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ESF FY 89 CONCEPT PAPER

USAID HONDURAS

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FY 1989 ESF CONCEPT PAPER
INDEX

I. SUMMARY

1. The purpose of this Concept Paper is to request authority to develop a FY 89 Economic Support Fund (ESF) Program for Honduras based on the analyses and policy measures proposed herein. We anticipate that a PAAD will be finalized by March in coordination with an IMF Standby arrangement and a World Bank SAL II Program.

2. The balance of payment support provided through the FY 89 ESF program will facilitate private investment, employment and production by easing the severe foreign exchange constraints currently facing the Honduran economy. With debt arrearages to private lenders continuing to mount, the net international reserve position increasingly precarious and overvaluation of the Lempira fast approaching 100 percent, the foreign exchange resources to be made available through the FY 89 program are of vital importance in preventing significant reductions in the availability of intermediate and capital goods to the Honduran private sector. At the same time the ESF resources will be used to leverage substantive GOH movement in key policy reform areas. This will be accomplished as part of a coordinated donor effort to correct economic policies which have limited the economy's growth potential and created its current balance of payments difficulties.

3. The FY 89 program will continue to emphasize reductions in the fiscal deficit of the consolidated nonfinancial public sector (CNFPS) and exchange rate flexibility. Moreover, it will target continued shrinkage in the size and scope of public sector activities, more extensive liberalization of the exchange rate regime and lower tariff and domestic pricing distortions. Furthermore, it will seek the gradual dissolution of institutional constraints hampering the efficient utilization of land and technology in the economy's most important employment and foreign exchange generating sector -- agriculture. The program is divided into three parts: a stabilization component, a structural adjustment component and a sectoral component. The design of the components are expected to be consistent with the macroeconomic and sectoral policy framework currently being supported by the World Bank, for which the basis was established under prior AID supported programs. A major goal of the FY 89 program will be the implementation of a sufficiently rigorous monetary and fiscal reform program to facilitate the achievement of a Standby agreement between the IMF and the GOH. This was also a goal in 1988 along with the achievement of a World Bank program. In 1988 a World Bank program was initiated and the GOH moved closer to an IMF agreement. It also completed Honduras' first Consultative Group Meeting and moved closer to obtaining Japanese and Canadian balance of payments assistance. The latter would facilitate a comprehensive debt rescheduling agreement with bilateral donors and the commercial banks, and open the way for a substantial increase in bilateral and private capital inflows into the economy.

4. Up to September 30, GOH compliance with the stabilization and structural reform measures elaborated in the FY 88 ESF Program has been very good (see Tegucigalpa 18755 for further details). Nevertheless,

during the first half of the year the Central Bank of Honduras exercised inadequate control over lending activities to the Central Government and most particularly, to the commercial banking sector. Associated with this excessive volume of credit expansion were heightened inflationary and balance of payments pressures, exacerbated by fiscal imbalances. However, in the subsequent three months the lending activities of the Central Bank stabilized as more stringent reserve requirement and rediscounting policies reduced commercial bank credit availability. Moreover, the combination of significant expenditure reductions by the Central Government and the passage of a revenue bill reducing the number of goods exempted from import duties have substantially improved the GOH's fiscal position during these three months. It now appears that the GOH may comply with the 1988 deficit reduction target. Nevertheless, the annual inflation rate is expected to be three to four times higher than last year's 2.5 percent rate. It could accelerate markedly in 1989 should balance of payment pressures fail to subside substantially.

5. Compliance with the major components of the structural reform program has been very good. The program embodies three major elements: (1) rationalization of public sector operations; (2) increasing the competitiveness of exports and promoting private investment; and (3) enhancing confidence in the Honduran economy. The compliance efforts of the GOH in the area of public sector management have included support of two performance assessments of decentralized government institutions and active efforts to privatize six state-owned enterprises. A strategic component of the reform efforts to improve the competitive position of Honduran exports has been the rapid expansion of the CETRA system. As a result of a recent Central Bank resolution, a full 40 percent of the value of all foreign trade transactions has been passed to the parallel foreign exchange market. The enhancement of export competitiveness generated by the expansion of the CETRA system should lead to a significant medium-term rise in export earnings. This should stimulate private investment activities through a loosening of the foreign exchange constraint which is currently impeding intermediate and capital good imports. The recent conclusion of negotiations between the GOH and the World Bank is considered a highly positive development. It has resulted in Bank agreements to extend a $50 million Structural Adjustment Loan and a fourth agricultural credit loan to the GOH. These agreements represent a major breakthrough in the effort to rebuild confidence in the viability of the Honduran economy. The continuation and successful conclusion of good faith negotiations between the GOH and the IMF, as the well as the resolution of the current impasse between the GOH and major commercial lenders, remain vital ingredients in the effort to restore investor confidence and stimulate a major increase in capital inflows into the Honduran economy.

II. RECENT ECONOMIC DEVELOPMENTS

A. Overview

6. Real GDP is expected to grow by 2 to 3 percent during 1988 (See Table 1). With projected population growth of 3 percent, this implies

little change in real per capita income. This performance is inferior to that registered in 1987, when real GDP increased by just over 4 percent and real per capita GDP rose for the first time in nearly a decade (by one percentage point). However, the 1987 GDP increase was fueled by the buildup of a huge volume of debt arrearages to both IFIs and commercial institutions. This accompanied a massive credit bulge which led to a 17-18 percent growth in money supply (M2) between December 1986 and December 1987. As a result the growth rate attained in 1987 was clearly unsustainable. It was inevitable that amelioration of the economy's balance of payments and fiscal pressures would necessitate less expansionary credit and public expenditure policies and, in turn, a significantly lower GDP growth rate. After a shaky start in the areas of Central Bank credit expansion, overall growth of the money stock, and fiscal deficit reduction, the GOH has made reasonable progress over the past few months in reversing the trends which resulted in the 1987 credit explosion. Likewise, the current projected GDP increase is consistent with a more stable balance of payments position.

B. Growth

7. The growth potential of the Honduran economy remains severely constrained by the shortage of imported inputs. Since the economy imports virtually all of its intermediate and capital goods, this overriding constraint limits investment opportunities in both the agricultural and nonagricultural sectors. It has also resulted in low rates of capacity utilization and considerable underemployment. The restoration of positive real per capita GDP growth rates and the stimulation of private investment activities are fundamentally dependent upon the adoption of a more realistic exchange rate policy and increased fiscal responsibility. The high 1987 real GDP growth rate was led by a 6 percent increase in the value of agricultural production. Nevertheless, this will not continue in 1988. As the result of a poor first harvest season, and acute shortages of fertilizers and other imported agricultural inputs, sectoral growth is expected to slow dramatically in 1988, reaching about 2 percent by year's end. Service sector growth is also projected to slow considerably, while industrial growth (modest in 1987) is expected to decline marginally in 1988.

C. Stabilization

8. As a result of the expenditure reduction and revenue enhancement measures undertaken by the GOH over the past few months, the fiscal position of the consolidated nonfinancial public sector looks considerably stronger than it did during the first half of the year. There is a reasonable chance that the GOH will meet its annual deficit reduction target of 60-70 million Lempiras. Tighter Central Bank credit policies have also been pursued during this period, and annual money supply growth is expected to slow significantly in relation to its 1987 rate of increase (12-13 percent in 1988 vs. 17-18 percent the year before). Despite the recent tightening of lending activities

(particularly to the commercial banking sector), intense balance of payments pressures continue to be experienced. This is a reflection of: (1) the weak international reserve position in which the economy found itself at the beginning of the year as the result of the massive 1987 credit expansion; (2) inadequate control over public sector lending and rediscounting activities exercised by the Central Bank during the first half of 1988; (3) continuing excess import demand pressures associated with a significantly overvalued exchange rate; and (4) the fall in export revenues experienced in 1987 resulting from a sharp decline in international coffee prices. Nonetheless, there is a reasonably strong likelihood that the 1988 deficit reduction target for the current account of the balance of payments (from 7.8 to 5.6 percent of GDP) will be achieved. This is due to restraints placed on import supplies through the scarcity of foreign exchange available at the official exchange rate and the expansion of export earnings associated with an expected improvement in coffee revenues and the impetus provided by the CETRA system.

9. The key to the improvement of the country's medium term balance of payments position, in additional to intensified fiscal and monetary restraint, is the continued expansion of the CETRA system. Although this is likely to be associated with short term inflationary pressures, the stimulation of export-oriented production activities and the reduction in excess import demand pressures can best be achieved through a liberalization of the exchange rate regime. At the moment inflationary pressures appear to be mounting. In 1987 the CPI increased at an annual rate of 2.5 percent, while for 1988 the rate of increase is projected at approximately 7-8 percent. A large increase in the CPI is expected in September -- the increment may be close to 2 percent for that month alone. Obviously the 1987-88 credit expansion policies and the stringent foreign exchange position of the Honduran economy have augmented inflationary pressures. The shift of a large share of import transactions to the parallel market can be expected to further accelerate these short term pressures over the next year.

III. PERFORMANCE UNDER THE FY 1988 ESF PROGRAM

A. Reduction of the Budget Deficit

10. As noted above, the GOH has made substantial progress in reaching its fiscal retrenchment goal of a L60-70 million Lempira reduction in the deficit of the consolidated nonfinancial public sector (CNFPS) from its projected June levels. In addition to an expenditure reduction of L47.3 million ordered by executive decree, recently passed legislation eliminating a range of import tariff exonerations is projected to generate an additional L7-8 million in tax revenues by the end of the year. With Central Government revenues running about 1.5 percent over earlier projections during the first eight months of 1988 (the result of both improved collection procedures and accelerating inflation), revenues for the year may be L21 million more than expected. The combination of

expenditure cuts, less tariff exonerations and higher revenues imply that the GOH stands a realistic chance of meeting its overall deficit reduction target for 1988. The main threat to achievement of the fiscal targets would be a last quarter surge in expenditures outside the budget. However, at the present time the GOH appears to have adopted sufficiently stringent expenditure and revenue-enhancement policies to allow it to satisfy its 1988 deficit reduction target.

B. Expansion of the CETRA System

11. CETRAs are certificates which allow exporters to effectively retain a portion of the foreign exchange revenues they generate. They can be used directly by the exporters or sold through the banking system. In its 1988 Economic Program, the GOH committed itself to an expansion of the CETRA system which would result in a full 40 percent of the value of trade transactions being passed outside the official exchange rate regime. This goal was satisfied in September (three months ahead of schedule), as the Central Bank officially sanctioned an expansion of the CETRA system to cover approximately 12.4 percent of exports. With about 29.4 percent of exports covered by the "autofinanciamiento" market (through which exporters of certain products -- primarily bananas and minerals -- are allowed to retain a portion of their foreign exchange receipts for purposes specified in a private agreement with the Central Bank), the total value of exports passed outside the official exchange rate system is now slightly greater than 40 percent.

12. The Central Bank has also approved additional measures designed to enhance the transparency and flexibility characterizing CETRA transactions. In September commercial banks were officially permitted to trade CETRAs, and individuals were given the right to purchase up to $5,000 with Lempira through the CETRA system. However, the maximum purchase was dropped to $2,500 in November "for the Christmas season." The measures implemented in September enhance the competitiveness characterizing CETRA trading activities and represent a major step toward official sanction of a parallel exchange rate. A measure passed in October, requiring that CETRAs be transferred through the banking system, may have a partially counterbalancing effect by reducing the flexibility with which the trading system operates. This measure may eventually permit the Central Bank to exert direct control over CETRA prices. Despite these potential drawbacks, the move is viewed as a positive overall development since it implies further formalization of the CETRA market.

C. Monetary Program

13. Monetary performance has improved considerably over the past few months, following a deterioration in the economy's net international asset position and inadequate Central Bank control over lending to the commercial banking sector during the first half of the year. This improvement has reflected the modest beneficial impact of delayed donor

TABLE 1

HONDURAS - MACROECONOMIC INDICATORS: 1983-88

Key Macroeconomic Indicators	1983	1984	1985	1986	Prel. 1987	Proj. 1988
Real GDP in 1978 Lempiras (Millions)	4061	4174	4307	4427	4612	4727
Real Per Capita GDP in 1978 Lempiras	992	987	985	982	993	988
Real GDP Growth Rate (%)	-0.3	2.8	3.2	2.8	4.2	2.5
Real Per Capita GDP Growth Rate (%)	-3.7	-0.5	-0.2	-0.3	1.1	-0.5
CNFPS Fiscal Deficit (as % of GDP)	12.2	11.3	7.6	6.6	6.2	5.6
Current Account Deficit (as % of GDP)	8.6	12.0	9.7	6.6	7.8	5.6
Total External Debt ($ Millions)	1807	2016	2319	2467	2412	2511
Accumulation of Arrears ($ Millions)	111	148	197	217	343	366
Debt Service Payments as a % of Exports	26	25.6	26.8	30.6	39	35.1
CPI Inflation Rate (%)	8.3	4.7	3.4	4.4	2.5	8
Broad Money Supply, Annual Growth Rate (%)	16.2	7.7	4.3	11.5	17.9	12.9

Source: Central Bank of Honduras, World Bank, IMF, and Mission Staff Estimates disbursements on net international asset availability, the impact of a more restrictive reserve requirement and, more particularly, tighter Central Bank rediscounting policies on internal credit expansion. As a result the GOH complied with each of the September 30 targets for Central Bank monetary expansion which had been set out in this year's PAAD (see Table 2). These targets pertain to net international asset levels, internal asset expansion (reflecting credit expansion to the public sector, banking sector and nonbank private sector) and public sector net internal asset expansion.

14. Net international asset levels have stabilized as the result of recent AID disbursements and a reduction in medium and long-term debt obligations. At the same time the continued buildup of arrear deposits (Lempira deposits placed in the banking system by individuals holding valid import permits and awaiting the release of the foreign exchange equivalent of their deposits) and the escalation of excess import demand pressures continue to place considerable pressure on the economy's stock of international reserves. The root cause of these pressures is the unrealistic official exchange rate policy which the government continues to follow. These pressures are aggravated by the excessive internal credit expansion of the 1987-88 period. Continued expansion of the CETRA system represents a major first step in putting the economy's international reserve position on a healthier long run footing.

15. The excessive expansion of credit to both the public and private sectors during 1987 and the first half of 1988 placed the economy in a dangerous position in terms of both foreign exchange availability and domestic inflationary pressures. The recent improvement in monetary performance has been achieved in large part through a significant reduction in Central Bank credit to the commercial banking sector. Commercial bank credit fell by almost L30 million during the July-September period, in line with reductions which had originally been programmed for the first six months of the year. The decline in banking sector credit reflects the lagged impact of the increase in reserve requirements (from 32 percent to 35 percent) implemented earlier this year and the enactment of significantly more restrictive rediscounting policies on the part of the Central Bank. AID rediscount lines moved very little during the period, while rediscounting activities relating to the World Bank's Industrial Credit Line (FONDEI) and commercial bank credit through the Central Bank's own rediscount lines slowed significantly during the period. As a result banking system liquidity (as measured by M2) actually fell slightly during the period, and annual money supply growth is expected to be well below its 1987 level of 17-18 percent. The September 30 limit on net public sector asset expansion by the Central Bank was satisfied though ongoing fiscal and exchange rate pressures continue to signal the need for stricter control of Central Bank credit flows to the Central Government. GOH bond placements with the private sector have increased significantly in 1988, as the GOH has accelerated efforts to locate nonbank credit sources to finance its expenditure activities. Removal of sight redemption and income tax

TABLE 2

CENTRAL BANK MONETARY PROGRAM TARGETS, SEPTEMBER 30, 1988
(In Millions of Lempiras)

	Actual Jun 88	Actual Sep 88	Target Sep 88
Net International Assets	-1019.8	-1019.6	-1069.7
-Change from 6/88		.2	-49.9
Internal Assets	1662.2	1670.9	1689.5
-Change from 6/88		8.7	27.3
Public Sector Net Internal Assets	723.4	758.7	785.3
-Change from 6/88		35.3	61.9

SOURCE: Central Bank of Honduras

exemption privileges for GOH bonds would significantly reduce private sector incentives to finance the GOH's fiscal deficit.

D. Structural Adjustment Program

16. The GOH has made significant progress in each of the three major components of the 1988 structural reform program -- rationalization of public sector operations, improvement of the competitive position of exports and promotion of private investment, and enhancement of confidence in the Honduran economy. Substantive progress is being made in efforts to enact institutional reforms which will facilitate the streamlining of public expenditures. The GOH has authorized internal management assessments of the two largest money losers among the decentralized public institutions: ENEE (the National Electric Utility), and SANAA (the Water and Sewerage Utility). The recommendations which emerge from these evaluations are expected to be implemented by an interministerial supervisory group in coordination with implementation assistance to be provided by the World Bank under a planned 1989 Public Enterprise Adjustment and Restructuring Loan. In 1988 the GOH completed the privatization of three public corporations -- a paper mill, a sugar mill, and construction products company -- and is currently eliciting purchase bids for three other publicly run companies -- a hotel, a saw mill, and a foundry. The previously mentioned reduction in import duty exemptions represents major progress towards the rationalization of the taxation system. The GOH has complied with a requirement to propose a municipal reform package before the National Congress. Nevertheless, progress toward the implementation of a road toll collection system has been inadequate, and implementation by the Ministry of Finance of an action plan designed to substantially improve tax administration procedures has been stalled.

17. The GOH's performance in undertaking structural reform measures designed to increase export competitiveness and promote private investment has generally been good. The GOH submitted reports on the implementation of a number of export-promotion measures on schedule. It has initiated studies which will examine the institutional barriers to investment in the economy as a whole, and in the agricultural sector in particular. The GOH also made substantial progress towards the establishment of an investment information and promotion center. Progress was considerably slower in the presentation of periodic evaluations of export performance before the Economic Cabinet and the development of legislation which would ease constraints on foreign investment in tourist industries. The key achievement in improving medium-term export and investment prospects has been the expansion of the CETRA system. This represents the focal point of ongoing Mission efforts to accelerate the formal development of a parallel foreign exchange market, and thereby relieve the crippling foreign exchange constraints limiting investment opportunities for Honduran companies and entrepreneurs.

18. Progress in enhancing confidence in the Honduran economy has been noteworthy, primarily as the result of the successful conclusion of negociations between the GOH and the World Bank. GOH repayment of massive World Bank debt arrearages (with the assistance of ESF resources), and mutual agreement on a fiscal and monetary reform package, have triggered the extension of a $50 million SAL by the Bank and led to serious negotiations with a major bilateral donor (Japan). These negotiations are expected to result in a $50 million GOJ cofinancing loan to Honduras in the coming months. The successful conclusion of ongoing negotiations between the GOH and both the IMF and the major commercial banks remains a high priority in terms of both augmenting immediate capital inflows and instilling investor confidence in the stability of the Honduran economy.

IV. ECONOMIC PROSPECTS FOR 1989 THROUGH 1993

19. Medium term growth prospects for the Honduran economy are dependent upon a number of key interrelated factors. Continued progress in reduction of past fiscal and credit imbalances is essential to alleviate pressures on the country's international reserve position, minimize inflationary tendencies, and facilitate the reallocation of resource flows toward private sector investment and production activities. Redesign of current trade policies, through reduction in the high rates of effective protection now enjoyed by industrial producers, would facilitate the reorientation of domestic production towards external markets, increase cost efficiency incentives and encourage the adoption of more appropriate input technologies. It would simultaneously improve the internal terms of trade for the less-heavily protected agricultural sector. The stimulation of agricultural production is of special importance. In particular, an urgent need exists to (1) increase the volume and quality of GOH infrastructural investments (particularly road maintenance and irrigation activities); (2) reform basic grain pricing policies which currently limit domestic production incentives; and (3) eliminate institutional constraints on efficient land use and transfer. These measures would enhance medium term agricultural growth prospects significantly and sharply reduce current unemployment and underemployment pressures.

20. Perhaps the key integrative factor in stimulating strong GDP growth rates over the medium term is the deepening of the exchange rate liberalization process through the continued expansion of the CETRA system and the associated formalization of the parallel foreign exchange market. As a successively larger share of trade transactions is passed outside the official exchange rate, domestic producers will be encouraged to adopt more cost-effective technologies and to concentrate productive resources in export and efficient import-substitution activities. A particularly strong stimulus would be provided to nontraditional agricultural export industries. This, in turn, would facilitate an intensification of ongoing export diversification efforts.

21. Certainly the recent SAL Agreement reached between the GOH and the World Bank has brightened the growth prospects for coming years. The achievement of an IMF Standby agreement in the near future would further enhance the economy's growth potential by providing a significant additional stimulus to both official and private capital inflows. Currently the World Bank is targetting the development and implementation of reform programs in key sectors -- trade, credit, agriculture, public sector operations -- over the 1989-92 period. The Bank's policy initiatives in these areas appear to be closely aligned with ongoing Mission policy dialogue activities. Close interdonor coordination in the design and implementation of reform proposals is expected. Capital inflows from the Bank's own resources and from the cofinancing activities of bilateral donors are projected at well over $100 million annually during this period with a much higher figure expected in 1989. This would improve the economy's import-capacity sufficiently to generate an additional 1-2 percent annual growth in GDP above that which would otherwise be possible. The reforms enacted during that time would be expected to sustain this higher growth rate after the withdrawal of concessionary financial support.

V. NEGOTIATING OBJECTIVES AND STRATEGY

A. Objectives

22. The Mission proposes a continuation and deepening of the objectives found in past ESF programs and the introduction of an explicit sectoral component in the 1989 program. As in the past, primary emphasis is placed on support of a program credible on its own merits. Recognizing, however, that ESF resources alone are unlikely to be sufficient to finance economic recovery of the Honduran economy, the Mission continues to place considerable emphasis on the establishment of IMF support for the GOH economic program. An IMF agreement would provide immediate balance of payments support and open the door to a Paris Club debt rescheduling. Equally important is the maintenance and expansion of the flow of IBRD resources toward Honduras. An additional objective stresses the need for obtaining the support of bilateral donors through the forum recently established by Honduras' first Consultative Group meeting.

1. A Program Credible on its Own Merits

23. The major objectives of the program the Mission proposes to negotiate are summarized in the Annex to this paper. It can be seen that these are divided into a general objective seeking a GDP growth rate of at least 2 percent and more specific objectives pertaining to a monetary program and a program of structural adjustments.

24. The general objective is considered crucial to obtaining political support for efforts designed to stabilize the Honduran economy and improve its underpinnings through making structural and sectoral adjustments. A minimum GDP growth rate of 2 percent reflects the

objective of implementing stabilization and structural adjustment measures which expand Honduras' exports instead of promoting policies to achieve stabilization objectives through choking imports and, at the same time, reducing domestic production, employment and incomes.

25. The stabilization goals are considered vital to alleviating pressures on domestic prices and the balance of payments in the short run while, over a longer time period, shifting the allocation of resources from the public to the private sector. These budget deficit reduction goals for 1989 (which are still considered tentative) call for reducing the fiscal deficit of the Central Government to no more than 5.1 percent of GDP (down from 6.4 percent expected in 1988) and that of the CNFPS to no more than 4.0 percent of GDP (down from 5.6 percent expected in 1988). The stabilization program also seeks to restrict the balance of payments deficit (defined to exclude official transfers) to no more than 5.6 percent of GDP. It should be noted that these objectives are ambitious and do not allow for surges in government expenditures which could easily occur in 1989 -- an election year. Even though the FY 1989 ESF program seeks a sharp reduction in the CNFPS deficit, it must be emphasized that we expect this to occur through cutting wasteful expenditures and through better enforcement of tax laws. We do not advocate cuts in the provision of basic social services although we would certainly encourage more efficient delivery of these services.

26. Unlike the stabilization component of the economic program, which aims at quick improvements in economic performance, the structural and sectoral adjustment components seek to improve economic performance over a longer time period. Structural and sectoral adjustments are crucial to improving the underpinnings of the economy, thereby permitting it to achieve broad-based, self-sustaining economic growth and development over the medium term.

27. In this aspect, the importance of the structural and sectoral adjustments cannot be overestimated. From a short-term perspective, these can partially substitute for, and in this way, reduce the severity of the generally harsher stabilization measures. From a medium term perspective -- that is, over a three to ten year period -- structural and sectoral adjustments will lead to improvements in the efficiency of resource allocation. This will, in turn, enable the economy to achieve and sustain higher levels of consumption, investment, employment and real incomes than would otherwise be possible.

28. Within the context of Mission's Action Plan, we expect to place increasing emphasis on sectoral issues in the FY 89 and FY 90 ESF programs. This year specific measures will be negotiated to achieve important agricultural policy adjustments. The Mission will continue to stress lowering effective protection to stimulate the export sector. Important corrective measures will also be sought for the financial sector. However, we realize that basic macroeconomic adjustments -- in particular, exchange rate flexibility and rationalizing public expenditures -- remain key to improving sectoral performance. These

adjustments are especially important in improving performance in the agriculture, export and financial sectors -- the sectors USAID has targetted for special attention.

29. The USAID Mission has assigned high priorities to exchange rate liberalization and improved trade policies as crucial for improving agricultural performance. Since 1980, the relative terms of trade between agriculture and the rest of the economy have deteriorated significantly. While this is partly a reflection of generally declining international prices of agricultural commodities, domestic policies have exacerbated this trend. The measures to expand the coverage of the parallel market (through the CETRA system), reduce effective protection and liberalize interest rates are key measures to reform and improve the pricing structure facing the agricultural sector.

30. Once the GOH progresses further in these areas -- hopefully with the backing of the IMF and World Bank -- USAID hopes to continue reorienting its focus toward sectoral programs. As IMF and World Bank programs grow in importance during the course of 1989, we expect to accelerate our shift toward sectoral programs. However, until the Fund and Bank programs are firmly in place, we believe USAID leadership must be maintained in the macroeconomic area.

31. Macro policy packages designed to achieve short run stabilization goals traditionally do so through policy mixes that emphasize a combination of devaluation, tight monetary policy and fiscal austerity. These measures often seek to achieve stabilization by reducing real imports to a level that can be financed by current export earnings and long-term capital inflows. As a consequence, real income and employment are reduced by their heavy dependence on imports. To some extent, the severity of the macro restraint package can be reduced by the parallel introduction of structural and sectoral measures designed to raise exports, rationalize imports and improve the efficiency of credit allocation and fiscal policies. For example, the parallel elimination of interest rate ceilings and directed credit lines would encourage credit allocation to efficient users -- those who are willing and able to outbid other claimants for the limited credit that can be made available within the limits of the stabilization objectives. At the same time these measures would encourage domestic saving. The elimination of tax preferences accorded interest earnings and of the automatic repurchase guarantees on Government bonds would immediately improve the prospects for private sector investment. The parallel introduction of improvements in tax administration could raise fiscal revenues without increases in tax rates.

32. Structural and sectoral adjustments are even more important from a mid term perspective. This reflects three unavoidable constraints on the immediacy of their impact: it takes time to design them, time to implement them and time for the reforms to be reflected in macro performance indicators. Reductions in the rate of effective protection -- a key goal in the GOH structural adjustment program -- is a case in

point. From the perspective of improving Honduras' economic performance, a reduction in effective protection is essential. The high effective protection that currently exists channels the limited investment resources to industries that produce for the domestic market at the expense of more efficient industries producing for export markets. By discriminating against industries that produce for export markets, high effective protection lowers growth prospects because it reduces the ability of the economy to pay for the import requirements of sustaining growth. It usually also raises the import requirements for sustaining growth by fostering industries producing for the local market with a high intermediate import content. Unfortunately, however, reducing effective protection is time consuming. It takes time to develop the information requirements for the technical proposal, to generate a political consensus and, once introduced, to redirect the structure of production and investment in conformity with the more efficient incentive structure that is introduced. Each step of the process in long and hard, but the magnitude of the potential gains are worthwhile even though results are not immediately observable.

33. As the illustrations above suggest, structural and sectoral adjustments must play a key role in any credible GOH economic program that seeks to produce a sustainable improvement in economic performance. In essence, while it will always be possible to stabilize the economy, the level of real income at which stabilization will be achieved depends on the efficiency with which the economy allocates the resources available to it. The structural and sectoral components of the ESF program are designed to raise the level of income at which stabilization will be achieved.

2. Expand The Support of Other Donor Agencies

34. The Mission is pleased with the progress made in this area in 1988 and is setting objectives for deepening this support in 1989. The expansion of the activities of other donors is considered to be vital for the continuation of the GOH efforts to achieve economic recovery. Net resource flows from other donors, in particular the IMF and the World Bank, have been negative in 1987 and 1988. That is, payments to these entities have exceeded the revenues entering from their programs. A shift to positive flows from the Bank and Fund would both contribute to attaining stabilization and structural adjustment goals while opening the way for increased bilateral donor support of the GOH economic program. The specific objectives for expanding donor support include the following:

a. Maintain the Existing World Bank Program and Expand its Scope

35. In 1988 the World Bank initiated a three year structural adjustment program in Honduras with a Structural Adjustment Loan (SAL). The conditionality of the SAL I tranche closely parallels that of the USAID supported economic program. A USAID objective for 1989 includes compliance with SAL I conditionality, entering into and complying with a

SAL II program and progressing on Bank support for major sectoral programs. The latter include agriculture, public sector operations, foreign trade and financial systems. It is expected that World Bank disbursements in 1989 will reach $175 million consisting of SAL I (the second disbursement of $25 million), SAL II ($50 million) and public sector operations ($100 million). The latter includes a restructuring of ENEE for which $50 million will be disbursed. Japanese cofinancing may reach $100 million in 1989 ($50 million for SAL I and another $50 million for SAL II).

b. Obtain IMF Support

36. Throughout 1988 the GOH maintained informal contacts with the IMF at the staff level. It discussed and negotiated the possible terms of a Standby arrangement. These contacts, however, were severely strained by GOH arrears to the Fund. As these arrears were reduced in September and eliminated in November, the prospects of an agreement with the IMF have improved substantially. It is an objective of the USAID Mission to have the GOH enter a Standby arrangement in early 1989. Contacts between the IMF and USAID indicate that both are seeking similar stabilization programs in 1989.

37. An IMF agreement is considered extremely important for several reasons apart from the direct balance of payments support which could be obtained through Fund resources. A Standby would solidify the World Bank program, encourage other donor programs and open the way to a Paris Club rescheduling of bilateral debt. The latter could result in balance of payments relief of about $50 million per year.

c. Assure a Second Consultative Group Meeting in the Spring of 1989

38. The first Consultative Group meeting for Honduras in October represented an important step toward obtaining increased donor support of the GOH economic program. The second meeting, scheduled for the Spring of 1989, would review the GOH investment plan and line up donor support for important projects and programs.

B. Strategy

1. Cooperation with the IMF and IBRD

39. Throughout 1988, USAID has engaged in ample discussions with the staff of the IMF and World Bank concerning GOH economic programs for both 1988 and 1989 which could be supported by USAID, the Fund and the Bank. Despite minor differences of opinion -- especially between the IMF and World Bank -- we are generally in agreement on the thrust of the 1989 program. All have benefited from technical discussions and from a mutual exchange of information concerning strategies and programs. We hope to maintain a similar, well-coordinated approach in 1989.

40. Since both the Fund and Bank will be formulating and negotiating their 1989 program toward the end of 1988 and perhaps early in 1989, the

most opportune time for USAID to engage in its own negotiations would be at the same time and on a parallel track. This would permit the Mission to participate fully in the negotiation process and to coordinate the elements of our FY 1989 ESF program with the World Bank and the IMF. It is for this reason that we are presenting our Concept Paper early in the FY 1989 year. We hope to firm up our program during January and February of 1989.

41. The USAID Mission wants to support a program that will complement, not substitute for, a program with the IMF and World Bank. As in 1988, we will continue to make this clear to the GOH. Although our conditionality will probably support measures different than those called for in the IMF and World Bank programs, we are working with those entities to design mutually complementary programs.

42. We believe that this strategy will prove far more productive than insisting upon prior agreements with the IMF and World Bank as conditions for USAID assistance. The latter would be confrontational and should be avoided. Based on past experience, we believe that a FY 1989 ESF agreement based on the strategy outlined above, could be reached in about 4 to 6 weeks following approval of this concept paper in Washington. Of course, if prior agreement is reached with the IMF/World Bank and if we consider their conditionality and objectives appropriate, we would consider incorporating this conditionality within the FY 1989 ESF Program.

43. Under the best scenario -- one which seems plausible at this time -- the GOH will define an economic program for 1989 early in the year with ample support from the IMF, World Bank and the USG. This would permit a Paris Club rescheduling of bilateral debt shortly after the effective date of a Standby agreement. It would also encourage other bilateral donor support of the GOH reform program through a second Consultative Group meeting, probably in the Spring.

44. All of the above would imply an ample resource flow into Honduras. As previously mentioned, World Bank programs with Japanese cofinancing could bring in up to $275 million in 1989. In addition the Central Bank has estimated that a Paris Club rescheduling could provide debt service relief of about $69 million in its first year. This includes rescheduling of arrears as well as obligations coming due in 1989.

45. By relieving the pressure to make debt service payments to multi- and bilateral donors, the GOH would be able to ratify its rescheduling agreement with commercial banks and proceed toward renewed creditworthiness. Important trade credits could also be reopened by clearing up arrears with the Export-Import Bank.

46. Perhaps the weakest link in the above scenario is the IMF. Throughout 1989 it was critical of the GOH's ability to agree to and abide by a program calling for monetary restraint. Citing the large monetary expansion in 1987 (an increase in the money supply of 17-18 percent) and the large increase expected in 1988 (a monetary expansion of

about 13 percent), Fund staff members have voiced a special concern about maintaining monetary restraint in 1989 -- an election year.

47. Nevertheless, there are reasons to believe that an IMF agreement and compliance with the agreement are, indeed, possible. The programs to be negotiated by the World Bank and USAID are expected to have similar stabilization targets as required by the IMF. All will seek measures to hold the CNFPS deficit to about 4.0 percent of GDP; however, given the likelihood of slippages in an election year, we may relax the targetted deficit to about 4.5 percent of GDP (we understand the Fund considers a 4.5 percent target as more appropriate than the 4.0 percent figure). The Fund, World Bank and USAID will also seek an expansion of the CETRA system and measures to strengthen the international reserve position of the Central Bank.

48. In reference to the special pressures to expand public expenditures during an election year, we recognize the difficulties in effectively resolving this issue. USAID hopes to maintain a dialogue with the presidential candidates in 1989 and demonstrate to each that the failure to restrain the deficit in 1989 will leave the next president facing a grave economic crisis -- perhaps one that will be beyond a solution during the forthcoming presidential term. Initial contacts with the leading contenders have given us some indications that an implicit agreement to restrain public spending in 1989 may be possible.

49. In the event that negotiations with the IMF -- and in the worst of cases with the World Bank -- were to break down, USAID would continue its attempt to negotiate a credible program. The program would have characteristics similar to those presented in this concept paper. However, without the full support of the World Bank and the IMF, a program similar to that presented may be difficult to negotiate with the GOH. Under these circumstances, it might be even more difficult for the GOH to implement a far-reaching program of economic reforms.

2. Measures to be Included in the Program

50. The measures USAID proposes to negotiate for inclusion in the GOH's 1989 economic program are outlined in the Annex to this paper. These measures are considered important and comprehensive. However, as mentioned in the previous paragraph, the negotiation and implementation of the program depend heavily on the active participation of the World Bank, the IMF and USAID.

a. Stabilization Component

51. Preliminary analyses indicate that a performance criterion consistent with the public sector deficit reduction target would call for a freeze on credit expansion by the consolidated banking system to the public sector. This would be accomplished by a zero net credit expansion to the public sector by both the Central Bank of Honduras (BCH) and the rest of the banking system. A freeze on credit expansion to the public

sector implies that the entire public sector deficit must be financed either through the use of external funds or through bond sales to the nonbank private sector.

52. The primary instrument for reducing the deficit in the current account of the balance of payments is through restraining overall credit expansion by the consolidated banking system. Besides a freeze on credit expansion to the public sector, a subceiling of about 6 percent would be sought on banking system credit expansion to the private sector. Another key measure for meeting the targetted reduction in the balance of payments deficit is an expansion in the CETRA system which would serve to stimulate exports and restrain low priority imports by subjecting them to market prices.

53. In order to strengthen the BCH's day to day management of the nation's foreign exchange situation, the 1989 program calls for a substantial increment in the Central Bank's net reserve position. The build up in net reserves is expected to result from a reduction in arrears and from an inflow of IMF, World Bank and other donor resources.

54. It should be mentioned that the targets establishing ceilings on credit expansion and a build-up of international reserves set out in this section and in the Annex are only preliminary. They were formulated to be consistent with tentative targets suggested by the IMF and World Bank. Before establishing and negotiating performance targets for 1989, it should be understood that the IMF, World Bank and USAID will carefully revise 1988 data through the latest month for which information is available. As mentioned in paragraph 47, there is reason to believe that the credit expansion ceilings may be eased to be consistent with a CNFPS deficit of 4.5 percent rather than 4.0 percent.

55. The monetary targets for 1989 are crucial not only for stabilizing the economy, but also for achieving structural adjustments. The latter require that resources be shifted from the bloated public sector to the more efficient private sector. In order to promote this process, the monetary program seeks to reduce credit to the public sector with the expectation of permanently restricting domestic credit to the public sector. Any new credit expansion would be channeled to the private sector.

56. The liberalization and transparency of the foreign exchange regime are also crucial for obtaining structural reforms. Instead of rationing foreign exchange only available at an overvalued official exchange rate, a liberalized exchange regime would permit imports by entities efficient enough to pay the full market price for them. A liberalized foreign exchange regime would also stimulate exports by increasing their domestic value.

57. As in 1988, the next year should be propitious for achieving further liberalization of the exchange regime. This will be a major topic on the

agendas of the IMF, World Bank and USAID. Several major politicians and private sector leaders have come out strongly for expanding the CETRA system. Although this topic is highly contentious, the lack of foreign exchange to support the official exchange rate continues to pressure the BCH to pass more transactions to the CETRA and "self-financing" markets.

b. Structural Reform Component

58. As seen by examining the Annex, the 1989 structural adjustment and sectoral components follow up on many important areas emphasized in prior year ESF programs. However, this year's program will incorporate some changes. It will be less complex than last year's program incorporating fewer measures but still seeking major improvements in the economy. Some of the previous measures which we found difficult to obtain such as road user charges will be dropped. Others will be dropped because they have already been successfully implemented (the establishment of a capital market, export incentives and zero-based budgetting).

59. A key structural adjustment, which will also be supported by the IMF, will call for passing the basis for assessing customs duties from the official exchange rate to the CETRA rate. This measure is not only important for raising revenues but also paves the way for a clean devaluation because it would enhance the flow of funds to the Central Government needed to meet its external debt service obligations and to pay for selected imports.

60. The structural component will follow up on several measures which have appeared in past ESF programs:

- Additional privatizations will be sought. The GOH has made excellent progress on this measure in 1987 and 1988. An ambitious privatization program will continue in 1989.

- The FY 1989 program will evaluate the SANAA and ENEE audits and seek to carry out major recommendations. The ENEE audit findings are expected to form the basis for the World Bank's $50 million Public Enterprise Adjustment and Restructuring Loan. USAID also will encourage the GOH to implement recommended audit findings.

- Full cost pricing of goods and services to the public sector will be encouraged. Measures will be sought requiring that the public sector pay the same price for utilities as the private sector. The elimination of customs exonerations for the public sector will also be sought. This measure calls for the elimination of special provisions giving the public sector access to credit at terms not applicable to private sector borrowing, namely repurchase guarantees and tax exemptions on interest paid on government bonds.

- In order to enhance confidence in the economy, a measure will encourage IMF and IBRD programs, a second Consultative Group meeting and ratification of a debt rescheduling agreement with commercial banks.

- The dialogue with the GOH will also seek formulas to reduce the legal and administrative impediments to private investments and exports.

c. Sectoral Component

61. In response to greater IMF and World Bank participation in the macroeconomic program, the Mission believes it is important that we set the bases for stronger sectoral programs. This year, sectoral measures will form an explicit component of the ESF program. They are divided into measures affecting three sectors -- agriculture, exports and the financial sector.

62. Of special importance is agriculture -- an area in which the Mission has prepared many useful policy analyses. Consistent with the development of the Mission's agricultural strategy, several important policy changes have already been identified which offer considerable potential for greatly improving agricultural production. Even though the Mission still needs more time to refine its suggested policy reform program for the sector, the 1989 ESF program will initiate a focus on agriculture by seeking the removal of distorted wheat prices to millers based on the official exchange rate. We will also seek corrective measures designed to improve the utilization of land.

63. The Mission is striving to better coordinate ESF conditionality with PL 480 self help measures, thereby achieving one well-coordinated policy agenda for agriculture. Several major sectoral measures which are being negotiated in this year's PL 480 program will be reinforced through inclusion in the ESF program.

64. Another sectoral focus, already incorporated in previous ESF programs, will be on the trade regime. Great strides were made in recent years in simplifying and standardizing customs tariffs. In addition, important export incentives were offered to producers. In 1989, the Mission hopes to build on these achievements by removing or reducing customs surcharges which discriminate against finished goods. The removal of a 20 percent surcharge on these goods would go a long way toward lowering the rate of effective protection. However, it is important that any revenue loss occurring as a result of lowering customs surcharges be offset by revenue increases from other sources.

65. The Mission will also seek, through the sectoral component aimed at the financial sector, the elimination or restriction of the use of overdrafts to finance public sector expenditures. As well as supporting a deficit reduction for the CNFPS, restrictions on overdrafts would add transparency to public sector expenditures by requiring prior congressional approval for funding.

66. The FY 1989 program will also search for measures to liberalize BCH interest and rediscount rate policies. In particular, the elimination or a raising of the interest rate ceiling will be sought. The program will also support the unification of rediscount rates and the elimination of special privileges granted to government bonds (see the third measure of paragraph 60). The unification of rediscount rates will be sought along with the relaxation of interest rate ceilings.

3. Compliance Monitoring System and Program Implementation

67. With respect to the implementation of the FY 1989 ESF program, the ESF compliance monitoring system that was developed two years ago has been institutionalized within the GOH. It functioned very well in 1987 and 1988.

68. Implementation of the 1989 program is expected to be facilitated by the technical assistance provided under the Policy Analysis and Implementation Project (522-0325). The project will to come fully on stream in the first half of 1989.

VI. ISSUES

A. Exchange Rate for Converting Dollars to Local Currency

69. The FY 1988 ESF program utilized the official exchange rate for converting dollars to local currency. This was justified on the basis of a thin and informal CETRA market. With the expansion and formalization of the CETRA market, careful consideration should be given to requesting that local currency generations take place at this rate. Unlike in early 1988, there is now formal trading of foreign exchange at the CETRA rate in the banking system. Conceivably ESF local currency generations could take place at the CETRA rate. This would be beneficial in that it would remove our support of the official exchange rate by making ESF resources available to users at an exchange rate determined in the market. However, we expect that the GOH would staunchly oppose the utilization of the CETRA rate as a basis for local currency generations and we are uncertain whether this can be successfully negotiated at this time..

B. Use of Dollars

70. In FY 1988, dollar disbursements for debt service payments to IFIs and the USG were permitted and so used. With an expanded World Bank, Japanese and IMF presence in 1989, it may not be necessary to extensively channel AID resources to debt service payments. The use of ESF disbursements for debt service might only be needed if other levels of donor assistance turn out to be less than expected. We request that ESF resources can still be attributed to IFI and selected USG debts with the understanding that such attributions will be used sparingly, if at all and only when they will leverage substantial additional resource inflows.

SUMMARY OF PROPOSED ECONOMIC PROGRAM FOR 1989

A. General

1. Objective: Achieve target GDP growth rate of at least 2 percent, preferably 3 percent.

2. Discussion: This is a recuperation objective to be achieved by raising exports and real income, as opposed to policies calling for cuts in imports and, in turn, incomes.

B. Stabilization Component

1. Objectives:

   a. Reduce the fiscal deficit of the Central Government to no more than 5.1 percent of GDP and that of the consolidated nonfinancial public sector (CNFPS) to no more than 4.0 percent of GDP.

   b. Restrict the current account deficit (excluding official transfers) in the balance of payments to no more than 5.6 percent of GDP.

2. Likely Performance Criteria: The Mission expects to agree with the IMF and IBRD as well as with the GOH on appropriate performance criteria. Approximate performance criteria targets are likely to consist of:

   a. A limit on net credit expansion of the consolidated banking system of 6 percent with a freeze on credit expansion to the public sector.

   b. A freeze on the expansion of net domestic assets of the Central Bank of Honduras (BCH) and a freeze on the net credit expansion of the BCH to the public sector.

   c. An increase in the net international reserves of the BCH of $65 million.

   d. At least half of the value of imports and exports to be moved off the official exchange rate by the end of 1989.

3. Likely Instruments to Achieve Performance Criteria: An appropriate mixture of the following measures is needed to meet the performance criteria:

a. Reduce the deficit of the Central Government through a combination of expenditure cuts and a fiscal package.

b. Agreements with the IMF and World Bank as well as a Paris Club rescheduling are needed to make the target for the expansion of international reserves.

c. An expansion in the CETRA system.

d. Eliminate or raise the interest rate ceiling.

e. Restrict the rediscounting operations of the BCH.

f. Curtail or eliminate the use of overdrafts to finance Central Government expenditures.

g. Expand the sale of government bonds to the private sector (at market terms without a tax exemption on interest).

C. <u>Structural Adjustment Component</u>

1. Pass the basis for the assessment of customs duties in Lempiras from the official exchange rate to the CETRA rate.

2. Continue the privatization of parastatals.

3. Adopt appropriate measures based on reviews of ENEE and SANAA audits.

4. Establish full cost pricing of public sector purchases of goods and services.

5. Enhance confidence in the economy through obtaining:

   - IMF support of GOH economic program.

   - Continued IBRD support through a SAL II and sectoral programs.

   - A second Consultative Group meeting.

   - Agreement on rescheduling of commercial bank debt.

6. Lower barriers to private investment and exports.

D. <u>Sectoral Component</u>

1. Agricultural sector: enhance agricultural production.

- Use the CETRA exchange rate for wheat sales to millers.

- Seek changes in land tenure and transfer policies to encourage more efficient land use.

2. Export sector: lower effective protection through the elimination of a 20 percent customs surcharge on finished goods -- the revenue loss must be offset by a complementary fiscal package.

3. Financial sector:

   - Restrict the use of overdrafts to finance Central Government expenditures (also included in the stabilization component).

   - Liberalize interest rate and policies.

   - Proceed toward unified rediscount rates as interest rate ceilings are relaxed and/or dropped.