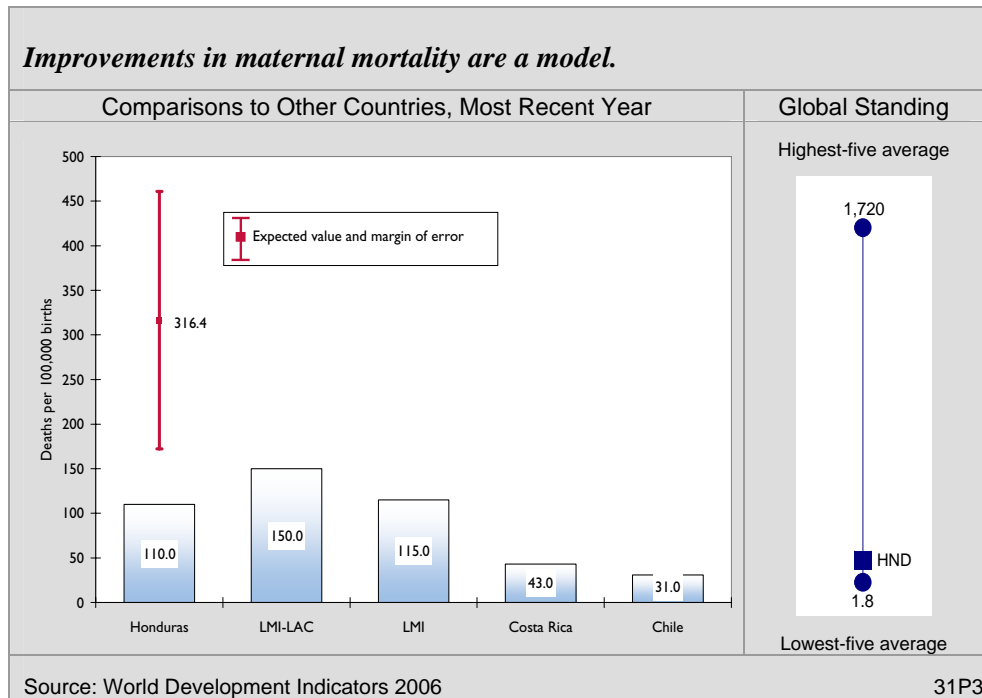
The provision of basic health service is a major form of human capital investment and a significant determinant of growth and poverty reduction. Although health programs do not fall under the EGAT bureau, an understanding of health conditions can influence the design of economic growth interventions.

Among Honduras's greatest recent achievements in public health is a reduction of maternal mortality rates. In 2000 Honduras had approximately 110.0 maternal deaths per 100,000 live births. The statistical benchmark predicts that a country with Honduras's characteristics would have a maternal mortality rate of 316.4. Although values for Chile and Costa Rica still leave something for Honduras to aspire to, the fact that such a poor country has surpassed the LMI-LAC average of 150.0 is an important accomplishment. Honduras drastically reduced maternal mortality through a concerted effort by the Ministry of Health in the mid- to late-1990s that improved women's access to prenatal care, improved rural women's access to hospital births, and enabled early identification of high-risk pregnancies. This was accomplished through the construction of an integrated system whose components included maternity waiting homes for rural women, birthing centers and maternal-infant clinics, the addition of a number of rural health centers, and several new rural hospitals (Figure 4-1).⁴³

⁴² This report focuses on economic growth performance and therefore does not cover emergency relief.

⁴³ Danel, Isabella. *Maternal Mortality Reduction, Honduras, 1990-1997: A Case Study*. World Bank, 2000, p. 4.

Figure 4-1
Maternal Mortality Rate per 100,000 Live Births



Life expectancy at birth in Honduras rose one entire year from 2001 to 2005, from 67.5 to 68.6 years. This trend is part of improving overall health in Honduras. Nevertheless, a few areas of public health still demand improvement. For instance, the prevalence of child malnutrition, at 17.0 percent in 2003, is high compared to the LMI-LAC average of 14.0 percent, and very high compared to the rate in Chile (0.8 percent). Furthermore, access to improved sanitation is limited, with only 68.0 percent of the population having access, a slightly poorer score than the LMI-LAC average of 71.0 percent and much worse than Chile's and Costa Rica's 92.0 percent. The HIV prevalence rate in Honduras is 1.8 percent; while still low in absolute terms, this is more than twice the regional average of 0.7.

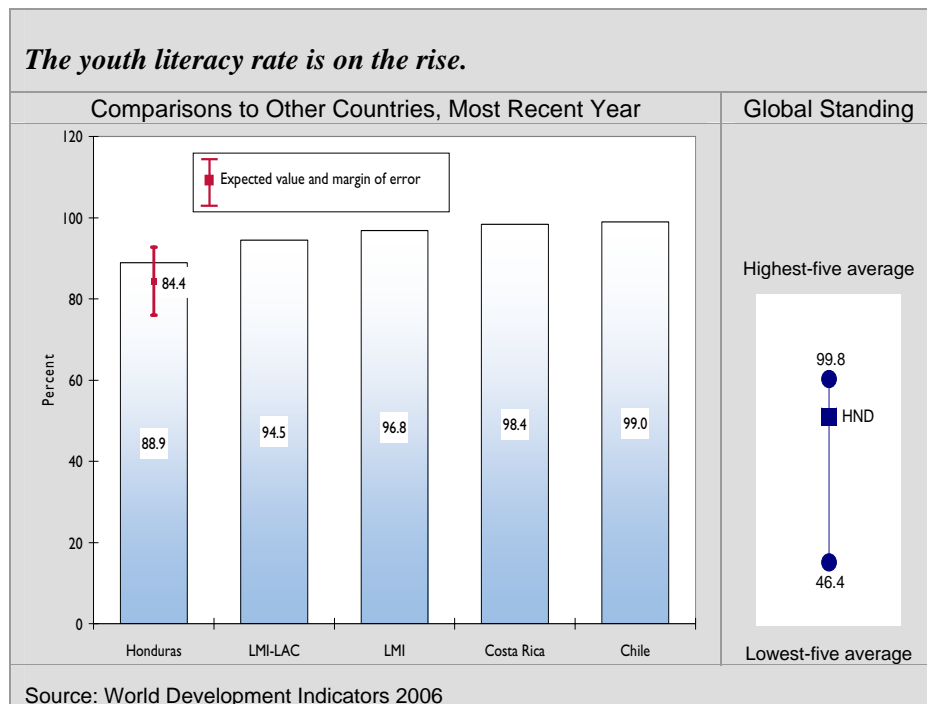
Honduras, in its reduction of maternal mortality, has demonstrated its capability to drastically improve public health. Lending this kind of dedication to other health concerns will contribute to better overall public health, which is an essential component to pro-poor growth.

EDUCATION

Few data on basic education for Honduras are available from standard international sources. The data that are available show a mixed picture. On the negative side, total primary enrollment in 2004 was 90.7 percent—low compared to the regional average of 95.1. As already mentioned, slightly more girls than boys are enrolled at the primary level (91.7 percent compared to 89.8 percent). On the positive side, in 2004, 79.4 percent of Honduran students persisted to grade 5. Although this rate compares poorly to Costa Rica's and Chile's persistence rates (91.6 percent and 99.9 percent, respectively), it is higher than the statistically predicted benchmark (71.8 percent) and the LMI-LAC average (69.4 percent).

A youth literacy rate of 88.9 percent, low compared with the LMI-LAC average of 94.5 percent, is a direct consequence of weak primary education. Yet youth literacy increased between 2000 and 2004, so this situation appears to be improving (Figure 4-2).

Figure 4-2
Youth Literacy Rate



Although the Honduran constitution stipulates free primary education for all children between the ages of 7 and 14, the public education system is plagued by a lack of schools, understaffing, and the inability to fund equipment.⁴⁴ The lack of funding is evidenced by a pupil–teacher ratio of 34.4, very high compared to the LMI-LAC average of 23.7 and Costa Rica’s 22.6. Rural students are particularly disadvantaged because rural schools are often hard to reach and have fewer staff and resources than their urban counterparts. The Library of Congress reports that rural classrooms often have more than 80 students. In 2005 the education expenditure for primary education was 2.37 percent of GDP, which is low in absolute terms as well as low relative to the LMI-LAC average of 2.93 percent. Honduras also needs to expand its rate of pupil persistence at the secondary and tertiary levels. Improvements in the quality and delivery of public education at all levels should therefore be a focal point of economic growth planning.

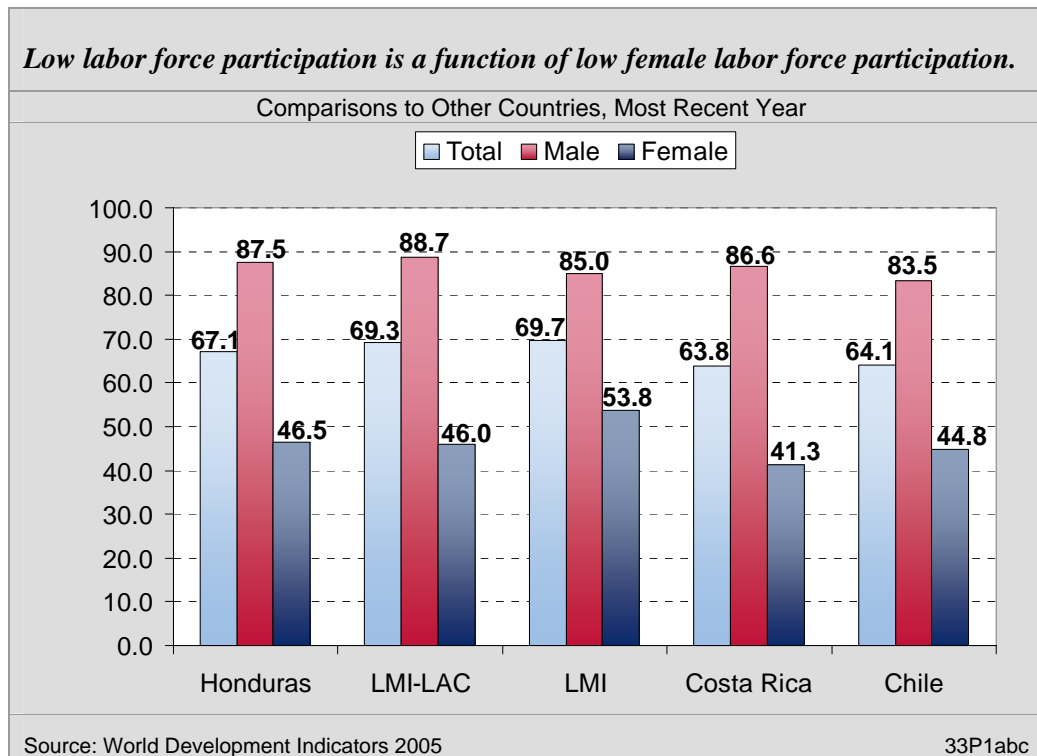
EMPLOYMENT AND WORKFORCE

The labor force in Honduras is underutilized, with a participation rate of 67.1 percent. Although low labor force participation rates are typical in Latin America—the LMI-LAC average is 69.3 percent—it is problematic for economic growth in absolute terms. The gender breakdown of Honduras’s labor force participation rate is of particular concern. Although male labor force

⁴⁴ *Country Study: Honduras*, Library of Congress, 2006 <http://countrystudies.us/honduras> .

participation is high, 87.5 percent, the female labor force participation is very low, 46.5 percent (Figure 4-3). This rate indicates a lack of employment opportunities for women in Honduras.

Figure 4-3
Total, Male, and Female Labor Force Participation Rates



The unemployment rate in Honduras is a low 5 percent. Extremely low unemployment rates are not uncommon in very poor countries because poverty, coupled with the lack of a social safety net, creates conditions of underemployment that are not accounted for in official statistics. Low unemployment in this case is not linked with a robust labor market.

Honduras scored a 34.0 in 2005 on the Rigidity of Employment Index, which ranges from 0 (minimal rigidity) to 100 (extreme rigidity). Its labor market is much less rigid than the LMI-LAC average 44.0. Although Honduras scores reasonably well on the index, concerns have been raised about the degree to which labor laws have traditionally been enforced.⁴⁵ Therefore, the ease of hiring and firing workers may have traditionally been even greater than the index suggests.

Honduras's employment generation capacity will need to expand in the coming years. Some 70,000 workers enter the Honduran job market each year; in 2004, this translated into a labor force growth rate of 2.5 percent. To avoid increased unemployment, the labor market needs to create enough jobs to keep pace with this growing demand. As noted above, Honduras needs to improve its investment climate if it is to grow. CAFTA-DR will provide an important push in this

⁴⁵ *The Labor Dimension in Central America and the Dominican Republic*. A Report of the Working Group of Vice Ministers Responsible for Trade and Labor in the Countries of Central America and the Dominican Republic. April 2005.

direction. Furthermore, job creation through the expansion of export sectors is likely to have a key role in ameliorating many of the problems with the quality and quantity of employment in Honduras.

AGRICULTURE

Agriculture employs over one-third of all workers in Honduras. Although value added per agricultural worker has grown in recent years—from \$979 per worker in 1999 to \$1,209 per worker in 2003 (the last available data)—it is still well below the LMI-LAC average of \$2,102 per worker and much below the levels of Chile (\$6,341) and Costa Rica (\$4,472). The growth rate for agricultural value added as a whole has varied significantly on a year-to-year basis. In 1999, agricultural value added contracted by 8.5 percent while in 2003 it grew by 9.0 percent. Honduras's cereal yield of 1,488 kilos per ha in 2005 was low compared to the LMI-LAC average of 2,413 kilos per ha and very low compared to Chile's yield (5,313 kilos per ha) and Costa Rica's yield (3,803 kilos per ha).

Honduras's agricultural sector is becoming more productive. However, there is a mismatch between the number of workers employed in agriculture and the ability of the sector, as it is currently structured, to generate the income required to lift significant numbers of people out of poverty. Donors should continue to work with Honduras to increase agricultural productivity because higher productivity translates into higher incomes and consumption for those employed in the sector.

5. Conclusions: Key Findings

In the 1980s, Honduras endured significant social tensions. In the late 1990s, Honduras suffered the devastating wrath of Hurricane Mitch. Despite this rather troubled recent history, the country has begun to turn the corner on its tumultuous past and seems to be entering on to a path of economic growth and poverty reduction. As it advances down this new path, Honduras brings to the table a number of key strengths but also suffers from a number of notable weaknesses.

Honduras will be able to draw on the following strengths in the years to come:

- **CAFTA-DR.** Through CAFTA-DR, Honduran producers of goods and services have secure tariff- and quota-free access to the largest consumer market in the world. Honduras will also benefit from CAFTA-DR's comprehensive rules on investment, intellectual property, government procurement, and transparency. Finally, CAFTA-DR is essential to the long-term future of the Honduran apparel sector.
- **Debt relief.** Honduras has benefited from significant debt relief in the past three years, from the multilateral financial institutions and individual countries that hold its debt. Lifting the debt burden will free the country to make productive investments that will have positive social and economic impacts.
- **Puerto Cortes.** The technical assistance, machinery and equipment, and most importantly, the expedited clearance in the United States of goods dispatched from Puerto Cortes offer Honduras tremendous competitiveness advantage in seaborne trade vis-à-vis competing ports in the region.
- **MCC compact.** Honduras will benefit significantly from the \$215 million compact that it has with the Millennium Challenge Corporation. The rural development and transport investments made under the compact will contribute significantly to upgrading of the country's competitiveness, particularly in rural areas and in the agricultural sector.

Honduras also must address certain weaknesses, including the following:

- **Poverty and income inequality.** Honduras a very poor country with a very unequal distribution of income. A reduction of the disparity between rich and poor in Honduras is fundamental to the country's long-term social stability and economic development.
- **Violent crime and corruption.** All levels of society in Honduras are deeply affected by violent crime, whether as direct victims or through paying the security costs to avoid this fate. The high social and economic costs of crime coupled with low levels of the rule of law are significant impediments to Honduras' development. Honduras also has high levels of corruption.
- **Mismatch between number of workers employed in agriculture and agricultural productivity.** Many Hondurans are employed in the agricultural sector at low-productivity jobs. Improving

the productivity of the agricultural sector while creating more non-farm employment opportunities is important.

- ***Lack of environmental sustainability.*** Honduras's environmental sustainability index has declined sharply in recent years. Although important advances in environmental management have been made, the massive scale of illegal logging not only encourages a culture of corruption but undermines the viability of communities in affected areas. It also undermines potentially lucrative ecotourism in the internationally recognized Río Plátano Biosphere Reserve.

Given Honduras's strengths and weaknesses, donors must choose among a number of competing priorities. Donors should consider the following as among the highest priorities for intervention:

- Assisting Honduras in taking advantage of the opportunities generated by CAFTA-DR. Potential activities include (1) a comprehensive trade facilitation audit to identify the impediments to reducing the time required to trade; (2) technical assistance to the apparel sector; (3) assistance in implementing and administering the agreement, including rules of origin, intellectual property rights, and trade in services; (4) development of a strategy to enhance the value-added share of Honduras's food and agricultural exports.
- Encouraging regional cooperation and coordination in efforts to fight transnational criminal gangs.
- Taking a multifaceted approach to assisting Honduras in stopping illegal logging and addressing other environmental challenges.
- Helping communities channel remittances to investment activities as well as to consumption. Remittances are an essential factor in the Honduran economy but have negative as well as positive effects. Regardless of how remittances are viewed, donors have an important role to play in strengthening the financial management skills of those receiving remittances and the intermediaries that channel remittances toward productive purposes.

Appendix

CRITERIA FOR SELECTING INDICATORS

The economic performance evaluation is designed to balance the need for broad coverage and diagnostic value, on the one hand, and the requirement of brevity and clarity, on the other. The analysis covers 15 economic governance–related topics and just over 100 variables. For the sake of brevity, the write-up in the text highlights issues for which the “dashboard lights” appear to be signaling problems, which suggest possible priorities for USAID intervention. The accompanying table provides a full list of indicators examined for this report. The separate Data Supplement contains the complete data set for Honduras, including data for the benchmark comparisons, and technical notes for every indicator.

For each topic, the analysis begins with a screening of *primary performance indicators*. These Level I indicators are selected to answer the question, Is the country performing well or not in this area? The set of primary indicators also includes descriptive variables such as per capita income, the poverty head count, and the age dependency rate.

When Level I indicators suggest weak performance, the analysis proceeds to review a limited set of *diagnostic supporting indicators*. These Level II indicators provide additional details or shed light on why the primary indicators may be weak. For example, if economic growth is poor, one can examine data on investment and productivity as diagnostic indicators. If a country performs poorly on educational achievement, as measured by the youth literacy rate, one can examine determinants such as expenditure on primary education, and the pupil–teacher ratio.⁴⁶

The indicators have been selected on the basis of the following criteria. Each must be accessible through USAID’s Economic and Social Database or convenient public sources, particularly on the Internet. They should be available for a large number of countries, including most USAID client states, to support the benchmarking analysis. The data should be sufficiently timely to support an assessment of country performance that is suitable for strategic planning purposes. Data quality is another consideration. For example, subjective survey responses are used only when actual measurements are not available. Aside from a few descriptive variables, the indicators must also be useful for diagnostic purposes. Preference is given to measures that are widely used, such as Millennium Development Goal indicators or evaluation data used by the Millennium Challenge Corporation. Finally, an effort has been made to minimize redundancy. If two indicators provide similar information, preference is given to one that is simplest to understand or most widely used. For example, both the Gini coefficient and the share of income

⁴⁶ Deeper analysis of the topic using more detailed data (level III) is beyond the scope of papers in this series.

accruing to the poorest 20 percent of households can be used to gauge income inequality. We use the income share because it is simpler, and more sensitive to changes.

BENCHMARKING METHODOLOGY

Comparative benchmarking is the main tool used to evaluate each indicator. The analysis draws on several criteria, rather than a single mechanical rule. The starting point is a comparison of performance in Honduras relative to the average for countries in the same income group and region—in this case, Latin America and Caribbean countries with lower-middle income levels.⁴⁷ For added perspective, three other comparisons are examined: (1) the global average for this income group; (2) respective values for two comparator countries selected by the Honduras mission (in this case, Chile and Costa Rica); and (3) the average for the five best- and five worst-performing countries globally. Most comparisons are framed in terms of values for the latest year of data from available sources. Five-year trends are also taken into account where this information sheds light on the performance assessment.⁴⁸

For selected variables, a second source of benchmark values uses statistical regression analysis to establish an expected value for the indicator, controlling for income and regional effects.⁴⁹ This approach has three advantages. First, the benchmark is customized to Honduras' specific level of income. Second, the comparison does not depend on the exact choice of reference group. Third, the methodology allows quantification of the margin of error and establishment of a “normal band” for a country with Honduras' characteristics. An observed value falling outside this band on the side of poor performance signals a serious problem.⁵⁰

Finally, when relevant, Honduras's performance is weighed against absolute standards. For example, if the Corruption Perception index for a given country is below 3.0, this is a sign of serious economic governance problems, regardless of the regional comparisons or regression result.

⁴⁷ Income groups as defined by the World Bank for 2005. For this study, the average is defined in terms of the mean; future studies will use the median instead, because the values are not distorted by outliers.

⁴⁸ The five-year trends are computed by fitting a log-linear regression line through the data points. The alternative of computing average growth from the end points produces aberrant results when one or both of those points diverges from the underlying trend.

⁴⁹ This is a cross-sectional OLS regression using data for all developing countries. For any indicator, Y , the regression equation takes the form: Y (or $\ln Y$, as relevant) = $a + b * \ln \text{PCI} + c * \text{Region} + \text{error}$ —where PCI is per capita income in PPP\$, and Region is a set of 0-1 dummy variables indicating the region in which each country is located. When estimates are obtained for the parameters a , b and c , the predicted value for Honduras is computed by plugging in Honduras-specific values for PCI and Region. When applicable, the regression also controls for population size and petroleum exports (as a percentage of GDP).

⁵⁰ This report uses a margin of error of 0.66 times the standard error of estimate (adjusted for heteroskedasticity, where appropriate). With this value, 25 percent of the observations should fall outside the normal range on the side of poor performance (and 25 percent on the side of good performance). Some regressions produce a very large standard error, giving a “normal band” that is too wide to provide a discerning test of good or bad performance.

LIST OF INDICATORS

Indicator	Level ^a	MDG, MCA, or EcGov ^b	CAS Code
OVERVIEW OF THE ECONOMY			
Growth Performance			
Per capita GDP, \$PPP	I		11P1
Per capita GDP, current US\$	I		11P2
Real GDP growth	I		11P3
Growth of labor productivity	II		11S1
Investment Productivity—incremental capital-output ratio (ICOR)	II		11S2
Gross fixed investment, % GDP	II		11S3
Gross fixed private investment, % GDP	II		11S4
Poverty and Inequality			
Human poverty index	I		12P1
Income-share, poorest 20%	I		12P2
Population living on less than \$1 PPP per day	I	MDG	12P3
Poverty headcount, by national poverty line	I	MDG	12P4
Income-share, richest 20%	I		12P5
Ratio of income shares, richest 20% to poorest 20%	I		12P6
PRSP Status	I	EcGov	12P5
Population below minimum dietary energy consumption	II	MDG	12S1
Poverty gap at \$1 PPP a day	II		12S2
Economic Structure			
Labor force structure	I		13P1
Output structure	I		13P2
Demography and Environment			
Adult literacy rate	I		14P1
Age dependency rate	I		14P2
Environmental sustainable index	I		14P3
Population size and growth	I		14P4
Urbanization rate	I		14P5
Gender			
Adult literacy rate, ratio of male to female	I	MDG	15P1
Gross enrollment rate, all levels, ratio of male to female	I	MDG	15P2
Life expectancy at birth, ratio of male to female	I		15P3
PRIVATE SECTOR ENABLING ENVIRONMENT			
Fiscal and Monetary Policy			
Govt. expenditure, % GDP	I	EcGov	21P1
Govt. revenue, % GDP	I	EcGov	21P2

Indicator	Level ^a	MDG, MCA, or EcGov ^b	CAS Code
Growth in the money supply	I	EcGov	21P3
Inflation rate	I	MCA	21P4
Overall govt. budget balance, including grants, % GDP	I	EcGov	21P5
Composition of govt. expenditure	II		21S1
Composition of govt. revenue	II		21S2
Composition of money supply growth	II		21S3
Business Environment			
Corruption perception index	I	EcGov	22P1
Ease of doing business ranking	I	EcGov	22P2
Rule of law index	I	MCA, EcGov	22P3
Cost of starting a business, % GNI per capita	II	MCA, EcGov	22S1
Procedures to enforce contract	II	EcGov	22S2
Procedures to register property	II	EcGov	22S3
Procedures to start a business	II	EcGov	22S4
Time to enforce a contract	II	EcGov	22S5
Time to register property	II	EcGov	22S6
Time to start a business	II	EcGov	22S7
Financial Sector			
Domestic credit to private sector, % GDP	I		23P1
Interest rate spread	I		23P2
Money supply, % GDP	I		23P3
Stock market capitalization rate, % of GDP	I		23P4
Cost to create collateral	II		23S1
Country credit rating	II		23S2
Legal rights of borrowers and lenders index	II		23S3
Real Interest rate	I		23S4
External Sector			
Aid , % GNI	I		24P1
Current account balance, % GDP	I		24P2
Debt service ratio, % exports	I	MDG	24P3
Export growth of goods and services	I		24P4
Foreign direct investment, % GDP	I		24P5
Gross international reserves, months of imports	I	EcGov	24P6
Gross Private capital inflows, % GDP	I		24P7
Present value of debt, % GNI	I		24P8
Remittance receipts, % exports	I		24P9

Indicator	Level ^a	MDG, MCA, or EcGov ^b	CAS Code
Trade, % GDP	I		24P10
Exports of services, % total exports	I		24P11
Imports of services, % total exports	I		24P12
Actual and expected trade size, index	I		24P13
Time to trade, days	I		24P14
Merchandise imports from CAFTA countries, current USD million	I		24P15
Merchandise exports to CAFTA countries, current USD million	I		24P16
Concentration of exports	II		24S1
Inward FDI Potential Index	II		24S2
Net barter terms of trade	II		24S3
Real effective exchange rate (REER)	II	EcGov	24S4
Structure of merchandise exports	II		24S5
Trade policy index	II	MCA, EcGov	24S6
Composition of merchandise imports from CAFTA countries by country	II		24S7
Composition of merchandise exports to CAFTA countries, by country, current USD million	II		24S8
Economic Infrastructure			
Internet users per 1,000 people	I	MDG	25P1
Overall infrastructure quality	I	EcGov	25P2
Telephone density, fixed line and mobile	I	MDG	25P3
Quality of infrastructure—railroads, ports, air transport, and electricity	II		25S1
Telephone cost, average local call	II		25S2
Science and Technology			
Expenditure for R&D, % GNI	I		26P1
FDI and technology transfer index	I		26P2
Patent applications filed by residents	I		26P3
PRO-POOR GROWTH ENVIRONMENT			
Health			
HIV prevalence	I		31P1
Life expectancy at birth	I		31P2
Maternal mortality rate	I	MDG	31P3
Access to improved sanitation	II	MDG	31S1
Access to improved water source	II	MDG	31S2
Births attended by skilled health personnel	II	MDG	31S3
Child immunization rate	II		31S4

Indicator	Level ^a	MDG, MCA, or EcGov ^b	CAS Code
Prevalence of child malnutrition (weight for age)	II		31S5
Public health expenditure, % GDP	II	EcGov	31S6
Education			
Net primary enrollment rate	I	MDG	32P1
Persistence in school to grade 5	I	MDG	32P2
Youth literacy rate	I		32P3
Education expenditure, primary, % GDP	II	MCA, EcGov	32S1
Expenditure per student, % GDP per capita, primary, secondary, and tertiary	II	EcGov	32S2
Pupil-teacher ratio, primary school	II		32S3
Employment and Workforce			
Labor force participation rate, females, males, total	I		33P1
Rigidity of employment index	I	EcGov	33P2
Size and growth of the labor force	I		33P3
Unemployment rate	I		33P4
Agriculture			
Agriculture value added per worker	I		34P1
Cereal yield	I		34P2
Growth in agricultural value-added	I		34P3
Agricultural policy costs index	II	EcGov	34S1
Crop production index	II		34S2
Livestock production index	II		34S3

^a Level I—primary performance indicators, Level II—supporting diagnostic indicators

^b MDG—Millennium Development Goal indicator

MCA—Millennium Challenge Account indicator

EcGov—Major indicators of economic governance, which USAID defines in *Strategic Management Interim Guidance* to include “microeconomic and macroeconomic policy and institutional frameworks and operations for economic stability, efficiency, and growth.” The term therefore encompasses indicators of fiscal and monetary management, trade and exchange rate policy, and legal and regulatory systems affecting the business environment, infrastructure quality, and budget allocations.