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HONDURAS

IDB COUNTRY STRATEGY
(2015-2018)

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ABBREVIATIONS

AECID	Agencia Española de Cooperación Internacional para el Desarrollo [Spanish Agency for International Development Cooperation]
CABEI	Central American Bank for Economic Integration
CID	Country Department Central America
CNBS	Comisión Nacional de Bancos y Seguros [National Banking and Insurance Commission]
DEI	Dirección Ejecutiva de Ingresos [Revenue Division]
EIB	European Investment Bank
ENDESA	Encuesta de Demografía y Salud [National Demographic and Health Survey]
ENEE	Empresa Nacional de Energía Eléctrica [National Electric Power Company]
EPHPM	Encuesta Permanente de Hogares de Propósitos Múltiples [Permanent Multipurpose Household Survey]
ERSAPS	Ente Regulador de los Servicios de Agua Potable y Saneamiento [Water and Sanitation Services Regulatory Agency]
FSO	Fund for Special Operations
G-16	Stockholm Declaration Follow-up Group
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH
IHSS	Instituto Hondureño del Seguro Social [Honduran Social Security Institute]
IMF	International Monetary Fund
INPREMA	Instituto Nacional de Previsión del Magisterio [National Pension Institute for Teachers]
INSEP	Ministry of Infrastructure and Public Services
IPSAS	International Public Sector Accounting Standards
ISSAI	International Standards of Supreme Audit Institutions
JICA	Japan International Cooperation Agency
KfW	Kreditanstalt für Wiederaufbau
MIF	Multilateral Investment Fund
NCB	National competitive bidding
NDF	Nordic Development Fund
NSG	Non-sovereign guaranteed
OFID	OPEC Fund for International Development
ONCAE	Oficina Normativa de Compras y Adquisiciones del Estado [Regulatory Office of State Contracting and Procurement]
PAHO	Pan American Health Organization
PPP	Public-private partnership
SAMI	Sistema de Administración Municipal Integrada [Integrated Municipal Management System]
SDC	Swiss Agency for Development and Cooperation
SEFIN	Ministry of Finance
SFW	Spanish Cooperation Fund for Water and Sanitation in Latin America and the Caribbean

SG	Sovereign guaranteed
SIAFI	Sistema Integrado de Administración Financiera [Integrated Financial Management System]
TSC	Tribunal Superior de Cuentas [National Audit Office]
UEPEX	External Loan Execution Units – SIAFI module for exclusive use in managing external financing agreements
UNEP	United Nations Environment Programme
UNFPA	United Nations Population Fund
UNICEF	United Nations Children's Fund
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

Country context	After posting strong growth from 2002 to 2008 (5.3% on average) followed by a sharp decline in 2009 and 2010 (-2.4%), GDP in Honduras averaged 3.4% growth from 2011 to 2013, in line with the historic average of the past three decades. Agriculture, manufacturing, and services were the most robust sectors. In spending, a recovery in exports, private consumption, and private investment has led growth in demand but has unfolded against a backdrop of low productivity and fiscal deterioration, limiting the country's growth potential. Neither has the past decade's growth translated into a reduction of similar magnitude in poverty. The poverty rate stood at 65% in 2013, one point above the 2005 rate (64%), while extreme poverty decreased by three percentage points in the same period.
The Bank in Honduras	The Bank's country strategy with Honduras for 2011-2014 identified five priority sectors for new sovereign guaranteed (SG) approvals: (i) public management; (ii) the financial system; (iii) social protection; (iv) health; and (v) energy. During the strategy period, SG loan approvals totaled US$514 million, of which US$80 million was for budget support. In addition, a total of US$131.5 million in loans from the private sector windows were approved.
Priority sectors 2015-2018	The objective of the Bank's country strategy with Honduras for 2015-2018[1] is to support government efforts to boost stagnant production and low growth; reduce gaps in the generation and accumulation of human capital, particularly in rural areas, and achieve real social inclusion (through coordinated interventions in social protection, health, and education); and improve the quality of life and standard of living in urban areas. To this end, the Bank will provide support in the following areas: (i) fiscal consolidation; (ii) sustainability and competitiveness in the energy sector; (iii) road infrastructure for regional integration; (iv) social inclusion; and (v) sustainable development in the Central District.
Lending framework	The lending framework anticipates SG approvals of US$742 million in the period 2015-2018, US$340 million of which would be during the period 2015-2016.[2] The country's debt with the Bank will rise from 7.7% of GDP in 2015 to 9.2% of GDP in 2018.
Risks	The main risks to implementation of the strategy are: (i) macroeconomic, associated with fiscal sustainability and external shocks; (ii) institutional, related to the capacity of local counterparts; and (iii) risks derived from the possible occurrence of natural disasters.

[1] The effective period of this country strategy will run from its approval by the Board of Executive Directors to December 2018.

[2] Subject to approval by the Board of Executive Directors of the document, "Fund for Special Operations. Proposal for the Allocation of Resources 2015-2016."

RESULTS MATRIX

Results Matrix – Country Strategy with Honduras					
Government Priority	**Sector**	**IDB Strategic Objective**	**Expected Outcomes**	**Indicators**	**Baseline**
To stabilize macroeconomic conditions and public finances in the country in the medium term, in order to drive economic growth and investment in poverty reduction and alleviation programs.	**1. Fiscal consolidation**	To strengthen tax revenue intake.	Increase in tax revenue as a percentage of GDP.	Tax revenue as a percentage of GDP.	15% (DEI, 2013)
		To make public expenditure more efficient.	Containment of growth in the central government wage bill (as a percentage of GDP).	Central government payroll as a percentage of GDP.	9.4% (SEFIN, 2013)
To strengthen the performance of public administration.		To strengthen the mechanisms for transparency and prevention and control of corruption.	Increase in transparency and control of expenditure among local governments.	Percentage of local government expenditure that is executed under the control of the Integrated Municipal Management System (SAMI).	10% (SEFIN, 2013)
		To improve budget management and reduce fiscal contingencies.	Reduction in budget mismatch.	Percentage deviation of the executed budget in relation to the originally approved budget.	23% (SEFIN, 2012)
			Improvement in the present value financial sustainability of the Honduran Social Security Institute (IHSS).	Estimated actuarial deficit in present value of the disability, old age, and death regime of the IHSS as a percentage of GDP.	25% (CNBS, 2012)

Results Matrix – Country Strategy with Honduras					
Government Priority	**Sector**	**IDB Strategic Objective**	**Expected Outcomes**	**Indicators**	**Baseline**
To guarantee electricity supply marked by quality, excellence, and responsibility, in support of the productive sectors and the population and in harmony with the environment.	**2. Sustainability and competitiveness in the energy sector**	To improve the efficiency and quality of electricity service and diversify the power generation matrix.	Reduction in technical and nontechnical losses in the transmission and distribution of electricity.	Total transmission and distribution losses.	32% (ENEE, 2014)
			Increase in low-carbon power generation capacity.	Power generated from low-carbon sources.	41% (ENEE, 2013)
			Improved service quality by reducing interruptions in the electricity supply.	Equivalent time of interruptions per year.	42 hours per year (ENEE, 2013)
			Improvement and expansion of the national transmission system.	Kilometers of transmission lines added and/or improved.	2,445 km (ENEE, 2014)
			Increase in the volume of transactions in the Regional Electricity Market.	Percentage of electricity bought and sold on the Regional Electricity Market in relation to the amount generated.	1.5% (ENEE, 2013)
		To increase access to electricity service.	Increase in electricity coverage nationwide.	Percentage of households with electricity service.[3]	89% (ENEE, 2013)

[3] On or off the commercial grid.

Results Matrix – Country Strategy with Honduras					
Government Priority	**Sector**	**IDB Strategic Objective**	**Expected Outcomes**	**Indicators**	**Baseline**
To promote production infrastructure as an engine of economic activity.	**3. Road infrastructure for regional integration**	To improve national and regional integration and reduce operating and transportation costs.	Improved physical condition of existing roads along the Pacific corridor.	Percentage of the Pacific corridor in good condition.	0 (Office of the President of the Republic, 2014)
			Consolidated road integration in the northeastern part of the country.	Kilometers of agricultural corridor in permanent operation (continuous).	80 (Office of the President of the Republic, 2014)
			Improvement in physical operating conditions at major border/customs posts.	Percentage of border/customs posts prioritized that have improved infrastructure.	0 (Office of the President of the Republic, 2014)

Results Matrix – Country Strategy with Honduras					
Government Priority	**Sector**	**IDB Strategic Objective**	**Expected Outcomes**	**Indicators**[4]	**Baseline**
To incorporate families living in extreme poverty into the Vida Mejor platform, which consists in conditional cash transfers and improved housing.	**4. Social inclusion**	To protect minimum levels of consumption among the population in poverty.	Increase in the coverage of the conditional cash transfer program in rural areas with high rates of extreme poverty.	Percentage of households in extreme poverty in rural areas of western Honduras receiving assistance under Bono Vida Mejor.	37% (EPHPM, 2013)
To expand the coverage and quality of education services.		To promote human capital accumulation of minors in households in extreme poverty.	Increase in the enrollment rate in the third cycle of basic education (grades 7, 8, 9) in rural areas of western Honduras.	Percentage of children ages 12 to 15 in rural households in western Honduras who attend school (grades 7, 8, 9).	20.1% (EPHPM, 2013)
To improve equitable access for the population to the benefits of comprehensive health care, especially for groups traditionally excluded due to economic, cultural, geographical, or gender reasons.		To improve the health indicators of children under 5.	Reduction in the chronic malnutrition rate among children in rural areas of western Honduras.	Chronic malnutrition rate among children under 5 in the western part of the country.	35% (ENDESA, 2011/12)
			Reduction in the child mortality rate in rural areas of western Honduras.	Child mortality rate.[5]	26.6 deaths per 1,000 live births (ENDESA, 2011/12)

4 The indicators refer to the western region of the country.

5 Refers to the average rate for the departments in western Honduras.

Results Matrix – Country Strategy with Honduras

Government Priority	Sector	IDB Strategic Objective	Expected Outcomes	Indicators	Baseline
To improve housing and health conditions in marginal areas, to develop the central corridor of the Central District, and to strengthen connectivity between residential zones and central districts.	**5. Sustainable development in the Central District**	To reduce marginalization and improve urban quality of life in the Central District.	Improved housing conditions in the city.	Percentage of households with residential connection to the water and sewer system.	47% (ERSAPS, 2011)
				Percentage of houses with infrastructure deficiencies.[6]	22% (Central District Construction Control Unit, 2011)
			Expanded green areas, reduced violence, and improved urban mobility.	Hectares of green areas per 100,000 inhabitants.	5.12 hectares (Central District Land Use Planning Department, 2011)
				Homicide rate per 100,000 inhabitants.	75.2 (Ministry of Security, 2013)
				Average speed of mass transit.	9.5 km/h (INSEP, 2013)

[6] Defined as substandard materials, no indoor water, no secure access, and overcrowded conditions.

MATRIX OF COUNTRY SYSTEMS

Matrix of Country Systems					
Government Priority	**Sector**	**IDB Strategic Objective**	**Expected Outcomes**	**Indicators**	**Baseline**
Efficient, effective, equitable, and reputable State.	**Strengthening of country systems or subsystems**	To reduce gaps to meet international rules/standards.	Implementation of International Public Sector Accounting Standards (IPSAS).	Percentage of IPSAS implemented.	0% (2014) 90% (2018)
			Partial implementation of International Standards of Supreme Audit Institutions (ISSAI) for external control in Honduras.	Percentage of ISSAI applicable to the TSC in Honduras implemented.	0% (2014) 80% (2018)
	Use of country fiduciary systems	To increase the use of country fiduciary systems – financial management.	To maintain use of SIAFI and UEPEX module in the Bank's portfolio of SG loans, to improve SIAFI/UEPEX functionality, and to support implementation of the IPSAS.	Percentage of SG loans using SIAFI and the UEPEX module in the Bank's SG loan portfolio.	100% (2014) 100% (2018)
			Implementation of strategic partnership with the TSC in Honduras for use of external control in Bank-financed operations in the country.	Number of Bank operations in which external control is used strategically.	0% (2014) At least 10% (2018)
		To increase the use of country fiduciary systems – public procurement.	Use of shopping subsystem in Bank operations.	Percentage of portfolio using the subsystem.	0% (2014) At least 15% (2018)
				Strategic analysis on the institutional framework for public procurement in the country, presented by the Bank to the country.	0 (2014) 1 analysis presented by the Bank (2018)

I. COUNTRY CONTEXT

1.1 After posting strong growth from 2002 to 2008 (5.3% on average) followed by a sharp decline in 2009 and 2010 (-2.4%), GDP in Honduras averaged 3.4% growth from 2011 to 2013, in line with the historic average of the past three decades. Agriculture, manufacturing, and services (especially communications and financial intermediation) were the most robust sectors. In spending, a recovery in exports, private consumption, and private investment has led growth in demand but has unfolded against a backdrop of low productivity and fiscal deterioration, limiting the country's growth potential.

1.2 The past decade's growth did not bring about a similar reduction in the magnitude of poverty.[7] The poverty rate stood at 65% in 2013, one point above the 2005 rate (64%), while extreme poverty trended downward, reaching 43% in 2013, which was three percentage points lower than in 2005.[8] Clearly, the country is facing a major challenge in terms of social and economic exclusion, especially in rural areas, where extreme poverty stands at 56% and access to basic services is seriously lacking.[9] Moreover, poverty is on the rise in the cities. In 2005, urban poverty and extreme poverty rates were 58% and 29%, respectively. In 2013, these rates stood at 60% and 29%. During the same period, rural poverty and extreme poverty fell by 1.0 and 8.0 points, respectively, illustrating the relative deterioration in income in urban areas. This trend partly reflects rapid demographic growth in the country's cities,[10] driven by internal migration, which is putting pressure on public services and creating discontent among the population.[11]

1.3 The government is promoting a series of policies to hasten the reduction in extreme poverty. The centerpiece of this strategy is "Bono Vida Mejor," a conditional cash transfer program. To date, the program covers 350,000 households (71% of which are in rural areas), benefiting approximately two million Hondurans (17.5% of the total population). According to an impact assessment, the program has managed to increase per capita consumption among beneficiary households by nearly 10%. An increase has also been observed in autonomous decision-making by women with

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[7] Since 2000, per capita GDP has grown by about 27%, and poverty has fallen by 15%. During the same period, in Latin America as a region, per capita GDP has grown by 28% and poverty has fallen by 36% (CEPALSTAT). It should be noted that Honduras uses a relatively high consumption cutoff to determine the poverty line, which tends to overestimate poverty. World Bank. "Centroamérica en el nuevo milenio: seis historias diferentes de pobreza y desigualdad" [Central America in the new millennium: Six different stories of poverty and inequality], 2013.

[8] Honduras also has marked income inequality. Its Gini coefficient is 0.54, among the highest in Latin America and the Caribbean.

[9] In rural areas, 70% of households have access to electricity (99% in urban areas), 69% have access to sanitation (85% in urban areas), and 79% have access to water (95% in urban areas).

[10] Between 2006 and 2013, the urban population grew by 24%, whereas the rural population grew by 6%. INE projections, based on the 2001 Census.

[11] According to the 2012 opinion survey for Honduras, conducted as part of Vanderbilt University's Latin American Public Opinion Project, 70% of respondents described the provision of public services as poor.

respect to household consumption, work outside the home, and the education and health of children.[12]

1.4 Social and economic exclusion have been exacerbated by deteriorating security conditions.[13] This situation is partly due to the infiltration of domestic and international organized crime networks into various levels of Honduran society, made possible by major institutional gaps in public security.[14]

1.5 The convergence of high rates of poverty, exclusion, and insecurity, particularly in urban areas, explains the rapid increase in emigration. According to United Nations figures, from 2006 to 2013, the number of Hondurans residing legally or illegally in the United States climbed from 405,258 to 550,694 (an increase of 36%).

1.6 An analysis of the constraints on growth and the determinants of productivity, as well as sector studies conducted for the Bank's new country strategy with Honduras, indicate that the main factors behind the slow growth and weak productivity gains are related to low accumulation of human capital,[15] infrastructure gaps,[16] limited global integration, and scarce technological innovation. In addition, Honduras has governance challenges, especially in terms of transparency and

[12] "First Impact Evaluation of the 'Bono 10,000' Presidential Program for Education, Health, and Nutrition in Rural Areas of the Republic of Honduras (2012-2013)." Prepared by the National Opinion Research Center (NORC) at the University of Chicago and ESA Consultores (2013).

[13] According to data from the Honduran Ministry of Security, from 2006 to 2013, the homicide rate per 100,000 inhabitants rose by nearly 30 points (from 46.7 to 75.2). The annual cost of violence in the country is estimated at around 10% of GDP according to data from the World Bank. According to a survey on security conditions in Honduras (United Nations Development Programme, 2012), insecurity in the Central District has prompted behavioral changes in the population: 46% no longer walk in the city for fear of becoming the victim of a crime; 40% limit going out to do their shopping; and 39% engage in fewer recreational activities.

[14] Technical note for the public policy dialogue on citizen security in Honduras (IDB, 2013).

[15] The restrictions on human capital accumulation are largely due to inadequate education and health services (coverage and quality), particularly in rural areas. **In education**, in terms of access, only 26% of 25-year-olds in rural areas have completed basic education (64% in urban areas). In addition, among rural households in extreme poverty, school attendance falls from 89% at 11 years of age to 74% at 12 years and 30% at 15 years. This is due to low rates of coverage in these areas, where 66% of communities lack access to the third cycle of basic education. Furthermore, the lack of preschool offerings adversely affects poor children's chances of success when they enter school. **In health**, chronic malnutrition affects 29% of children under 5 in rural areas (23% nationwide). Challenges persist in terms of ensuring coverage and quality of health services in these areas, where the gap in health care affects 1.36 million people (16% of the total population).

[16] Data from the World Economic Forum for 2013-2014 rank Honduras as 115th (among 148 economies) in the infrastructure pillar. In two of the main subcategories of this pillar—quality of roads and quality of electricity supply—the country comes in at positions 114 and 110, respectively. Over the last three years, public investment averaged 3% of GDP, below the rate (5%) of the previous decade

control of corruption, as well as in fiscal management.[17] These weaknesses also act as active constraints that reduce incentives and limit the impact of investment.[18]

1.7 The Strategic Plan 2014-2018, prepared by the Government of Honduras based on the objectives, targets, and guidelines set out in the Country Vision and National Plan, in effect since 2010, aims to build a society with better levels of well-being and social inclusion, against a backdrop of peace and democracy, creating greater opportunities for the population by deepening participatory democracy, modernizing and streamlining the State, promoting competitiveness, and making sustainable use of human resources and materials.

II. THE BANK IN HONDURAS

2.1 The Bank is the main source of external financing for the country. Over the past three years, financing from the Bank has represented, on average, 25% of the country's total public investment.[19] Disbursements totaled US$687 million during the same period.[20] In addition, the Bank provides significant technical assistance, making it a key actor in the generation of knowledge for development in Honduras.[21]

2.2 The Bank's country strategy with Honduras for 2011-2014 identified five priority sectors for new approvals: (i) public management; (ii) the financial system; (iii) social protection; (iv) health; and (v) energy. It should be noted that the strategy was implemented after the pause that resulted from the events of 2009, which presented additional challenges in terms of restoring dialogue with the authorities and reactivating financing operations. During the strategy period, sovereign guaranteed (SG) loan approvals totaled US$514 million,[22] of which US$80 million

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17 Between 2011 and 2013, the central government ran a deficit averaging 6.1% of GDP. The deficit at end-2013 stood at 7.9% of GDP. Public debt rose by nearly 36%, increasing to 42% of GDP in 2013.

18 Inter-American Development Bank, "Competitividad y Crecimiento en Honduras" [Competitiveness and Growth in Honduras], 2012.

19 In terms of borrowing, during the period 2011-2013, financing from the Bank represented, on average, 26% of public external debt and 37% of multilateral debt, while financing from the World Bank represented, on average, 21% of external debt and 30% of multilateral debt. The Central American Bank for Economic Integration contributed 20% of external debt and 29% of multilateral debt. During the same period, World Bank disbursements totaled US$294 million, and the Central American Bank for Economic Integration disbursed US$409 million.

20 During the period 2011-2013, World Bank disbursements totaled US$294 million, and the Central American Bank for Economic Integration disbursed US$409 million

21 As of August 2014, there were 18 technical cooperation agreements in place, for a total amount of US$44 million, of which US$16 million had been disbursed.

22 This amount includes the Primary Education and Technology Integration Program (loan 2524/BL-HO) for US$37 million and the Program to Support the 2012 Population and Housing Census and the Integrated System of Household Surveys of Honduras (loan 2529/BL-HO) for US$25 million, two operations that were approved months prior to the December 2011 approval of the 2011-2014 country strategy. Also in that period, the Contingent Loan for Natural Disaster Emergencies (HO-X1016) for US$100 million was approved.

was for budget support. The education, transportation, and water and sanitation sectors have featured prominently in the portfolio in execution. In addition, loans from the private sector windows totaling US$131.5 million were approved.[23]

2.3 In this context, Bank support has made some notable achievements, both in the portfolio in execution and in the portfolio of operations approved during the strategy period, including the following: (a) in the ***social sectors***: expanded coverage and better targeting of the conditional cash transfer program Bono Vida Mejor, which provides cash transfers to 350,000 of the country's poorest rural households, increasing their average spending capacity by 10% and incentivizing their participation in education and health programs;[24] expanded technology services in basic education;[25] and promotion of a decentralized health system in rural areas in the western part of the country that serves over 10% of the population with quality services;[26] (b) in ***public management***: strengthening of risk-based prudential regulation and supervision of the financial sector; promotion of parametric reforms of public social welfare institutes to resolve their actuarial deficits;[27] the implementation of neighborhood improvement programs in urban areas, with positive impacts on the citizenry; support for policy reforms in citizen security; and support for the Population and Housing Census; in ***infrastructure***: reform of the electricity sector; improvements in road connectivity through the completion of divided highways and interchanges on strategic sections of the logistics corridor (52 kilometers) and construction of the agriculture corridor (80 kilometers completed and 47 kilometers under contract); launch of an initiative to overhaul the port sector under a public-private partnership model; construction of the first phase of a bus rapid transit (BRT) system, an innovative public transportation program in Tegucigalpa (Trans 450); contract to improve the second ring road around San Pedro Sula; and the reconstruction of works throughout the country that were destroyed by the October 2011 floods.

[23] Based on information as of August 2014. It should be noted that 43% of the US$131.5 million corresponding to non-sovereign guaranteed (NSG) operations was for trade operations and the rest was for operations related to financial markets and business development (29% each).

[24] National Opinion Research Center – University of Chicago and ESA Consultores, "First Impact Evaluation of the "Bono 10,000" Presidential Program for Education, Health, and Nutrition in Rural Areas of the Republic of Honduras," 2013.

[25] With Bank support, universal achievement testing has been established and educational achievement in rural sectors has improved through the provision of computers.

[26] The National Demographic and Health Survey (ENDESA) 2011-2012 reported that the institutional delivery rate increased from 71% to 83% between 2006 and 2012, nearly doubling in the lowest quintile (from 33% to 57.6%). During the same period, also in the lowest quintile, infant mortality fell from 37 to 30 deaths per 1,000 live births, and child mortality dropped from 50 to 39 deaths per 1,000 children. These improvements were partly due to the expanded coverage under the decentralized management model, which has enhanced women's access to family planning, early identification of pregnant women, timely access to birth services, and quality postpartum care.

[27] With Bank support, the National Pension Institute for Teachers (INPREMA) was overhauled in 2011. The reform included a number of parametric changes intended to improve the Institute's actuarial sustainability. It was successful in halting the severe financial crisis facing the Institute, reducing the actuarial deficit in present value from 27% of GDP to a range of between 9% and 13%.

2.4 The country's progress made toward fulfilling the indicative targets set out in the previous strategy has been favorable overall: (a) in *social protection*, the percentage of rural households in extreme poverty covered by the conditional cash transfer program went from 19% in 2010 to nearly 40% in 2013; (b) in *health*, infant mortality among children under 1 per 1,000 live births went from 25 per 1,000 in 2005-2006 to 24 per 1,000 in 2011-2012; (c) in *public management*, the IHSS top contribution rate went from 4,800 lempiras in 2010 to 7,000 lempiras at present; the actuarial deficit of the National Pension Institute for Teachers (INPREMA) decreased from 27% of GDP in 2010 to a range of 9%–13% of GDP in 2013; and (d) in the *financial sector*, provisioning coverage for commercial banks' portfolio of past-due and nonperforming loans went from 77.6% in 2009 to 125% in 2013. The percentage of the population with access to financial services (savings accounts) increased from 70.5% in 2010 to 80% in 2013.

2.5 The Bank's portfolio in Honduras is composed of 22 sovereign guaranteed (SG) loan operations[28] totaling US$901 million, 5 non-sovereign guaranteed (NSG) operations for US$47 million, a credit line for US$ million, as well as investment grants and 43 nonreimbursable technical-cooperation operations for US$62.5 million. It should be noted that these two nonreimbursable financing instruments have boosted program execution, promoting knowledge generation and supporting institutional strengthening activities as well as the design of public policies.[29] In addition, the MIF administers 18 regular operations for US$19.4 million, 10 operations in the Social Entrepreneurship Program for US$3.9 million, and 1 investment operation for US$4.5 million, for a MIF portfolio totaling US$27.9 million. Of the total SG approvals, US$423 million have yet to be disbursed, an amount that is split between the Infrastructure and Environment Sector (INE) with US$213 million (47% of the total), the Social Sector (SCL) with US$125 million (28%), the Institutions for Development Sector (IFD) with US$75 million (17%), and the Integration and Trade Sector (INT) with US$8.5 million (1%). With respect to NSG operations, the undisbursed amount is US$35 million.

2.6 In terms of performance, since 2011, the Bank's portfolio in the country has been in a period of sustained recovery with annual disbursements at 39% of the undisbursed balance at the start of the year, between 2011 and 2013. Furthermore, significant targeting efforts have been made, resulting in the concentration of the portfolio in a smaller number of operations for larger amounts in comparison with previous

[28] This list does not include loans that are cofinanced by the OPEC Fund for International Development (1008/OP-HO, 1190/OP-HO, 1412/OP-HO, and 1525/OP-HO), all linked to the transportation sector, which are not part of the Bank's portfolio but are administered by the Country Office in Honduras.

[29] In 2013, the government requested support for reviewing power purchase agreements (PPAs) with private generation companies. With nonreimbursable financing provide by the Bank, the government will achieve savings of approximately US$56 million per year through 2017.

strategy periods.[30] The good management of the country portfolio can also be viewed in terms of credit fee costs, which are among the lowest in the Country Department Central America (CID) region.[31]

2.7 **Lessons learned.** Two lessons stand out from the previous strategy: (i) the importance of strengthening the compatibility between operation designs and local execution capacity, using technical assistance in the preparation and execution stages in order to streamline project implementation—one clear example in this regard are the rapid implementation schemes seen in the transportation sector, developed in coordination with the Millennium Challenge Account, which has ample experience executing infrastructure projects; and (ii) the importance of incorporating communication strategies into project design; for example, the Trans450 urban transit project has required a major communication effort between municipal authorities, civil society, and other relevant actors.

2.8 The Country Program Evaluation: Honduras 2011-2014, prepared by the Office of Evaluation and Oversight (OVE), offers the following recommendations: (i) give priority to fiscal consolidation; (ii) design the country strategy based on development challenges, defining the criteria for participation by the Bank's various sectors, and for the prioritization of projects, while ensuring consistency with the diagnostic assessment; (iii) strengthen the design of operations though institutional assessments, analyses of governance and sustainability risks, and engaging fiduciary staff; (iv) devote greater efforts to building the management capacity of the institutions responsible for projects in execution, while considering the use of policy-based loans; and (v) include in future country strategies the sectors corresponding to each country's existing portfolio in order to facilitate their execution and the continuity of the dialogue. Management's implementation of these recommendations is summarized in Annex V.

III. PRIORITY ISSUES

3.1 The objective of the Bank's new country strategy with Honduras is to support government efforts to boost stagnant production and low growth; reduce gaps in the generation and accumulation of human capital, particularly in rural areas, and achieve real social inclusion (through coordinated interventions in social protection, health, and education); and improve the quality of life and standard of living in urban areas. To this end, the Bank will provide support in the following areas: (i) fiscal consolidation; (ii) sustainability and competitiveness in the energy sector;

[30] The size of the portfolio shrank from 37 sovereign guaranteed operations in 2004 to 22 in 2014, but the average amount of a sovereign guaranteed operation increased in inverse proportion from US$20 million in 2004 to US$41 million in 2014, while the level of private sector operations has risen from US$10 million in 2004 to US$30 million at present.

[31] Along with countries like Nicaragua, Mexico, and the Dominican Republic, Honduras has one of the lowest credit fee costs, at US$0.0093 per dollar disbursed.

(iii) road infrastructure for regional integration; (iv) social inclusion; and (v) sustainable development in the Central District.[32]

3.2 The private sector windows will seek to take advantage of opportunities to provide financing and technical assistance in the priority area identified in the country strategy, specifically energy, roads and regional integration, social inclusion, and sustainable development in the Central District.[33]

A. Fiscal consolidation

3.3 Honduras faces macroeconomic imbalances that widened after the global financial crisis and grew even worse in 2013. The central government's fiscal deficit grew from 2.9% of GDP in 2007 to 7.9% of GDP in 2013, due to rising spending and tax revenue constraints. The larger financing needs have led to a sharp increase in public debt, from 19.3% of GDP in 2007 to 41.8% of GDP in 2013. Against this backdrop, the Honduran government has set itself to the task of improving its management of economic policy and reducing macroeconomic imbalances, by adopting fiscal consolidation measures that are expected to yield 2.4% of GDP.[34] In addition, the government has launched an initiative to streamline the State apparatus by merging and reorganizing its ministries and agencies. The Law for Optimization of Public Administration resulted in the creation of a strategic planning ministry, seven sector ministries, and eleven area ministries, reducing the number of ministry-level portfolios from 38 to 19.[35] These reforms clearly represent forward progress, but a number of challenges remain.

3.4 On the ***revenue*** side, one of the main weaknesses is the fragmentation and lack of cohesion in the tax system. The legal framework is piecemeal and complex.[36] Tax spending is high, close to 7% of GDP, due to myriad exemptions and loopholes

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[32] The previous strategy identified five priority sectors: (i) public management; (ii) the financial system; (iii) social protection; (iv) health; and (v) energy. The current strategy provides continuity for the abovementioned areas, except the financial sector, which will partly be addressed through funds available in the portfolio in execution and/or the Bank's NSG windows or other donors.

[33] It should be noted that although only a few sectors for intervention are mentioned here, the NSG windows are prepared to carry out projects in other areas as new cooperation opportunities arise, provided they meet criteria for high development impact and are compatible with the Bank's priorities as set out in the Ninth General Capital Increase (GCI-9) and with the specific strategies of the windows. Pursuant to these criteria, four areas have been identified in which the NSG windows may continue their activities and increase their participation in order to improve their development impacts: financing for small and medium-sized enterprises (SMEs) and productive activities; agroindustry; critical infrastructure; and secondary and university education.

[34] Law on Public Finances, Control of Exemptions, and Measures to Combat Tax Evasion, Decree 278-2013. Among the main actions adopted were: (i) a three-point increase in the sales tax (from 12% to 15%); (ii) a reduction in the energy subsidy (decrease in the subsidy cutoff level from 150 kWh/month to 75 kWh/month); (iii) a US$0.25 increase in the price of gasoline and diesel fuel (equivalent to an average increase of 22% in the sales price).

[35] Law for Optimization of Public Administration, Improvement of Citizen Services, and Strengthening of Government Transparency, Decree 266-2013.

[36] The personal income tax and sales tax laws have been subject to reforms that have not been incorporated into the original legislation but rather have given rise to new laws, many of which have no relation to fiscal or tax issues.

both in the personal income tax and in the coverage of the sales tax.[37] Another challenge is the weakness of the Revenue Division (DEI), with its limited presence outside the country's major cities[38] and its serious shortcomings in the area of information management.[39] It also faces problems in terms of managing budgetary and human resources, with 85.5% of its spending going to paying a workforce with limited professional training.[40]

3.5 On the ***expenditure*** side, the primary challenges are associated with the low efficiency of public administration and the high rigidity of current expenditures (equivalent to 19.7% of GDP), the main components of which are: service on domestic debt (maturities equivalent to 2.8% of GDP); transfers to deconcentrated entities (equivalent to 5% of GDP), mainly municipalities and State-owned enterprises that are in the red;[41] and salaries and wages (equivalent to 9.4% of GDP).[42]

3.6 In terms of ***budget management and transparency***, there are also significant gaps. The weak regulatory and budget framework is the preeminent challenge. The budget is used as a tool for authorizing expenditures instead of as a tool for restricting them in line with medium-term fiscal sustainability. Formally, programmatic budgeting is used, but in practice, an incremental budgeting approach prevails, as determined by the rigidity of spending.[43] The budget has an annual horizon, which makes it impossible to strategically program, monitor, and evaluate public policies based on the priority objectives set out in the government plan.

3.7 A second challenge is the weak execution of public expenditure and the limited coverage of financial management systems, at both the central and local government levels. In terms of budgetary and financial management, the current budget planning system focuses its control on scheduling payments (control of cash flow), instead of control of commitments. Furthermore, procurements are handled

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37 Nearly 270 items in the basic basket are exempt from sales tax, the main source of tax revenue.

38 DEI operations are concentrated in the cities of Tegucigalpa and San Pedro Sula (and metropolitan areas), and as a result, roughly 96% of tax receipts come from those areas.

39 The registry of active taxpayers is out of date and incomplete in terms of basic information such as obligations, domicile, economic activities, and shareholder interest. Moreover, the number of registered active taxpayers is low compared with similar countries (1.6% of the population).

40 Spending on personnel at the DEI is very high as a percentage of total spending (85.5%), surpassing the average in Latin America by over 17 points. The level of professional training among the DEI workforce is low: only 33% of employees hold some type of college degree, with the rest having completed, at most, a technical degree.

41 In 2013, loss transfers to the National Electric Power Company (ENEE) and the State-owned telephone company Hondutel represented nearly 2.1% of GDP.

42 Honduras is among the countries in Latin America that spend a significant percentage of GDP and budget on the central government payroll (9.4% and 41.9%, respectively, in 2013). The country has been endeavoring to cut its wage bill, which indeed is down from the 2011 levels of 11% of GDP and 49% of total expenditure.

43 These problems are reflected in a budget mismatch that stood at 23% in 2012 and floating debt that surpassed 2.5% of GDP that year.

outside a procurement and contracts system due to lack of integration with the Integrated Financial Management System (SIAFI).

3.8 A third challenge is the weak legal and institutional framework for the prevention and control of corruption.[44] Despite progress, there is an ongoing need to strengthen the technical capacity of the transparency and control institutions, including the National Audit Office (TSC) and particularly the capacity of recently created institutions, and to develop a comprehensive policy and common strategy to optimize public administration and improve citizen services, with greater transparency and accountability. The latter challenge will entail addressing the lack of coordination between sector entities and the absence of hierarchies between them, as well as strengthening strategic management, cross-sector coordination, performance monitoring and improvements, and accountability from the Government Ministry.

3.9 Lastly, there are weaknesses in terms of the ***management of debt and contingent fiscal risks***, especially as related to public-private partnerships (PPPs),[45] and the social security system.[46] Improvements are needed in the identification, valuation, mitigation, and monitoring of these obligations.

3.10 In view of the aforementioned challenges, the Bank will provide technical and financial support, including knowledge generation, for reforms to promote comprehensive fiscal responsibility in the country. These include: (i) ***strengthening tax revenue intake***, through actions to simplify and reorganize the existing tax law structure, support implementation of a professional career in tax and customs administration, and facilitate implementation of programs to improve information management systems; (ii) ***making public spending more efficient***, through actions to improve human resource planning in the government and gradually and selectively restructuring the government workforce, improving the extent to which the executive and civil service are aligned with the government's strategic priorities; (iii) ***strengthening the mechanisms for transparency and prevention and control of corruption***; and (iv) ***improving budget management and reducing fiscal contingencies***, through a revision of the national financial management systems, processes for planning, monitoring, and evaluating public resources, the

[44] Honduras obtained a score of D+ for the Public Expenditure and Financial Accountability (PEFA, 2011) PI-26 indicator "Scope, nature, and follow-up of external audit."

[45] The number of PPP projects has increased rapidly, especially through bank-administered trust funds. Preliminary estimates indicate that the upper limit on using PPPs, based on the cumulative net present value of all approved projects, established by law, has already been surpassed (5% of GDP). The government plans to reform the legal framework to ensure greater consistency with fiscal targets.

[46] According to a recent actuarial valuation conducted by the National Banking and Insurance Commission (CNBS) using figures as of 31 December 2012, the disability, old age, and death regime of the Honduran Social Security Institute (IHSS) has an actuarial deficit on the order of 98.651 billion lempiras (approximately 25% of GDP).

regulatory framework currently in place for the budget and for PPPs, as well as the creation of a medium-term expenditure framework with a multiyear budget.[47]

3.11 The proposed approach runs the following risks: (i) a weakening in macroeconomic conditions due to external shocks that could affect economic growth and tax intake; (ii) political resistance to tax system improvements, civil service reforms, reforms to the PPP framework, and reforms to the social security system; and (iii) the possible instability of the new structure of the Executive.

3.12 The government's economic program, which has been endorsed by the International Monetary Fund (IMF), calls for fiscal and macroprudential management reforms that will help mitigate macroeconomic risks. In order to mitigate the risk of opposition to the proposed reforms, the Bank will support a strategy that effectively communicates the expected benefits of the reforms to the general public, especially government employees. Similarly, support will be provided to consolidate the Government Ministry (as a central government agency) and to strengthen the legislative process as it concerns fiscal and budget matters.

B. Sustainability and competitiveness in the energy sector

3.13 The electricity sector is up against significant technical and financial challenges that have a strong bearing on the country's fiscal sustainability and competitiveness. The sector produces losses on the order of 32% of total power generated. Technical losses (transmission and distribution) are estimated to account for 40% of total losses, with nontechnical losses (fraud, metering errors) making up the rest. In addition, the rate schedule is not current, having last been updated in 2009.[48] Lastly, delinquent accounts are equivalent to 3.2 billing months. This situation has translated into a rapid deterioration in the company's finances, with losses equivalent to 2% of GDP in 2013. It should be noted that in 2013 and 2014, the government initiated reforms designed to ensure the financial sustainability of the sector, including: approving a new framework law to establish an Electricity Regulatory Commission and restructure the National Electric Power Company (ENEE) into business units (generation, transmission, and distribution) to facilitate the incorporation of private actors, trimming subsidies for residential consumption, renegotiating contracts to purchase thermal power, and increasing purchases on the Regional Electricity Market.

3.14 The central objective of the Bank's work will be to support consolidation of the electricity sector reform process, particularly the new General Law on the

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[47] These actions will bring continuity to the support provided under the previous strategy for efficient management of human resources and strengthening of financial management systems, as well as strengthening the social security system.

[48] The formula for setting rates defined by the National Energy Commission uses the short-term marginal cost, which is linked to the expansion of power generation. For 2014, the short-term marginal cost (US$114/MWh) is less than the average cost of power generation (US$129/MWh), which means there is a gap between the authorized rate and the financial cost of generating power. Furthermore, the formula for calculating cross subsidies between groups of consumers is out of balance. The estimated rate gap in 2013 was equivalent to 0.7% of GDP.

Electricity Industry. Specifically, the Bank will simultaneously seek to: (i) improve the efficiency and quality of electricity service and diversify the power generation matrix; and (ii) increase access to electricity service. In both cases, the Bank will support reforms by providing financial and technical support,[49] as well as through sovereign guaranteed loan operations and/or PPP cofinancing.[50] Investments in the sector (both SG and NSG) will move forward as progress is made on implementing reforms to facilitate the efficiency and financial sustainability of the sector.

3.15 The main risks for the country strategy in the electricity sector are related to: (i) possible delays in implementation of the reform process, including political resistance to rate adjustments by the new regulatory agency; (ii) problems with recruiting the private sector to participate in distribution and transmission, having to do with lack of confidence in the financial capacity of the ENEE; (iii) greater frequency of adverse climate-related events that limit hydroelectric generating capacity; and (iv) problems with consolidating regional initiatives in Central America owing to the precedence given to national initiatives.

3.16 To mitigate these risks, the Bank is providing technical support for the reform process and engaging in ongoing dialogue with sector authorities on the priority reforms to be implemented. In addition, the government's economic program pivots on the need to restore the financial sustainability of the ENEE. This entails moving ahead with some of the reforms proposed by the Bank, which will help counteract political resistance to rate adjustments and build confidence among potential private investors in the sector. The Bank will also provide sovereign guaranteed financing

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[49] The support planned for the electricity sector represents a continuation of efforts made under the Bank's previous country strategy with Honduras, which called for budget support linked to reforms in the sector and investment loans contingent on improvements to the institutional framework for the electricity sector and on the financial sustainability of the ENEE. The recent adoption of the new General Law on the Electricity Industry, which entered into force on 4 July 2014, reflects the government's efforts to remedy the main structural weaknesses in the sector. The General Law on the Electricity Industry is designed to improve and modernize the rules and structure by which the industry functions through: (i) creation of the Electricity Regulatory Commission; (ii) establishment of an operator for the national electricity system to guarantee a safe continuous supply and correct operation of the system; (iii) participation of the private sector in distribution and transmission and operation of the system; (iv) modernization and restructuring of the ENEE as a matrix of subsidiary companies in charge of generation, transmission, distribution, and system operation; (v) unrestricted access to power grids and setting of usage rates; and (vi) creation of the Social Fund for Electricity Development to finance projects of social interest.

[50] There are barriers to financing nonconventional renewable energy projects owing to difficulties in accessing credit, even when the pertinent studies and permits to develop such projects have been secured. These are particularly significant for geothermal, and medium-sized hydroelectric and thermal projects, which require considerable levels of preinvestment and investment. These barriers can be overcome with concessional funds and risk mitigation instruments applied by the private sector windows. The Inter-American Investment Corporation already has experience with this sector in the country. One of its recent operations was a US$5.59 million loan, completed in January 2014, to finance the construction of a new 20MW biomass-fueled power plant. In addition, the Structured and Corporate Financing Department (SCF) will explore opportunities to expand access to electricity for the industrial sector, as well as to promote small-scale power generation and introduce new photovoltaic energy technologies. The MIF will also explore decentralized electric power generation initiative in regions without access to the electricity supply. New investments in the sector (both SG and NSG) will move forward as progress is made on implementing reforms to facilitate the efficiency and financial sustainability of the sector.

to preserve and modernize ENEE assets during the reform process, helping fund investments that will guarantee the sustainability and functionality of the electricity system in the generation, transmission, and distribution sectors. These investments may be made in partnership with other international donors, such as the Japan International Cooperation Agency (JICA), the European Investment Bank (EIB), and the World Bank, and will seek to strengthen the country's integration into the Central American Electrical Interconnection System, strengthening the regional dimension of sector policy in the country.

C. Road infrastructure for regional integration

3.17 Between fiscal constraints and institutional weaknesses (overlapping functions, weak management of demand, and outdated laws and regulations), Honduras's road system has a low pavement rate (23%) and is poorly maintained, impeding national connectivity, limiting regional integration, raising logistics costs, and blocking the potential of local producers to participate in international markets. As a result, Honduras was ranked 103 of 160 countries in the World Bank's 2014 Logistics Performance Index, below most Central American countries and the Latin American average.

3.18 The road infrastructure and integration situation in Honduras is characterized by the following aspects: (i) a single road corridor, consolidated as the main logistics axis (Tegucigalpa – San Pedro Sula – Puerto Cortés, 299 km); (ii) Tegucigalpa and San Pedro Sula as major consumption and industrial development nodes; (iii) La Ceiba (in the north) and Choluteca (in the south) as smaller logistics hubs that need to improve their connectivity to the main axis or other areas of potential commercial development; (iv) exports highly dependent on the road system (80% of freight is transported by road), on efficiency at overland border crossings, and on the competitiveness of Puerto Cortés and Puerto Castillo on the Atlantic, and Henecán on the Pacific; and (v) with the exception of the logistics corridors and nodes mentioned, the country's road system has developed unevenly, and airports and border control facilities have infrastructure, equipment, and operational weaknesses.[51]

3.19 The Government Plan 2014-2018 sets the goal, within the area of production infrastructure, of improving the current condition of the road network in its different categories, in order to lower costs and shorter travel times, through

[51] According to the Ministry of Infrastructure and Public Services (INSEP), 84% of the country's roads (12,787 km) are not in good enough condition to efficiently transport freight (sum total of unpaved, semi-paved, and paved kilometers). The country's agriculture, livestock, and fisheries industries primarily use secondary roads to move goods. Together, these sectors represent 20% of GDP, 50% of exports, and 50% of jobs. Owing to the combined effect of declining investment in routine road maintenance in the period 2010-2013 and the vulnerability of the road network to the effects of climate change, in Honduras for every US$1/km not invested in road maintenance, an investment of US$9/km was needed for rehabilitation of the same stretch of road four years later.

construction and maintenance programs drawing on public investment and public-private investment.[52]

3.20 The Bank's approach to road infrastructure and integration will include actions to reduce shipping times and costs, improve the management of high-value-added supply chains, and strengthen border management.[53] This is consistent with the strategy agreed upon by the Meso-American countries to strengthen their economies.[54]

3.21 Specifically, the Bank will seek to improve national and regional integration and reduce operating and transport costs through the following sovereign guaranteed investment actions and technical assistance to generate more knowledge in the area (see Figure 1): (i) consolidation of the Pacific corridor and other complementary logistics axes, including those with strong regional tourism potential; (ii) maintenance and improvement of east-west road connections and feeder roads for the agricultural and logistics corridors under considerable pressure due to their current condition, role, and vulnerability to disasters; (iii) adoption of a national freight logistics plan to guide national policy on transport logistics and trade facilitation, including the priority development of a coordinated border management unit for the Pacific corridor and other points of entry/exit that are commercially important (Puerto Cortés and points of access to regional tourism destinations, such as the Copán ruins). Given the financing needs of the sector, the participation of the private sector windows in PPP financing for the construction, rehabilitation, and/or management of road corridors will also be explored.

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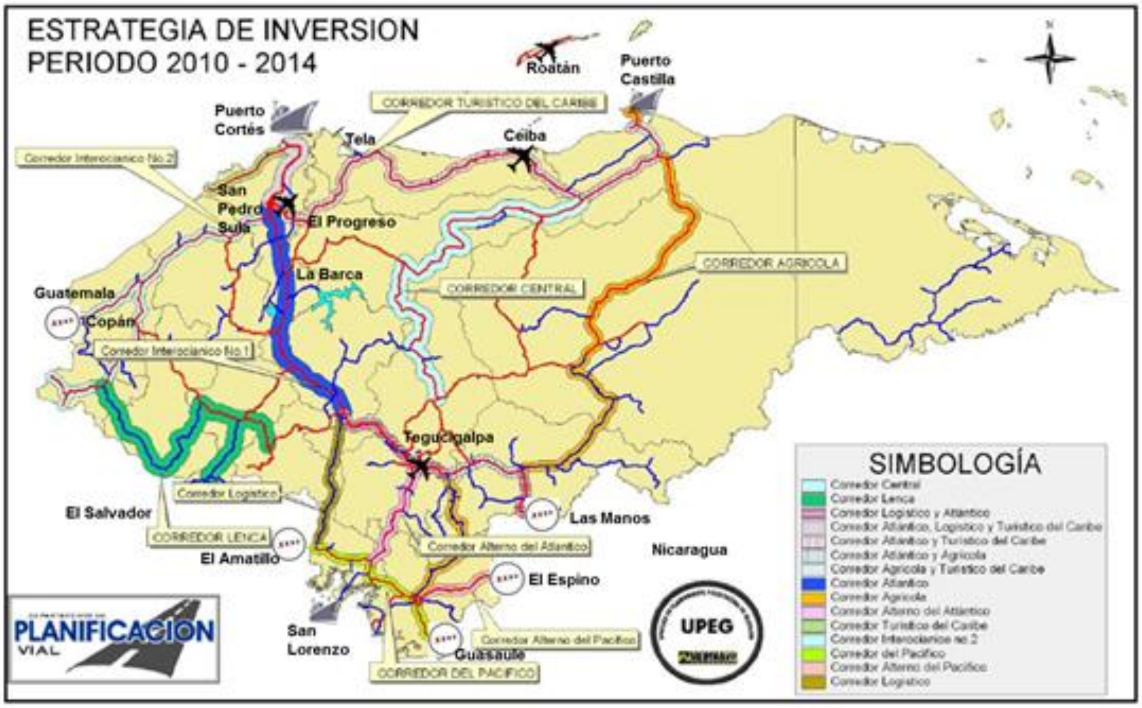
[52] The expected outcomes of the plan in the area of production infrastructure as concerns the transportation sector include: (i) interoceanic logistics corridor completed; (ii) other strategic corridors completed; and (iii) paved and unpaved road system improved, through periodic maintenance programs. The plan also calls for expanding and modernizing port and airport infrastructure, in order to position Honduras as a regional logistics hub.

[53] Ensuring continuity in integration policies with a positive economic impact on regional development is a basic requirement for facilitating integration (*Support to competitive global and regional integration*, IDB, 2010). Meanwhile, bringing down logistics costs is associated with benefits in terms of regional integration and productivity (*Logistics, competitiveness and integration – Transportation Sector Framework*, IDB, 2014). Logistics costs include the cost of transporting goods from the factory to the point of consumption or exportation.

[54] The strategy includes: (i) consolidation of the Meso-American Pacific corridor as the backbone for intraregional freight flows; (ii) adoption of a model technical framework for the integrated management of border operations; and (iii) prioritization of logistics on the sector agenda, through projects to lower logistics costs and increase the reliability and security of freight transportation.

Figure 1. Major transportation infrastructure in Honduras



Source: INSEP.

3.22 Taking into account that the investments associated with the country strategy proposals may come to represent a significant sum for the country, the main implementation risk is associated with: (i) a reduction in public investment in infrastructure due to the need for fiscal adjustment; (ii) institutional capacity for the implementation of large-scale infrastructure investment projects; and (iii) incentives to private investment.

3.23 To mitigate these risks, recently adopted fiscal measures will help guarantee the public resources needed to execute infrastructure projects and incentivize private investment in the area. In addition, the restructuring of the State apparatus, launched by the present administration, creates an opportunity to streamline sector institutions and make them more efficient, particularly in terms of implementation.[55]

D. Social inclusion

3.24 Poverty, health, and education indicators point to considerable challenges throughout Honduras, but the departments in the western part of the country face the biggest hurdles, both in terms of minimum income and access to basic services. Six of Honduras's 18 departments are located in this western region: Copán, Intibucá, La Paz, Lempira, Ocotepeque, and Santa Bárbara. These departments are primarily rural (70.5% of the population is rural, compared with 48.8% in the rest

[55] In those cases in which there are exceptional execution risks in the sector, the Bank will turn to alternative execution mechanisms such as those used under the Millennium Challenge Account.

of the country), and extreme poverty rates are considerably higher than in the rest of the country: 63.4% versus 44.0% (79.2% versus 67.7% in the case of total poverty). Although the western region is home to just one quarter of the country's rural population, fully one third of rural dwellers in extreme poverty live there. In this sector of the country, national programs have come up against impediments to resolving the array of needs associated with structural extreme poverty. Though the "Bono 10 Mil" (now "Bono Vida Mejor") conditional cash transfer program has raised the income of many families living in extreme poverty, and decentralized health programs have improved their access to basic health services, there are still important challenges in terms of eliminating exclusion errors in the Bono program and improving its coordination with the supply of human capital services (education and health). To tackle these challenges, a multisector territorial strategy is needed.[56]

3.25 Along these lines, the Bank proposes a series of complementary interventions in western Honduras that are consistent with the social protection strategy Vida Mejor.[57] They seek to increase, in a coordinated manner, demand for education and health services while simultaneously improving access to those services. Through sovereign guaranteed investment instruments and technical assistance, the plan is to: (i) ***protect minimum levels of consumption among the population in extreme poverty in western Honduras and neighboring areas (Dry Corridor)***, providing funding continuity for the conditional cash transfer program Bono Vida Mejor and improving its targeting and distribution mechanisms;[58] (ii) ***promote human capital accumulation of minors in households in extreme poverty, at the preschool level and the third cycle of basic education*** (grades 7, 8, and 9). At the preschool level, support will be provided to expand the supply of quality services, with priority

[56] In education, school attendance and achievement are lower in the rural western areas of the country than in the rest of rural Honduras. For example, attendance among 6- to 18-year-olds is 61% compared with 66%, and average years of school completed among 18- to 22-year-olds is 6.47 compared with 7.35. In the case of health, the rate of chronic malnutrition, which is 20% nationwide, is 35.5% in the western part of the country and nearly 50% in Intibucá and Lempira. The maternal mortality rate, too, in Intibucá and La Paz is over 110 deaths per 100,000 births, compared with a national average of 74. Lastly, in health and sanitation, although the availability of water is similar to the rest of the country, EPHPM data (2013) show that the probability of having sanitation services is 80% in rural areas of western Honduras, but 86% in rural areas in the rest of the country, and of households with sanitation service, only 25% have connected service in the western region, compared with 34% in the rest of rural Honduras.

[57] The principles of the Vida Mejor strategy are human development, reduction in inequalities, and protection of the most vulnerable sectors. The strategy has five key elements: a minimum income guarantee for the poorest families, food security, healthy housing, access to preschool and basic education (to ninth grade), and primary health care. This is paired with actions to support vulnerable sectors (children at social risk, older adults in situations of neglect, women victims of violence, and indigenous and Afro-descendant communities).

[58] The annual cost of Bono Vida Mejor is around 0.64% of GDP and is expected to decline to 0.6% of GDP in the years ahead, in line with regional values. The new transfer structure and fiscal efforts will contribute to the fiscal sustainability of the program. The government recently created the Solidarity Fund, which will be endowed with US$185 million and is intended, among other objectives, to finance the Bono program. It will take 30% of the Solidarity Fund's resources to finance 50% of the total cost of Bono Vida Mejor. The government plans to contribute US$30 million per year to the Solidarity Fund to cover beneficiaries in rural areas.

given to flexible modalities, such as the community preschool education centers model. For the third cycle, the Bank will support activities to expand supply in rural areas in the western part of the country that are currently not served and strengthen the relevance of the curriculum; (iii) ***improve the health indicators of children under 5 in rural western Honduras***, strengthening the basic set of services provided under the decentralized management model, both at the primary care level and at hospitals.[59] The private sector windows may participate in cofinancing for the decentralized delivery of health services through private providers, and may support, under criteria of quality and inclusion, financing for the private secondary education system, particularly the third cycle.

3.26 The main risks for implementing the multisector strategy described here are: (i) possible funding shortfalls; (ii) possible weakness in the providers' implementation capacity; and (iii) insufficient institutional coordination. In the education sector, the success of the strategy will require effective coordination between the Ministry of Education, the department divisions, and the local governments. In the health sector, the risks derive from the fragmentation of the healthcare system and the uncertainty surrounding the national health system reform, currently under way.[60]

3.27 In terms of mitigating risks, the institutional capacity of the three subsystems (cash transfer, education, and health) has been steadily building, due in part to the Bank's support,[61] so the main challenge now is to further coordination among these subsystems at the subnational level. The proposed territorial approach would support the ongoing improvements in local coordination between social welfare, health, and education institutions, including traditional as well as nontraditional or decentralized providers. Mindful of budget constraints, the government has devised realistic coverage plans for the Vida Mejor strategy in the western part of the country. To that end, the strengthening and effective guidance of the sector cabinet for development and social inclusion is key, and the Bank is supporting this process with technical assistance. Moreover, the Bank will continue to support, via technical assistance, Vida Mejor targeting, execution, and supervision.

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59 These services include: (i) basic obstetric and neonatal primary care as well as referrals and transfers of women and newborns to facilities offering more specialized care in cases of obstetric and neonatal complications; (ii) strengthening of counseling services and provision of reversible and permanent modern family planning methods; and (iii) preventive nutrition services: communication for behavioral changes in feeding and caring for children under 24 months, micronutrient supplementation for children ages 6 months to 24 months, and the use of zinc to treat diarrhea in children ages 0 to 5.

60 A central issue to consider is the sustainability over time of the programs, which will be achieved by ensuring adequate appropriations of fiscal resources from national sources and the gradual reduction of external financing for the programs. In this sense, the use of resources from the Solidarity Fund created as part of the 2013 fiscal reform is crucial.

61 The Bank has provided support to the government to: (i) ensure a minimum income for the poorest households, though the Bono Vida Mejor program; (ii) strengthen health services through the decentralized management model; and (iii) improve scholastic achievement by expanding technology services at the basic education level.

E. Sustainable development in the Central District

3.28 In Honduras, infrastructure and public service gaps persist in urban areas, reflecting the lack of a planning model for the organic growth of the major cities.[62] At present, 4.5 million people (53% of the total population) are urban dwellers, a figure that is expected to double by 2030.[63] Demographic growth and internal migration patterns have fueled the growth of cities without adequate planning and the proliferation of informal settlements on the urban fringes with only limited access to basic services.[64] Although total water and sanitation coverage in urban areas stands at 95% and 85%, respectively, in marginal and fringe areas of these urban centers, particularly in the Central District, access to these services is even lower than in rural areas.[65] The country's major cities, such as Tegucigalpa, face problems related to traffic congestion, inefficient public transportation, increased motorization, roads in just fair condition, and increased pollution.[66] In recent years, poor living conditions have become further entrenched by the vulnerability of these settlements to natural disasters associated with climate change—above all, torrential rains—and skyrocketing crime, linked to criminal organizations. Given the prospect of continuing rapid urbanization in the years ahead, in order to safeguard the country's future quality of life, public policies must be identified that resolve these types of problems.

3.29 The Bank will seek to reduce marginalization and improve urban quality of life in the Central District by taking action in four areas where urban problems are concentrated: (i) improve the city's disaster risk management by considering the potential effects of climate change; (ii) improve citizen security; (iii) improve the basic components of the urban structure (services, facilities, green areas, and the housing stock) in degraded urban areas, informal areas, and areas of expansion; and (iv) improve the network of roads between residential areas of the city (especially marginal areas) and central areas and commercial and public service districts. An integrated intervention model is proposed to coordinate effective solutions that match the complexity of the challenges facing densely populated metropolitan areas of the Central District, with a territorial approach to ensure adequate coordination,

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[62] Honduras has experienced significant urban growth, at an annual rate of 4%. If this trend continues, the country's urban population will double by 2030, with respect to 2009. Although 47% of the population still lives in areas that are considered rural, the country is rapidly urbanizing. Honduras has 12 medium-sized and large cities with a population of more than 85,000 people. The two largest cities are the Central District (encompassing Tegucigalpa and Comayagüela), with over one million people, and San Pedro Sula, with over 684,000. The two areas combined concentrate around 42% of the country's urban population. The next eight cities in terms of size are home to over 30% of the country's urban population.

[63] Country Vision and National Plan of the Government of Honduras (February 2010).

[64] In the Central District, urban growth has been characterized by a steady exodus from areas adjacent to major bodies of water.

[65] There are 72 marginal neighborhoods in the Central District with a total population of about 300,000 inhabitants. Of these neighborhoods, only 18% have access to the water system and 6% to the sanitary sewer system.

[66] Sustainable Urban Mobility Plan for the Central District (ALG Transportation, Infrastructure & Logistics, 2013).

dialogue, and collaboration between the Bank's units and divisions.[67] In this context, the proposal is for the Bank to provide financial support through sovereign and non-sovereign guaranteed investment operations and technical assistance to facilitate coordination of the proposed intervention areas and generate new knowledge on the development of urban improvement models. There could be demand for the private sector windows to support PPP arrangements for the provision of mass transit systems and the deconcentration process for water and sanitation service providers. Once the intervention model has been consolidated in the Central District, the Bank will consider implementing it in the metropolitan area of Valle de Sula.

3.30 The main risks that have been identified are related to: (i) the relatively weak and fragmented municipal institutional structure; (ii) weaknesses in legal frameworks at the national and municipal levels; and (iii) lack of coordination between the central government, municipios, and private sector actors.

3.31 To mitigate the institutional risk, executing units will be established to centralize the activities corresponding to the proposed interventions, and support will be provided for municipal authorities, or otherwise existing executing units with proven experience in the area to receive support will be engaged, which would contribute to the development of laws and regulations appropriate for the area of intervention and create suitable conditions for maximizing the investment. In addition, it will be important to work with the national and local governments to strengthen the legal frameworks and coordinate interventions, which could be arranged through technical cooperation operations.

F. Crosscutting and dialogue areas

3.32 The strategy will have two crosscutting sectors: (i) gender focus and development with identity; and (ii) climate change and disaster risk management. Specifically, in the transportation, energy, and Central District development sectors, the focus will be on vulnerability reduction, incorporation of climate change adaptation and mitigation into the design of viable systems, renewable energy actions, and actions to improve the coverage of public services. In addition, the gender and development with identity perspective will be incorporated into the social and environmental sectors (health, education, social protection). The mechanisms for mainstreaming these areas into the Bank's programs and initiatives will be defined during implementation of the strategy.

3.33 In addition to the above-mentioned priority areas, the proposal is to continue to engage in dialogue on reform of the social security system (pensions) and strengthening of citizen security. The Bank will support efforts to strengthen the regulatory framework and PPP financing, thereby ensuring the mitigation of fiscal

[67] These interventions will provide continuity and better coherence to a series of interventions that the Bank has been supporting under the previous country strategy with projects in the portfolio, including: the Trans450 urban transit system and neighborhood improvement programs in the Central District Metropolitan Area, and the citizen security program, which is financing improvements at police posts in preparation for a community policing approach in marginal and low-income areas.

contingencies that could result from such arrangements. Lastly, it will continue to support actions that help consolidate a vision and processes for regional integration. The Bank plans to maintain the dialogue initiated with the government on the migration of unaccompanied minors to the United States,[68] as it relates to the approach and instruments, particularly in terms of job and technical training for repatriated youth and/or youth at risk of emigrating, as well as regional coordination and cooperation between the Northern Triangle countries.

IV. LENDING FRAMEWORK

4.1 **Fiscal situation.** After the negative impact of the 2008 global financial crisis and the instability generated by events in Honduras in 2009, which translated into an overall deficit in the central government of 6% of GDP, Honduras managed in 2010 and 2011 to partially reverse the deterioration in the fiscal accounts. Nevertheless, in 2012 and 2013, the central government deficit worsened owing to tax revenue collection problems related to the institutional weakness of the collection agency, as well as slower economic growth and higher current spending. After closing 2013 with a central government deficit of 7.9% of GDP, Honduras has designed an economic program to achieve fiscal sustainability in the medium term.

4.2 **Financing needs and financial scenario.** In this framework, the country's financing needs are projected at US$1.8 billion for the period 2015-2018.[69] The strategy's financial scenario anticipates SG approvals of US$742 million for the period 2015-2018. This assumes an allocation of US$340 million for the period 2015-2016, with the following blend: 40% from the Fund for Special Operations (FSO); and 60% from the Ordinary Capital (see Annex III).[70] The country's debt with the Bank would rise from 7.7% of GDP in 2015 to 9.2% of GDP in 2018. The financial scenario is consistent with the debt sustainability analysis, based on the Debt Sustainability Framework.[71]

V. STRATEGY IMPLEMENTATION

A. Measures to improve portfolio execution and quality

5.1 The Bank will continue to improve operational designs, taking into account the capacities of local counterparts and strengthening their execution and risk management capacity, as relevant. The factors affecting implementation of the portfolio of projects in Honduras include design problems, budget constraints, and

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[68] The number of unaccompanied minors reported by the U.S. Border Patrol rose from 6,747 in fiscal year 2013 to 18,244 in fiscal year 2014 (from 1 October 2013 to 30 September 2014).

[69] International Monetary Fund, Article IV.

[70] Subject to approval by the Board of Executive Directors of the document, "Fund for Special Operations. Proposal for the allocation of resources 2015-2016."

[71] Inter-American Development Bank, "Macroeconomic Sustainability Assessment," 2014 (confidential document).

complicated execution arrangements, in addition to limited institutional capacity in the country.

5.2 To neutralize these factors, the Bank will further advance efforts already under way in the following areas: (i) adapt operational designs, taking into account the capacities of local counterparts and, in particular, strengthening their execution and risk management capacity; (ii) maintain a high level of coordination with the borrower in order to anticipate possible fiscal constraints and agree on the budget space needed for the operations program; (iii) maintain an active dialogue with the borrower (SEFIN) and the Presidential Project Monitoring Office in order to agree upon and take advance corrective action in the case of situations that may cause projects to become problematic; (iv) report promptly to the institutions cited in the above on the implications of low project execution levels in terms of allocation of FSO and Ordinary Capital resources for the country; (v) maintain and deepen training processes for integrated management and results-based management at project executing units; and (vi) in those cases in which there are recurring and/or isolated problems with execution, implement alternative execution mechanisms such as those used under the Millennium Challenge Account, private sector trust funds, private management companies, etc.

B. Country systems

5.3 In the area of financial management, the Bank will continue to support efforts to strengthen the Integrated Financial Management System (SIAFI), maintaining its use and use of the reporting module in the Bank's portfolio of sovereign guaranteed loans. Likewise, support will continue to be provided for the strategic plan for implementation of the International Public Sector Accounting Standards (IPSAS). In the area of external control, support will be provided for implementation of the International Standards of Supreme Audit Institutions (ISSAI), as well as for implementation of a strategic partnership with the National Audit Office (TSC) for use of external control in Bank-financed operations in the country. In the area of procurements, the Bank will continue to use the government e-procurement system HONDUCOMPRAS for publicizing procurements and will provide support for installation of the framework agreements and purchasing system promoted by the Regulatory Office of State Contracting and Procurement (ONCAE), with a view to its subsequent use in Bank-financed operations. To further advance the Strategy for Strengthening and Use of Procurement Systems in the country, ONCAE will continue to receive support to develop and implement the necessary operational tools and management instruments. Moreover, given its crosscutting importance, it will also receive support to develop its institutional position as a robust lead agency for public procurements in the country. Lastly, in the area of nonfiduciary systems, support will be provided to strengthen statistics and public policy planning and evaluation systems.

Table 1. Country systems

Use of country systems[72]	2014 baseline	2018 estimated use	Planned actions
Financial management			
Budget	100%	100%	Improve the functionalities of the UEPEX/SIAFI and support implementation of the IPSAS.
Cash management	100%	100%	
Accounting and reporting	100%	100%	
Internal audit	0%	0%	
External audit	0%	10%	Implement a strategic partnership with the TSC for use of external control in Bank-financed operations in the country.
Procurements			
Information system	100%	100%	Provide technical assistance to validate system improvements or updates by ONCAE.
Shopping	0%	15%	Provide technical assistance for activities conducted by ONCAE to implement measures and tools to strengthen the system.
Individual consulting services	0%	0%	
Partial NCB	0%	0%	
Advanced NCB	0%	0%	

5.4 **Coordination with other donors.** The Bank will continue to promote coordination with bilateral and multilateral donors active in the country (see Annex III) through its participation in the Stockholm Declaration Follow-up Group (G-16).[73] It will deepen operational coordination in the following areas: (i) social protection, with the World Bank and CABEI; (ii) education, with USAID, the World Bank, GIZ, KfW, Spanish cooperation, Canadian cooperation, JICA, UNICEF, UNFPA, and the French Embassy; (iii) health, with USAID, JICA, UNFPA, AECID, and PAHO; (iv) water and sanitation, with SFW (Spain), Switzerland, JICA, and the European Union; (v) energy, with JICA, the World Bank, EIB, the Millennium Challenge Account, the U.S. Department of State, the Climate Investment Fund, and the Global Environment Facility; (vi) transportation, with CABEI and OFID (OPEC); (vii) citizen security, with Switzerland, JICA, and USAID; (viii) natural disaster risk management, with GIZ; (ix) fiscal and municipal management, with the World Bank and AECID; and (x) environment and climate change, with the Global Environment Facility, NDF, the World Bank, and UNEP.

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72 Percentage of the Bank's active loan portfolio (operations) that is managed using country systems.

73 This group was created in 1998 to coordinate support by the community of donors following Hurricane Mitch.

VI. RISKS

6.1 **Macroeconomic risks.** Possible macroeconomic risks to strategy implementation include: (i) shocks to external sustainability; and (ii) shocks to fiscal sustainability.

6.2 Although the main indicators of external sustainability point to relatively moderate sustainability risks,[74] the Honduran economy is highly vulnerable to external shocks. The balance-of-payments trade account has run a deficit of more than 16% of GDP since 2011. This deficit has been financed by sizeable remittance flows (equivalent to 16% of GDP) and foreign direct investment (equivalent to 6% of GDP), which account for the observed surplus. In both cases, the flows come primarily from the United States, Honduras's main trading partner, so a slowdown in that economy would present real risks for consumption, investment, and production. Meanwhile, the country is heavily dependent on oil imports for transportation and electricity (equivalent to 18% of GDP), so international price hikes for crude oil could exacerbate the imbalance in the trade account, undermine the stability of domestic prices, and further weaken the financial position of the ENEE.

6.3 The rapid deterioration of the fiscal accounts, with a deficit of 7.9% of GDP in 2013, and the attendant rise in public borrowing (42% of GDP in 2013) have weakened fiscal sustainability in the country.[75] Deeper reforms are needed, particularly in relation to the ENEE's financial position, so any deviation from implementation of the fiscal adjustment policies could affect the dynamic of borrowing, perception of risk, and availability of public investment. At the same time, it is important to note the expansion of public-private investment arrangements, given the implications in terms of contingent liabilities for fiscal sustainability. Recently adopted fiscal reforms seek to restore balance in the budget over the medium term, which has generated positive expectations.

6.4 If both shocks were to occur, public and private financing capacity could decline, affecting the implementation and scope of the actions proposed in the country strategy. As a mitigating measure, the Bank is working in coordination with the Honduran government and the IMF on the design and execution of measures to help restore fiscal balance and reduce the incidence of contingent liabilities.[76]

6.5 **Institutional risks.** The main risk is related to the execution capacity of the local counterparts, which could affect the pace of execution and impact portfolio performance and subsequent allocation of financing. To mitigate this risk, the Bank will support institutional strengthening actions that lead to the identification of new program design and execution arrangements, adapted to local capacity. In addition,

[74] As of August 2014, international reserves covered over 3 months of imports and represented 10 times the short-term external debt obligations.

[75] The public debt sustainability analyses indicate adequate levels in terms of short-term sustainability, but there is a certain risk of illiquidity in the medium term.

[76] As of August 2014, the fiscal adjustment measures implemented in early 2014 had resulted in a return of 1.6% of GDP, equivalent to 60% of the target set for the close of the year (2.7% of GDP).

the Bank will continue to work on strengthening country systems for financial management and public procurements, with a view to enhancing the transparency of the programs and maximizing their impact.

6.6 **Natural disaster risks.** Honduras is among the countries in the region that are highly exposed to natural disaster risks. The country has high rates of vulnerability, related to environmental degradation and the absence of urban planning programs, as well as poor disaster risk management, especially due to institutional weaknesses and limited interagency coordination.[77] Natural disasters could adversely affect attainment of the expected results of the strategy. Accordingly, the proposed actions, both in urban development and in energy and regional integration, incorporate risk management activities.[78]

[77] According to estimates of vulnerability to climate change, 30 of Honduras's 298 municipios have indigenous and Afro-Honduran communities that are classified as highly vulnerable (Comisión Permanente de Contingencias [Permanent Contingency Commission], Estimaciones de Municipios con Alta Vulnerabilidad y con Índice de Vulnerabilidad Municipal [Estimates of Municipios with High Rates of Vulnerability and with Municipal Vulnerability Index], Tegucigalpa, 2012). In addition, 51 municipios have indigenous and Afro-Honduran communities with a medium level of vulnerability to climate change, as well as social vulnerability. Social vulnerability is measured using proxy variables of high population density, presence of vulnerable groups, low human development indices, and unmet basic needs.

[78] In addition, the Bank can respond to climate-related eventualities through its US$100 million Contingent Loan for Natural Disaster Emergencies (HO-X1016).

MAIN ECONOMIC AND SOCIAL INDICATORS

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Social indicators									
Population (thousands)	7197	7367	7537	7707	7877	8046	8215	8385	8555
Poverty rate	63.7	59.9	58.2	59.2	58.8	60.0	61.9	66.5	64.5
Extreme poverty rate	46.0	40.4	37.5	36.2	36.4	39.1	41.6	46	42.6
Unemployment rate	4.8	3.5	3.1	3	3.1	3.9	4.3	3.6	3.9
Per capita GDP (US$)	1355.7	1481.9	1640.1	1802.0	1852.0	1968.6	2154.9	2208.0	2160.9
Real sector indicators									
Real GDP (% growth)	6.1	6.6	6.2	4.2	-2.4	3.7	3.8	4.1	2.6
Nominal GDP (US$ millions)	9757.4	10917.5	12361.2	13888	14587.4	15839.3	17702.8	18513.7	18486.6
Fiscal indicators 1/ (% of GDP)									
Fiscal revenue	16.4	16.6	17.5	17.9	15.2	15.5	15.8	15.4	16.1
Total expenditures	19.7	19.2	22.0	22.4	23.1	21.5	21.5	22.2	24.6
Capital expenditures	4.5	3.3	4.1	4.9	5.1	3.7	4.6	4.5	5.2
Global balance	-3.3	-2.6	-4.5	-4.5	-7.9	-6.0	-5.6	-6.8	-8.5
Public debt	44.7	30.0	18.3	19.3	22.4	24.8	27.3	30.2	38.6
External debt	41.4	26.1	15.0	15.8	16.1	17.1	17.5	19.2	27.6
External indicators (% of GDP unless otherwise indicated)									
Balance in current account	-3.0	-3.7	-9.0	-15.3	-3.8	-4.3	-8.0	-8.5	-9.5
Foreign direct investment	6.1	6.1	7.5	7.2	3.5	6.1	5.7	5.7	5.7
Family remittances	18.2	21.3	20.9	20.2	16.9	16.5	15.8	15.6	16.9
Net international reserves (US$ million)	2162.8	2613.7	2514.3	2460.0	2116.3	2719.3	2820.7	2570.9	3055.9
Monetary and exchange rate indicators									
Inflation rate (end of period)	7.75	5.29	8.87	10.83	2.95	6.48	5.6	5.39	4.92
Growth of monetary aggregates (M2)	19.8	24.0	17.1	2.5	-0.2	13.3	13.0	4.4	8.0
Nominal exchange rate (Dec. average, L/US$)	19.0	19.0	19.0	19.0	19.0	19.0	19.1	20.1	20.7
Real effective exchange rate (% variation + dep.)	-3.5	-1	-2.5	-8.6	-0.9	-3.6	-1.5	1.2	-0.3

1/ Fiscal data refer to the central government. Public debt data refer to the nonfinancial public sector.
Sources: Central Bank of Honduras, Ministry of Finance (SEFIN), National Statistics Institute, and the Executive Secretariat of the Central American Monetary Council.

MACROECONOMIC CONTEXT

Over the past decade, Honduras has grown at a sustained pace, but recent episodes of political instability, as well as the global financial crisis, have had a negative impact on economic activity. Between 2000 and 2008, the economy expanded at an average annual rate of 5.3%, led by increases in household consumption and exports. The global financial crisis of 2007-2009 and the events in Honduras in 2009 prompted a real contraction in GDP of 2.4%. In 2010, the economy began to recover on an uptick in exports and private investment. However, average growth of 3.3% remains below pre-crisis levels.

Honduras has sustainable debt levels in the short term, with a moderate risk of insolvency in the medium and long term. Public debt sustainability analyses indicate adequate levels in terms of short-term sustainability. However, there is a risk of illiquidity in the medium term, considering the magnitude of the fiscal imbalance and the rapid increase in debt (42% of GDP in 2013). It should be noted that the rise in debt is primarily explained due to the issuance of external bonds totaling US$1 billion in 2013, which in turn required the Central Bank to conduct open market operations to sterilize the liquidity surplus and keep inflationary pressures under control. The central government deficit in 2013 stood at 7.9% of GDP, two points above the level from the previous year. In the last two-year period, the deficit has grown due to tax collection problems, as well as higher current expenditure and public investment.

The authorities have announced a set of reforms aimed at reducing expenditure and increasing fiscal revenue. The fiscal measures adopted in the framework of the Public Finance Law are expected to produce fiscal revenue totaling as much as 2% of GDP, according to Ministry of Finance estimates. Among the main actions adopted are: (i) a three-point increase in the sales tax (from 12% to 15%); (ii) a reduction in the energy subsidy (decrease in the subsidy cutoff level from 150 kWh/month to 75 kWh/month); and (iii) a US$0.25 increase in the price of gasoline and diesel fuel (equivalent to an average increase of 22% in the sales price).

The external sector has adequate liquidity indicators, despite imbalances in the current account and a slightly overvalued exchange rate. In the long run, a significant current account adjustment is needed. The current account posted a deficit of 8.8% of GDP in 2013, above the 2012 level of 8.6%, due to imbalances in the trade, services, and income account (-27% of GDP), which were barely offset by the surplus in the transfers account (18%). Meanwhile, the capital and financial account posted a surplus of 13% of GDP, above the 2012 level of 8%, driven by an expansion in direct investment (6% of GDP). External liquidity indicators remain at adequate levels thanks to the influx of foreign currency associated with bond issues in the international markets: (i) international reserves cover 3.5 months of imports; (ii) gross reserves cover short-term external debt commitments by a factor of 12; and (iii) gross reserves represent 45% of the money supply. However, in the long run, a current account adjustment on the order of 4.3% of GDP, or nearly US$800 million in 2013, will be needed to stabilize the net international investment-to-GDP position (CGER methodology) at 41% (average value in 2008-2012). In relation to the exchange rate, several analyses suggest that the lempira is overvalued in real terms by about 2%.

The financial sector has solid solvency, capital adequacy, efficiency, and liquidity indicators, mostly above the averages for Central America. The capital adequacy ratio stands at about 14%, above the 10% required by the Banking Commission. Readily available liquid assets account for 28% of total assets, while the ratio of liquid assets to ordinary deposits is 44%. Lastly, the proportion of credit denominated in foreign currency is approximately 31%, and the ratio of liquid assets to ordinary deposits in foreign currency is 42%.

Price trends are stable. At end-2013, inflation stood at 4.9%, within the target band of 4.5% to 6.5% set by the Central Bank, which represents a cooling in relation to the 5.4% rate in 2012. Annualized inflation has been trending downward from a level of 7.7% in July 2011. In addition, price volatility, measured as the standard deviation from the inflation rate for 12-month periods, has steadily eased for the last three years (0.86% in 2011, 0.54% in 2012, 0.43% in 2013).

INDICATIVE LENDING FRAMEWORK

Fiscal situation and external debt. After the negative impact of the 2008 global financial crisis and the instability generated by events in Honduras in 2009, which translated into an overall deficit in the central government of 6% of GDP, Honduras managed in 2010 and 2011 to partially reverse the deterioration in the fiscal accounts. Nevertheless, in 2012 and 2013, the central government deficit worsened owing to tax revenue collection problems related to the institutional weakness of the collection agency, as well as slower economic growth and higher current spending. Honduras closed 2013 with a central government deficit of 7.9% of GDP, over four points above the originally budgeted deficit (3.5% of GDP).

The fiscal imbalances of recent years have led to a rapid expansion of public debt, which represented 42% of GDP in 2013. Since 2009, public debt has increased by nearly US$4 billion, which marks a departure from the trend observed at the beginning of the last decade, when economic and social reforms pursued under the HIPC initiative prompted a reduction in Honduras's external debt on the order of 50%.

The government has adopted measures to reduce the fiscal deficit and is actively seeking an agreement with the International Monetary Fund. To this end, the authorities adopted a set of reforms aimed at reducing expenditure and increasing fiscal revenue. Fiscal measures adopted in late 2013 in the framework of the Public Finance Law are expected to produce a fiscal balance of 2.4% of GDP. Among the main actions adopted are: (i) a three-point increase in the sales tax (from 12% to 15%); (ii) a reduction in the energy subsidy (decrease in the subsidy cutoff level from 150 kWh/month to 75 kWh/month); and (iii) a US$0.25 increase in the price of gasoline and diesel fuel (equivalent to an average increase of 22% in the sales price).

Financing needs and financial scenario. The country's financing needs are projected at US$1.8 billion for the period 2015-2018.[1] The baseline financial scenario assumes that the allocation from the Fund for Special Operations (FSO) blended with the allocation from the Ordinary Capital (in a 40:60 ratio) remains the same as in the period 2013-2014. Based on that assumption, SG approvals are projected at US$742 million for the period 2015-2018, and the country's debt with the Bank would rise from 7.7% of GDP in 2015 to 9.2% of GDP in 2018. The financial scenario is consistent with the debt sustainability analysis, based on the Debt Sustainability Framework.[2]

Leveraging of financing from other donors. Efforts will be made to maximize the impact of the financing through coordination with other multilateral institutions and donors, making use of instruments such as the grant leverage mechanism.

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1 International Monetary Fund, Article IV.

2 Inter-American Development Bank, "Macroeconomic Sustainability Assessment," 2014 (confidential document).

Lending envelope and flows in relation to the IDB (2015-2018)

	2015	2016	2017	2018	2015-2018
Approvals 1/	**185,0**	**155,0**	**201,2**	**201,2**	**742,4**
Disbursements	**192,0**	**181,0**	**187,0**	**191,0**	**751,0**
Repayments	**19,9**	**25,6**	**36,0**	**46,1**	**127,6**
Net loan flows	172,1	155,4	151,0	144,9	623,4
Subscriptions	7,6	7,6	7,6	7,6	30,4
Net capital flows	164,5	147,8	143,4	137,3	593,0
Interest and fees	**26,9**	**27,6**	**27,8**	**27,4**	**109,7**
Net cash flow	137,6	120,2	115,6	109,9	483,3
IDB debt	**1544,3**	**1699,7**	**1850,7**	**1995,6**	
IDB debt/GDP (%)	7,7	8,2	8,8	9,2	
IDB debt/Public external debt (%)	24,5	25,7	27,2	28,2	
IDB debt/Multilateral external debt (%)	38,3	39,6	40,9	42,1	

1/ Amounts subject to the availability of Bank capital and FSO allocations (IDB-9).

MAP OF DONORS AND MAIN AREAS OF INTERVENTION

Country	Agency	Sector of support																			
		Environment and climate change	Natural disaster prevention	Education	Energy	Health	Water and sanitation	Rural infrastructure	Infrastructure	Local development	Social protection and food security	Economic development (job creation)	Public finances	Agriculture	Private sector (competitiveness)	Regional integration	Security	Violence prevention	Rule of law	Governance	Civil society
BILATERAL																					
Germany	GIZ	■		■	■		■	■	■			■				■					
Japan	JICA	■	■	■	■	■	■	■		■	■	■				■	■				
Canada	Embassy	■		■		■	■	■		■	■	■									
Italy	Embassy					■	■										■		■		
France	Embassy	■		■													■	■	■		
Spain	AECID			■	■		■	■		■	■	■				■		■	■	■	■
Switzerland	SDC		■				■			■		■		■			■	■	■		■
United States	USAID	■		■	■	■		■	■	■	■	■	■	■	■	■	■	■	■	■	■
MULTILATERAL																					
World Bank	Multilat.		■	■	■		■	■	■	■	■	■	■	■	■	■	■	■		■	■
IDB	Multilat.	■	■	■	■	■	■	■	■	■	■		■	■	■		■				
European Union	Multilat.	■	■				■			■	■	■	■			■	■		■		■
OAS	Multilat.		■		■							■					■	■	■	■	
United Nations	Multilat.	■	■	■	■	■	■			■	■	■	■	■		■	■	■	■	■	■
CABEI	Multilat.				■		■	■	■		■	■		■	■	■					
Source: Description of G-16 cooperation in Honduras.																					

In terms of economic support, the G-16 group of donors in Honduras together account for close to 90% of the external cooperation for the country. This group consists of multilateral organizations, embassies, and bilateral donor agencies, providing support in 21 sectors and various subsectors. On average, the main beneficiary sectors are the economic development and water and sanitation sectors, with support provided by 11 donors, followed by citizen security, with support provided by 10 donors. Sectors receiving support from 9 donors are: environment and climate change, regional development (decentralization and local, municipal, and departmental development), education (infrastructure and technical assistance), energy (renewable and nonrenewable), and social protection and food security, which includes the Bono Vida Mejor program. All this support is consistent with efforts to reduce poverty, as one of the primary motivations of the G-16 members.[1]

[1] Description of G-16 cooperation in Honduras (Office of the President pro tempore, Switzerland, 2014).

COMMENTS ON THE COUNTRY PROGRAM EVALUATION FOR HONDURAS 2011-2014

Recommendation	Management's response
1. **Give priority to fiscal consolidation.** For such purposes, it is recommended that the Bank continue to work with the IMF and the World Bank in order to ensure a sustained process of fiscal consolidation that reduces risks related to program sustainability.	**Agreed**. Management is aware that fiscal consolidation is a priority. A technical dialogue is under way on this subject with the government in the context of preparing the Bank's country strategy for 2015-2018. As part of this dialogue, fiscal consolidation is being considered for inclusion as one of the priority sectors of intervention, continuing support for the country in the strengthening of public finances.
2. **Design the country strategy based on the most critical development challenges, clearly defining the criteria for participation by the Bank's various sectors (including VPP), and for the prioritization of projects, while ensuring consistency between the diagnostic assessment and the country strategy.** To do this, Management should consider: a) Forming an interdisciplinary team to identify and determine the scope of the development problems faced by the country (e.g., worsening fiscal position, poverty, insecurity, low productivity, etc.) and their causes, based on the growth study, the government's priorities, and other necessary elements. b) Including criteria explaining why the Bank is engaged in the solution to those development problems and the selection of the sector or sectors proposed for resolving them (e.g., in the case of the fiscal consolidation problem, possible actions could be considered in the area of revenues, expenditures, and weaknesses in the respective institutions (ENEE, COALIANZA, ERSAPS, FHIS, etc.), inefficiencies in the energy sector, potential contingent liabilities that may arise from PPPs, etc.). This could involve the preparation of multisector Technical Notes.	**Partially agreed.** The design of the Bank's country strategy for the period 2015-2018 will consider the most critical development challenges. In doing so, a process of analysis and consultations is being followed that seeks to enhance the Bank's work in the country. This process includes the following: a. Technical analyses regarding constraints on growth and productivity. b. Agreements reached with government authorities during the dialogue (including discussions on national development plans). c. Analysis of the portfolio status and presence of other donors. In addition, the process of preparing the new strategy will follow the suggested guidelines in terms of a multisector approach. Four of the five sector notes to be completed are multisector notes: (1) fiscal consolidation; (2) roadways for regional integration; (3) social inclusion; and (4) sustainable urban development. It should be noted that the urban development note will unequivocally respond to this recommendation as it will be a document prepared by a multidisciplinary team made up of seven Bank divisions attached to the Institutions for Development (IFD) and Infrastructure and Environment (INE) sectors.[1] The note will be based on a multisector diagnostic assessment and will propose territorial interventions that coordinate the actions of the various sectors in specific geographic areas. Lastly, while Management agrees with the recommendation as a whole, it would like to express its difference of opinion with OVE's observations regarding the consistency between the diagnostic and the country strategy. Its clarification is presented in **paragraph 3.1 of this document**.

[1] Fiscal and Municipal Management Division (FMM); Institutional Capacity of the State Division (ICS); Climate Change and Sustainability Division (CCS); Environment, Rural Development, and Disaster Risk Management Division (RND); Transport Division (TSP); Water and Sanitation Division (WSA); and the Emerging and Sustainable Cities Initiative (ESCI).

3. Strengthen the design of operations by: (i) conducting more rigorous institutional assessments; (ii) performing more realistic analyses of governance and financial sustainability; and (iii) engaging fiduciary staff more intensively in the design of execution, disbursement, and procurement mechanisms and plans for investment projects.	**Partially agreed.** Management agrees with OVE's recommendation to strengthen the design of operations, but would like to reiterate that it is already giving priority to the issues highlighted in the recommendation: (i) *Institutional assessments*. The institutional capacity assessment of executing agencies is being conducted systematically in accordance with the Bank's current model for these purposes (the Institutional Capacity Assessment System (ICAS)). This model is based on the analysis of the planning, organizational management, personnel management, goods and services management, financial management, and internal and external control systems. Efforts will continue to improve the quality of institutional assessments under the new country strategy; (ii) *Risk analysis*. Similarly, resources will continue to be allocated for conducting and improving project risk analyses; and (iii) *Engagement of fiduciary staff in the design of execution mechanisms and plans*. The participation of fiduciary staff has been maintained in 100% of IDB-financed projects in Honduras, both in the design and during the execution of operations. This will continue during the next strategy period. In addition, as OVE points out in the CPE, strengthening the Country Office in terms of specialists, and the improvement in risk-based portfolio management achieved during the evaluation period will allow the strengthening of the design and execution of operations to continue.
4. Devote greater efforts to building management capacity (e.g., human resources, financial and budgetary management, procurement, etc.) in the institutions responsible for projects in execution (e.g. DEI, the Police, SEFIN, SESAL, SOPTRAVI, etc.) and consider making disbursements for future policy-based loan operations contingent on effective changes in the management capacity of key institutions and in the institutional framework of their respective sectors in order to improve their governance.	**Partially agreed.** Management would like to note that the management capacity of the institutions responsible for projects being executed has been strengthened through the training of staff on financial and budget matters, as well as on issues specific to the intervention area. In this regard, the Bank is playing a central role in the dissemination of knowledge (courses, seminars) aimed at strengthening the government's capacities. Management agrees on continuing these efforts, while noting that they have been under way since implementation of the 2011-2014 strategy. However, it recognizes that there is room to deepen support in this area. In this regard, the Bank is considering a series of measures to improve execution, which will be set out in detail in the new country strategy. These measures will be aimed at deepening the efforts undertaken to date, such as, for example, in the following areas: (i) tailoring the design of operations to the counterparts' capacities; (ii) coordinating with the borrower in order to anticipate risks; and (iii) deepening training processes in integrated and results-based management in the project executing units. With respect to making disbursements for PBLs contingent upon changes in the management capacity of institutions, this is feasible provided that it is consistent with the Bank's policies and current national legal frameworks. Decisions on the content of operations will be determined in accordance with the programmatic dialogue with the authorities. It is also important to bear in mind that achieving sustainable institutional changes requires a combination of PBLs and technical assistance.

5. Include in future country strategies the sectors corresponding to each country's existing portfolio in order to facilitate their execution and the continuity of the relevant dialogue, as OVE has recommended in prior CPEs.	**Agreed.** We agree that the design of the country strategy has to consider the portfolio in execution. Management is currently engaged in a process of revising the methodology for preparing the country strategies and programs, in consultation with the Board. This exercise is being done in the framework of implementation of the recommendations stemming from OVE's IDB-9 evaluation.

DEVELOPMENT EFFECTIVE MATRIX

COUNTRY STRATEGY: DEVELOPMENT EFFECTIVENESS MATRIX

In August 2008, the Board of Executive Directors approved the Development Effectiveness Framework (document GN-2489) to increase the evaluabiliy of all Bank development products.
The Development Effectiveness Matrix for Country Strategies (DEM-CS) is a checklist of the elements that are necessary to evaluate a country strategy. It is based on the evaluation criteria developed by the Evaluation Cooperation Group of the Multilateral Development Banks in the "Good Practice Standards for Country Strategy and Program Evaluation."

COUNTRY STRATEGY:

STRATEGIC ALIGNMENT Measures two dimensions: (i) the extent to which the objectives of the strategy are consistent with the country's development challenges and with the government's priorities and plans; and (ii) use of a mix of products (financial, knowledge, technical assistance) to attain the objectives, and identification of other cooperation agencies and their areas of action:

Consistency of strategic objectives: The objective of the Bank's new country strategy with Honduras is to support government efforts to boost stagnant production and low growth; reduce gaps in the generation and accumulation of human capital, particularly in rural areas, and achieve real social inclusion (through coordinated interventions in social protection, health, and education); and improve the quality of life and standard of living in urban areas.

To this end, the Bank will provide support in the following areas: (i) fiscal consolidation; (ii) sustainability and competitiveness in the energy sector; (iii) road infrastructure for regional integration; (iv) social inclusion; and (v) sustainable development in the Central District.

All of the selected areas address development challenges, are consistent with the priorities set by the Honduran government, and derive from the dialogue between the country and the Bank.

Mix of products and participation of other donor institutions: The strategy plans to use various Bank instruments, such as sovereign guaranteed operations, non-sovereign guaranteed operations, and technical cooperation operations. The strategy takes into consideration the interventions of other multilateral and bilateral donor institutions (such as the World Bank, CABEI, USAID, and AECID) and calls for coordinating interventions with other development organizations.

EFFECTIVENESS *This measures whether the country strategy is likely to achieve its intended objectives, through an examination of four dimensions: (i) the quality of the diagnostics on which Bank action is based in each area of work; (ii) the quality of the results matrix for the strategy; (iii) the use and build-up of country systems; and (iv) the analysis of the lending framework:*

Effectiveness dimensions	%
I. Sector diagnostics	
- Identifies the main problems based on empirical evidence	100%
- Identifies the main beneficiaries	100%
- Identifies and measures the factors that contribute to the problems identified	80%
- Presents the policy framework and a sequence for Bank interventions	100%
- The diagnostic corresponds to the objectives presented in the strategy	100%
II. Results matrix	
- Expected outcomes are clearly defined	100%
- Indicators are outcome indicators and are SMART	96%
- Indicators have baselines	100%

Five sector notes supporting the strategy were presented. All of the notes have been validated.

-100% of the notes clearly identify the main sector problems based on empirical evidence.
-100% of the notes identify the potential beneficiaries in each area of intervention.
-80% of the notes identify or measure the factors that contribute to the problems identified.
-100% of the notes identify the policy framework and a sequence for Bank actions.
-In 100% of the notes the subjects dealt with are consistent with the Bank's strategic objectives.

Results matrix: The results matrix contains 11 strategic objectives for Bank action and 23 indicators to measure progress towards the proposed objectives.

- 100% of the strategic objectives clearly identify expected outcomes.

- 96% of the indicators used are outcome indicators and are SMART; the remaining 4% are not adequate for measuring the expected outcome or require greater specificity.

- 100% of the indicators have baselines.

Country systems: In relation to the fiduciary systems (financial management and procurement), for preparation of the Bank's country strategy with Honduras (2015-2018), the following financial management subsystems were evaluated: budget, cash management, accounting and reporting, external audit, and internal audit. None of the procurement subsystems or nonfiduciary country systems were evaluated.

During the country strategy period, the following financial management subsystems are expected to be used: budget, cash management, accounting and reporting, and external audit.There are no plans to use the internal audit country subsystem. In terms of the use of procurement subsystems, the information and purchasing subsystems are expected to be used. In addition, there are plans to use the country systems for statistics and monitoring and evaluation. During the strategy period, the purchasing and information subsystems in the area of procurement and the external control subsystem in the area of financial management will be strengthened.

Financing framework: The strategy contains an analysis of the country's financing requirements and provides a single scenario for sovereign guaranteed lending. The financial framework is consistent with the macroeconomic projections and the country's financing strategy.

RISKS This measures three dimensions: (i) identification of factors that affect or might affect attainment of the proposed objectives; (ii) definition of mitigation measures; and (iii) monitoring mechanisms:

The strategy identifies the risks associated with Bank participation in each of the strategic sectors and identifies mitigation measures. It also identifies macroeconomic, institutional, and natural disaster-related risks that could affect implementation of the country strategy, along with measures to mitigate these risks.