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# HONDURAS

# EMERGENCY PROGRAM FOR MACROECONOMIC AND FISCAL SUSTAINABILITY

**(HO-L1215)**

**LOAN PROPOSAL**

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## ABBREVIATIONS

| | |
|---|---|
| AML/CFT | Anti-money laundering / combating the financing of terrorism |
| BANADESA | Banco Nacional de Desarrollo Agrícola |
| BANHPROVI | Banco Hondureño de la Producción y la Vivienda |
| BCH | Banco Central de Honduras [Central Bank of Honduras] |
| BVM | Bono Vida Mejor ["Better Life" voucher] |
| CABEI | Central American Bank for Economic Integration |
| COVID-19 | Coronavirus disease 2019 |
| EMBIG | Emerging Market Bond Index Global |
| ENEE | Empresa Nacional de Energía Eléctrica [National Electric Power Company] |
| EPBA/DSF | Enhanced Performance-based Allocation/Debt Sustainability Framework |
| FFF | Flexible Financing Facility |
| IMF | International Monetary Fund |
| MSMEs | Micro, small, and medium-sized enterprises |
| NFPS | Nonfinancial public sector |
| OC | Ordinary Capital |
| SAR | Servicio de Administración de Rentas [Revenue Administration Service] |
| SARS-CoV-2 | Severe acute respiratory syndrome coronavirus 2 |
| SBA | Stand-by Arrangement |
| SCF | Stand-by Credit Facility |
| SDL | Special Development Lending |
| SDR | Special drawing rights |
| SEDIS | Ministry of Development and Social Inclusion |
| SEFIN | Ministry of Finance |
| SIAFI | Sistema Integrado de Administración Financiera [Integrated Financial Administration System] |
| SSIS | Sub Secretaría de Integración Social [Office of the Undersecretary for Social Integration] |
| TC | Technical cooperation |
| UNDP | United Nations Development Programme |
| WHO | World Health Organization |

## PROJECT SUMMARY

## HONDURAS
## EMERGENCY PROGRAM FOR
## MACROECONOMIC AND FISCAL SUSTAINABILITY
## (HO-L1215)

**Financial Terms and Conditions**

| **Borrower** | | |
|---|---|---|
| Republic of Honduras | | |
| **Executing agency** | | |
| Ministry of Finance (SEFIN) | | |
| **Source** | **Amount (US$)** | **%** |
| **IDB (Regular OC):** | 26,670,000 | 35 |
| **IDB (Concessional OC):** | 49,530,000 | 65 |
| **Total:** | 76,200,000 | 100 |

| **Special Development Lending**[a] | | |
|---|---|---|
| | **Regular OC (FFF)** | **Concessional OC** |
| **Amortization period:** | 7 years | 40 years |
| **Disbursement period:** | 1 year | |
| **Grace period:** | 3 years | 40 years |
| **Interest rate:** | 3-month LIBOR in U.S. dollars, plus/minus the IDB lending spread, plus the variable interest spread for OC resources, plus the fixed premium on the lending spread of 115 basis points[a] | 0.25% |
| **Front-end fee:** | 1% | N/A |
| **Credit fee:** | 0.75%[a] | N/A |
| **Weighted average life:** | 5 years | N/A |
| **Currency of approval:** | United States dollars | |

**Project at a Glance**

**Project objective/description:** The general objective of the program is to preserve macroeconomic stability by supporting the policies pursued by the Government of Honduras to confront the COVID-19 pandemic. The specific objectives are: (i) to ensure the sustainability of public finances while safeguarding social spending; and (ii) to ensure monetary and financial stability by strengthening the respective institutional frameworks.

The program's objectives and components are aligned with the IMF stand-by arrangement (SBA) approved on 15 July 2019 and are synchronized with the most recent review of the arrangement approved on 1 June 2020. The program is structured under the Special Development Lending (SDL) category as a single operation to be disbursed in a single tranche. The SDL budget support will contribute to finance the efforts to contain the COVID-19 pandemic, mitigate its impact on vulnerable households, and promote countercyclical policies to reduce its effect on the economy in the short term.

**Policy actions and disbursement of the loan proceeds:** The sole disbursement of the loan proceeds will be made in accordance with the terms established in the Loan Contract to be signed between the borrower and the Bank, including the provision requiring that proceeds from the SBA approved by the IMF are being or have been disbursed. Disbursement will be contingent on fulfillment of the policy conditions outlined in the Policy Matrix (Annex II) and Policy Letter (see paragraph 4.2).

**Exceptions to Bank policies:** None.

**Strategic Alignment**

| | | | |
|---|---|---|---|
| **Challenges:**[b] | SI ☒ | PI ☐ | EI ☐ |
| **Crosscutting themes:**[c] | GD ☐ | CC ☐ | IC ☒ |

[a] Under the category of Special Development Lending (SDL) (document AB-3134) and its Operational Guidelines (document GN-2031-17), this operation will be documented under the Flexible Financing Facility with limited debt management options. The borrower has the option of requesting currency, interest rate, and commodity conversions. The Bank will take operational and risk management considerations into account when reviewing such requests. The applicable amortization schedule for this loan will consist of equal, six-monthly installments that begin to accrue at the end of the grace period.

[b] SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

[c] GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

# I. PROJECT DESCRIPTION AND RESULTS MONITORING

## A. Background, problem addressed, and rationale

1.1 In recent years Honduras has made significant strides in strengthening its macrofiscal policy framework in a context of stable economic growth: its economy averaged 3.7% growth from 2014 to 2019, ahead of the average of Latin America and the Caribbean (1.4%). With implementation of the Fiscal Responsibility Law in 2016, the Honduran government established an institutional structure for the fiscal consolidation process: at the level of the nonfinancial public sector (NFPS), current expenditure fell (from 31.6% of GDP in 2013 to 26.5% in 2019), and tax revenue rose (from 15.3% of GDP to 18.3%) narrowing the fiscal deficit (from 7.5% of GDP in 2013 to -0.9% in 2019) and thus stabilizing the public debt below 45% of GDP. As a result, confidence improved and the country's sovereign debt spreads thinned, which translated to better financial terms for the private sector and public investment.[1] Honduras also reformed its energy regulatory framework and reduced losses at the National Electric Power Company (ENEE) by trimming the ENEE's financial deficit (from 1.8% of GDP in 2013 to 1.0% in 2019). In addition, Honduras introduced measures to modernize its monetary policy framework, lowering inflation (from 5.6% in 2010-2013 to 4.1% in 2014-2019) while strengthening the institutional framework for the financial system[2] (see Table 1).

1.2 Despite this progress, Honduras faces significant public-policy challenges in its path to inclusive economic growth. It remains one of the region's poorest countries, which has an impact on the country's levels of violence and emigration.[3] It has the third-lowest per capita income in Latin America and the Caribbean, with high inequality (Gini coefficient of 0.52 in 2019) and a sizable gap between urban and rural areas (8.8 percentage points). Spending on social programs is low (1.9% of GDP in 2018), and leakages to nonpoor households are on the order of 0.5% of GDP.[4] Open unemployment has deteriorated (from 5.3% in 2014 to 5.7% in 2019) and is particularly high among women and young people. Underemployment[5] has risen (from 27.7% in 2014 to 50% in 2019), and 80% of the workforce is in the informal economy.

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[1] In view of this strong macrofiscal performance, Standard & Poor's and Moody's upgraded their respective risk ratings and outlooks for Honduras to BB-/stable in 2018-2019 (from B+/stable in 2014) and B1/stable (from B3/stable in 2014).

[2] Financial system supervision capacity was strengthened in line with the Basel III standards and the recommendations made in the Financial Sector Stability Report of the International Monetary Fund (IMF).

[3] Although the economy grew, and social programs expanded, the moderate and extreme poverty rates remain high (59.3% and 36.7%, respectively, in 2019), with a disproportionate impact on young people (66%).

[4] Székely, M. (2018). *Recomendaciones en el tema de calidad del gasto público en los países del Triángulo Norte: Focalización del gasto en Honduras*, 2018.

[5] Percentage of the population who are employed full-time but earning less than minimum wage.

**Table 1. Selected macroeconomic indicators**

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|
| **Growth and inflation** | | | | | | | |
| Real GDP growth (%) | 2.8 | 3.1 | 3.8 | 3.9 | 4.8 | 3.7 | 2.7 |
| Annual inflation (%) | 4.9 | 5.8 | 2.4 | 3.3 | 4.7 | 4.2 | 4.1 |
| **Balance of payments** | | | | | | | |
| External current account (% GDP) | -9.5 | -6.9 | -4.7 | -2.6 | -0.8 | -5.3 | -1.4 |
| Gross international reserves (US$ millions) | 3,255 | 3,698 | 4,187 | 4,488 | 5,088 | 5,147 | 6,140 |
| Terms of trade (annual %) | -3.2 | 5.5 | 12.4 | 5.1 | -2.3 | -6.1 | -0.4 |
| Remittances (% GDP) | 16.7 | 17.0 | 17.4 | 17.7 | 18.6 | 19.8 | 21.4 |
| **Public finances (central government)** | | | | | | | |
| Total revenue (% GDP) | 17.0 | 18.5 | 19.2 | 20.0 | 20.3 | 20.2 | 19.3 |
| Tax revenue (% GDP) | 15.1 | 16.5 | 17.3 | 18.3 | 18.3 | 18.5 | 17.5 |
| Current expenditure (% GDP) | 19.8 | 17.7 | 17.6 | 17.8 | 17.7 | 17.7 | 17.1 |
| Wage bill (% GDP) | 9.7 | 9.0 | 8.3 | 8.0 | 7.8 | 7.7 | 7.6 |
| Capital expenditure (% GDP) | 5.2 | 5.1 | 4.6 | 5.0 | 5.3 | 5.3 | 4.6 |
| Primary fiscal balance (% GDP) | -5.6 | -2.1 | -0.4 | -0.1 | -0.1 | 0.6 | 0.3 |
| Overall fiscal balance (% GDP) | -8.0 | -4.3 | -3.0 | -2.7 | -2.7 | -2.1 | -2.5 |
| **Public finances (NFPS)** | | | | | | | |
| Primary fiscal balance (% GDP) | -7.0 | -3.4 | 0.1 | 0.3 | 0.1 | 0.0 | 0.2 |
| Overall fiscal balance (% GDP) | -7.5 | -3.9 | -0.9 | -0.5 | -0.8 | -0.9 | -0.9 |
| Total gross debt (% GDP) | 38.6 | 39.3 | 39.2 | 40.1 | 40.1 | 42.2 | 43.1 |

Sources: IMF, SEFIN, and BCH.

1.3 In terms of fiscal policy, tax expenditure in Honduras is among the highest in the region (nearly 7% of GDP), due mainly to the numerous tax exemptions.[6] As for public spending, the wage bill remains high (8% of GDP), due to the absence of centralized wage bargaining mechanisms. Weaknesses also affect the ability to efficiently manage revenue. Five years into its existence, the Revenue Administration Service (SAR) has laid the groundwork for modern tax administration, but there is still room for improvement in compliance risk management and effective use of information to improve tax operations.[7] A significant challenge for fiscal transparency is the need for better control in managing trust funds, which account for 15% of primary expenditure but are not part of the general budget,[8] undermining effective budget planning and the ability to control how such funds are used. Also, the question of financial sustainability of

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[6] Tax expenditure in the form of exemptions to the value-added tax is equivalent to 4.1% of GDP, while income tax exemptions amount to 2.2% of GDP (IMF, Article IV consultation report for Honduras, 2019). Excessive exemptions and concessions have eroded the tax base: most exemptions disproportionately benefit high-income segments of the population and also alter the relative prices of goods.

[7] The SAR has been weakened by tax amnesties and other tax code measures limiting its efficiency in enforcing criminal penalties for tax fraud, and the audit and verification of tax exemptions is under the control of the Ministry of Finance (SEFIN). The customs administration, meanwhile, lost autonomy when it was spun off from the revenue administration (in 2016), limiting its management capacity and making it less efficient in collecting revenue.

[8] Social and infrastructure expenditure, spending by State-owned enterprises, and other budget items are currently channeled through trust funds not governed by public financial management regulations. Moreover, some of these funds give rise to additional contingencies and risks by incurring off-balance sheet debt.

State-owned enterprises jeopardizes reaching the aggregate fiscal targets. In particular, despite previous efforts[9] and progress in implementing institutional reforms in the electricity sector,[10] the ENEE's financial position has deteriorated recently.[11]

1.4 Lastly, in terms of monetary and fiscal policy, there is room to more efficiently buffer external shocks and reduce vulnerabilities in the financial sector. Honduras currently has a "crawling peg" policy,[12] but international evidence suggests that more flexible exchange rate regimes are more effective in buffering external shocks.[13,14] The financial sector's vulnerabilities are in public financial institutions and weaknesses in the sector regulatory framework. Banco Nacional de Desarrollo Agrícola (BANADESA) is in a severe financial position,[15] and loans of public pension funds[16] account for 30% to 35% of the investment portfolio, creating significant exposure to consumer credit risk. Moreover, given high levels of dollarization, the financial system needs to be strictly supervised, and the anti-money laundering / combating the financing of terrorism (AML/CFT) framework needs to be strengthened in line with the recommendations of the Financial Action Task Force, including the gathering and exchange of information on ultimate beneficiaries and continued implementation of the Basel III recommendations.

1.5 **IMF support.** To address these challenges, on 15 July 2019 the IMF approved a stand-by arrangement (SBA) for 149.88 million special drawing rights (SDR) (US$207.5 million) and an arrangement under the Stand-by Credit Facility (SCF) for SDR 74.94 million (US$103.88 million), to be treated as precautionary.[17] In

9 The ENEE's fiscal balance improved from 2014 to 2016 (-0.3% of GDP in 2016), due to a workforce adjustment amid lower oil prices.

10 See paragraph 2.7 for a more detailed description of progress in implementing structural reforms to make the ENEE more financially sustainable, and the electricity supply more operationally efficient and reliable, with the Bank's support.

11 The deficit was 1% of GDP in 2019; the debt doubled with respect to 2015 (10% of GDP in 2018); arrears in paying private generators increased significantly (1.75% of GDP in March 2019); rates are insufficient to cover the high costs; and losses are significant (35% in 2018, twice the regional average). The ENEE has persistent operational inefficiencies as well, such as a rate schedule that does not reflect costs (for generation, distribution, and transmission).

12 Honduras has three possible exchange rates at any given time: (i) one for Central Bank of Honduras (BCH) auctions; (ii) one for the foreign exchange interbank market; and (iii) the official (benchmark) exchange rate. The country also maintains two multiple currency practices: despite rules limiting deviations of more than 2% from the official exchange rate on foreign exchange transactions, there is no mechanism to prevent them.

13 Honduras: Selected Issues, IMF Country Report No. 19/237, June 2019.

14 Although the BCH has taken steps to transition to inflation targeting, the BCH's operational autonomy needs strengthening to ensure the credibility of monetary policy instruments, which become even more important with a more flexible exchange rate.

15 BANADESA has a negative capital adequacy ratio and a 70% arrears rate. While BANADESA does not pose a systemic risk for the financial system since its assets represent about 1% of GDP, and its ties to the rest of the banking system are limited, it plays a key role in enhancing access to credit for small and medium-sized agricultural producers, which constitute one of the country's leading industries.

16 These include the retirement and pension funds for executive branch employees, teachers, employees of the Universidad Nacional Autónoma de Honduras, and military service members.

17 Precautionary arrangements are employed when countries do not intend to use the approved amounts but reserve the option to request disbursements, if the need for financing arises at a later stage.

general terms, the SCF arrangement provides financial assistance to low-income countries by supporting economic programs aimed at maintaining or restoring sustainable macroeconomic conditions, consistent with the objectives of fostering growth and reducing poverty. Unlike other IMF instruments (e.g., the Rapid Financing Instrument), stand-by arrangements are structured around fulfillment of policy conditions and are subject to periodic reviews where the IMF Executive Board assesses program performance and, based on results achieved, facilitates access to program resources, so that countries can request the corresponding disbursements. In the case of Honduras, the priorities of the SBA arrangement include: (i) reforms to enhance fiscal policy, maintaining collection efforts and protecting social spending while ensuring the ENEE's financial sustainability and enhancing fiscal transparency; and (ii) strengthening of the monetary policy and financial sector framework, including measures to improve the business climate, strengthen governance, combat corruption, and AML/CFT.[18] The program is for 24 months and has satisfactorily completed two reviews.

1.6 Honduras completed the first review in December 2019 and was found to have met all quantitative performance criteria, all but one of the indicative targets,[19] and the structural benchmarks for the period (see required link 4). For example, the decree was issued creating the new customs administration and appointing its management, and an annex on spending through trust funds was included in the 2020 budget. Five additional structural benchmarks to be met in the second half of 2020 were proposed in this review.[20]

1.7 The second review, completed in April and approved on 1 June 2020 by the IMF, assessed progress on the quantitative performance indicators and indicative targets as of December 2019, and on structural benchmarks met as of March 2020. For this review, Honduras had met all quantitative performance indicators and all but one of the indicative targets[21] and had implemented many of the program's structural benchmarks (see required link 5).[22] Specifically, the floor and ceiling targets for fiscal, debt, monetary, and social spending variables were met. At the level of structural benchmarks, improvements were made in public financial

[18] The measures associated with this latter priority are slated to be introduced in the second half of 2020 and early 2021, and so are not included in this Bank program.

[19] The central government's wage bill ceiling was exceeded because seasonal variables were not factored into the indicative target.

[20] These include: (i) amending the law establishing the Court of Accounts to reform the asset declaration system for public officials (end-September 2020); (ii) issuing regulations for SEFIN's public-private partnerships unit (end-June 2020); (iii) improving procurement through the implementation of the Honducompras 2 platform at key central government agencies (late September 2020); (iv) amending the public procurement law (end-September 2020); and (v) submitting legislative proposals to create a centralized registry of beneficial ownership (late September 2020).

[21] The ENEE's ratio of income to operational expenditure was 0.98, slightly below the target of 1.02.

[22] Under the IMF conditionality framework, failure to meet structural benchmarks and indicative targets does not require a waiver for the review to be completed by the Executive Board. When a quantitative performance criterion is not met, the Executive Board can approve a formal waiver for the review to be completed, if it believes the program will be implemented successfully regardless, either because the deviation was insignificant or temporary, or because the authorities have taken corrective measures.

management,[23] including measures to strengthen the management and transparency of trust funds,[24] and in lowering transaction costs and streamlining administrative processes. The country also made progress in transitioning to a more flexible exchange rate and took steps toward implementation of inflation targeting[25] while strengthening statistics on pricing and economic activity that are critical to assessing the monetary position.[26]

1.8 In sum, the country's macroeconomic and fiscal performance through early 2020 had been strong, and significant progress had been made in implementing the IMF program. Under initial favorable growth forecasts—the BCH had projected growth as high as 2.5%—Honduras was expected to continue strengthening its fiscal position and achieve even more ambitious quantitative performance indicators and indicative targets. However, this progress is jeopardized by the impact of the COVID-19 pandemic, as described below.

1.9 **The COVID-19 pandemic and the health emergency.** Severe acute respiratory syndrome coronavirus 2 (SARS-CoV-2), which causes coronavirus disease 2019 (COVID-19), was first detected in China in late 2019 and spread rapidly to the rest of the world. On 11 March 2020, the World Health Organization (WHO) declared the disease a pandemic, and by late May 2020 there were more than five million confirmed cases and over 340,000 deaths related to COVID-19 worldwide.[27] Although the spread of SARS-CoV-2 in Latin America and the Caribbean began later than in Asia and Europe, the number of cases in the region is increasing rapidly. By late May 2020, the number of confirmed infections in Latin America and the Caribbean had reached 748,000, and the number of deaths was over 40,000.

1.10 COVID-19 is a highly contagious disease. On average, recorded cases in a country rise daily by 33%.[28] This high rate of contagion leads to spikes that can overwhelm the capacity of health systems, since sick patients require specialized medical care. To keep this from happening, social distancing and isolation have become essential measures in the public health response, since they slow the transmission of COVID-19[29] and delay demand for medical services.[30] Implementing this type of

[23] For example, SEFIN added a module to the Integrated Financial Administration System (SIAFI) to set ceilings (in line with Financial Responsibility Law targets), and the Honducompras 2 procurement platform is being gradually implemented while ensuring its integration with the SIAFI. A team was formed within SEFIN's budget office to evaluate the quality of public expenditure and implement results-based budgeting.

[24] An annex on trust fund spending was included in the 2020 budget package.

[25] These measures include: (i) an electronic platform for interbank operations, and (ii) collateralized interbank operations, as well as strengthening the BCH's technical capacity to develop a predictive analytics and policy system.

[26] The policy conditions fulfilled by the Government of Honduras in the second review of the SBA program, which was evaluated satisfactorily by the IMF Executive Board in June 2020, are reflected in the Policy Matrix (Annex II) of this operation.

[27] World Health Organization. Situation Report (2020).

[28] This means that the number of new infections more than doubles approximately every three days, if no public health measures are taken to contain the spread (Financial Times, 2020).

[29] Eichenbaum, M. S., S. Rebelo, and M. Trabandt (2020). The Macroeconomics of Epidemics (No. w26882). National Bureau of Economic Research.

[30] Hellewell, J., S. Abbott, A. Gimma, N. I. Bosse, C. I. Jarvis, T. W. Russell, et al. (2020). Feasibility of Controlling COVID-19 Outbreaks by Isolation of Cases and Contacts. Lancet 8(4):488-496.

measure is particularly important in Latin America and the Caribbean, considering that a recent WHO analysis shows that most countries of the region are unprepared to manage pandemics.[31]

1.11 The country's first case of COVID-19 appeared in early March, and by late May there had been 3,950 cases and 180 deaths. The Honduran government declared a state of emergency on 10 February 2020 (Decree PCM-005-2020) to confront the dengue crisis and the imminent COVID-19 health crisis. An emergency powers decree was issued on 16 March 2020 (Decree PCM-021-2020). A commission consisting of representatives of the government, the National Risk Management System, the National Convergence Forum, the Honduran Private Enterprise Council, and the Pan American Health Organization was formed to work alongside the Ministry of Health, private hospitals, and the WHO to develop a strategic plan that includes the use of medical equipment, medications, and logistics for the COVID-19 emergency.

1.12 **Macroeconomic repercussions.** On top of the economic slowdown that Honduras was already experiencing,[32] COVID-19 will impact the economy through multiple channels, including decreased economic activity around the world, including its main trading partners, and weaker domestic demand due to social distancing measures. Preliminary projections put Honduras's growth rate at -3.3% for 2020,[33] an even sharper contraction than in the last international financial crisis (-2.4% in 2009). The main channels of this impact are as follows:

a. **Decreased trade.** Declines are expected in exports—especially agricultural products (primarily coffee) and the maquila sector (4.4% of GDP in 2019)—as well as imports, particularly with the country's main trading partners. The United States accounts for 36.7% of total exports, followed by Europe (26.4%), Central America (22.2%), and the rest of the world (12.7%). Imports from China and the United States account for 11.4% and 43.4%, respectively, of all imported goods and services. Honduras may also be hurt by lower commodity prices, primarily coffee prices.

b. **Lower demand due to less remittances.** About 55% of Honduran families depend on remittances as their main source of income to cover basic needs for food, housing, education, and health care, and 86% of remittances come from the United States, one of the countries hardest hit by COVID-19. Remittances as of April 2020 had fallen 28.5% year-on-year, and the BCH projects that remittances in 2020 will be 14% below their 2019 level.[34]

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31 Operational capacity was assessed according to the percentage of fulfillment of the 13 core capacity requirements to manage public health events established in the International Health Regulations (2005), an agreement among 196 countries to develop their capacities to respond to such events.

32 GDP growth slowed from 4.8% in 2017 to 3.7% in 2018 and 2.7% in 2019 due to a deterioration in the terms of trade and a severe drought that hurt the agriculture, livestock, and energy sectors.

33 According to IMF estimates. The BCH is projecting a contraction of 2.9% to 3.9%.

34 Remittances declined 11% during the 2009 international financial crisis.

c. **Sharp decline in tourism revenue.** Due to its structure and nature, tourism is one of the sectors hardest hit by the pandemic. Tourism accounts for about 5% of all jobs in Honduras and more than 8% of GDP. Almost all hotels were shuttered as of late April, according to the Honduran Tourism Institute, which is projecting a slow recovery and a nearly 20% contraction of the tourism sector in 2020.

d. **Disrupted manufacturing value chains.** The value chains in which Honduras participates may be hurt by declining imports of intermediate goods and outputs for manufacturing production. Factories closing in the United States has driven down demand for inputs produced in Honduras. Meanwhile, with San Pedro Sula among the areas hardest hit by COVID-19, the country's manufacturing activity is limited. The sector is projected to shrink by more than 10%.

e. **Increased sovereign risk.** The Emerging Market Bond Index Global (EMBIG) spread for Honduras stood at around 250 basis points in early 2020, below the Latin American and Caribbean average. However, uncertainty surrounding the progression and impact of the virus is prompting investors to move toward "safe" assets, which raises the refinancing risks of emerging countries. Honduras's EMBIG spread widened by some 500 basis points between January and April, driving up the cost of sovereign bond issues for the country, but settled back to around 450 basis points in May.

f. **Impact on employment and poverty.** The pandemic is also expected to impact labor markets, particularly for low-income households. Anywhere from 7.9% to 21.7% of all formal-sector jobs in Honduras may be lost due to COVID-19,[35] and the large numbers of Hondurans employed in the informal economy[36] are even more vulnerable.[37] Amid falling GDP and rising unemployment, moderate and extreme poverty may increase by 3.0 and 1.7 percentage points in 2020,[38] respectively, and this impact will be exacerbated by the decline in remittances. Meanwhile, a 25% decline in earned income would raise the extreme and moderate poverty rates by 8.8 and 9.3 percentage points, respectively.[39]

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[35] IDB. *¿Cómo impactará la COVID-19 al empleo? Posibles escenarios para América Latina y el Caribe*. April 2020.

[36] An estimated 3.2 million people work in the informal sector. IDB, ibid.

[37] Despite recommendations for teleworking, Internet usage at work is less prevalent among informal-sector workers, and over 50% have no Internet access at home. Only 17.9% of the bottom income quintile has Internet access (United Nations Development Programme (UNDP), "Social and Economic Impact of the COVID-19 and Policy Options in Honduras," March 2020).

[38] Economic Commission for Latin America and the Caribbean (ECLAC). *El desafío social en tiempos del COVID-19*. Special Report No. 3, May 2020.

[39] UNDP, ibid.

1.13 **Pandemic response actions.** Once the first COVID-19 cases were confirmed, and in view of the public health system's low level of preparedness to manage pandemics,[40] the government quickly took steps to curb the spread of the virus, such as temporarily closing schools (Decree PCM-018-2020) and businesses, canceling events, suspending public transportation, closing borders, etc. (Decree PCM-021-2020). These steps have been supplemented with health measures to strengthen prevention and control and mitigate the economic impact of the crisis, as described below:

a. **Health measures.** Approval was issued for: (i) COVID-19 care and treatment for the entire population (Decree PCM-005-2020); and (ii) price ceilings on basic cleaning and personal hygiene products (Decree PCM-030-2020). Congress also passed legislation for an additional US$420 million (1.6% of GDP) to be spent on new health care infrastructure (hospitals and medical centers) (Decree PCM-031-2020).

b. **Fiscal measures.** Temporary measures were approved for expenditure reallocation (Decree PCM-020-2020) to procure goods, incur health expenditures, and provide food support ("solidarity sacks" of food distributed to 800,000 families, or one third of the population). The government was also authorized to secure financing and redistribute or reallocate up to US$2.5 billion in external funding (10% of GDP), if necessary, in fiscal years 2020 and 2021 (Decree 033-2020). The following temporary tax measures were introduced (Decree 033-2020): (i) deferment of tax and fee payments; (ii) a tax exemption on imports of all basic goods, medical equipment, and medications; and (iii) a special deduction for employers keeping their employees during the lockdown, as well as unemployment benefits (for formal-sector workers).

c. **Monetary policy measures.** The BCH adopted a series of measures to ease the country's financial conditions (Press Release 13-2020 and Press Release 19-2020), including: (i) cutting the monetary policy rate by 75 basis points to 4.5%; (ii) cutting the interest rate on standing credit facilities from 6.25% to 5.5%; (iii) continuing to offer repo operations to the financial system, lowering the rates from 7% to 6.25%; (iv) cutting the mandatory local currency investment requirement from 3% to 0%; and (v) temporarily suspending the daily auctions of BCH bills of exchange and the structural auctions of BCH securities (in the second quarter of 2020), which will have the effect of injecting liquidity on the order of 3.5% of GDP.

d. **Credit measures.** Approved measures (Decree 033-2020) include: (i) grace periods for debtors of Banco Hondureño para la Producción y Vivienda (BANHPROVI) (which serves the agriculture and tourism sectors as well as micro, small, and medium-sized enterprises (MSMEs); (ii) refinancing or restructuring of loans from regulated financial institutions; (iii) a fund for additional financing and capitalization through BANHPROVI for MSMEs

[40] Honduras scored 27.6 (out of 100) on the Global Health Security Index, trailing the global average (40.2), the Latin American and Caribbean average (38.1), and the average for other middle-low income countries (35.8) (Johns Hopkins Center for Health Security, 2019).

(Decree PCM-017-2020); and (iv) a guarantee fund for the recovery of MSMEs affected by COVID-19, under the leadership of the BCH.

e. **Plan for Smart Reopening of the Economy.** The Council of Ministers formed a multisector body entity comprised of private enterprise, civil society, churches, the academic sector, maquila operations, the agriculture sector, and the government to lead the reopening of the economy (Decree PCM-045-2020). This multisector panel recommended a 75-day phased reopening process starting on 8 June 2020, with a differentiated approach for three regions based on the COVID-19 infection rate and population density. During the preparatory phase, health care capacity will be strengthened at the municipal level, including personal protective equipment for health workers and supplies for ambulatory and hospital care. Guidelines for the phased reopening are as follows: (i) five phases in Region 3 (high infection rate, high population density), starting with the return of 20% of the workforce and adding another 20% every two weeks, until 100% capacity is reached within 75 days; (ii) four phases in Region 2 (medium infection rate, medium population density), starting with 40% of the workforce and adding in 20% increments over a 60-day period; and (iii) three phases in Region 1 (low infection rate, low population density), starting with 60% of the workforce and adding in 20% increments over a 45-day period.

1.14 **Impacts on the fiscal position.** The Medium-term Macrofiscal Framework, introduced early this year, calls for a deficit level consistent with the Fiscal Responsibility Law, i.e., holding the NFPS deficit below 1% of GDP. Due to the COVID-19 shock, however, the NFPS deficit[41] is expected to temporarily widen from -0.9% of GDP in 2019 to 4% in 2020.[42] This would push the debt to 47.8% of GDP, more than 4 percentage points higher than in 2019. The widening of the deficit reflects the drop in tax revenue,[43] due to the economic contraction, and increased public spending to cover additional health and social assistance expenditure (estimated at 2% of GDP), partially offset by budget reallocations. Table 2 summarizes the expected impacts of the COVID-19 pandemic on the main fiscal aggregates of the NFPS.

41 The fiscal deficit of the central government will rise above 6% of GDP in 2020, twice the level projected early this year in the Medium-term Macrofiscal Framework.

42 Article 4 of the Fiscal Responsibility Law includes an "escape clause" allowing fiscal rules to be waived in the event of a national emergency, catastrophe, and/or economic recession. Congress invoked this clause on 14 May to suspend the original numerical targets for a two-year period, and new ceilings were set for the exception period 2020 and 2021 (Decree 55-2020).

43 According to these estimates, tax revenue will drop by nearly 3 percentage points of GDP from the target projected early this year as part of the Medium-term Macrofiscal Framework 2021-2024.

**Table 2. Impacts of the COVID-19 pandemic on public finances at NFPS level (% GDP)**

| | 2019 | 2020 | | Change (pre- to post-COVID-19) |
|---|---|---|---|---|
| | | Pre-COVID-19 | Post-COVID-19 | |
| Total revenue | 31.2 | 31.9 | 29.5 | -2.4 |
| Tax revenue | 18.3 | 18.5 | 16.5 | -2.0 |
| Total expenditure | 32.0 | 32.9 | 33.5 | 0.6 |
| Current expenditure | 28.3 | 28.7 | 29.6 | 0.9 |
| Capital expenditure | 3.8 | 4.2 | 3.9 | -0.3 |
| Fiscal balance | -0.9 | -1.0 | -4.0 | -3.0 |
| Total gross debt | 43.1 | 43.2 | 47.8 | 4.6 |

Source: IMF.

1.15 **Financing needs.** The projected widening of the fiscal deficit creates a need for an additional US$850 million (relative to the pre-COVID-19 scenario) in financing for the central government. This brings total financing needs to approximately US$2.85 billion for 2020.[44] Due to constraints in the international financial market, multilateral institutions will account for 40% of this financing, with the rest to be covered by other external, bilateral, and internal sources. Sources of multilateral finance include the World Bank, the Central American Bank for Economic Integration (CABEI), and the IMF, in addition to the IDB's response, as noted in Table 3 (see paragraph 2.11).[45] These resources will be used in part to finance additional health and social assistance expenditure as part of the COVID-19 response, as well as to cover debt repayments in 2020. The IDB's support accounts for one fifth of the multilateral financing listed here (1% of GDP).

**Table 3. Sources of multilateral finance**

| Source | Amount (US$ millions) | Status |
|---|---|---|
| International Monetary Fund (IMF)* | 462 | In execution |
| Central American Bank for Economic Integration (CABEI)** | 300 | Approved |
| World Bank | 139 | Approved |
| IDB (Special Development Lending loan) | 76.2 | In preparation |
| IDB (Programmatic policy-based loans)*** | 171.6 | Approved and disbursed |
| **Total** | **1,148.8** | **4.7% of GDP** |

* Including US$143 million disbursed in March 2020 with the remainder to be disbursed later during the rest of the year.
** Including US$100 million for BANHPROVI.
*** Including the Central District Water and Sanitation Services Reform Program (loans 4878/BL-HO and 4879/KI-HO, 2019) and the Honduras Transportation and Freight Logistics Sector Reform Program II (loan 5017/BL-HO, 2020). Both programs were designed prior to the COVID-19 emergency. The disbursed resources support the Government of Honduras in covering total financing requirements for 2020.

1.16 **Fiscal convergence actions.** Once the COVID-19 crisis recedes, the government expects to gradually resume the path of deficit reduction in 2021, to meet the target of a 1% NFPS deficit in 2022 and thereafter, as required by the Fiscal Responsibility Law. In this convergence scenario, Honduras is expected to be able to resume average 4.5% growth in 2021-2022, with tax revenue intake recovering

[44] Debt repayments account for US$1.212 billion of this amount.

[45] See Uses and Sources of Public Sector financing, 2020 for a breakdown of sources of external (multilateral and bilateral) and internal financing for 2020.

to pre-crisis levels in 2022 while tapering the public spending stimulus measures introduced during the pandemic.

## II. ELIGIBILITY CRITERIA

2.1 In view of heightened needs for health care and social spending to protect the well-being of Hondurans, along with the associated fiscal fallout and financing needs, Honduras requested on 31 March 2020 an initial disbursement of US$143 million under the IMF stand-by arrangement (SBA). Based on the country's progress in implementing these arrangements as of March 2020, the IMF increased its support under the program to US$530 million, and Honduras may request a second disbursement as of 1 June 2020 upon successful completion of the second review by that date. In all, the IMF is expected to have disbursed US$462 million by the end of 2020 (see Table 3).

2.2 In this context, Honduras has requested emergency support from the Bank, taking the form of this Special Development Lending (SDL) loan to be disbursed in a single tranche. The structure and content are aligned with the SBA, and the SDL Policy Matrix reflects the implementation progress noted in the second review, approved on 1 June 2020 by the IMF Executive Board (see paragraph 2.5). This SDL offers Honduras additional support to restore macroeconomic sustainability by aiding efforts to curb the spread of COVID-19, while advancing the fiscal consolidation process, implementing structural measures to strengthen NFPS institutions and enterprises, strengthening mechanisms to buffer external shocks, and protecting social spending targeted to vulnerable populations, mainly through conditional cash transfers or similar programs, including childcare services, early childhood support, lending to women, and support for people with disabilities and returning migrants. These programs are key to supporting vulnerable households affected by the health crisis and the lockdown measures impacting production.

2.3 **Eligibility criteria for SDL loan.** The SDL category, established in the Proposal to Create a Special Development Lending Category (document AB-3134), approved by the Board of Governors on 30 June 2017 pursuant to Resolution AG-9/16, and its Special Development Lending Category Operational Guidelines (document GN-2031-17), is a budget support lending instrument for dealing with macroeconomic crises[46] and preserving social gains and economic growth in the countries of the region. The Government of Honduras meets the eligibility criteria for this loan (document AB-3134) because Honduras: (i) is experiencing a macroeconomic crisis[47] (see paragraphs 1.12, 1.14, and 1.15); (ii) has a lending arrangement approved by the IMF; and (iii) has a low risk of debt distress according the debt sustainability framework of the World Bank and IMF for

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46 Defined as "a situation in which a country lacks or potentially lacks sufficient financing on affordable terms to meet its net international payments, such as paying imports or external debt redemptions, while maintaining prudent reserve buffers" (document GN-2031-17).

47 The economy will contract significantly in 2020, and financial market conditions make it prohibitive to issue bonds on the international market.

low-income countries (see required link 6).[48] The SBA was approved by the IMF on 15 July 2019 for an original amount of about US$311.3 million (including the Stand-by Credit Facility (SCF)).[49] The April 2020 debt sustainability analysis found that Honduras has a low risk of debt distress, since all solvency and liquidity indicators for external and overall public debt are below the indicative thresholds[50] in both baseline and alternate scenarios for the projection period (see required link 6).

2.4 The operation also contributes to the objective of the SDL instrument to protect social gains and economic growth. The operation's proceeds, despite being for budget support, and thus untied, will contribute directly to the financing of measures to protect the income of the most vulnerable populations in the near term. The instrument also supports the government's efforts to continue implementing structural reforms in order to improve the country's medium-term growth outlook.

2.5 The Policy Matrix for this program includes the quantitative performance criteria, indicative targets, and structural benchmarks of the SBA program with the IMF, which reflect the progress under the SBA program as noted in the most recent review, approved in June 2020[51] (see the required link 5). All policy conditions of the SDL program have been met, are aligned with the SBA, and entail no additional transaction costs for the Honduran government, since all means of verification for this program are the same as agreed upon and validated by the authorities, the IMF, and the Bank.[52]

2.6 **The Bank's operational work and technical support in the country and lessons learned.** The Bank has supported the government in designing and implementing structural reforms to strengthen fiscal policy and management, ensure the financial sustainability of the National Electric Power Company (ENEE), and enhance the social protection system, all in line with the priorities of the country's program with the IMF. On the fiscal front, after supporting the Government of Honduras in designing the Fiscal Responsibility Law and

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48 The IMF and World Bank debt sustainability analysis for low-income countries classifies a country's risk of debt distress into one of four categories: (i) low; (ii) moderate; (iii) high; or (iv) "in debt distress." This assessment looks at a variety of solvency and liquidity indicators of external public debt relative to benchmark thresholds based on the country's debt-carrying capacity (strong, medium, or weak).

49 As noted, in view of progress in implementing the program and greater financing needs, the IMF increased the size of the program to US$530 million in June 2020.

50 These thresholds are: (i) present value of external public debt below 240% of exports; (ii) present value of external public debt below 55% of GDP; (iii) external debt service below 21% of exports; (iv) external debt service below 23% of fiscal revenue; and (v) present value of total public debt below 70% of GDP.

51 Due to this timing, the Policy Matrix only includes conditions agreed upon with the IMF and fulfilled that have been included in the second review under the SBA/SCF. Conditions verified in the first review or scheduled for verification in future reviews are not included.

52 Some of the structural benchmarks under the SBA were not met on time and were rescheduled by the IMF in agreement with the government and therefore are not included in this operation. These benchmarks include: (i) transferring the management of tax exemptions from the Ministry of Finance (SEFIN) to the Revenue Administration Service (SAR); (ii) allowing the SAR to send taxpayers electronic notifications of procedural information; (iii) streamlining tax exemptions; (iv) establishing a centralized wage bargaining mechanism for the public sector; (v) submitting a legislative bill for simplified administrative procedures; and (vi) submitting a new law on the securities market to Congress.

implementing the new Revenue Administration Service (SAR),[53] the investment project "Tax Administration Institutional and Operational Strengthening" (loan 3541/BL-HO, 2015) is supporting the sustainability of recent improvements in tax revenue levels.[54] Meanwhile, the Bank is supporting the Ministry of Finance (SEFIN) through a set of technical cooperation (TC) operations to enhance fiscal transparency and manage fiscal risks (operation ATN-OC-17092-HO, 2018), develop mechanisms to improve the quality of public expenditure (operation ATN/OC-17686-HO, 2019), and improve management of public investments (operation ATN/OC-17107-HO, 2018). For public procurement, operation ATN/KR-17698-RG (2019) supported the creation of a digital dashboard of reference prices, as well as a pilot initiative to develop a price tracker for medical supplies, which is an essential tool for the current COVID-19 emergency.

2.7 As part of its support for the electricity sector, the Bank is supporting reforms to enhance the financial sustainability, operational efficiency, and reliability of the electricity supply. The series "Programmatic Support for Structural Reforms of the Electricity Sector" (loans 3386/BL-HO, 2014; 3619/BL-HO, 2015; and 4448/BL-HO, 2017) made progress in reducing the ENEE's deficit and losses while creating and putting the Electric Power Regulatory Commission into operation, as well as strengthening other key components of electricity reform: (i) implementation of rules for distribution and transmission services and for setting provisional rates, which is key to the ENEE's financial recovery; (ii) creation of the service operator responsible for ensuring a continuous, reliable electricity supply and system operation; and (iii) supporting the spin-off of the ENEE into three subsidiaries—generation, transmission, and distribution—to make the sector more efficient. Additionally, a set of TC operations, now in execution, are supporting proposals for the financial restructuring of the ENEE and improved sector planning and operations as a whole.[55] In the context of the COVID-19 pandemic, strengthening of the electricity sector is essential, to prevent additional fiscal strains.

2.8 In the area of social protection, the Bank has supported implementation of the Bono Vida Mejor ["Better Life" voucher] (BVM) program[56] since its inception. This program provides conditional cash transfers to households living in extreme poverty and promotes access to education, health care, and nutrition.[57] The programmatic series "Social Protection Reform Support Program I and II" (loans 4613/BL-HO, 2018; and 4877/BL-HO, 2019), supported measures to make

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53 Fiscal Consolidation Support Program (loan 3590/BL-HO, 2015).

54 These improvements were achieved by updating tax procedures, modernizing technological systems and infrastructure, and strengthening human resources. The SAR's new human resources policy helped to recruit more than 1,000 new staff members through a transparent and rigorous selection process. This has led to higher levels of professionalization at the agency: 60% of its staff have attended higher education, and 6% have a postgraduate degree.

55 Operations ATN/OC-16508-HO (2017), ATN/OC-16427-HO (2017), ATN/SX-16689-HO (2018), and ATN/OC-17745-HO (2019).

56 Created in 2010 under the name "Bono 10,000," the BVM program is administered by the Office of the Undersecretary for Social Integration (SSIS) at the Ministry of Development and Social Inclusion (SEDIS). The BVM program provides a conditional cash transfer against fulfillment of coresponsibilities in health, education, and nutrition.

57 In 2019, the BVM program reached 254,039 households, or 37% of all households in extreme poverty that include children; 85% of BVM program households are in rural areas.

the BVM program more sustainable[58] by increasing its financing with local funds (from 18% in 2014 to 80% in 2019) and improving its targeting. Support was also provided to update the methodology for measuring monetary poverty, making it possible to share information on the design of poverty reduction policies and programs and leverage lessons learned from previous operations to benefit the most vulnerable population.[59] The program "Support for the Comprehensive Social Protection System" (loan 5008/BL-HO, 2020) will contribute to strengthening and expanding the BVM program's comprehensive intervention model by financing the BVM and basic services for education and health in the country's poorest municipios, as well as restructuring the social protection floor by evaluating, prioritizing, and coordinating interventions. Amid the COVID-19 pandemic, the program will strengthen basic health services in the poorest municipios and expand the BVM program's coverage and operational capacity as a way of protecting the households most vulnerable to the impact of the pandemic. In summary, the Bank's support through the aforementioned operations, including technical cooperation, shows the importance of ongoing technical and financial assistance and offers complementary support to ensure fulfillment of the policy conditions of the IMF program.

2.9 **The Bank's experience in the region and lessons learned.** The Bank has experience assisting the countries of the region in overcoming macroeconomic crises. The Bank recently provided SDL support to the Government of Ecuador for its efforts to reestablish macroeconomic stability, restore fiscal sustainability, and safeguard social spending for the vulnerable population through the Emergency Program for Macroeconomic Sustainability and Prosperity (loan 4771/OC-EC, 2019). Similarly, in Barbados, the Macroeconomic Emergency Programme to Protect Economic and Social Progress (loan 4656/OC-BA, 2018) supported the government in reestablishing macroeconomic stability and promoting a sustainable fiscal balance in the short and medium term, while protecting social spending to safeguard social gains. Both operations were approved in conjunction with IMF macrofiscal support. Lastly, as part of its immediate response to the COVID-19 pandemic in the region, the Bank has recently supported El Salvador through the Emergency Program for Macroeconomic and Fiscal Sustainability (loan 5033/OC-ES, 2020).

2.10 Lessons learned from this experience and incorporated into the design of this operation include the following: (i) the Bank's SDL instrument is an effective vehicle for channeling budget support resources swiftly in crisis situations; (ii) its main value-added, other than financial, is that it leverages and strengthens the IMF program and adds a layer of technical support to help the government carry out the agreed measures; and (iii) the TC assistance and ongoing dialogue with the authorities to support fulfillment of the commitments with the IMF play an important role. To provide close technical support to SEFIN, a combination of Regional and Client Support TCs is planned that will contribute to fiscal

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58 Executive Decree 021/2018 required that at least 10% of the Poverty Reduction Fund be allocated to the BVM program. In 2019, 15.5% of this fund was allocated to the BVM program.

59 The Social Protection System Support Program (loan 3371/BL-HO, 2014) financed the BVM program and expanded access to the third cycle of basic education (grades 7-9) in 84 municipios. The Program to Support the Social Inclusion Network with Priority in Western Honduras (loan 3723/BL-HO, 2016) expanded basic health services and BVM program coverage in 33 poor municipios.

strengthening in the post-pandemic period and to achievement of expected outcomes of this operation (see paragraph 2.13).

2.11 **Coordination with other donors**. Since the SDL instrument requires that an IMF program be approved and disbursing funds, ongoing coordination with the IMF mission team for Honduras was necessary in the preparation of this operation.[60] The Bank is also actively coordinating with other donors contributing financing for the emergency, such as the World Bank and the Central American Bank for Economic Integration (CABEI) (see Table 3). The World Bank operation supports the strengthening of Honduras's financial and institutional framework for better management of risks associated with adverse natural events or health emergencies. CABEI approved a contingency credit line and financing for a guarantee fund for the reopening of MSMEs affected by the COVID-19 pandemic.

2.12 **Complementarity with other Bank operations.** In the context of the Bank's immediate response to the COVID-19 pandemic in the region, in addition to the SDL financing, the Government of Honduras requested reformulation of its portfolio with the Bank for up to US$50 million, as a source of financing for the government's COVID-19 response.[61] This operation and the aforementioned investment operation (now in preparation) provide the country with additional support during the emergency, since both operations will help finance measures to contain the health crisis and mitigate the impact of the pandemic on vulnerable households in the short term.

2.13 To ensure that the policies under this operation are pursued in the medium term, the Bank is supporting Honduras in the public policy areas impacted by the SBA program: fiscal sustainability in general and State-owned enterprises in particular, tax and expenditure policy and management, and the social protection system (see paragraphs 2.6 to 2.8). Meanwhile, the Bank is preparing a set of Regional TC operations to assist countries in the post-pandemic economic and fiscal recovery. These TCs will help member countries leverage each other's solutions and will offer specific technical assistance to strengthen fiscal management. Lastly, a Client Support TC, now in preparation, will help identify and design policy options for promoting efficiency and improve prioritization in public expenditure, as well as lay the groundwork for a more efficient and equitable tax system. This package of operational and technical support will contribute to the sustainability of the reforms supported by this operation and to meeting outcome targets in the medium term.

2.14 **Strategic alignment.** The program is consistent with the Update to the Institutional Strategy (document AB-3190-2) and aligned with the development challenge of social inclusion and equality through measures to protect social expenditure

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[60] As a primary coordination mechanism, regular meetings are held between the IDB and the IMF to monitor progress in implementing the SBA and restructuring targets amid the pandemic.

[61] SEFIN requested redirection of the following portfolio operations: (i) Civic Coexistence and Neighborhood Improvement Program (loan 4518/BL-HO), for US$15 million; (ii) Improving Educational Quality to Develop Skills for Employment: Project Youth (loan 4449/BL-HO), for US$15 million; and (ii) Regional Road Integration Program II (loan 3815/BL-HO), for US$20 million, for a total of US$50 million. The disbursement period will be 12 months, and the components are: (i) response leadership at the country level; (ii) case detection and monitoring; (iii) interruption of the chain of transmission; and (iv) improvement of the capacity for service delivery.

targeting the vulnerable population. The program is also aligned with the crosscutting area of institutional capacity and rule of law, as it contributes to improving the government's capacity to respond to the current crisis and supports the country's fiscal sustainability. The program will contribute to the Corporate Results Framework 2020-2023 (document GN-2727-12) by helping to strengthen tax and expenditure policy and management. It is aligned with the fiscal management area of the Sector Strategy: Institutions for Growth and Social Welfare (document GN-2587-2) and is consistent with the Fiscal Policy and Management Sector Framework Document (document GN-2831-8), as it promotes actions to strengthen fiscal sustainability in the medium term. The program is aligned with the IDB Group Country Strategy with Honduras 2019-2022 (document GN-2944) through the priority area of strengthening public management and the institutional structure, and the operation's expected outcomes are directly responsive to the strategic objectives of: (i) improving budget management; (ii) improving the quality and efficiency of public expenditure; and (iii) increasing the efficiency of the tax system.

## B. Objectives, components, and cost

2.15 **Program objective.** The general objective of the program is to preserve macroeconomic stability by supporting the policies pursued by the Government of Honduras to confront the COVID-19 pandemic. The specific objectives are: (i) to ensure the sustainability of public finances while safeguarding social spending; and (ii) to ensure monetary and financial stability by strengthening the respective institutional frameworks.

2.16 The program's objectives and components are aligned with the IMF stand-by arrangement (SBA) approved on 15 July 2019 and are synchronized with the most recent review of the arrangement approved on 1 June 2020. The program is structured under the Special Development Lending (SDL) category as a single operation to be disbursed in a single tranche. The SDL budget support will contribute to finance the efforts to contain the COVID-19 pandemic, mitigate its impact on vulnerable households, and promote countercyclical policies to reduce its effect on the economy in the short term. The following components will be financed:

2.17 **Component 1. Ensure the sustainability of public finances while protecting social spending** through fulfillment of the quantitative performance criteria and indicative targets as of 31 December 2019 and the structural benchmarks agreed upon with the IMF under the SBA between December 2019 and March 2020. The quantitative performance criteria are: (i) a ceiling of 6.1 billion Honduran lempiras (L) on the NFPS deficit; (ii) a ceiling of L 6.16 billion on the ENEE deficit; (iii) a ceiling of L 0 on the accumulation of domestic arrears by the ENEE; and (iv) a ceiling of US$0 on the accumulation of new external arrears by the ENEE. The indicative targets are: (v) a floor of L 107.18 billion on central government tax revenues; (vi) a ceiling of L 47 billion on the central government

wage bill; and (vii) a floor of L 5.873 billion on priority social spending.[62] The structural benchmarks are: (viii) present a plan to execute social and infrastructure spending currently funneled by trust funds to be managed within full public financial management regulations for the 2021 budget; and (ix) prepare a plan to implement electronic signature.

2.18 **Component 2. Ensure monetary and financial stability by strengthening the respective institutional frameworks** through fulfillment of the quantitative performance criteria and structural benchmarks agreed upon with the IMF under the SBA as of 31 December 2019. The quantitative performance criteria are: (i) a floor of US$4.016 billion on the stock of net international reserves of the BCH; (ii) a ceiling of L -55.019 billion on the stock of net domestic assets of the BCH; and (iii) a ceiling of L 800 million on lending minus repayments from public pension funds. The structural benchmarks are: (iv) the new draft BCH charter submitted to Congress, in line with recommendations of IMF staff;[63] (v) a plan prepared to phase out foreign exchange surrender requirements; and (vi) a proposal submitted to Congress to address the financial situation of BANADESA.

## C. Key results indicators and program beneficiaries

2.19 The expected impact is to contribute to preserving macroeconomic stability by returning to the path of economic growth from 2021 onward. The main indicators of expected outcomes are: (i) NFPS fiscal balance improved by 1 percentage point of GDP; (ii) ENEE financial deficit reduced by 0.3 percentage points of GDP; (iii) priority social spending increased by 0.2 percentage points of GDP; (iv) stock of net international reserves increased to US$4.947 billion in 2021; and (v) BCH stock of net domestic assets reduced to L -80.991 billion in 2021.

2.20 The program will benefit:

a. The Government of Honduras, by: (i) securing fast-disbursing resources to finance pandemic response and economic recovery actions; and (ii) providing a strategic medium-term fiscal policy framework to ensure fiscal sustainability.

b. The general public, by promoting measures to contain the impact of the health crisis and countercyclical policies to mitigate the pandemic's effect on the economy in the short term; and, in the medium term, by implementing structural reforms to maintain macroeconomic stability and promote inclusive growth. The program will specifically benefit the vulnerable, low-income population by protecting income levels though prioritized social programs.

[62] The prioritized programs are the "Bono Vida Mejor" cash transfers and other "Vida Mejor" interventions, the "Bono 75 Kilovatios" program, Ciudad Mujer, Criando con Amor, and programs for school lunches, childcare, persons with disabilities, preschool education, maternal and newborn health, women and children experiencing violence, opportunities for women and young people, and assistance for persons with special abilities.

[63] The new BCH charter will safeguard operational autonomy and increase transparency and accountability by stating price stability as the policy mandate of the BCH, improving transparency through the use of International Financial Reporting Standards, establishing a sound governance structure, and allocating daily management, oversight, and policy formulation responsibilities, etc.

# III. FINANCING STRUCTURE AND MAIN RISKS

## A. Financing instruments

3.1 This Special Development Lending (SDL) operation, outside the 2019-2020 EPBA/DSF[64] biennial allocation period for Honduras, will be financed with the Bank's Ordinary Capital and Concessional Ordinary Capital resources. The concessional portion will be financed as part of the Bank's regular lending program approved for the two-year period 2019-2020 in the Long-term Financial Plan. The nonconcessional portion will be financed against the enhanced lending capacity. The operation has been prepared in coordination with the stand-by arrangement (SBA) approved by the International Monetary Fund (IMF). The single-tranche structure and supplemental financing arrangements with the IMF provide a flexible and effective mechanism for supporting the government's emergency measures to mitigate the health and economic impact of the pandemic. The SDL resources will be disbursed to the government in a single tranche into the bank account designated for such purpose by the Ministry of Finance (SEFIN).

3.2 The amount of this program is US$76.2 million. The following were taken into account in determining the loan amount: (i) the size of the package of measures necessary to address the macroeconomic crisis; the government's financing gaps; and the limit for funds per country applicable to countries eligible for concessional financing[65] (see paragraphs 3.3, 3.4, and 4.2 of the SDL guidelines (document GN-2031-17)). The program will help bridge the additional financing gap resulting from COVID-19, estimated at US$850 million for the remainder of 2020, US$76.2 million of which will be provided by the Bank through the SDL loan.

## B. Environmental and social safeguard risks

3.3 Under Directive B.13 of the IDB's Environment and Safeguards Compliance Policy (Operational Policy OP-703), no ex ante impact classification is required for this program. The operation supports the development of policies, regulations, management instruments, and other institutional strengthening actions, so no significant direct impacts on the environment or natural resources are foreseen.

## C. Fiduciary risks

3.4 No fiduciary risks have been identified for this program. The loan proceeds will be disbursed directly into the Treasury Single Account, which SEFIN will access to cover financing needs. The executing agency has the necessary financial management instruments and control systems for such purpose. The proceeds will be disbursed upon fulfillment of the conditions stated in the Policy Matrix, as established the Loan Contract.

## D. Other key risks and issues

3.5 **Macroeconomic and fiscal sustainability (medium).** The economic outlook is subject to a high level of uncertainty as to how severely the COVID-19 pandemic

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64 Enhanced Performance-based Allocation/Debt Sustainability Framework (EPBA/DSF).

65 This limit is up to 20% of the biennial allocation approved by the Bank's Board of Executive Directors. Honduras was approved for a biennial allocation of US$381.61 million for 2019-2020 (document GN-2442-64).

will impact the economy both within Honduras and worldwide. Projections of fiscal impacts may vary significantly if the pandemic lingers, with consequent effects on the productive system, a delayed start to the economic recovery, and an even further weakening of public finances. To mitigate this risk, the Bank will offer technical assistance through its Regional and Client Support TC operations for the pandemic response, to identify additional measures for restoring fiscal sustainability while protecting the most vulnerable populations. A complementary mitigation mechanism is the coordination and identification of opportunities to collaborate with multilateral and bilateral institutions in designing and implementing such measures.

3.6 **Public management and governance (medium).** There is a risk of delays in implementing some structural reforms that require coordinated and sequenced actions, collaboration with multiple stakeholders, complex legal procedures, and, in some cases, congressional approval. This risk may be amplified in the runup to the 2021 elections. Mitigating this risk will be the IMF's regular monitoring of policy actions under the SBA and the Bank's technical assistance through TC operations, including its Regional and Client Support TCs, with activities aimed at building consensus and promoting technical dialogue on key structural issues.

## IV. Implementation and Management Plan

### A. Summary of implementation arrangements

4.1 **Borrower and executing agency.** The borrower will be the Republic of Honduras. The executing agency will be the Ministry of Finance (SEFIN), which will be responsible for: (i) providing evidence that the loan disbursement conditions agreed upon by the government and the Bank have been met; (ii) promoting measures to achieve the policy objectives set in the program; and (iii) compiling, maintaining, and providing to the Bank the necessary information, indicators, and parameters for monitoring and evaluation of the program outcomes.

4.2 **Policy actions and disbursement of the loan proceeds. The sole disbursement of the loan proceeds will be made in accordance with the terms established in the Loan Contract to be signed between the borrower and the Bank, including the provision requiring that proceeds from the stand-by arrangement (SBA) approved by the IMF are being or have been disbursed. The Bank's disbursement will be contingent on Honduras's fulfillment of the policy conditions agreed upon with the IMF under the second review of the SBA, as outlined in the Policy Matrix (Annex II) and Policy Letter**.

4.3 The Bank financing will be disbursed to, and executed by, SEFIN. The expected expenditures are aligned with the areas of support envisaged for SDL operations in the respective operational guidelines (document GN-2031-17), particularly supporting new efforts to mitigate the impact of the crisis on poor and vulnerable segments of the population and facilitating access to credit for small and medium-sized enterprises.

## B. Summary of arrangements for monitoring results

4.4 **Monitoring.** The borrower and the Bank will meet regularly to monitor the program. IMF staff visits to Honduras will be a monitoring instrument. The executing agency will compile and process all data necessary for program monitoring and evaluation. Consulting engagements to verify Results Matrix and Policy Matrix indicators will be financed with IDB administrative funds.

4.5 **Evaluation.** After the close of fiscal year 2021 and the completion of the SBA/SCF arrangements, the Bank will prepare an evaluation of the agreed indicators and respective targets for this operation, as input for an assessment of the SDL instrument's overall effectiveness.

4.6 **Policy Letter.** The Policy Letter of the Government of Panama, reaffirming its commitment to the macroeconomic framework policies agreed upon with the Bank, is aligned with the program's Policy Matrix and Results Matrix.

## RESULTS MATRIX

**Objective:** The general objective of the program is to preserve macroeconomic stability by supporting the policies pursued by the Government of Honduras to confront the COVID-19 pandemic. The specific objectives are: (i) to ensure the sustainability of public finances while safeguarding social spending; and (ii) to ensure monetary and financial stability by strengthening the respective institutional frameworks.

## EXPECTED IMPACT

| Indicators | Unit | Baseline 2020[1] | Target 2021 | Means of verification | Comments |
|---|---|---|---|---|---|
| **General objective: Preserve macroeconomic stability** | | | | | |
| GDP growth | % | -3.3 | 4.7 | Central Bank of Honduras (BCH) | Source: Baselines and targets from the second review under the stand-by arrangement (SBA). |

## EXPECTED OUTCOMES

| Indicators | Unit | Baseline 2020[2] | Target 2021 | Means of verification | Comments |
|---|---|---|---|---|---|
| **Specific objective 1: Ensure the sustainability of public finances while protecting social spending** | | | | | |
| NFPS fiscal balance as % of GDP | % | -4.0 | -3.0 | Ministry of Finance (SEFIN) budget execution report | Source: Baselines and targets from the second review under the SBA program. |
| ENEE balance as % of GDP | % | -0.8 | -0.5 | SEFIN budget execution report | Source: Baselines and targets from the second review under the SBA program. |
| Priority social spending as % of GDP | % | 1.0 | 1.2 | SEFIN budget execution report | Source: Baselines and targets from the second review under the SBA program. Baseline is from 2019. |

1 The baseline is the projected indicator for 2020 included in the staff report for the second review under the SBA program. For evaluation purposes, this figure will be updated once final, official data become available. Although the SBA will end in June 2021, the outcome indicators listed here are on an annual basis and consistent with SEFIN and BCH projections for the end of the year in question.

2 See footnote 1.

| Indicators | Unit | Baseline 2020[2] | Target 2021 | Means of verification | Comments |
|---|---|---|---|---|---|
| **Specific objective 2: Ensure monetary and financial stability by strengthening the respective institutional frameworks** | | | | | |
| Stock of net international reserves (US$ millions) | $ | 4,669 | 4,947 | BCH | Source: Baselines and targets from the second review under the SBA program. Baseline is from 2019. |
| Stock of net domestic assets of the central bank (millions of Honduran lempiras) | L | -70,430 | -80,991 | BCH | Source: Baselines and targets from the second review under the SBA program. Baseline is from 2019. |

## OUTPUTS[3]

| Outputs | Unit of measure | Baseline | | Final target (year) | Means of verification |
|---|---|---|---|---|---|
| | | Value | Year | | |
| **Component 1: Ensure the sustainability of public finances while protecting social spending** | | | | | |
| Document with fulfilled SBA quantitative performance criteria | Document | 0 | 2019 | 1 (2020) | Staff report for the second review under the SBA program. |
| Document with fulfilled SBA indicative targets | Document | 0 | 2019 | 1 (2020) | Staff report for the second review under the SBA program. |
| Plan presented to execute current trust fund spending in budget | Plan | 0 | 2019 | 1 (2020) | Staff report for the second review under the SBA program. |
| Plan presented to implement electronic signature | Plan | 0 | 2018 | 1 (2019) | Staff report for the second review under the SBA program. |
| **Component 2: Ensure monetary and financial stability by strengthening the respective institutional frameworks** | | | | | |
| Document with fulfilled SBA quantitative performance criteria | Document | 0 | 2019 | 1 (2020) | Staff report for the second review under the SBA program. |
| Document with fulfilled SBA indicative targets | Document | 0 | 2019 | 1 (2020) | Staff report for the second review under the SBA program. |
| New draft BCH charter submitted to Congress | Legislative bill | 0 | 2018 | 1 (2019) | Staff report for the second review under the SBA program. |
| Plan presented to phase out foreign exchange surrender requirements | Plan | 0 | 2018 | 1 (2019) | Staff report for the second review under the SBA program. |
| Proposal submitted to address the financial situation of BANADESA | Proposal | 0 | 2018 | 1 (2019) | Staff report for the second review under the SBA program. |

3 The quantitative performance criteria and indicative targets are specified in the Policy Matrix.

# POLICY MATRIX

| |
|---|
| **Objective:** The general objective of the program is to preserve macroeconomic stability by supporting the policies pursued by the Government of Honduras to confront the COVID-19 pandemic. The specific objectives are: (i) to ensure the sustainability of public finances while safeguarding social spending; and (ii) to ensure monetary and financial stability by strengthening the respective institutional frameworks. |

| Components/ Policy objectives | Conditions for the single-tranche operation[1] | Fulfillment status of conditions[2] |
|---|---|---|
| **Component 1. Ensure the sustainability of public finances while protecting social spending** | | |
| Ensure the sustainability of public finances while protecting social spending | I.a. The borrower has met the quantitative performance criteria agreed upon with the IMF under the stand-by arrangement (SBA), as of 31 December 2019:<br>(i) Nonfinancial public sector (NFPS) deficit does not exceed a ceiling of 6.1 billion Honduran lempiras (L).<br>(ii) National Electric Power Company (ENEE) deficit does not exceed a ceiling of L 6.16 billion.<br>(iii) ENEE accumulation of domestic arrears does not exceed a ceiling of L 0.<br>(iv) ENEE accumulation of new external arrears does not exceed a ceiling of L 0. | Fulfilled (December 2019) |
| | I.b. The borrower has met the indicative targets agreed upon with the IMF under the SBA, as of 31 December 2019:<br>(v) Central government tax revenues are at or above a floor of L 107.18 billion.<br>(vi) Central government wage bill does not exceed a ceiling of L 47 billion.<br>(vii) Priority social spending[3] is at or above a floor of L 5.873 billion. | Fulfilled (December 2019) |
| | I.c. The borrower has met the structural benchmarks agreed upon with the IMF under the SBA, between December 2019 and March 2020:<br>(viii) Present a plan to execute social and infrastructure spending currently funneled by trust funds to be managed within full public financial management regulations for the 2021 budget.<br>(ix) Prepare a plan to implement electronic signature. | Fulfilled<br><br>(March 2020)<br><br>(December 2019) |

[1] These policy conditions are consistent with the quantitative performance criteria, indicative targets, and agreed structural benchmarks met by the government under the SBA as of December 2019 and March 2020, which have been the subject of the second review of the SBA approved by the IMF Board on 1 June 2020.

[2] This information is merely indicative as of the date of this document. The fulfillment of all disbursement conditions will be verified by the Bank at the time of the corresponding disbursement request by the borrower and promptly noted in the disbursement eligibility memorandum.

[3] The prioritized programs are the “Bono Vida Mejor” cash transfers and other “Vida Mejor” interventions, the “Bono 75 Kilovatios” program, Ciudad Mujer, Criando con Amor, and programs for school lunches, childcare, persons with disabilities, preschool education, maternal and newborn health, women and children experiencing violence, opportunities for women and young people, and assistance for persons with special abilities.

| Components/ Policy objectives | Conditions for the single-tranche operation[1] | Fulfillment status of conditions[2] |
|---|---|---|
| **Component 2. Ensure monetary and financial stability by strengthening the respective institutional frameworks** | | |
| Ensure monetary and financial stability by strengthening the respective institutional frameworks | II.a. The borrower has met the quantitative performance criteria agreed upon with the IMF under the SBA, as of 31 December 2019:<br>(i) BCH stock of net international reserves is at or above a floor of US$4.016 billion.<br>(ii) BCH stock of net domestic assets is at or below a ceiling of L -55.019 billion.<br>(iii) Lending minus repayments from public pension funds is at or below a ceiling of L 800 million. | Fulfilled (December 2019) |
| | II.b. The borrower has met the structural benchmarks agreed upon with the IMF under the SBA, as of 31 December 2019:<br>(iv) Submit the new draft BCH charter to Congress.<br>(v) Prepare a plan to phase out foreign exchange surrender requirements.<br>(vi) Submit a proposal to Congress to address the financial situation of Banco Nacional de Desarrollo Agrícola (BANADESA). | Fulfilled (December 2019) |

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/20

Honduras. Loan ____/BL- HO to the Republic of Honduras
Emergency Program for Macroeconomic and
Fiscal Sustainability

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Honduras, as Borrower, for the purpose of granting it a financing to cooperate in the execution of the Emergency Program for Macroeconomic and Fiscal Sustainability. Such financing will be chargeable to the Bank's Ordinary Capital (OC) resources in the following manner: (i) up to the amount of US$49,530,000, subject to concessional financial terms and conditions ("Concessional OC"); and (ii) up to the amount of US$26,670,000, subject to financial terms and conditions applicable to loan operations financed from the Bank's regular program of OC resources ("Regular OC"), as indicated in the Project Summary of the Loan Proposal, and subject to the Special Contractual Conditions of said Project Summary.

(Adopted on ___ ______________ 2020)

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