

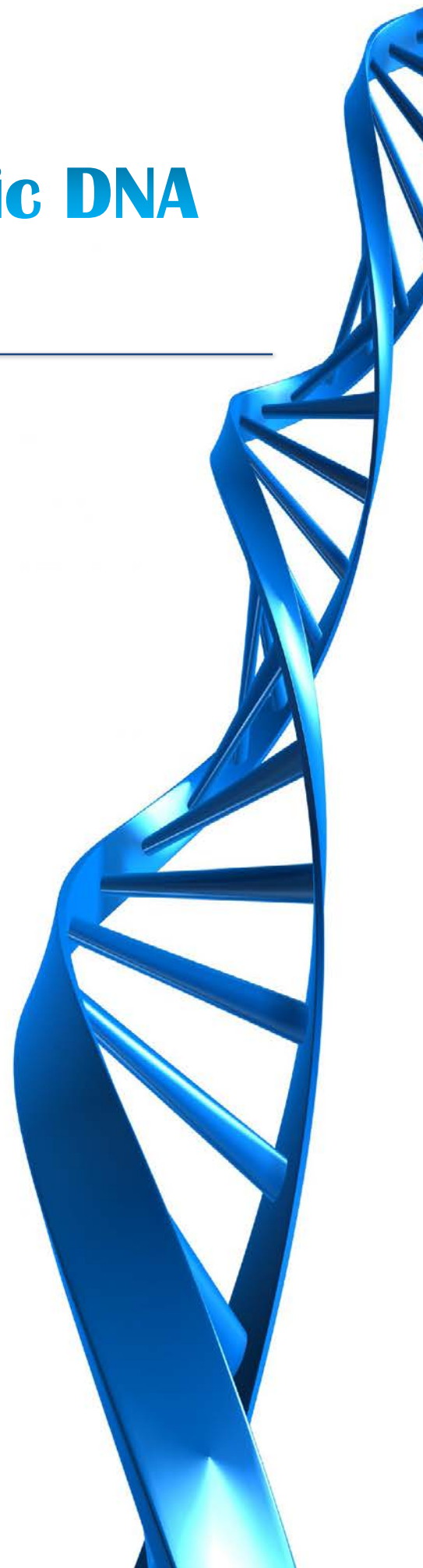
# Honduras Economic DNA

First Edition • June 2015



## Maintaining Commitment

With a Special Focus Section on  
Poverty and Shared Prosperity





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## Abbreviations and Acronyms

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CAFTA-DR	Dominican Republic-Central America-United States Free Trade Agreement (includes: Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua)
DNA	Diagnostic for National Action
ENEE	State-Owned Electricity Company
EPHPM	Multiple Purpose Household Survey ( <i>Encuesta Permanente de Hogares de Propósitos Múltiples</i> )
FAOSTAT	Food and Agriculture Organization Corporate Statistical Database
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
Gini	Coefficient of inequality distribution
GNI	Gross National Income
HIPC	Heavily Indebted Poor Countries
HOI	Human Opportunity Index
IMF	International Monetary Fund
KWh	Kilowatt/hour
LAC	Latin America and the Caribbean
MDG	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
R&D	Research and Development
REER	Real Effective Exchange Rate

## Foreword

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It is a great pleasure to present this first edition of the Honduras Economic DNA (*Diagnostic for National Action*) prepared by the World Bank. The objective of this series is to provide policymakers, academics, the private sector, civil society, and the general public with a review of recent developments in the Honduran economy and its evolving prospects for the future.

This first edition of the Honduras Economic DNA brings together the efforts that Honduras is undertaking to achieve macroeconomic stability with its continuing struggle to increase the welfare of its poorest and most vulnerable. While poverty fell in 2013, Honduras continues to have one of the highest rates of poverty and inequality in Latin America, exhibiting only marginal and, at times, fleeting progress over the past decade. Violence and limited opportunities remain substantial obstacles to long-term poverty reduction and have contributed to emigration outflows in recent years. Addressing the country's deeply ingrained social challenges is a goal for the medium-term that will require not only continued economic growth but also a solid macroeconomic and fiscal base.

For those of us who have had the privilege of working with Honduras over the years, it is clear that while the country faces difficult development challenges, sustained reform efforts can help overcome these challenges. Today, there are reasons to be optimistic. Honduras' economic outlook is positive, with growth improving from 2.8 percent in 2013 to 3.1 percent in 2014, and projected at 3.2 percent in 2015. Prudent monetary policy has effectively kept inflation under control. The fiscal stance has also improved, with the deficit decreasing significantly in 2014 thanks to the implementation of an ambitious reform agenda that began in December 2013. The country should be recognized for its commitment to restore confidence and build the foundations for inclusive economic growth and sustainable poverty reduction. The ongoing fiscal consolidation program is notable in two key aspects. First, the magnitude of the adjustment is significant, with a planned reduction of the deficit by about 5 percent of GDP over 2014-15, of which over 3 percent of GDP already took place in 2014. Second, the government is undertaking structural measures to address long term challenges, such as the financial sustainability of the state-owned Electricity Company.

A typical Economic DNA will be published every twelve months and will (i) review the most recent developments in the Honduran economy; (ii) reflect about future economic prospects; and (iii) analyze development topics of interest. In this first edition the focus is on poverty and shared prosperity. The global community has a renewed mission to eradicate extreme poverty by 2030 and promote shared prosperity. The World Bank can contribute to these objectives by promoting an exchange of development experiences, highlighting important lessons from Honduras and bringing to Honduras lessons from other countries.

I hope you will find this new report series, which reflects the best analysis of the World Bank for Honduras, to be a useful tool for understanding the country's complex economic dynamics.



**Humberto Lopez**  
Director for Central America  
The World Bank

## Acknowledgements

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This First Edition of the Honduras Economic DNA (*Diagnostic for National Action*) was prepared by a World Bank team led by Marco Antonio Hernandez (Senior Country Economist). Liliana D. Sousa (Economist) and Kinnon Scott (Senior Economist) led the Focus Section on poverty and shared prosperity. The team consisted of Susana Sanchez, Miguel Angel Saldarriaga, Jorge Loyola, Sean Lothrop, Brendan Coates, Mateo Salazar, Megan Rounseville, German Caruso, German Reyes, and Diana Lachy.

Humberto Lopez (Country Director for Central America), Giorgio Valentini (Country Manager), Pablo Saavedra (Manager of the Macroeconomics and Fiscal Management Global Practice), and Oscar Calvo-Gonzalez (Program Leader) provided overall guidance. Active collaboration with Honduran policymakers was instrumental in the production of this report.

The Honduras Economic DNA evaluates the implications of economic trends and policy reforms in terms of the government's stated development objectives, and reviews challenges and opportunities currently facing the Honduran economy. The Honduras Economic DNA is intended for a wide audience, including policymakers, business leaders, civil society organizations, academics, and the community of analysts and partners engaged in Honduras' evolving economy.

The findings, interpretations, and conclusions expressed herein are those of the authors, and do not necessarily reflect the views of the World Bank's Board of Executive Directors or the countries they represent. The cut-off date for the data in this report was May 22, 2015.

For more information about the World Bank and its activities in Honduras please visit: [www.worldbank.org/honduras](http://www.worldbank.org/honduras). If you would like to be included in the email distribution list of this semiannual series and related publications, please contact [amaso@worldbank.org](mailto:amaso@worldbank.org).

For questions and comments related to this publication, please contact Marco Antonio Hernandez at [marcohernandez@worldbank.org](mailto:marcohernandez@worldbank.org).



## Executive Summary

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**Successfully alleviating poverty, protecting social gains, and promoting shared prosperity in Honduras requires an ongoing commitment to sound macroeconomic and fiscal policies.** The experience of the past decade has demonstrated that while accelerated growth is critical to increasing incomes among the poor, macroeconomic stability as well as improved fiscal space to adjust spending policies during downturns are equally vital to ensuring that these gains are sustained over time. In the past, substantial imbalances in the public accounts and high levels of debt have destabilized the Honduran economy, undermining wealth creation and perpetuating poverty. In the context of a slow and uncertain global recovery, reinforcing the country's resilience to shocks will depend on the authorities' commitment towards fiscal stabilization. The successful completion of the fiscal consolidation process will be a crucial first step to free up resources for targeted antipoverty programs.

**Honduras has been slow to recover from the global economic crisis, but recent developments present cause for optimism.** After a negative growth of 2.4 percent in 2009, economic growth increased to an average of 3.8 percent during 2010-12, still below pre-crisis levels, before sliding to 2.8 percent in 2013. In 2014, growth improved to 3.1 percent and the outlook is expected to improve during 2015-2016, as the global economy continues to recover. Nevertheless, growth is expected to approach but not reach the rates observed in the mid-2000s.

**Episodes of fiscal instability have slowed growth and limited the authorities' ability to cope with shocks; a recent example was the rise of the deficit of the public sector from 4.5 percent of GDP in 2008 to 7.6 percent in 2013.** This trend was driven by an

increases in public spending in a context of worsening terms of trade. As a result, the public debt stock increased from 30 percent of GDP in 2010 to 43 percent in 2013. Structural challenges undermined fiscal consolidation efforts, as weak budgetary controls caused spending to exceed projections, undermining the credibility of the budget. In addition, the share of nondiscretionary or "rigid" expenditures—including public sector salaries and debt service payments—progressively increased, limiting the resources available for public investment or countercyclical fiscal policies.

**Since December 2013 the authorities have been working to overcome Honduras' legacy of chronic fiscal instability, and over the past months have launched a set of reforms to consolidate the public finances and improve key dimensions of public financial management.** The ongoing government's fiscal consolidation agenda has been addressing important challenges on both the revenue and expenditure side. While the reform agenda is still in its early stages, significant progress has already been achieved. A tax reform approved in December 2013 boosted revenues by 1.7 percentage points of GDP in 2014 relative to the previous three-year average. The government is also tightening controls over current expenditures by strengthening its oversight of payroll and procurement systems. Furthermore, the government has embarked on a reform of the power sector, which in 2013 represented a direct fiscal impact of 1.8 percent of GDP. Finally, a set of measures designed to improve the targeting, monitoring, and evaluation of social protection programs is expected to enhance the cost-effectiveness of social spending.

**The fiscal consolidation agenda has led to a significant reduction in the deficit.** Notably,

the deficit of the public sector was brought down by 3.3 percentage points of GDP in one year, from 7.6 percent of GDP in 2013 to 4.3 percent in 2014. Going forward, the 2015 budget includes measures to contain spending, including freezing the hiring of new public sector staff. Structural measures complement the fiscal adjustment, including adjustments to the electricity tariffs, reduction of electricity subsidies, and institutional measures to improve the governance of the state-owned Electricity Company.

**While previous reform efforts proved sporadic and short-lived, and this record should temper expectations, the authorities have thus far demonstrated a credible commitment to fiscal consolidation.** Although the full impact of the government's current fiscal reform program will not be immediately apparent, and efforts to contain current spending may even dampen growth rates in the short term, over the longer term the successful consolidation of the public finances will be essential to reinforcing resilience and accelerating economic growth.

**In 2015 Honduras' economy is projected to grow at 3.2 percent, with growth anticipated in all major sectors.** Domestic consumption is expected to drive economic activity while private investment recovers following a significant contraction in 2013. Growth will also be supported by the ongoing recovery in the United States, which is expected to drive increases in both export demand and remittances inflows. On the supply side, coffee production is expected to increase, as the "coffee rust" blight that hit the sector in 2012-2014 now appears to be contained. Steadily rising production in palm oil and fruits, as well as robust yields of food crops intended primarily for the domestic market, will also contribute to the growth of the agricultural sector. In the service sector the sale of rights to the 4G band will allow telecoms and internet providers to expand their services. Financial services are also expected to grow over the medium term, though financial access remains limited.

**Macroeconomic indicators are projected to improve subject to a sustained implementation of the reform agenda, and also supported by lower oil prices.** In 2015, fiscal consolidation efforts, strong remittance inflows, and lower oil prices would support a reduction in the current account deficit, which in the past has reflected a long-term decline in national savings. The significant rise in public debt stock seen since 2010 is expected to slow down, peaking in 2017 and decreasing gradually over the medium term. Inflation is expected to be contained. Meanwhile, the real effective exchange rate has been gradually appreciating, which is expected to affect Honduras' trade competitiveness.

## **Focus Section: Poverty and Shared Prosperity in Honduras**

**Poverty in Honduras is both pervasive and severe, but recent data suggests the country is moving in the right direction.** In 2013, official statistics reported that 64.5 percent of Hondurans lived in poverty, and 42.6 percent lived in extreme poverty. While high, these poverty rates reflect a decrease in poverty from 2012.

**An examination of the nature and causes of poverty trends in Honduras reveals the sensitivity of poverty to economic growth and fiscal stability.** During the high-growth years of the mid-2000s both poverty and extreme poverty declined as employment opportunities expanded with labor income reducing extreme poverty by 5.2 percentage points between 2003 and 2007. However, lower growth rates in the wake of the global financial crisis have undone much of the progress made over the past decade, with 2013 poverty rates returning to the levels seen in 2001.

**Targeted social programs have a demonstrated potential to reduce poverty, and the completion of the government's**

**reform agenda would generate much-needed fiscal space to expand these efforts.**

For instance, the conditional cash transfer program *Bono Vida Mejor* (formerly, *Bono 10,000*) reduced extreme poverty among program beneficiaries by three percentage points since 2011, even as national poverty rates increased during the same period. Continued fiscal consolidation would provide the resources necessary to expand this

program, while improvements in the precision with which beneficiaries are targeted could greatly enhance its impact on poverty by reducing leakages and increasing the program's ability to respond to changing needs.

## I. Recent Economic Developments

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### Honduras' Economy: A Modest Recovery

*The Honduran economy has experienced a modest and uneven recovery following the turbulent period of 2008-09 when the country experienced the global financial crisis combined with a political crisis. After contracting by 2.9 percent in 2009, as the crisis reached its nadir, GDP growth rebounded modestly, averaging 3.8 percent from 2010-12, below pre-crisis levels, then slid to 2.8 percent in 2013 and recovered to 3.1 percent in 2014. The recovery in 2014 was driven by rebounding domestic demand due to higher private investment, increasing remittances, and the gradual acceleration of growth in the United States, Honduras's main trading partner. In terms of sectors, services accounted for almost half of the total increase in economic output in 2013-14. The communications industry has been a major driver of growth in services, with internet and cellular networks both expanding rapidly. Financial services were a major contributor to growth in the tertiary sector, but while total lending has increased, access to financial services and credit remains narrowly concentrated. The agricultural sector contributed to growth as the sector recovered from exogenous shocks in 2012-13. Manufacturing decelerated due to lower demand in the auto parts and assembly "maquila" industry. Since 2011 construction activity has exhibited a declining trend, reflecting a fall in residential projects and lower public investment. Consumption, which accounts for over 70 percent of GDP, has been fuelled by increasing remittances, but the Honduran labor market is weak and labor participation remains low. In this context, underemployment and informality are becoming increasingly prevalent, and the share of workers earning less than minimum wage has increased significantly in the past 5 years.*

**Honduras' economy has gradually recovered since the global financial crisis, but economic growth rates have not yet returned to pre-crisis levels (Figure 1).** Real GDP growth averaged 5.9 percent during 2003-2007, above the Latin America and the Caribbean (LAC) regional average of 4.9 percent. Growth was mainly driven by agriculture, particularly coffee exports, construction, financial and communications services, and manufacturing. Growth slowed to 4.2 percent in 2008, at the onset of the crisis, and the economy contracted by 2.4 percent in 2009, the year in which the country experienced political instability and the full impact of the crisis registered. The economy partly recovered during 2010-2013, expanding by an average of 3.6 percent.

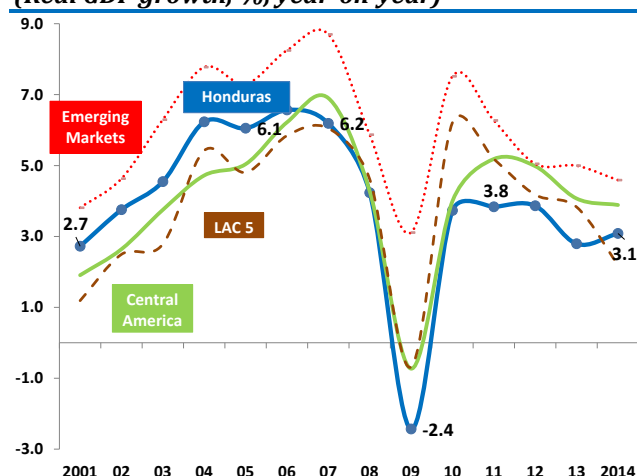
**In 2014 the Honduran economy grew by 3.1 percent (up from 2.8 percent in 2013), the second lowest growth rate in Central America.** The country's poor performance was due to a combination of three factors: (i) a generally adverse trade environment marked by low demand among Honduras' main export partners; (ii) supply-side shocks in the coffee sector—Honduras' main export—cause by disease, combined with a drop in international coffee prices; and (iii) a decline in investor confidence due to a deteriorating economic outlook in a context of election-related political uncertainty. In 2014, the growth in consumption and the increase in investor confidence spurred economic activity, yet the post-crisis recovery remains modest.

**Domestic consumption has driven economic growth since the global financial crisis and the political crisis of 2009, while the share of investment has declined.** The growth rate of private consumption, which accounts for more than 70 percent of GDP, remained positive at 3.8 and 2.7 percent in 2013 and 2014. Consumption growth has been fueled in part by rising remittances—around 80 percent of which go to consumption—and in part by the expansion of consumer credit. Meanwhile, the contribution of private investment to GDP has recovered after it dropped sharply in

2013, as investors' confidence increased due to a positive macroeconomic outlook. In contrast to the positive contribution that investment had in 2011 and 2012 (3.2 and 1.1 percentage points of GDP growth, respectively), investment had a negative contribution to GDP growth in 2013 following a contraction of 4.7 percent with respect to the previous year. In 2014, private investment (comprising close to 80 percent of total investment) grew by 2.9 percent, though this growth was contrasted by a decline in public investment of 27.1 percent explained by the implementation of a fiscal consolidation program. This pattern of investment led to declines in construction activity and capital goods imports. Since the global financial crisis, exports grew by 11 percent annually between 2010 and 2012, exhibited a contraction in 2013 explained partly by exogenous shocks to the coffee sector, and recovered again in 2014. An increase in imports has led to a marginal worsening in Honduras' net export position, which contributed negatively by 0.1 percentage points to GDP growth in 2014 (Figure 2).

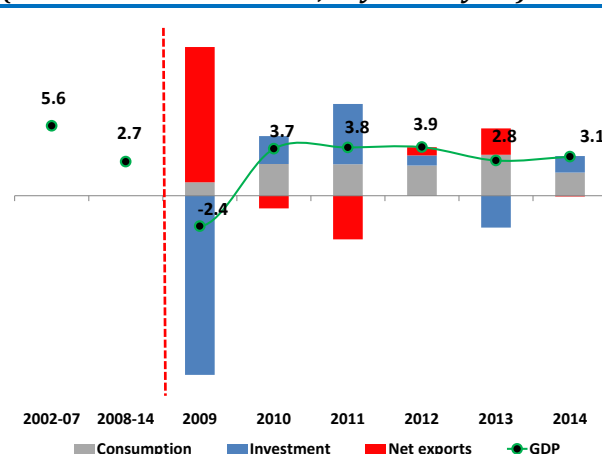
**Figure 1: Honduras' growth was hit hard in 2009 by the global financial crisis, and has not recovered to pre-crisis levels.**

*(Real GDP growth, %, year-on-year)*



**Figure 2: Honduras' recent growth has been driven by rising consumption and recovering investment**

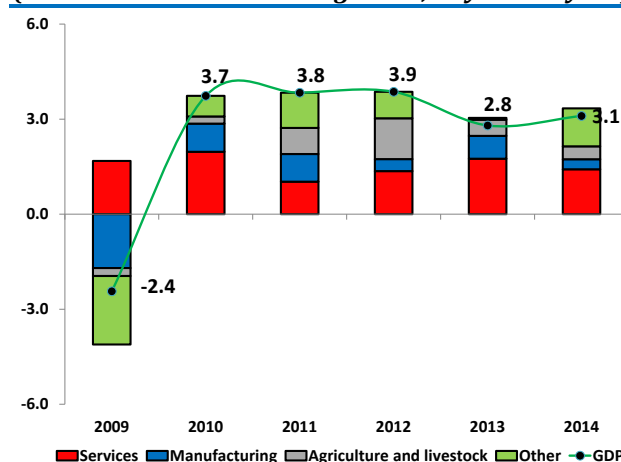
*(Contributions to real GDP, %, year-on-year)*



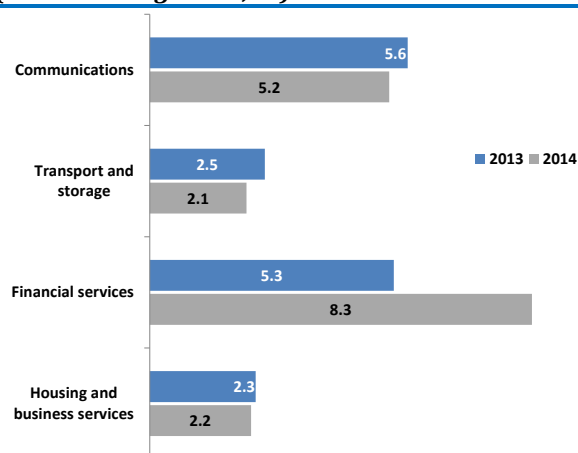
Source: Honduran authorities and World Bank staff estimates.

**Services, agriculture and manufacturing led economic activity in 2014.** Nonetheless, growth in almost all economic activities decelerated in 2014 relative to 2013. Services, which represent 40 percent of Honduran GDP, decelerated from 3.8 in 2013 to 3.0 percent in 2014, contributing 1.3 percentage points to GDP growth. The manufacturing sector decelerated from a growth rate of 3.4 percent in 2013 to 1.5 percent in 2014, contributing 0.3 percentage points to overall growth. In the primary sector, agriculture and livestock grew by 2.7 percent, down from 3.4 percent in 2013, and contributed 0.4 percentage points to overall growth. In this context, the acceleration in the growth rate from 2013 to 2014 is explained by the significant increase of net taxes and subsidies (by 14.9 percent), which contributed 1.2 percent to GDP (Figure 3).

**Figure 3: Services remain the primary driver of total value added growth...**  
(Contributions to real GDP growth, % year-on-year)



**Figure 4: ...with communications and financial services leading the sector.**  
(Real annual growth, %)



Source: Honduran authorities and World Bank staff estimates.

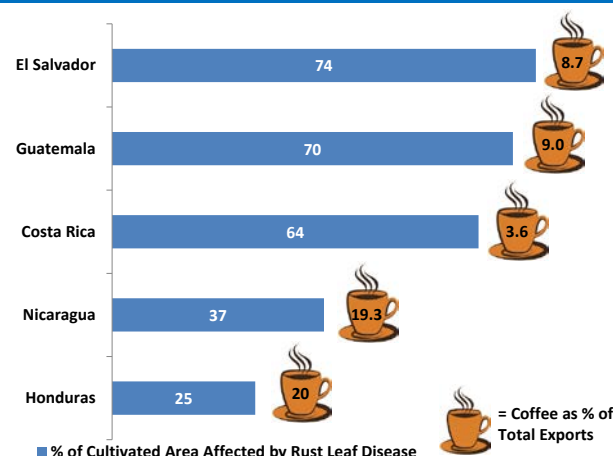
**Communications and financial services led growth in the tertiary sector (Figure 4).** Activity in the communications sector was boosted by technological expansion programs, as mobile services companies expanded the geographical coverage of their networks, increased speed of data transmission (through a 4G band allocated in 2013), and diversified their services into cable and satellite television. Meanwhile, the growth of financial services was driven by increasing loans to the commercial sector combined with rising consumer credit. However limited progress has been made towards financial deepening and inclusion. Just over 31 percent of Honduran adults have an account at a formal financial institution, and only 6 percent have credit cards; these rates are well below the Latin American averages of 51 percent and 22 percent, respectively.

**The coffee industry recovered in 2014 after it was hit hard in 2012-2013 by a combination of exogenous factors.** Coffee production represents one third of total agricultural production in Honduras. It accounts for 20 percent of total exports and about 3.5 percent of GDP. The impact of the coffee rust disease (or “*roya*”), a parasitic fungus that has affected coffee production throughout Central America, slashed output growth from 20.5 percent in 2012 to just 1.1 percent in 2013 (see Figure 5). Yet, the recovery in production in 2014 has been modest and production levels have not reached 2012 levels. The coffee rust is estimated to have affected at least one quarter of coffee plantations in Honduras, with deep economic and social consequences. As illustrated in Box 1, the impact of the rust extends well beyond GDP and exports, but also the incomes of households working in the sector, which suffer from high rates of poverty.

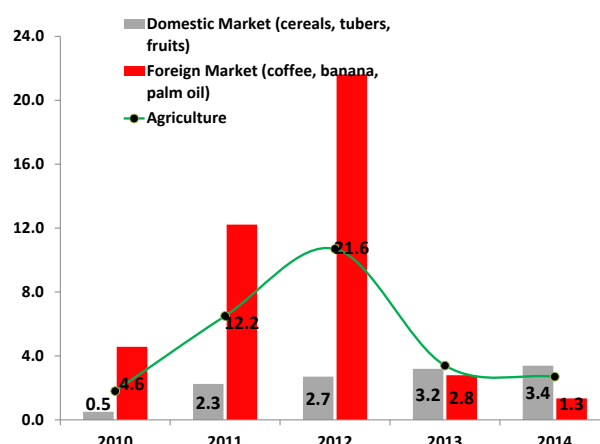


**Figure 5: Coffee producers in Honduras were heavily affected by coffee rust compared to other Central American exporters, even though the affected area was relatively small.**

*(Area affected by coffee rust, %; share of coffee in total exports in 2013, %)*



**Figure 6: Overall agricultural growth remained positive despite the impact of the coffee rust.**  
*(Real annual growth, %)*



Source: Honduran authorities, International Coffee Organization and World Bank staff estimates.

**Despite the recovery in the coffee sector, overall agricultural production decelerated due to deceleration in the production of crops oriented towards the domestic market and a contraction in banana production.** The sector grew by 2.7 percent in 2014, down from 3.4 percent in 2013, but still relatively robust. Meanwhile, growth in export-oriented agriculture slowed from 2.8 percent in 2013 to 1.3 percent in 2014, due to the decline of banana production, explained by adverse weather conditions. It is worth noting that agricultural production in Honduras has diversified over the last decade, and the country has positioned itself as one of the main exporters of banana, melon and palm oil in Latin America.

## Box 1

## Trouble Brewing?

### Coffee, Productivity, and Poverty in Honduras

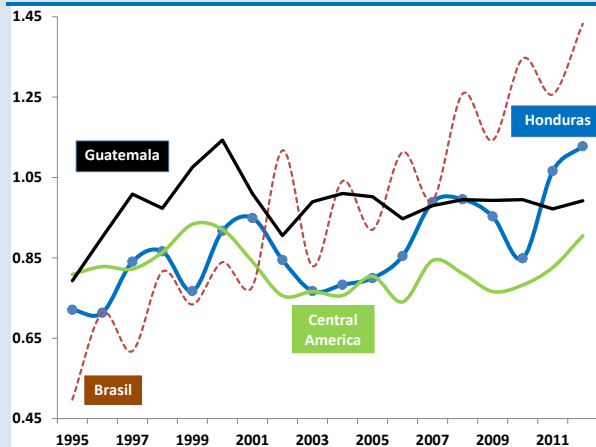
The coffee sector is a key driver of economic activity and an important source of income and employment for many households: 1 in 10 workers are employed in the sector and coffee is one of Honduras' top five exports. The importance of coffee to the Honduran economy has increased in recent years: accounting from an average of 2.4 percent of annual GDP from 2003-2007 to 3.7 percent of GDP between 2008 and 2012. In addition, there are strong linkages between the coffee sector and the external accounts. Around 90 percent of coffee production is exported. Moreover, coffee is Honduras' second highest value export behind the *maquila* sector. Meanwhile, about 20 percent of foreign exchange purchases were related to the coffee sector. The bulk of Honduran coffee is higher-value *Arabica*, with Honduras' share of world *Arabica* coffee exports rising from 2.3 percent in the 1990s to 4 percent over the last decade. Yet despite recent progress, Honduras remains vulnerable to shifts in international prices, especially since the bulk of coffee exports are traded on commodities markets at spot prices, rather than via bilateral contracts (as futures).

**Honduras has made great progress in improving productivity of the coffee sector over the past decade.** Between 2001 and 2012 coffee production increased dramatically from 2.5 million to 5.9 million 60 kg bags due to the adoption of new practices to improve coffee quality and the introduction of new, disease-resistant seeds, which drove significantly higher yields per *manzana* (the basic unit of land in the sector, equivalent to 1.4 hectares) (Figure 7). In addition, increases in international prices due to rising global demand and production declines in Brazil and Colombia have spurred higher production. Since 2011 Honduras has become the largest coffee producer in Central America, surpassing Guatemala, which has suffered relatively stagnant productivity in its coffee sector over the past decade.

**Despite these gains, workers in the coffee sector are among the lowest paid and report high levels of poverty.** Of the 280 thousand hectares of land under cultivation, the bulk remains in the hands of small producers. In fact, of Honduras' 110,000 coffee growers, about 92 percent are small producers and account for the majority of production. According to the 2012 national household survey the average monthly income among coffee workers is 2,700 lempiras per month. Further, around half of the workers in the sector live in extreme poverty, and over two-thirds are poor. Low income reflects, among other factors, the relatively low productivity in the coffee sector, and the agricultural sector more broadly, despite recent productivity gains.

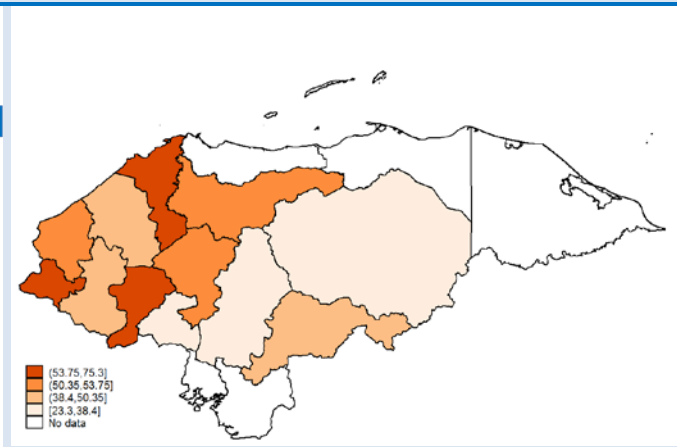
**Although Honduras' coffee crop has been less affected by the rust leaf disease than others across Central America, the economic and poverty impact has proved significant.** The current attack of rust leaf disease is the most severe since 1976, affecting some 25 percent of crops. The most affected regions are El Paraiso, Santa Barbara, Comayagua and Lempira (Figure 8). Affected producers have seen incomes decline by as much as 30 percent due to lower production, as well as recent declines in global prices. Recovery of affected areas is expected to take at least three years, with a total cost of around US\$ 100 million, placing additional burdens on small producers in particular.

**Figure 7: Productivity in Honduras' coffee sector has significantly improved in the last decade.**  
(Coffee yield, kilograms per hectare)



Source: FAOSTAT and World Bank staff estimates.

**Figure 8: Developments in the coffee sector have direct implications for poverty in Honduras.**  
(Incidence of coffee rust disease, 2012)

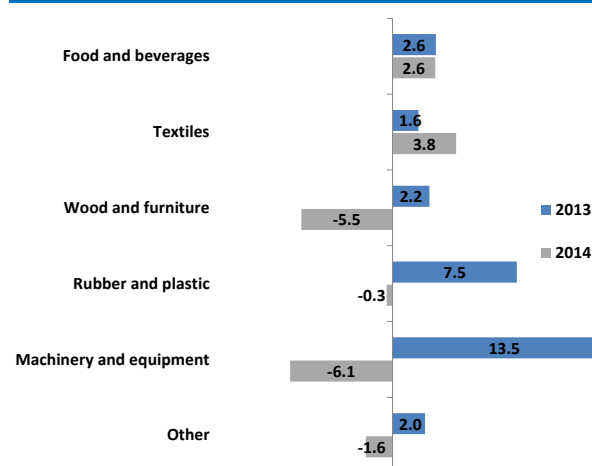


Source: Honduran Coffee Institute.

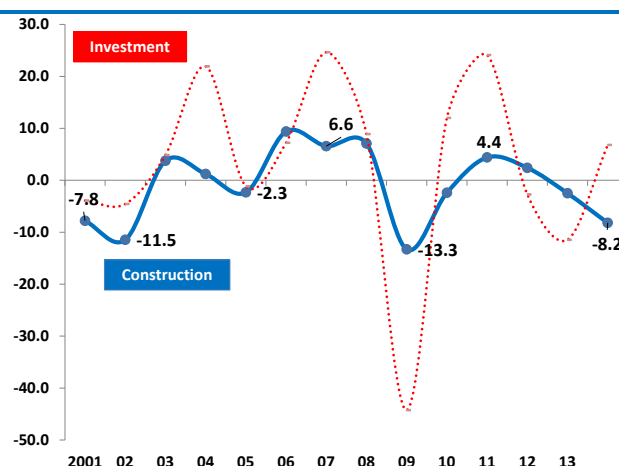
**Growth in the manufacturing sector has been led by rising foods and beverage and textiles production.** The food and beverage industry, which accounts for about 45 percent of total manufacturing, grew by just 2.3 percent, similar to the growth exhibited in 2013, explained by rising exports of frozen shrimp and the expansion of the harvested area of sugarcane. Meanwhile, textile production accelerated from a growth rate of 1.6 percent in 2013 to 3.8 percent in 2014, as a result of a higher external demand. Meanwhile, machinery and equipment decreased as a result of lower demand from the United States automobile market. The “maquila” industry (of which textile represents 30 percent and machinery and equipment 41 percent), has played a key role in Honduran manufacturing. According to the Honduran Maquila Association, maquila-style plants currently employ 103,180 workers.



**Figure 9: Manufacturing growth was led by food and beverages and textiles.**  
(Contributions to non-primary manufacturing growth, percentage points)



**Figure 10: Construction activity continued declining although investment recovered.**  
(Construction activity and investment, % growth)



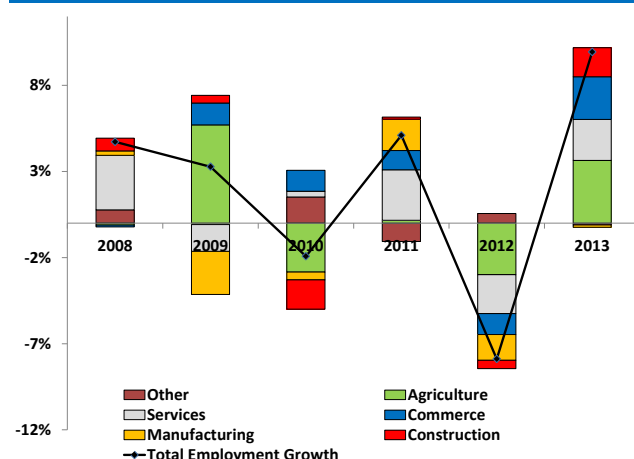
Source: Honduran authorities and World Bank staff estimates.

**Construction activity has decelerated due to weakening residential and commercial investment, and the reduction of public infrastructure projects.** Construction accounts for 3 percent of Honduras' GDP, and its share is above the average seen across Central America. The sector was hit hard during the global financial crisis and the domestic political crisis of 2009, with construction activity falling by 13.3 percent in 2009 and 2.4 percent in 2010. Construction activity has yet to recover to pre-crisis levels. In 2014, construction activity contracted by 8.2 percent, exacerbating the contraction of 2.5 percent registered in 2013.

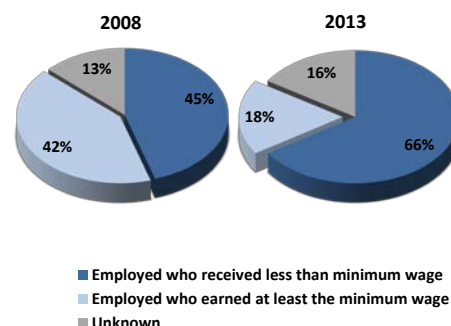
**Agriculture and commerce have led job creation; yet, modest economic growth has translated into weaker labor opportunities.** The latest household survey estimates the size of the Honduran labor force at around 3.5 million, of which about 36 percent of are employed in the agricultural sector, 24 percent in the commercial sector, and 13 percent in manufacturing. Together, these three sectors provide livelihoods for more than 70 percent of the labor force (Figure 11). Unemployment is concentrated among urban youth and those lacking secondary education. The urban unemployment rate is 6.4 percent, while in rural areas it is 1.7 percent. According to the most recent labor survey, the unemployment rate in Honduras increased from 3.6 percent in 2012 to 3.9 percent in 2013, which represented a loss of around 140,000 (private-sector) salaried jobs. This loss in salaried jobs led to increases in the number of self-employed workers and in the number of workers receiving less than the minimum wage (see further below). However, in the capital of Tegucigalpa, the average time required to find a job dropped from 4.2 months in 2012 to 2.5 months in 2013.

**Two-thirds of the labor force earned less than the minimum wage in 2013.** Moreover, the share of workers earning less than the minimum wage has significantly increased over the last 5 years (Figure 12). This is likely an effect of rising underemployment, which is estimated to affect around 40 percent of the labor force, particularly in urban areas. In effect, the high level of the minimum wage is likely acting as a constraint to overall job creation in formal sector employment. Indeed, the minimum wage has risen faster than economic growth in recent years, as noted further in the Focus Section to this report.

**Figure 11: Agriculture, commerce, and services led employment creation in 2013.**  
(Contributions to employment growth by sector, % year-on-year)



**Figure 12: The share of workers earning less than the minimum wage has increased.**  
(Employment by wage level, % of total)



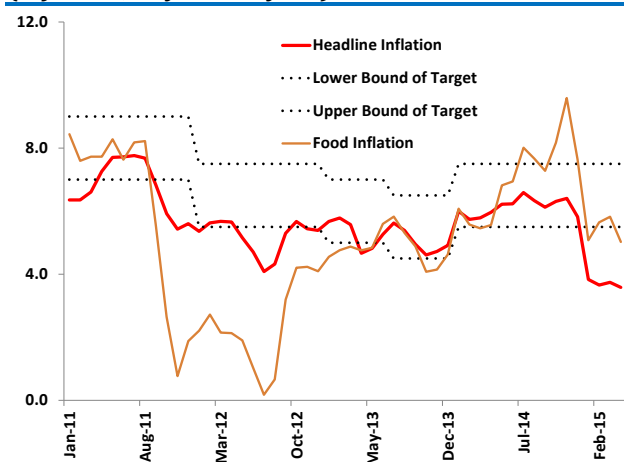
Source: Honduran authorities and World Bank estimates based on Honduras' Labor Surveys.

## Inflation: Contained amid Pressures due to Higher Food Prices

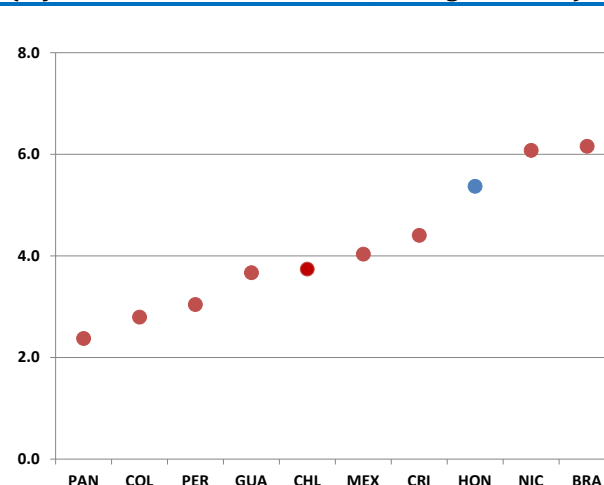
*Inflation remains within the target band established by the Honduran Central Bank. In recent years, low food prices have helped to ease inflationary pressures. In 2014, however, drought conditions generated an increase in food-price inflation, but headline inflation remains contained due to lower oil prices.*

**Inflation remains within the Central Bank's target band of 5.5–7.5 percent.** Inflation increased from 4.9 percent in 2013 to 5.8 percent in 2014 (Figure 13) as a result of higher food prices; food-price inflation reached 9.6 percent by November 2014, compared to 4.2 percent in 2013. Food-price inflation was driven by rising prices for beans, milk, oil, tomatoes, potatoes, eggs and meat. Drought conditions and demand factors also contributed to rising prices for livestock and major food crops during 2014. Since end-2014, however, inflation began to decline following the fall in international oil prices, which eased inflationary pressures in transport and communications. In the first four months of 2015, inflation has continued to decline following a reduction in fuel and food prices.

**Figure 13: Headline inflation has recently decelerated as fuel and food inflation eased.**  
(Inflation, % year-on-year)



**Figure 14: Honduras' inflation rate is relatively high in comparison to its regional peers**  
(Inflation in selected countries, % avg. 2012-14)



Source: Honduran authorities and World Bank staff estimates.

## Fiscal Policy: The Path Towards Fiscal Consolidation

*Honduras has a history of chronic fiscal deficits. Periodic efforts at consolidation have failed to produce a lasting realignment in the country's fiscal stance, and the result has been a persistent accumulation of debt. The country's debt burden currently exceeds 40 percent of GDP, and its nominal debt stock is higher now than it was before Honduras received multilateral debt relief in 2006-07. Public revenues are relatively strong by regional standards, but current expenditures are high and rigid. Large losses incurred by the state-owned Electricity Company further hinder the fiscal position. Since December 2013 the authorities have renewed their efforts to stabilize public finances, adopting a series of fiscal, administrative and regulatory reforms. These measures have generated positive results. One year later, results are encouraging: the growth of current spending has been contained, public financial and debt management systems have been tightened, and the fiscal deficit is narrowing. Nevertheless, given structural rigidities in spending, a strong commitment will be required to maintain fiscal discipline over the medium term, supported by consecutive administrations.*

**Over the past four decades public financial management in Honduras has been characterized by long periods of fiscal deficit punctuated by efforts at consolidation.** Honduras' fiscal stance is closely tied to the electoral cycle, as higher fiscal deficits have repeatedly coincided with presidential and parliamentary elections. In addition, weak budgetary controls have led to higher-than-projected deficits and the accumulation of public arrears, which in turn has undermined the efficient allocation of resources.

**Honduras' fiscal position weakened significantly during 2012-2013.** The country's fiscal policy became increasingly expansionary as current expenditures grew. This contributed to the long-term deterioration of the public sector's fiscal deficit, which widened from 1.7 percent of GDP in 2008 to 4.2 percent in 2012 and reached 7.6 percent of GDP in 2013—well above the deficit target of 3.5 percent established when the 2013 budget was approved (Table 1). The 2013 fiscal deficit of the consolidated public sector was the highest of the decade, even exceeding the deficits incurred in 2009

during the peak of the global financial crisis. Expenditures rose fastest during the second half of the year, driven by election-related spending and rising debt costs.<sup>1</sup>

**Yet, in 2014, the Government took a series of steps to enhance fiscal management and achieve fiscal consolidation.** Congress approved a comprehensive fiscal reform in December 2013 designed to reduce the fiscal deficit and strengthen public finances (see Table 2). This initiative aimed to mobilize increased domestic revenues while limiting expenditures and slowing the growth of new debt. Key reforms targeted customs and tariff policy, public expenditures, debt management and tax administration. The legislation also called for the creation of a trust fund for combatting extreme poverty. Moreover, the program includes structural measures that will also address medium and long term challenges, such as the financial sustainability of the state-owned Electricity Company by separating generation, transmission, and distribution for better accountability, increasing private sector participation, and improving regulatory oversight. Furthermore, the Government has taken additional structural measures such as the establishment of new systems to improve payroll and procurement controls and the adoption of a new medium-term debt management strategy that defines priorities for borrowing and refinancing.

**Table 1: Honduras' aggressive fiscal consolidation program successfully reduced the deficit in 2014.**  
(Fiscal indicators of the Central Government, % of GDP)

Fiscal operations of the Central Government						
	2009	2010	2011	2012	2013	2014
<b>Revenues and grants</b>	<b>17.1</b>	<b>16.9</b>	<b>17.0</b>	<b>16.7</b>	<b>17.0</b>	<b>18.7</b>
<b>Tax revenues</b>	<b>14.2</b>	<b>14.4</b>	<b>14.8</b>	<b>14.5</b>	<b>14.8</b>	<b>16.3</b>
Income taxes	4.1	4.0	4.4	4.4	4.8	4.9
Taxes on goods and services (VAT)	5.2	5.4	5.7	5.6	5.5	6.8
Taxes on foreign trade	0.7	0.8	0.8	0.8	0.7	0.7
Other tax revenues	4.1	4.2	4.0	3.7	3.8	3.9
<b>Non-tax revenues</b>	<b>2.9</b>	<b>2.4</b>	<b>2.2</b>	<b>2.2</b>	<b>2.3</b>	<b>2.4</b>
<b>Total expenditures</b>	<b>23.0</b>	<b>20.7</b>	<b>20.2</b>	<b>20.8</b>	<b>22.8</b>	<b>20.6</b>
<b>Current expenditures</b>	<b>17.9</b>	<b>17.1</b>	<b>15.9</b>	<b>16.6</b>	<b>17.5</b>	<b>15.5</b>
Wages	10.9	10.7	9.6	9.6	9.7	9.1
Good and services	3.0	2.5	2.4	2.7	3.0	2.5
Transfers	4.1	4.0	3.8	4.3	4.9	3.9
<b>Capital expenditures</b>	<b>5.1</b>	<b>3.6</b>	<b>4.4</b>	<b>4.2</b>	<b>5.2</b>	<b>5.2</b>
Gross Public Investment	2.8	1.7	1.7	1.5	2.5	2.1
Transfers	2.4	1.9	2.7	2.7	2.7	3.1
<b>Interest payments</b>	<b>0.7</b>	<b>1.0</b>	<b>1.4</b>	<b>1.7</b>	<b>2.3</b>	<b>2.5</b>
Domestic	0.4	0.7	1.1	1.3	1.7	1.6
External	0.3	0.2	0.3	0.3	0.5	0.9
<b>Overall Balance</b>	<b>-6.0</b>	<b>-4.7</b>	<b>-4.6</b>	<b>-5.9</b>	<b>-7.9</b>	<b>-4.4</b>

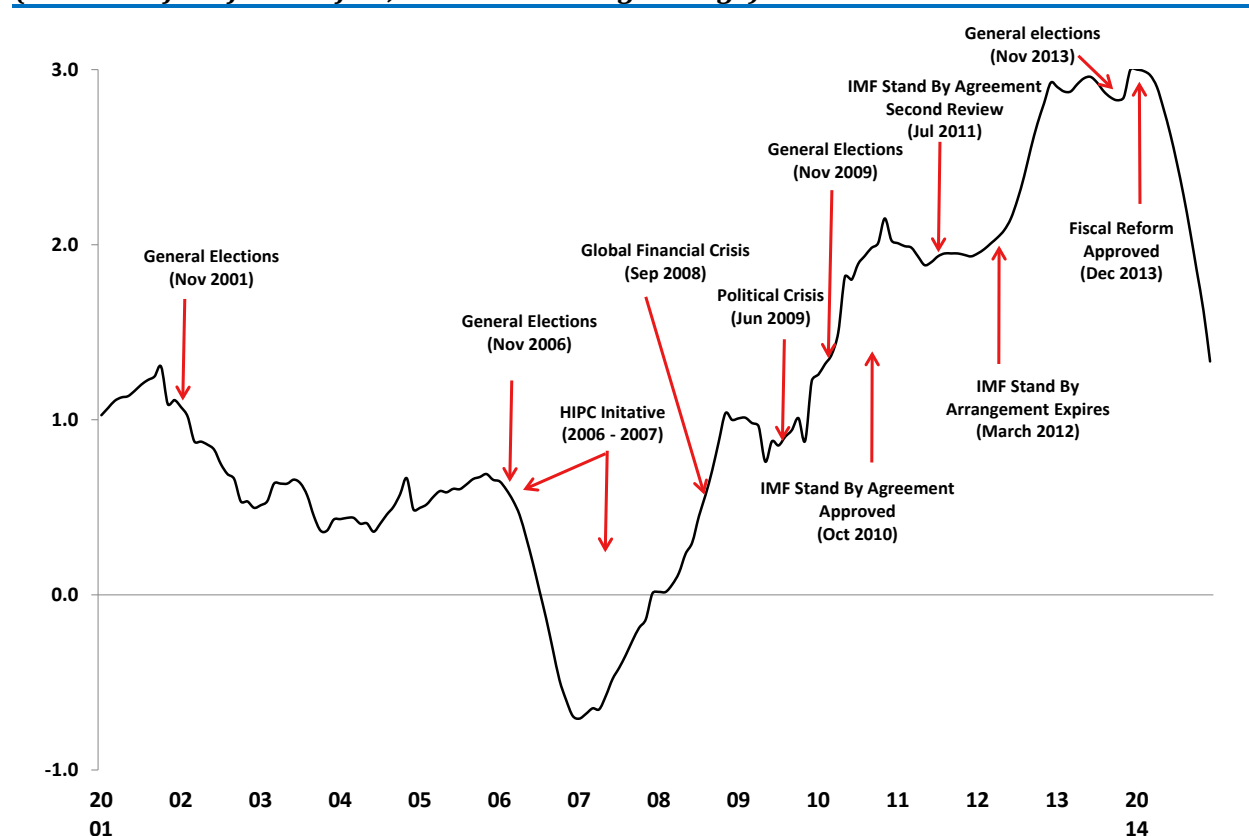
Source: Honduran authorities and World Bank staff estimates.

**Since this reform was implemented, significant progress has already been made and international lenders are responding positively.** Central Government's fiscal deficit declined from 7.9 percent of GDP in 2013 (the highest in the last decade) to 4.4 percent of GDP in 2014. The reduction of the fiscal gap was a consequence of a significant increase of 20 percent in current revenue due to elimination of fiscal exemptions and the increase in the rate of Value Added Tax from 12 to 15 percent. Current expenditure decreased by 1.5 percent due to lower purchases of goods and services and the reduction of transfers, which allow the Government to exhibit a primary surplus for the first time in five years. Notwithstanding the increase in debt service, the government's overall debt profile, including the yields and maturity for new domestic bonds, has improved since 2013. In addition, debt yields of 2014 international bond placements have improved (yields fell from a peak of 10 percent in August 2013 to 6.7 percent in April 2015).

<sup>1</sup> See World Bank (2013a), "Managing Fiscal and Public Finance Challenges in Honduras".

**One of the main contributors to persistent deficits of the combined public sector has been the state-owned Electricity Company (ENEE).** ENEE is in charge of the electric grid and public lighting systems, while private companies manage most of the country's power plants. In 2013 ENEE registered a loss of 8 billion lempiras (roughly US\$230 million), the largest loss in its history, and its deficit reached 1.8 percent of GDP in 2013. In 2014, ENEE recorded losses over US\$ 1 million per day, equivalent to 1.3 percent of GDP, down from 1.8 percent of GDP in 2013, but still significant and above the goal of 5 billion lempiras established by the authorities. Although the Government had embraced several reforms in the electricity sector in 2014, the reduction in the ENEE is explained mainly as a consequence of the reduction in international oil prices. Overall, ENEE's weak financial position is explained by structural issues, including its below-cost tariff structure, subsidies, and high technical losses (e.g., arising from poor infrastructure) and non-technical losses (e.g., arising from weak commercial management, theft and fraud). This performance points to inefficiencies in administration, amid rising concerns about commercial losses related to fraud, theft and billing errors. Even though public spending on electricity is relatively high, access to electricity is limited: in 2011, only 55 percent of rural households reported having electricity, a modest improvement from 43 percent in 2001. Moreover, the public investment in productive sectors and infrastructure are being diminished by transfers to cover ENEE's deficit, with an evident impact on economic growth.

**Figure 15: The fiscal deficit rose steadily over the last 4 years, but since the approval of the fiscal reforms the deficit shrunk.**  
*(Timeline of the fiscal deficit, 12-month moving average)*



Source: Honduran authorities and World Bank staff estimates.

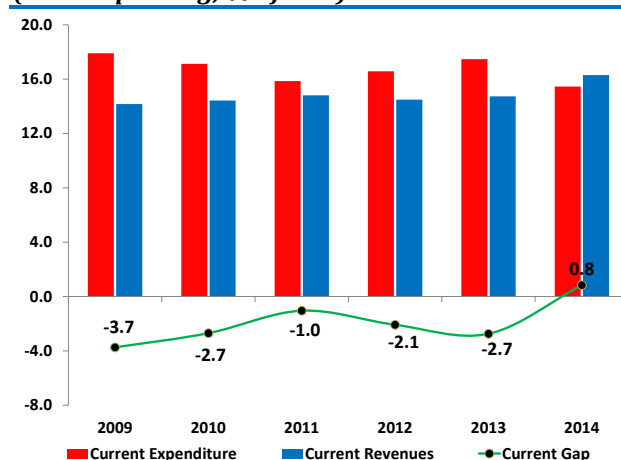
**Overall, the actions taken thus far represent important steps in the right direction and will require a sustained commitment over the medium-term.** The 2015 budget includes measures to

contain spending by enhancing public investment, procurement, and payroll controls including freezing the hiring of new public sector staff. In particular, it (i) keeps wages and expenditures on goods and services unchanged in nominal terms relative to the previous year, and indexes wage increases to inflation for a selected number of public institutions; (ii) specifies limits for disbursements of investment projects so as to reduce capital expenditures; and (iii) maintains public transfers to sub-national entities unchanged in nominal terms with respect to the previous year.

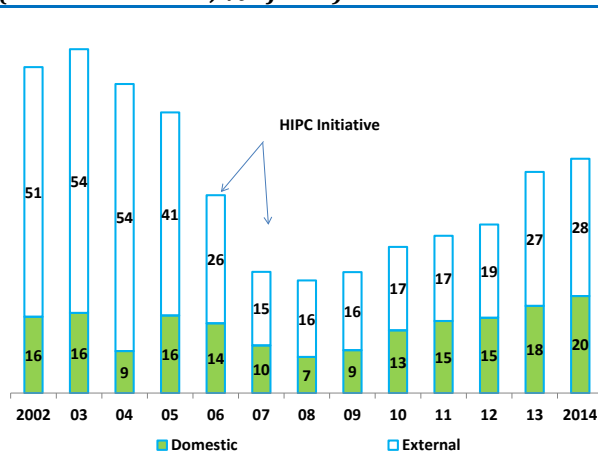
**While recent reforms are stirring fiscal management in a positive direction, Honduras still faces structural challenges that if not adequately managed could offset the recent fiscal gains.** The World Bank's Public Expenditure Review of 2013 highlights that it would be important to enhance the budgetary system to effectively monitor and control spending, and provides a series of recommendations to enhance budgetary controls.

**Despite its relatively high revenue collection, the government has relied on borrowing to finance its current expenditures.** Only in 2014, and as a result of the fiscal reform, Honduras' Central Government current revenue intake reached 18.0 percent of GDP, of which 91 percent came from tax collection, and slightly surpassed current expenditure (17.9 percent of GDP). However, during the last decade expenditures have consistently exceeded revenues. Current expenditures, account for around 78 percent of all public spending, although they have reduced from 20 percent of GDP in 2013 to 18 percent of GDP in 2014. The reduction in current expenditure is explained by the reduction in purchases of goods and services and the reduction in transfers. However, there has been a rapid rise in interest payments resulting from a rise in the stock of public debt. In 2013, public debt interest payments reached 2.0 percent of GDP, and one year later they reach 2.3 percent of GDP (similarly, total public debt increased from US\$8.3 billion in 2013 to US\$9.3 billion in 2014 ). Moreover, the increase in the stock of debt has been accompanied by a rise in interest rates. The rise in debt service is constraining the resources available for social spending and investment. Social spending has declined as a share of GDP from 18.8 percent in 2008 to 15.3 percent in 2012. Reductions in social spending have been largest in education (from 6.9 percent of GDP to 4.6 percent) and social security (from 7.3 percent of GDP to 5.9 percent).

**Figure 16: In 2014 current revenues surpassed current expenditure due to lower expenditures and higher tax collection...**  
(Public spending, % of GDP)



**Figure 17: ...Yet, the stock of public debt has risen rapidly, and interest payments represent a significant share of the budget.**  
(Public debt stock, % of GDP)



Source: Honduran authorities and World Bank staff estimates.

**Financing costs have increased significantly, and the stock of public debt is now close to 50 percent of GDP.**

In 2014 the public sector debt burden reached almost US\$9 billion or 47.8 percent of GDP, up significantly from 45.1 percent in 2013. The nominal debt stock is now higher than it was in 2004 (US\$4.8 billion), a year before the Heavily Indebted Poor Countries (HIPC) initiative cut the public external debt stock in half. Both domestic and external debt levels have increased, with external debt rising by from 28.1 to 29.7 of GDP percent between 2013 and 2014 Honduras' sovereign credit rating was downgraded in 2013 due to the country's weakening fiscal stance and rising debt stock.

**The debt-to-GDP ratio is projected to peak in 2017 and Honduras' risk of public external debt distress is considered to be moderate.**

A Debt Sustainability Analysis was finalized by the IMF and the World Bank in November 2014. Honduras's debt-to-GDP ratio is expected to peak in 2017 at 50.8 percent, and decrease gradually to 35.9 percent by

2034. Interest payments are projected to increase from 2 percent of GDP in 2013 to 3 percent in 2016, in line with the rise in the stock of public debt. The Debt Sustainability Analysis highlights that under a number of alternative scenarios, public debt dynamics in Honduras remain somewhat vulnerable to both policy-related and exogenous shocks, especially to those related to lower economic growth and a worsening of the fiscal balance.

**Table 2: Fiscal measures approved in the fiscal package are expected to generate additional fiscal space**  
*(Expected benefits of fiscal measures in 2014, % of GDP)*

Revenue measures - 1.4 percent	
Exemptions	Selected VAT, import tax and income tax exemptions were eliminated.
VAT increase	Increase in the VAT rate from 12 percent to 15 percent.
Advance income tax	All companies and individual with sales above 10 million lempiras will have to pay a minimum income tax.
Increase in fuel taxes	Increase of about US\$ 0.25 per gallon.
Other measures	Income tax surcharge and other taxes.
Spending measures - 1.9 percent	
Electricity subsidy reduction	Subsidy for households consuming between 75 and 150Kwh per month was reduced.
Reduction of transfers	Transfers to local governments are being lowered.
Reduction in purchases of goods and services	Purchases of goods and services are being lowered
Reduction of the wage bill	Wages of some public sector staff kept steady in nominal terms.
TOTAL - 3.3 percent	

Source: World Bank staff estimates based on IMF Article IV (June 2014).



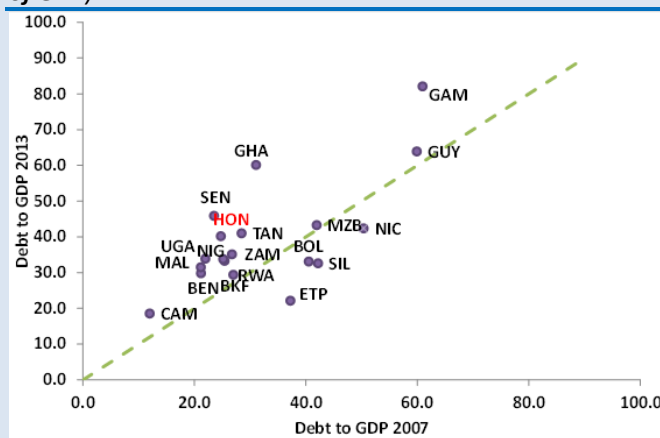
The Heavily Indebted Poor Countries (HIPC) Initiative was launched in 1996 by the World Bank and the IMF with the aim of ensuring that no poor country faces a debt burden it cannot manage. In 2005 the HIPC Initiative was supplemented by the Multilateral Debt Relief Initiative (MDRI), which allowed for 100 percent relief on eligible debts for countries completing the HIPC Initiative process. Of the 39 countries eligible for HIPC Initiative assistance, 35 have received full relief from their creditors after reaching their completion points. Debt relief is one part of a much larger effort, which also includes aid flows, to address the development needs of low-income countries and make sure that debt sustainability is maintained over time. For debt reduction to have a tangible impact on poverty, the additional money needs to be spent on programs that benefit the poor. The total cost of providing assistance to these 39 countries is estimated to total around US\$ 74 billion by end-2012.

**Honduras' reached the Completion Point under the HIPC Initiative in 2005.** By 2007, Honduras had received 100 percent debt relief from the World Bank, the International Monetary Fund (IMF), and the Inter-American Development Bank. The stock of public debt decreased from 63 percent of GDP in 2004 to 25 percent of GDP in 2007.

**However, like many countries that participated in HIPC, after receiving debt relief Honduras has since seen a significant increase in its stock of debt as a share of GDP.** Since 2008 the stock and cost of public debt has increased as a consequence of the deterioration of the fiscal balance. Public debt increased from 21.9 percent of GDP in 2008 to more than 40 percent of GDP in 2014. This significant upward trend over 2008 – 2012 was mainly driven in by domestic debt, although further increases in debt in 2013 were driven by external debt following the issuance of US\$ 1 billion in Eurobonds. By the end of 2014, in nominal terms Honduras' external debt stock was higher than the stock in 2005, before the HIPC Initiative.

**Figure 18: Public debt in Honduras increased significantly after the HIPC initiative.**

*(Public debt of non-fragile HIPC countries, 2007 vs. 2013, % of GDP)*



Source: World Bank staff estimates.



## External Sector: Reduced Pressures Amid Fiscal Consolidation Efforts and Favorable Global Conditions

*The current-account deficit widened dramatically between 2009 and 2013. On the export side a general worsening of demand conditions was coupled with supply-side shocks to coffee production. On the import side rising consumer demand was exacerbated by higher oil prices, which contributed to a long-term decline in domestic savings rates. Meanwhile, the large and persistent fiscal deficit accelerated the overall deterioration of the current account. Yet, in 2014 more favorable global conditions reduce the external gap. Foreign direct investment inflows have recovered rapidly since the global financial crisis and now finance 70 percent of the current-account deficit. Remittances have also recovered as the US labor market has improved, and remittances represent Honduras's second-largest source of foreign exchange after merchandise exports. Moreover, fall in international oil prices has been driving a reduction in the current account deficit.*

Between 2009 and 2014 a series of exogenous shocks combined with domestic policy factors caused the current-account deficit to reach record highs not seen since the early 1980s. The first shock was the global financial crisis and in particular its impact on demand in the United States. The US accounts for 40 percent of all Honduran merchandise exports and is the country's main trading partner. The decline in export demand, particularly for coffee and bananas, was followed by an increase in import prices, especially the price of imported oil. Meanwhile, Honduras' fiscal stance further contributed to the widening of the current-account deficit, as expansionary policies pursued in the context of a rigid exchange-rate regime and an appreciating real effective exchange rate exacerbated the impact of exogenous shocks on the current account. Yet, in 2014 the current account balance improved due to a combination of factors: the reduction in the fiscal deficit, lower oil prices, a mild recovery in exports, and higher remittances.

**Table 3: Current-account deficits have widened due to rising deficits in the trade and income balances.**  
(% of GDP)

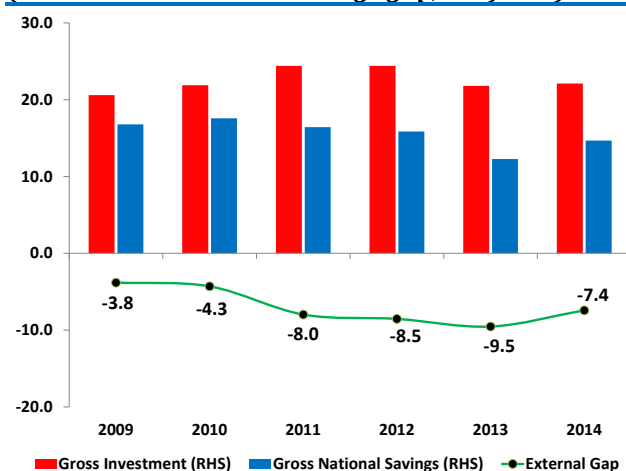
	2009	2010	2011	2012	2013	2014
<b>Current Account Balance</b>	<b>-3.8</b>	<b>-4.3</b>	<b>-8.0</b>	<b>-8.5</b>	<b>-9.5</b>	<b>-7.4</b>
<b>Trade balance</b>	<b>-17.4</b>	<b>-16.7</b>	<b>-17.8</b>	<b>-16.3</b>	<b>-17.0</b>	<b>-15.4</b>
Exports of goods	33.1	39.5	45.1	45.2	42.2	41.5
Imports of goods	50.5	56.2	63.0	61.4	59.2	56.9
<b>Services</b>	<b>-0.1</b>	<b>-1.2</b>	<b>-2.4</b>	<b>-3.2</b>	<b>-3.6</b>	<b>-3.6</b>
Exports	6.5	6.2	5.8	5.7	5.5	5.6
Imports	6.6	7.4	8.2	8.9	9.1	9.2
<b>Income</b>	<b>-4.3</b>	<b>-4.6</b>	<b>-5.5</b>	<b>-6.8</b>	<b>-7.3</b>	<b>-6.8</b>
<b>Transfers</b>	<b>18.1</b>	<b>18.2</b>	<b>17.8</b>	<b>17.8</b>	<b>18.4</b>	<b>18.4</b>
Of which: Remittances	16.9	16.5	15.8	15.6	16.7	17.2
<b>Capital and Financial Account Balance</b>	<b>1.0</b>	<b>9.2</b>	<b>6.5</b>	<b>7.7</b>	<b>13.5</b>	<b>8.5</b>
Foreign direct investment	3.5	6.1	5.7	4.6	5.4	5.8
Net Portfolio investment	0.3	-0.3	0.5	0.0	5.4	0.2
Other investment (including loans)	-2.7	3.4	0.2	3.1	2.7	2.5
<b>Errors and Omissions</b>	<b>-1.4</b>	<b>-1.9</b>	<b>1.0</b>	<b>-1.3</b>	<b>-2.1</b>	<b>0.6</b>
<b>Overall Balance</b>	<b>-3.2</b>	<b>3.6</b>	<b>0.5</b>	<b>-1.6</b>	<b>2.6</b>	<b>2.4</b>
<b>International Reserves</b>	<b>14.5</b>	<b>17.2</b>	<b>16.0</b>	<b>13.9</b>	<b>16.5</b>	<b>18.1</b>

Source: Honduran authorities and World Bank staff estimates.

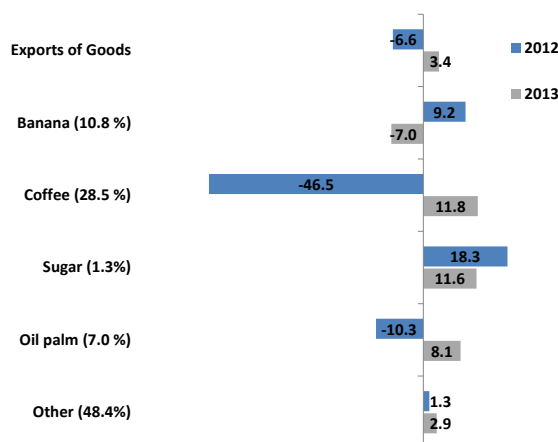
**Honduras' current-account deficit reflects a sustained decrease in saving rates (Table 3).** Underpinning the current-account deficit is a medium-term decline in saving rates. This decline is explained in part by the downward trend of private saving and in part by the widening of the fiscal deficit. The investment rate, on the other hand, has picked up after dropping by more than 10 percentage points of GDP in 2009 (Figure 19). Foreign investment has significantly bolstered investment rates, though on average they remain substantially below their pre-crisis levels.

**The trade deficit improved in 2014, after the country reached in 2013 its highest deficit in the past five years.** Honduras' external position improved during 2014 as coffee exports increased due to the recovery in production volumes. In 2014 the general-merchandise trade deficit reached US\$3.0 billion, down from US\$3.1 billion in 2012. Total exports increased by 3.4 percent, while imports increased by just 1.1 percent (-3.7 percent in 2013), due to a rebound in purchases of consumer goods, oil, raw materials and capital goods.

**Figure 19: Recent current-account dynamics reflect a decline in domestic savings.**  
(Honduras' investment-savings gap, % of GDP)



**Figure 20: Higher exports of coffee and oil palm led growth in total exports.**  
(Annual change, %)



Source: Honduran authorities and World Bank staff estimates.

**Overall, the impact of the global financial crisis has been more acute in Honduras than in other countries in Central America.** Honduras has run current-account deficits for thirty consecutive years, relying on foreign borrowing to finance the shortfall, and has seen higher deficits, on average, than other countries in the region. For instance, during 2000-2014 Honduras' current-account deficit averaged 6.4 percent of GDP, compared to an average of 5.5 percent for the countries in its regional free-trade zone, the CAFTA-DR.<sup>2</sup> However, this gap has continued to widen in the post-crisis period; Honduras' current-account deficit averaged 8.1 percent of GDP over the past five years compared to an average of 6.5 percent for the CAFTA-DR.

<sup>2</sup> Costa Rica, the Dominican Republic, El Salvador, Guatemala and Nicaragua.

### Box 3

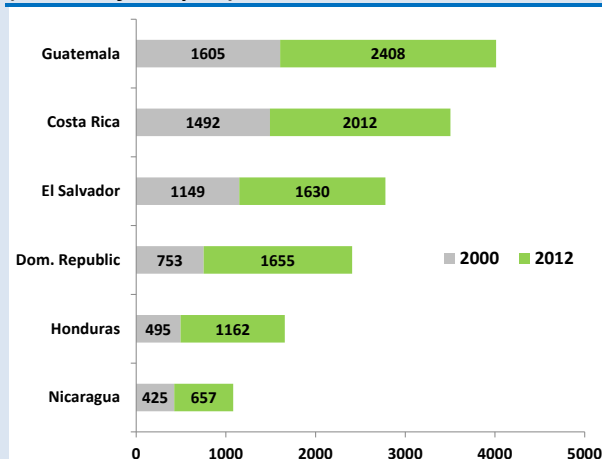
## Honduran Melons in Hong Kong Recent developments in export diversification

In recent years Honduras has become increasingly integrated into world markets, reaching export destinations far beyond its traditional trading partners. In 2000 Honduras exported to 62 countries. By 2012 that number had risen to 101. This remarkable 66 percent increase in export destinations was double the average for the other CAFTA-DR countries over the same period (Figure 21).

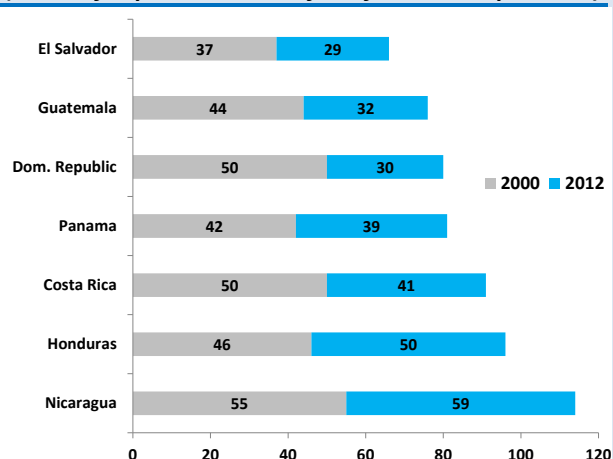
At the same time Honduran exports have also become more diversified. The expanding range of exports has helped to mitigate the impact of shocks in Honduras' traditional export markets. Melon exports, for example, doubled in value in less than ten years. By 2012 Honduran melons were available in Hong Kong, Singapore, the United Arab Emirates and other distant markets. Yet despite the rapid diversification of Honduran exports, the share of the five most important exports in total export revenue increased from 46.3 percent to 49.7 percent over the same period, reflecting, among other factors, increased in international prices for Honduran primary commodities over the past decade (Figure 22).

The signing of a number of trade agreements over the past few years are likely to help in further diversifying Honduras' export basket. These agreements are expected to help Honduran firms reduce their fixed costs in penetrating new markets. Trade costs are expected to fall not only due to the reduction of tariffs as a result of the trade agreements, but also due to increased trade and trade-related services between Honduras and its trade partners. Research and development (R&D) collaboration between enterprises and universities has been conducive to innovations, and to the diffusion of knowledge. For instance, Honduras' successful experience with the Agricultural School Zamorano has been held up as an example of regional best practice and deserves further attention (see World Bank 2014, Honduras Current Account Assessment).

**Figure 21: Honduras has significantly increased the number of products exported...**  
(Products for export)



**Figure 22: ...yet, its 5 main products have become more important in total exports.**  
(Share of exports revenue of the first 5 main products)

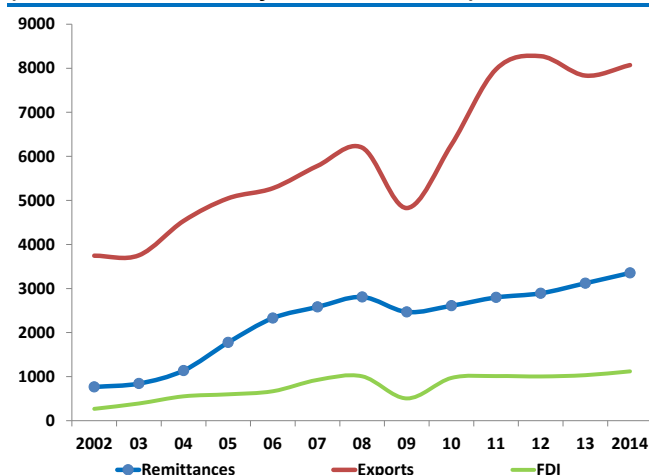


Source: World Bank (2014a), Honduras Current Account Assessment.

**Remittances have registered strong growth as the US labor market continues to recover.** Remittances are Honduras' second-largest source of foreign exchange (after goods exports) and are equivalent to more than three times the value of foreign direct investment (FDI). During the post-crisis period remittances averaged US\$2.9 billion (16.4 percent of GDP), reaching a peak of US\$3.3 billion (16.9 percent of GDP) in 2014. Although large remittance inflows can cause the real exchange rate to appreciate, with potentially negative impacts on the tradable sector, they also provide an important source of external financing, particularly for domestic consumption.

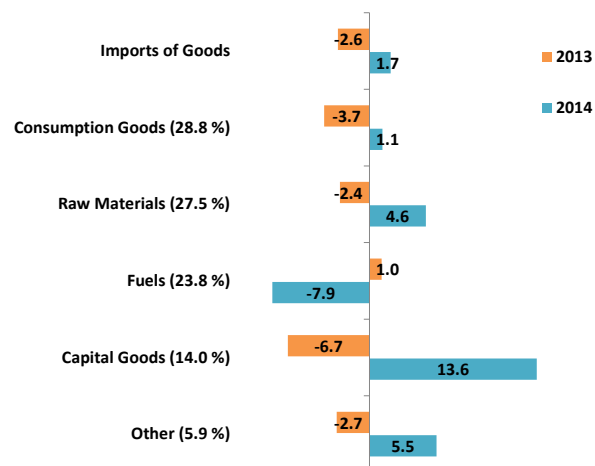
**Figure 23: Remittances are an important component of the Honduran economy.**

(Annual remittances inflows, US\$ millions)



**Figure 24: Imports have recover in almost all categories.**

(Annual change, %)



Source: Honduran authorities and World Bank staff estimates.

**FDI remains the largest source of external financing for the current-account deficit.** Honduras' FDI inflows have regularly exceeded 5 percent of GDP—except in 2009, when FDI volumes plummeted worldwide. In recent years FDI has financed almost 70 percent of the current-account deficit, roughly in line with the CAFTA-DR average. In 2014, FDI surpassed US\$1.1 billion, 5.7 percent of total GDP. FDI inflows have also shown much less volatility than portfolio and other investment inflows, and are typically associated with technological and knowledge transfers from abroad.

#### Box 4

### Saving and Spending

#### *Are Honduras' Current-Account Deficits a Cause for Concern?*

**The widening in Honduras' "twin deficits"—fiscal deficit and current account deficit—particularly between 2009 and 2013 has raised concerns about macroeconomic sustainability.** The public sector's fiscal deficit widened from 4.5 percent of GDP in 2009 to 7.6 percent in 2013. The current account deficit has widened from less than 4 percent of GDP in 2009 to 9 percent of GDP in 2013, a level not seen since the early 1980s. While Honduras has run sustained current account deficits for the past thirty years, the recent widening in the deficit seen over the past five years reflects a series of shocks, including weaker demand for Honduran exports as a result of the global financial crisis, as well as higher import prices and a widening in the fiscal deficit.

**The current account measures the difference between what an economy produces and what it consumes and invests in a given period (or alternatively, the difference between national savings and investment).** When countries consume and invest more than what they produce, they need to borrow from the rest of the world to finance that gap. The current account deficit reflects that amount that a country borrows from the rest of the world to finance the investment and consumption in excess of its level of production, or income. The current account balance of a country comprises three subcomponents: the trade balance, the income balance and the transfer balance.

**A large current account deficit in itself is not necessarily a source of concern, provided that the borrowing is used to fund productive investment in the economy.** For example, if a relatively poor country on a path to growth, and constrained by low levels of domestic savings, borrows from abroad to finance higher investment rates, all other things equal, it will run a current account deficit. Over time, the returns on these investments will help generate the income to repay foreign creditors via accelerating economic growth. On the other hand, current

account deficits can also arise without a corresponding increase in investment, as often occurs when current account deficits are caused by public sector deficits. When governments spend more than what they collect in taxes, countries run current account deficits, all else being equal. If public borrowing is predominately channeled into greater public investment, such as in infrastructure, it can generate a future economic return. However, in most cases public deficits are unlikely to be associated with faster future growth, and instead typically reflect higher current expenditures. These simple examples stress the importance of identifying the underlying sources of the current account deficit: is it mainly driven by fiscal deficits, by low private saving rates, or by high private investment rates?

**In Honduras the deterioration of the current account deficit in the past few years is partly driven by a decline in national saving rates resulting from rising fiscal deficits.** From 2009-2011, the widening in the current account deficit can largely be attributed to a recovery of national investment in the aftermath of the global financial crisis – up from around 20 percent of GDP in 2009 to 26 percent in 2011, which was not matched by a commensurate rise in domestic savings. However the further widening in the current account deficit since 2011 has coincided with declines in national investment, which has been more than offset by even greater declines in national savings (Figure 19). Over the same period, the fiscal deficit has widened further from 2.8 percent of GDP in 2011 to 7.6 percent in 2013, suggesting that fiscal deficits have been a principal driver of the widening current account deficit.

**A recent World Bank study notes that government expenditures have played a crucial role in the dynamics of the current account deficit:** every extra US\$100 spent by Honduras' government is associated to an increase in the current account deficit of US\$14, keeping everything else constant.

**If poorly managed, the current account deficit could present external financing risks in the short-term.** The sustainability of the current account depends upon the degree of borrowing, and whether foreign investors are willing and able to lend to the country to finance the current account the short term. To date, the widening current account deficit has been financed largely via FDI inflows, which are typically a more stable source of financing. However the size of the current account deficit and recent run up in Honduras' external debt as a result of accumulated deficits remain a cause for concern. The country's large current account deficit could reduce confidence in the currency, which is particularly relevant since firms and households hold almost 30 percent of their credit lines in foreign currency, mostly unhedged. As such, the potential flow on impacts from problems with financing the deficit could have severe implications for access to finance and business and consumer confidence, with flow on impacts for growth and job creation.

## Monetary Policy and the Financial Sector: Credit Growth Decelerates and Dollarization Increases

*The depreciation of the real effective exchange rate between mid-2011 and 2013 has boosted Honduras's trade competitiveness, though this situation has reversed in 2014. Credit growth decelerated but remains relatively robust, and the banking industry appears healthy. However, lending activity is heavily concentrated in particular economic sectors, such as consumer and housing lending and by geographic regions, with over 90 percent of formal lending focused in just three provinces. Going forward, greater financial deepening to extend access to financial services and credit to households and firms across the country would help support economic growth. Meanwhile, the dollarization of the economy remains significant and continues to rise.*

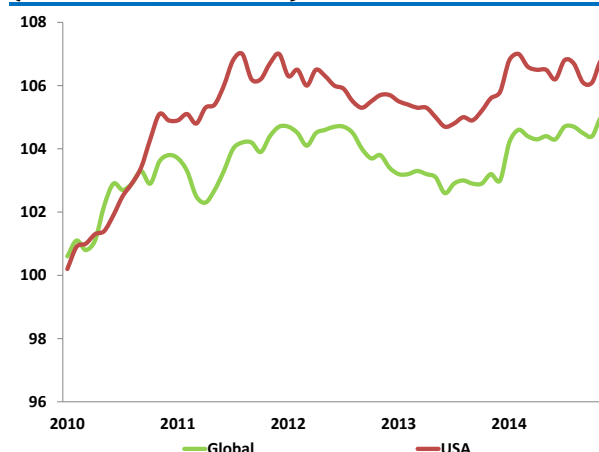
**In the first quarter of 2015, the Honduran Central Bank adopted an expansionary monetary policy.** Although in the last three years the Central Bank had successfully reduced liquidity in the money market while keeping its policy rate stable, this year the Central Bank raised the policy rate by 25 basis points on February and March after 32 months (from 7.0 percent to 6.5 percent) in a

context of anchored inflation expectations, decreasing fuel prices and a negative output gap. In addition, since 2011 the Central Bank has permitted greater flexibility in daily exchange-rate movements. In mid-2011 a crawling band was introduced for exchange-rate and foreign-exchange market interventions. This policy was expanded in July 2013, allowing for more flexibility in exchange-rate fluctuations, and allowing the currency to depreciate faster since the last few months of 2014.

**Although the nominal exchange rate remained broadly stable in 2014, the modest depreciation of the real effective exchange rate (REER) has provided some support to Honduras' export competitiveness since 2011.** The real effective exchange rate has seen a modest depreciation since mid-2011, before stabilizing from mid-2013. This has provided some support to exports, but has been insufficient to generate any significant shift in Honduras' external imbalances, and especially the current account deficit. Yet, during 2014 the REER appreciated continuously, affecting Honduras' export competitiveness.

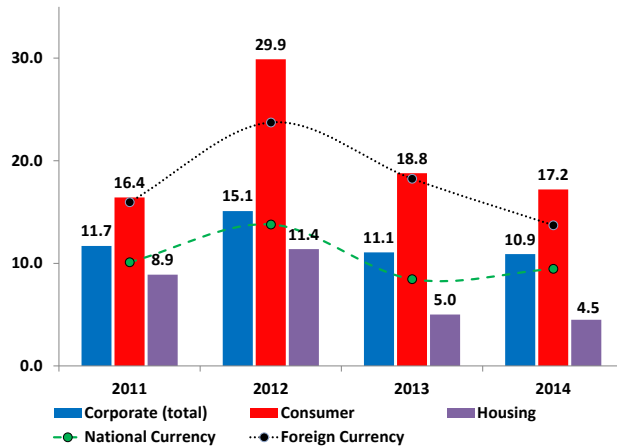
**Credit growth to the private sector has slowed, but the rising share of credit in foreign currency warrants careful monitoring.** Credit to the private sector grew by 10.7 percent in 2014, down from 11.1 percent in 2013 (Figure 26). The slowdown in lending was the result of a deceleration of credit in foreign currency in a context of the depreciation of the local currency, combined with higher interest rates and less market liquidity (controlled by the Central Bank through open market operations). Yet, the credit dollarization ratio has increased on the back of comparatively stronger foreign currency lending, reflecting the gap in interest rates between local and foreign currency lending. Financial dollarization was also boosted by the increasing foreign currency liquidity held by Honduran banks.

**Figure 25: Recent exchange-rate depreciation has boosted Honduras' trade competitiveness. (REER index, 2009=100)**



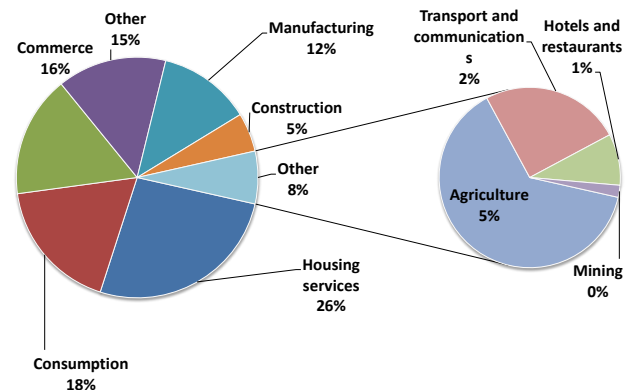
Source: Honduran authorities and World Bank staff estimates.

**Figure 26: The growth of credit to the private sector has slowed...**  
(Credit growth, %)



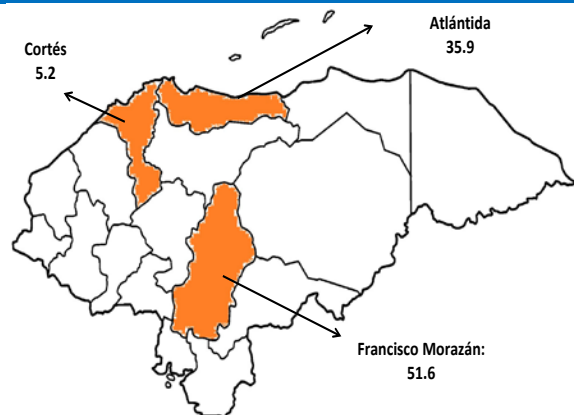
Source: Honduran authorities and World Bank staff estimates.

**Figure 27... and is currently concentrated in housing and consumption.**  
(Shares of outstanding bank loans, %)



**There is considerable scope for further financial deepening in Honduras.** The banking sector as a whole remains relatively sound: banks are profitable, liquid, well-capitalized and domestically funded, and their recent performance on key financial-soundness indicators has been robust. Nevertheless, domestic capital markets remain relatively shallow, with a highly concentrated investor base and a virtually nonexistent secondary government-debt market. Lending remains focused on residential housing and consumption (Figure 28). Finally, despite the expansion of credit, 90 percent of all outstanding banking loans are concentrated in the provinces of Francisco Morazán, Atlántida and Cortes.

**Figure 28: Provinces' share of credit is growing, but lending is concentrated in the Francisco Morazán Region.**  
(Shares of outstanding bank loans in 2013, %)



Source: Honduran authorities and World Bank staff estimates.



## II. Economic Outlook and Risks

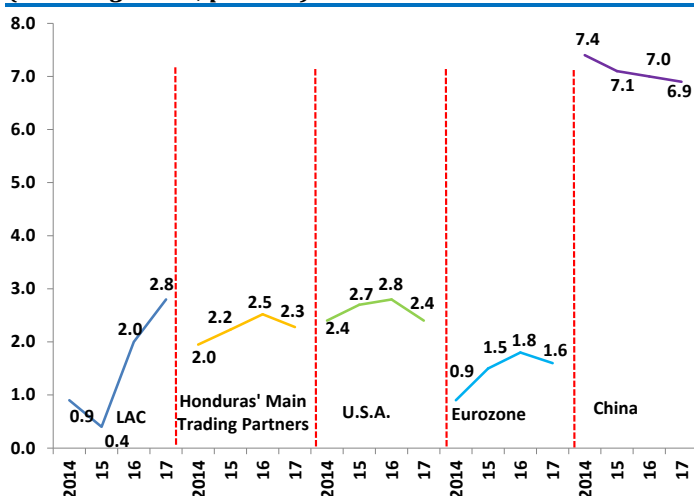
### The Global Outlook: A Rising Tide Lifts Expectations

*Growth rates among Honduras' main trading partners are expected to accelerate over 2015-2016, and current projections anticipate a gradual return to normalcy in international financial markets as the US and other advanced economies continue to scale back their monetary stimulus policies. Rising consumer demand in the United States will fuel export growth, while the recovery of the US labor market is expected to bolster remittance inflows, supporting an increase in domestic consumption. Emerging economies are projected to grow at a more moderate pace, which should have only modest implications for Honduras, but further disruptions in the euro zone could indirectly impact the Honduran economy indirectly via its main trading partners, especially the US. Lower oil prices are expected to drive real income shifts from oil-exporting countries to oil-importing countries.*

#### **Growth among Honduras' major trading partners is projected to grow by an average of 2.3 percent in 2015-2017.**

The US economy is projected to grow by 2.7 percent in 2015 and by about 2.6 percent in 2016-2017, accompanied by low inflation, a declining unemployment rate, and a stabilizing real estate market. These factors are expected to underpin an increase in import demand in Honduras' top export market. Meanwhile, economic activity in Mexico, El Salvador, Guatemala and Costa Rica is expected to recover over 2015-2017 thanks to their similarly strong trade ties with the US. On average, Central American economies are projected to grow between 3.2 and 3.7 percent over 2016-2017. The euro zone is also projected to recover gradually over the next few years. Although the euro zone represents a relatively small share of Honduran trade, developments in the region have important implications for Honduras' main trading partners.

**Figure 29: Growth among Honduras' main trading partners is expected to accelerate over 2015-16 (Annual growth, percent)**



Source: Global Economic Prospects and World Bank staff estimates.

**After recovering modestly in 2014, Honduras' terms of trade are projected to continue improving from 2015.** The stabilization of the Chinese economy, coupled with accelerating growth in advanced economies, is expected to boost global commodity prices, improving Honduras' terms of trade. Overall, prices for key Honduran exports are expected to remain relatively stable, although some major export products are expected to see very modest price declines over 2015-16. In 2013 coffee prices fell to their lowest level since 2009, as global markets responded to an excess of supply, but have since recovered. Over 2015-2016, robust coffee production in major exporting countries and high levels of inventories worldwide should keep coffee prices low and stable. At the same time, prices for Honduras' imports are expected to decline, driven by falling oil prices.



**A gradual rise in global long-term interest rates is projected as the US Federal Reserve slows the pace of its bond purchases through a process known as “tapering”.** In recent years, a combination of high commodity prices and favorable global financing conditions has supported the growth of many developing and emerging economies. However, in January 2014 the Federal Reserve began to reduce the size of its bond purchases, indicating an important shift in US monetary policy. During 2015-2016, investors are expected to continue restructuring their portfolios and migrating toward less risky markets. This in turn, is expected to increase financing costs in emerging markets and slow capital inflows to Latin America and the Caribbean, which could further increase the cost of Honduras’ debt and hinder its efforts at fiscal consolidation.

## **Honduras’ Outlook: The Pivotal Role of Reform**

*The Honduran economy is expected to experience a recovery during 2015-16. Growth is projected across all major sectors. The agricultural sector will benefit from a continuous recovery in coffee production combined with rising yields for other export-oriented crops. Meanwhile, continued growth in the manufacturing sector, driven by the auto parts and “maquila” subsectors, will have an especially positive impact on employment indicators—as will increased construction activity, which is anticipated to improve as investor confidence rises. Increasing investment will boost the credit supply in the context of a solvent, albeit relatively shallow, financial sector, while expanding internet and telecoms infrastructure spurs growth in communications and related services. Furthermore, lower oil prices would help reduce the current account deficit. Yet, this forecast is predicated on the assumption that current efforts at fiscal consolidation, as well as broader governance reform measures, will continue to be implemented and that past progress will be maintained. Consequently, sustained political commitment to the reform agenda is critical to the positive domestic outlook presented below.*

**The Honduran economy is projected to grow at an average annual rate of 3.2 percent during 2015-16, with growth forecast across all economic sectors (Table 4).** The scenario for 2015-2016 envisages a gradual economy-wide acceleration supported by the steady expansion of agriculture, manufacturing, construction and services. Agricultural output will continue to grow partly driven by the fall in oil prices, the recovery in coffee production and because prices for Honduran exports are expected to remain relatively high overall. Demand for palm oil and fruits is expected to grow rapidly, particularly from the United States and Central America. Growth in the manufacturing sector will be supported by rising domestic demand and the ongoing economic resurgence in the United States, with clothing and textiles and food and beverages projected to lead sectoral exports. In addition, an expanding manufacturing sector is projected to have an especially positive impact on employment. Meanwhile, services will continue to grow at the pace observed over the last two years. The expansion of the tertiary sector will be driven by transportation and communications (especially internet and telecom) and by financial services. Meanwhile, construction is expected to rebound after the deceleration of 2014, as increasing confidence in the economy spurs a mild recovery in private investment, although lower public investment may affect construction.

**Table 4: Economic growth is expected to improve, and sustained fiscal consolidation efforts would support improvements in other macroeconomic indicators.**

*(Forecast of Key Economic Indicators for Honduras;  
Fiscal figures are for the combined public sector)*

	2010	2011	2012	2013	2014e	2015f	2016f
<b>Real Economy</b>	(Percent change)						
GDP	3.7	3.8	4.1	2.8	3.1	3.2	3.2
Agriculture and livestock	1.8	6.5	10.7	3.4	2.7	4.4	4.0
Mining	-4.0	-10.6	-3.2	-6.9	-5.1	1.3	1.0
Manufacturing	4.5	4.4	1.8	3.4	1.5	3.3	4.1
Electricity and Water	-0.2	3.6	2.9	-2.5	1.3	2.5	2.5
Construction	-2.4	4.4	2.4	-2.5	-8.2	0.0	1.0
Commerce	3.4	4.2	3.8	2.1	2.0	2.8	2.8
Services	4.8	2.9	3.6	3.2	5.0	3.1	3.0
Domestic demand	4.4	6.7	2.5	0.6	2.9	5.9	2.8
Private consumption	3.6	3.6	4.3	3.8	2.7	8.9	3.7
( percent of GDP )	78.1	77.6	78.6	81.3	81.1	77.2	78.6
Gross Capital formation	12.0	24.1	-2.7	-11.4	6.8	1.7	1.7
( percent of GDP )	21.9	26.0	24.6	21.8	22.1	23.1	22.7
Exports of goods and services	15.7	8.4	9.8	-1.3	1.6	6.1	1.8
( percent of GDP )	45.8	51.3	50.9	48.3	46.9	43.2	40.4
Imports of goods and services	15.2	12.7	6.3	-4.1	1.5	10.4	1.4
( percent of GDP )	63.7	71.0	70.3	69.3	65.7	58.3	56.0
Consumer prices (end of period)	6.5	5.6	5.4	4.9	5.8	4.0	4.0
<b>Fiscal Accounts</b>	(Percent of GDP, unless noted)						
Non-interest revenues and grants	24.1	23.1	22.5	22.9	24.4	25.6	25.9
Of which: Tax revenues	15.1	15.4	15.1	15.3	17.3	17.3	17.5
Total Non financial expenditures	26.1	24.8	25.4	28.4	26.6	25.4	24.7
Current expenditures	20.7	19.0	19.4	22.0	20.7	20.4	19.7
Capital expenditures	5.4	5.9	6.0	6.4	6.0	5.0	5.0
Primary balance	-2.0	-1.7	-2.9	-5.6	-2.2	0.2	1.1
Interest payments	0.9	1.1	1.3	2.0	2.1	3.0	3.1
Overall balance	-2.8	-2.8	-4.2	-7.6	-4.3	-2.9	-2.0
<b>Balance of Payments</b>							
Trade balance (Billions of US\$)	-2.6	-3.1	-3.0	-3.1	-3.0	-2.7	-2.7
Trade balance (Percent of GDP)	-16.8	-17.9	-16.3	-17.1	-15.7	-13.7	-13.7
Current Account Balance (Percent of GDP)	-4.3	-8.0	-8.6	-9.6	-7.6	-6.0	-6.0
International Reserves (Percent of GDP)	17.3	16.0	13.9	16.6	18.4	19.3	19.8

E: estimates, F: forecasts

Source: Honduran authorities and World Bank staff estimates.

**Honduras' macroeconomic outlook is expected to improve during 2015-16, with a positive external environment supporting critical efforts to strengthen the country's fiscal position and boost economic growth.** The ongoing recovery in the United States is expected to bolster export revenues and remittance inflows. Lower oil prices are expected to have a positive impact on domestic inflation<sup>3</sup> (as observed in the last quarter of 2014 and the first quarter of 2015) and on the trade balance. In particular, inflation is expected to decline below the Central Bank's target band of 5.5-7.5 percent. The current-account deficit is projected to fall from 7.6 percent in 2013 to 6.0 percent by 2015, reflecting an improved trade balance, increasing remittances, and a supportive fiscal policy.

<sup>3</sup> To the extent that there is a high pass-through effect from oil-prices to domestic prices, inflation is expected to fall more rapidly than the increasing purchasing power of Honduran households.

**However, this positive macroeconomic outlook is vulnerable to downside risks.** Uncertain global market conditions, and especially the possibility of weaker growth in the United States, could negatively impact Honduras' prospects over the medium term. Perhaps most crucial, however, is the risk posed by the potential erosion of fiscal discipline and commitment to the structural reform agenda, as the positive domestic outlook presented below hinges on the government's continued pursuit of fiscal consolidation in a context of sound macroeconomic management.

**Near-term growth will be driven by consumption, while the share of private investment in GDP is projected to recover.** According to World Bank projections, the share of private investment to GDP will increase from about 18 percent in 2014 to an average of 19 percent during 2015-16. Meanwhile, the GDP share of public investment is expected to remain steady, at around 4 percent during 2015-16 as a consequence of the ongoing fiscal consolidation program. Going forward, accelerating private investment growth will require further efforts to reduce the cost of doing business and promote foreign investment, as well as measures to improve domestic security conditions. However, if achieved, higher investment holds the potential to significantly lift growth and expand employment opportunities.

**Sustained fiscal consolidation will be critical to Honduras' long-term growth trajectory.** The overall fiscal deficit of the combined public sector is projected to decline from 4.3 percent of GDP in 2014 to 2.0 percent by end-2016. This projection is contingent on the success of efforts to continue improving the government's revenue position, limit the growth of current expenditures and mitigate the fiscal risks posed by state-owned enterprises. The fiscal reform would build the foundations for more robust economic growth in the longer-term, although they are expected to weigh on growth in the near-term. The government is also attempting to shore-up the financial position of the ENEE, the state-owned electricity company, through efforts to improve the utility's corporate governance structure. Meanwhile, enhanced public financial management, particularly in the areas of procurement and payroll, are also expected to yield fiscal savings provided that enhanced controls can be maintained over time.

**The public debt is expected to stabilize over the medium-term as part of a general improvement in debt indicators.** As noted in Part I, Honduras' debt-to-GDP ratio is projected to peak in 2017 before gradually decreasing in subsequent years. The near-term increase in external debt will be driven by new bond issues in international markets and by loans from multilateral institutions, while the domestic debt stock should remain stable. Two-thirds of Honduran debt is denominated in foreign currency; consequently, a sharp depreciation of the lempira could potentially threaten debt sustainability. Interest payments are projected to increase over the medium-term, but the country's overall debt-service obligations should remain manageable given ongoing implementation of the fiscal consolidation program.

**The domestic financial sector is well capitalized and profitable, and it is expected to remain so over the medium term; however, the shallowness of financial markets and narrow concentration of access to credit means that many lack access to financial services, while placing a brake on growth.** The banking sector is relatively sound, and all financial institutions exceed the minimum capital-adequacy ratio. Bank deposits have held roughly constant, while nonperforming loans have declined from 4.7 percent in 2009 to a projected 3.6 percent in 2014. Over the medium term, however, the projected expansion of foreign-currency lending caused by excess bank liquidity will require close monitoring, especially the foreign-currency loan portfolio held by unhedged borrowers. Planned reforms supported by an ongoing IMF program would help mitigate financial sector risks.



## Focus Section

### Poverty and Shared Prosperity in Honduras





### III. Focus Section: Poverty and Shared Prosperity in Honduras<sup>4</sup>

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**The government of Honduras defines poverty reduction as a key development goal in its national development strategy, *Plan de Todos para una Vida Mejor*, adopted in 2014.** Eradicating extreme poverty and promoting shared prosperity are both fundamental development goals shared by the government and the World Bank.<sup>5</sup> And they are of especially critical importance in Honduras, as the country continues to suffer from high levels of poverty and inequality coupled with low levels of socioeconomic mobility.

**Progress in alleviating poverty achieved during the high-growth years of the mid-2000s was undermined in the wake of the global financial crisis, but 2013 poverty rates suggest the country is recovering.** While economic growth, job creation and significant increases in remittances led to a decline in poverty and inequality in the mid-2000s, between 2009 and 2012, a combination of exogenous shocks and domestic fiscal instability had an especially damaging impact on Hondurans living below or near the poverty line. Low productivity and inequitable distributions of services and opportunities also contributed to the resurgence of poverty rates.

**This Focus Section analyzes recent trends in and drivers of poverty in Honduras and evaluates the country's progress in achieving shared prosperity.** Understanding the drivers of poverty and inequality is key to designing effective development policies. The section begins with an examination of recent trends in poverty, inequality, and shared prosperity in Honduras, situating Honduras' performance in an international context. An analysis based on international poverty lines reveals similar trends to those indicated by national poverty measures. The focus section concludes with a look at how different factors have contributed to recent progress on poverty alleviation and improvements in the living standards of the population as a whole.

#### Poverty and Shared Prosperity: Recent Trends

**Honduras continues to experience very high rates of poverty, and extreme poverty is especially prevalent.** Honduras is one of the poorest countries in the region, with an annual GDP per capita of US\$4,445 in purchasing power parity terms, equivalent to about one-third of the average for Latin America and the Caribbean (LAC). Poverty rates in Honduras are very high, both by regional and international standards. In 2013, the moderate poverty rate was 64.5 percent according to the national poverty line, and a full 42.6 percent of Hondurans lived in extreme poverty. While high, these rates represent a sizeable reduction in poverty since 2012.

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<sup>4</sup> This section is partly based on a forthcoming World Bank study on Shared Prosperity and Extreme Poverty Reduction in Latin America.

<sup>5</sup> In April 2013, the World Bank Group endorsed two ambitious goals: (1) to end extreme poverty by 2030; and (2) to promote "shared prosperity" by boosting the incomes of the poorest 40 percent of the population in every country. The introduction of the second goal marked a shift in the World Bank Group's poverty reduction mission.

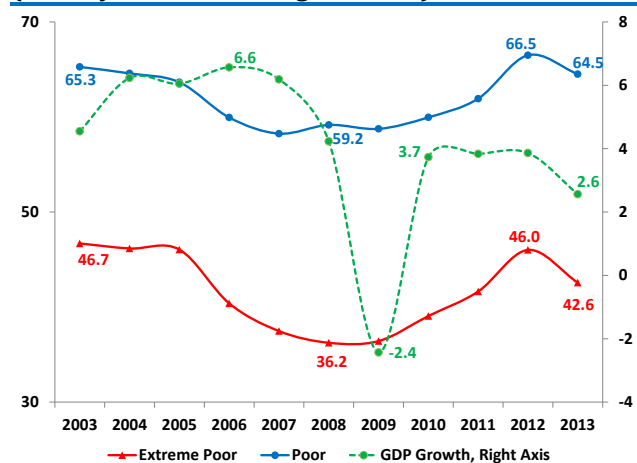
**To measure the incidence of poverty, Honduras uses two income-based poverty lines.** First, the extreme poverty, or “food poverty”, line reflects the cost of a locally obtained basic food basket that meets minimum caloric requirements. Second, the overall poverty line is constructed by taking the extreme poverty line and adding a set of basic nonfood goods. Using the national household survey, income estimates are constructed at the household level, which include both labor and non-labor income. This aggregate income is adjusted by a factor to correct for under-reported incomes. The adjusted household income is then divided by the number of household members to obtain the household income per capita.

**There are some concerns with respect to how poverty is measured in Honduras.** First, the methodology used to adjust for non-declaration of income was developed fifteen years ago and may not be appropriate today. Second, different poverty lines are used for urban and rural areas, but it is not clear that there are significant spatial differences in cost of living. Finally, the nominal urban poverty line may be too high when compared to other countries in Central America, such as Costa Rica or Panama, which have a higher GDP per capita than Honduras.<sup>6</sup>

**Poverty in Honduras fell during the economic expansion of the mid-2000s.** Between 2003 and 2009 the national poverty rate declined by almost 6.3 percentage points (Figure 30). A robust global economy boosted export revenue, large investment inflows created new employment opportunities, and a vibrant US labor market boosted remittances and fuelled increased domestic consumption. In 2009, however, a series of shocks in the global economy caused a sharp contraction in Honduras. Export demand declined, foreign investment dried up, and remittances faltered as the US unemployment rate spiked. The years that followed were characterized by slow and uncertain recoveries in both the Honduran and global economies. Growth resumed, but at a much slower pace, and both exports and remittances remained depressed. Finally, the spread of the coffee rust blight began to damage output among coffee producers, many of whom are among the nation’s poor. The weakening macroeconomic environment took a heavy toll on lower income Hondurans, and the poverty rate rose by 7.7 percentage points to reach 66.5 percent in 2012.

**While other countries in the region have also suffered from slower growth rates in the years following the global financial crisis, the impact on poverty in Honduras has been especially acute.** The country’s rates of poverty and extreme poverty are now approaching the levels observed a decade ago. This stands in stark contrast to the significant progress made elsewhere in the region during the same period. In LAC as a whole, both poverty and extreme poverty have fallen steadily since 2001, with the rate of decline remaining roughly similar in both the pre-crisis and post-crisis periods (Box 6). Poverty in Honduras, meanwhile, shows a markedly different trend, indicating that gains in poverty reduction have been harder to achieve and maintain in the Honduran context.

**Figure 30: Gains in reducing poverty during the mid-2000s were reversed in recent years. (Poverty rates and GDP growth, %)**



Source: Honduran authorities and World Bank staff estimates.

<sup>6</sup> For more information, see Cadena et al (2013).

## Box 6

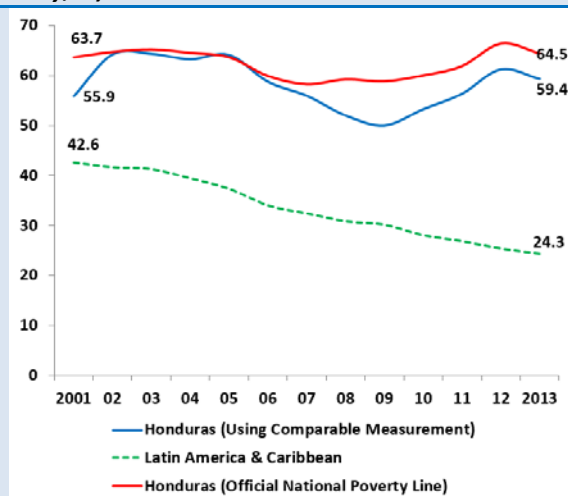
## Falling Behind

### Comparing Poverty Trends in Honduras with Regional Averages

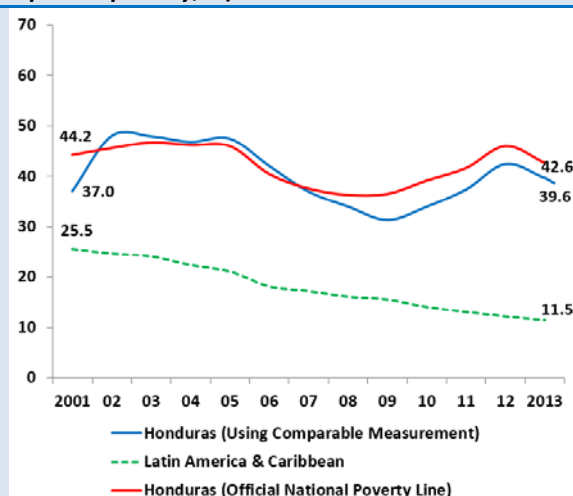
To measure poverty across countries, the World Bank and its partners have developed comparable income data and international poverty lines.<sup>7</sup> The figures produced by the Honduran National Statistics Office reveal the evolution of nationally-defined poverty indicators over time – these are the poverty trends underlying much of the analysis presented in this report. Though informative, poverty lines and estimation techniques vary between countries, thus these are not internationally comparable. The World Bank figures, on the other hand, enable international comparisons and benchmarking. Hence, all cross-country analyses presented in this report are based on these international lines.

Using comparable poverty estimates, poverty rates in the LAC region have declined significantly in recent years, in contrast with recent trends in Honduras (Figure 31). On average, total poverty rates in LAC (measured as the share of individuals earning less than US\$4 per day in 2005 purchasing power parity) fell by more than a third between 2001 and 2013. Much of this decline is attributable to gains in the Southern Cone and Brazil, with lower gains in Central America and Mexico.<sup>8</sup> Meanwhile, Honduras' poverty rate has fluctuated far above the regional average, ending the period with poverty rates more than double those of the region.

**Figure 31: Poverty in Honduras remains high, and recent trends are in contrast with those in LAC.**  
(Poverty Rates in Honduras and LAC, US\$4 per person per day, %)



**Figure 32: The difference in extreme poverty between the LAC region and Honduras has widened**  
(Extreme Poverty Rates in Honduras and LAC, US\$2.5 per person per day, %)



Source: World Bank tabulations based on SEDLAC (CEDLAS and the World Bank); estimates are comparable across countries and are based on national household surveys.

Trends in extreme poverty rates also lag behind the LAC average (Figure 32). Between 2005 and 2009, extreme poverty in Honduras (measured as the share of individuals earning less than US\$2.5 per day in 2005 purchasing power parity) fell from 47.4 percent to 31.3 percent. These gains have largely been reversed since 2009 with extreme poverty reaching 39.6 percent in 2013. This is more than three times the LAC average. From 2009 to 2013, 8.3 percent of Hondurans, or roughly 780,000 people, fell into extreme poverty. Furthermore, 17.3 percent of Hondurans have

<sup>7</sup> In conjunction with CEDLAS, the World Bank produces a harmonized set of household surveys for the LAC region called SEDLAC. As of this writing, the last year of data available for Honduras in the SEDLAC project was 2013.

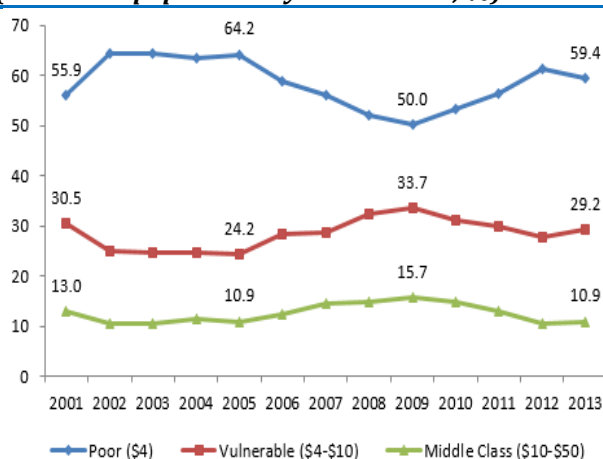
<sup>8</sup> World Bank (2014b).



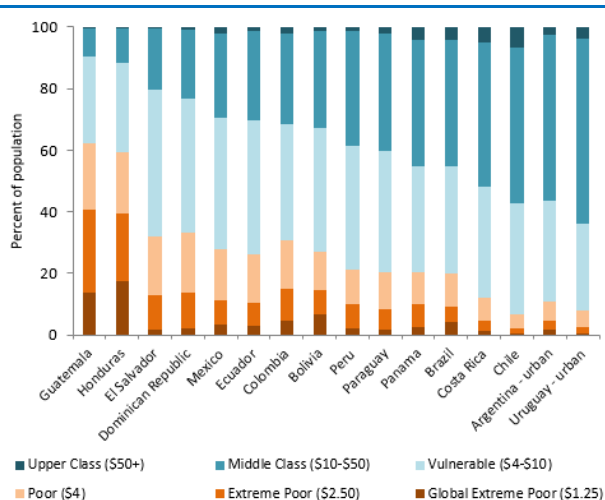
incomes below US\$1.25 per day – the global extreme poverty line. This is more than four times higher than the LAC rate of 3.9 percent and second highest among the region’s countries with available poverty estimates, with only Haiti surpassing it. As such, it is one of the countries in LAC furthest from achieving the eradication of extreme poverty as espoused by the World Bank’s twin goals.

**After expanding modestly during the mid-2000s, Honduras’ middle class contracted in the wake of the global financial crisis.** As poverty fell from 2005 to 2009, the middle class (those living on between US\$10 and US\$50 per day) grew, and by 2009 had risen from 10.9 percent to 15.7 percent of the population (Figure 33). However, by 2013, the middle class had fallen to less than 11 percent of the population as a consequence of the financial crisis and its aftermath. As of 2013, Honduras had one of the smallest middle classes in Latin America, and among the largest shares of poor households, including the highest proportion living on less than \$1.25 per day (Figure 34). In many countries, a large and growing middle class is associated with stronger economic growth and a more stable society. In Honduras, the share of households living above the poverty line but vulnerable to falling back into poverty (those with per capita incomes between US\$4 and US\$10 per day) rose in the years prior to 2009, reflecting the economy’s modest success in moving people out of poverty. After 2009 that share declined again as poverty levels increased.

**Figure 33: During the mid-2000s, the middle class grew while poverty declined, but the global financial crisis reversed this trend**  
(Honduran population by income level, %)



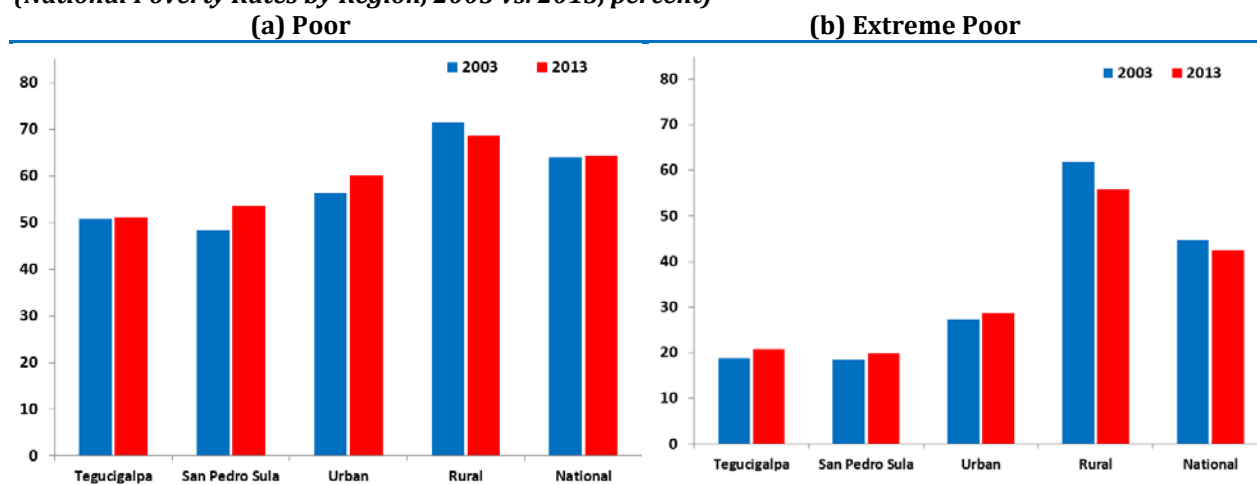
**Figure 34: Honduras has a very small middle class compared to other LAC countries**  
(Distribution of population by income level, 2013)



Source: World Bank tabulations based on SEDLAC (CEDLAS and the World Bank); estimates are comparable across countries and are based on national household surveys. All monetary values are reported in 2005 US dollars adjusted for purchasing power parity.

**National poverty trends mask significant regional disparities in the incidence and severity of poverty in Honduras (Figure 35).** In 2013, extreme poverty rates were almost three times higher in rural areas than in the capital of Tegucigalpa. Over the past decade, reductions in extreme poverty were observed mainly in rural areas. Poverty and extreme poverty increased slightly in urban areas throughout the country, contributing to an observed increase in poverty rates.

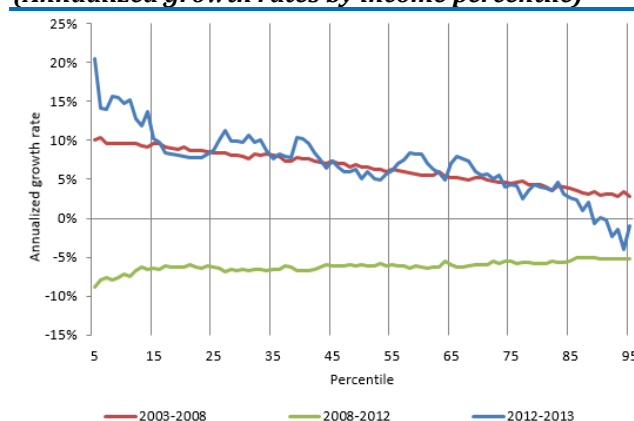
**Figure 35: Poverty and extreme poverty remained highest in rural areas**  
**(National Poverty Rates by Region, 2003 vs. 2013, percent)**



Source: World Bank staff estimates based on the Honduran household surveys (*Encuesta Permanente de Hogares de Propósitos Múltiples, EPHPM*).

**Honduras made good progress in promoting shared prosperity before the global financial crisis but the crisis and its aftermath reversed this progress.** Income grew across the board between 2003 and 2008, with the poorest seeing the strongest growth (Figure 36); during this period, the income of the poorest 40 percent of Hondurans, the World Bank's official indicator of shared prosperity, grew by 9.3 percent per year, more quickly than average income. Indeed, Honduras outperformed almost all LAC countries in growth of the income of the bottom 40 percent during this period. However, during 2008-2012 as poverty rates increased, the incomes of the bottom 40 percent contracted by 4.2 percent per year, while average incomes fell by 2.8 percent. These outcomes were among the worst in the region. This income contraction hit the poorest the hardest, with those in the 5<sup>th</sup> percentile seeing their income fall by almost 9 percent per year. Household income growth in 2013 showed signs of recovery as it was positive for the bottom 90 percent of households in 2013, particularly the poorest.

**Figure 36: While 2003-08 saw pro-poor income growth in Honduras, income fell after 2008, hitting the poorest especially hard**  
**(Annualized growth rates by income percentile)**



Source: World Bank tabulations based on SEDLAC (CEDLAS and the World Bank). Estimates are based on harmonized national household surveys.

**The extreme poor in Honduras were better off in 2013 than in 2003, reporting more access to education and higher per capita income (Table 5).** The average daily per capita income of the bottom 40 percent has increased as family sizes and number of children as a proportion of household members have fallen. In addition, the investment in human capital of the bottom 40 percent increased substantially in the last decade. Not only did school enrollment of children 6-14 years old increase by 10 percent, but the average number of years of schooling for the bottom 40 percent also grew by more than one year to 4.5. Even as these improvements have benefited the bottom 40 percent, this group still faces significant obstacles: At less than \$1.40 per day, their average income remains

significantly lower than the average among LAC's bottom 40 percent (\$3.50 per day), while the share of 15 to 24 year olds still in school remains significantly lower for those in the bottom 40 percent.

**Table 5: Profile of the Bottom 40 percent and the Top 60 percent in Honduras, 2003 and 2013**

Characteristics	2003			2013		
	All	Bottom 40	Top 60	All	Bottom 40	Top 60
<b>Household</b>						
Daily per capita income (2005 US\$ PPP)	6.2	1.0	8.9	6.4	1.4	9.0
Household size (average)	4.8	5.7	4.4	4.4	5.0	4.0
Households with female head (%)	26.3	23.5	27.7	33.0	30.7	34.2
Proportion of members 0-14 years old (%)	35.7	45.5	30.7	28.5	37.6	23.7
Proportion of members 15-24 years old (%)	20.4	16.8	22.3	19.7	17.4	21.0
Proportion of members 25-65 years old (%)	37.4	31.3	40.6	42.5	36.3	45.7
Proportion of members 66+ years old (%)	6.5	6.5	6.5	9.3	8.7	9.6
Proportion of population living in urban areas (%)	50.0	26.2	62.3	48.9	28.7	59.7
School enrolment (% of ages 5 - 14)	80.0	74.4	84.1	86.6	82.3	89.9
School enrolment (% of ages 15 - 24)	31.9	19.1	38.3	35.4	23.7	41.7
Average years of education (ages 15 and older)	5.3	3.3	6.4	6.4	4.5	7.4
Number of children (ages 0-14)	2.0	2.8	1.6	1.5	2.1	1.1
<b>Labor force (ages 18 - 65)</b>						
Labor force participation (%)	65.4	57.0	69.7	68.7	62.5	71.8
Female	43.2	26.9	51.4	49.3	34.8	56.5
Male	90.5	90.8	90.3	90.6	93.3	89.2
Unemployment rate (%)	5.1	5.4	4.9	4.0	4.6	3.7
Female	6.3	8.1	5.8	5.0	7.0	4.4
Male	4.4	4.5	4.4	3.3	3.6	3.2
<b>Employment characteristics (ages 15 - 65 and employed)</b>						
Median hourly wage (2005 US\$ PPP)	1.4	0.6	1.8	1.4	0.6	1.9
Sector of employment (%)	18.4	9.5	9.5	20.4	10.1	10.1
Share of workers in construction and utilities sectors	6.6	5.7	7.0	6.0	5.1	6.5
Share of workers in manufacturing sector	19.6	13.6	22.1	14.0	9.4	16.1
Share of workers in primary sector	32.4	60.2	20.7	33.6	61.4	20.9
Share of workers in retail sector	23.0	10.9	28.0	26.0	14.0	31.4
Share of workers in services sector						
Type of employer (%)						
Share of workers in private firms with more than 5 workers	25.3	9.6	31.7	20.8	4.9	27.9
Share of workers in private firms with 5 or fewer workers	67.6	89.4	58.7	72.8	93.9	63.5
Share of workers in the public sector	7.1	1.1	9.6	6.4	1.2	8.6
Type of worker (%)						
Employer	9.8	8.3	10.4	13.0	14.8	12.1
Self-employed	33.3	43.2	29.3	34.0	46.0	28.7
Unpaid worker	6.4	9.0	5.4	7.4	10.9	5.9
Wage employee	50.5	39.5	55.0	45.6	28.3	53.2

Source: World Bank tabulations based on SEDLAC (CEDLAS and the World Bank).

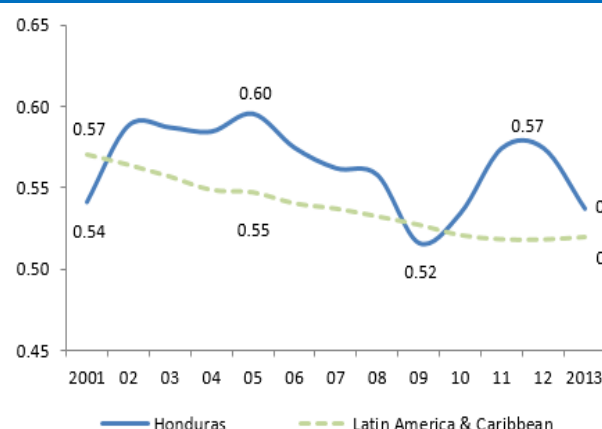
**Labor market outcomes, however, show mixed signs of improvement for the bottom 40 percent.** Unemployment rates fell, particularly for men, while the female participation rate among the bottom 40 increased (Table 5). Even so, female labor force participation of the bottom 40 percent remained extremely low (34.8 percent), and significantly lower than the female labor force participation rate for the bottom 40 in LAC (61 percent).<sup>9</sup> Additionally, several indicators of job quality fell during this period—including a reduction in the share of workers in manufacturing (both

<sup>9</sup> World Bank tabulations based on SEDLAC (CEDLAS and the World Bank).

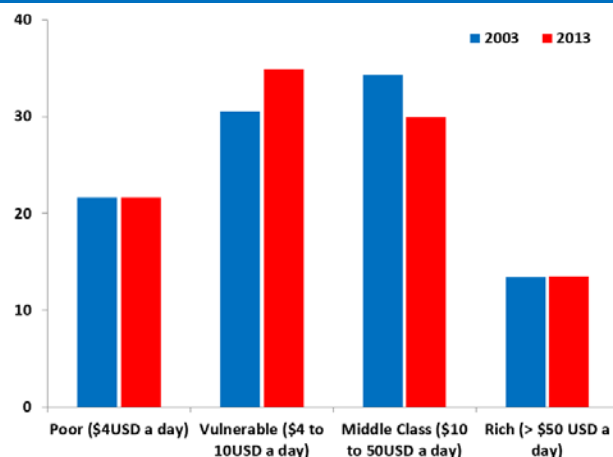
among the bottom 40 and the top 60) and a shift away from wage employment towards unpaid employment among the bottom 40 percent.

**Income inequality in Honduras remains above average in LAC.** In spite of having lower inequality than the LAC region in 2001, by 2013 Honduras' Gini index was 0.53, higher than LAC's Gini of 0.52 (Table 5).<sup>10</sup> While the 2001-2013 decade was one of consistently falling inequality for the LAC region, Honduras experienced notable swings in its level of inequality. Between 2005 and 2009 inequality fell as the income growth of the poorest significantly surpassed that of the richest. In 2009, the global financial crisis further helped reduce inequality by reducing the income of the top decile by 13.8 percent, leading to a reduction in the share of income held by the top decile from 44 percent in 2008 to 39 percent in 2009.<sup>11</sup> However, in 2010 and 2011 inequality increased as income recovered for the top decile but fell for the bottom 90 percent, hitting the poorest particularly hard. Income growth for the bottom 90 percent in 2013 led to a fall in inequality. Efforts to alleviate income inequality through more macroeconomic stability, equitable opportunities and progressive fiscal policy would contribute to reducing poverty and securing political and social stability, which in turn would facilitate continued growth and help pave the way towards the attainment of Honduras' development objectives.

**Figure 37: Income inequality in Honduras has fluctuated while declining in the LAC region as a whole**  
(Gini coefficient of income distribution, 0-1 index)



**Figure 38: The middle class saw its share of income fall between 2003 and 2013**  
(Share of Income by Social Group, 2003-2013, %)



Source: World Bank tabulations based on SEDLAC (CEDLAS and the World Bank). Estimates are based on harmonized national household surveys. A higher Gini coefficient implies a more unequal distribution of income.

**Rising income inequality is a significant concern among the public (Figure 37).** According to opinion polls, almost 47 percent of Hondurans find the current distribution of income to be unjust, and 34 percent think that it is very unjust.<sup>12</sup> The continued income gap between the top of the distribution and the majority of the population contributes to the perception of inequality, with the top half percent of households, those earning more than \$50 per day, earning 13 percent of total income in 2013.

<sup>10</sup> The Gini index is a frequently used measure of income inequality. The coefficient varies between 0, which reflects complete income equality and 1, which indicates complete inequality in the distribution of income.

<sup>11</sup> World Bank tabulations based on SEDLAC (CEDLAS and the World Bank).

<sup>12</sup> See *Latinobarometro Honduras*, 2010

**Low levels of intra-generational mobility suggest that the poor have been trapped in poverty.**

Only 6 percent of Hondurans left poverty since 2003 and remained non-poor in 2011 (Box 7). The very high rates of poverty observed in Honduras over the past decade coupled with low socioeconomic mobility implies that almost half of Hondurans have lived in poverty continuously over the past decade. Limited credit access, low productivity of land and labor, limited access to quality education, and the absence of effective risk-mitigation strategies prevent the poor from accessing new economic opportunities, thereby constraining social mobility.

**Moreover, a range of circumstances outside of individuals' control may limit access to the basic services needed to break the cycle of chronic poverty.**

Just over 84 percent of Honduran children between the ages of 10 and 14 were enrolled in school in 2011, while only 37 percent of children had access to running water in the home. The Human Opportunity Index (HOI) examines the correlation between household circumstances and access to services, thus capturing the degree of inequality of access to services deemed important for human capital development.<sup>13</sup> Lack of access to basic services in Honduras is largely correlated with living in rural areas, parental education, and family per capita income. Access to schooling (as measured by enrollment rates of 10-14-year-olds and on-time completion of the 6<sup>th</sup> grade) and cellphones are the most equitably distributed services, while access to sanitation and running water are the most uneven. Honduras has both higher levels of inequality in access and lower overall coverage rates compared to other countries in LAC.<sup>14</sup> This unequal access directly feeds into continued income inequality as these children grow up and enter the labor market.

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<sup>13</sup> See World Bank (2014b) for further details on the HOI concepts and methodology. Household circumstances included in this analysis are rural/urban status, gender (both of the child and the head of household), parental education, family per capita income, number of siblings, and the presence of both parents in the home.

<sup>14</sup> This analysis is limited to 16 countries with suitable data.

## Box 7

# Who is moving in and out of poverty?

## Tracking intra-generational income mobility in Honduras

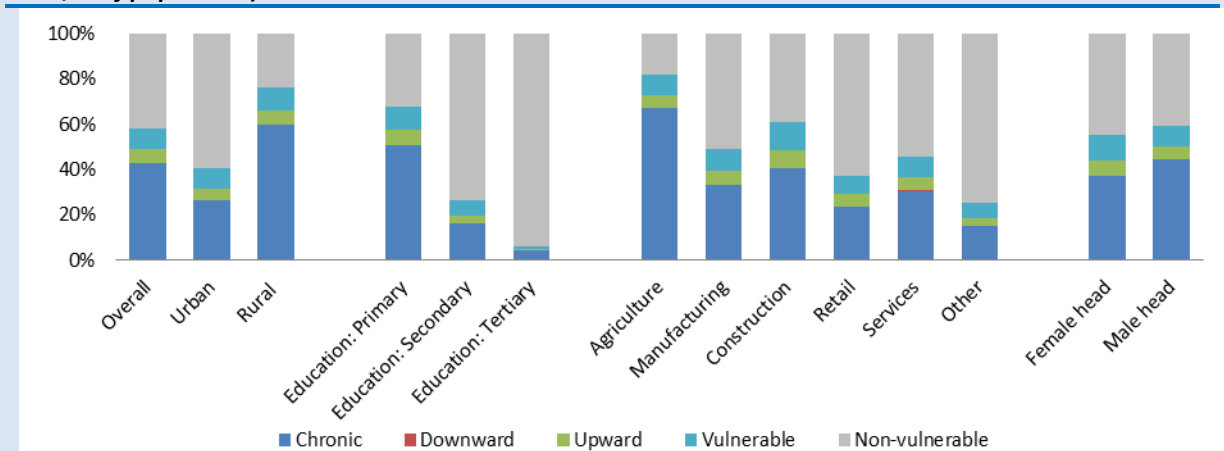
**Intra-generational income mobility measures change in the income levels of the same people over time.** Measures of poverty taken at one point in time, or even multiple points in time provide little information on intra-generational mobility. Honduras does not collect the panel data required to follow individuals over time. However, a methodology that simulates panel data was applied to household surveys in Honduras for 2003, 2007, and 2011 to look at movements into and out of poverty using the international poverty line of US\$4 per capita per day.<sup>15</sup>

**The possibility of exiting poverty in Honduras is very low.** According to estimates, only six percent of the population has been able to move out of poverty since 2003 - that is, only 6 percent exited poverty in 2007 and were still out of poverty as of 2011. Households that managed to escape poverty saw income growth of almost 50 percent over the period. In contrast, chronically poor households, those who remained poor across all three surveys, saw income growth of over 30 percent between 2003 and 2011, growth insufficient to move them out of poverty. Chronically poor households in rural areas saw stronger income growth (around 40 percent) than those in urban areas (around 20 percent). This is corroborated by sharper falls in the poverty gap indicator for the rural population than for the urban population (25 percent versus 18 percent reduction) between 2003 and 2011, indicating that the poor in rural areas, while still poorer than those in urban areas, saw their incomes rise faster.<sup>16</sup>

**Mobility out of poverty is correlated with higher levels of education and with living in urban areas.** For both individuals and households, rural residence is associated with much greater levels of chronic poverty (65 compared to 31 percent). Meanwhile rates of extreme poverty were particularly high among those working in agriculture. Perhaps owing to the importance of remittances and family migration strategies in which men are more likely to emigrate, female-headed households in Honduras have lower chronic poverty rates and saw greater upward income mobility than male-headed households, in contrast to most LAC countries.

**Figure 39: The poor have tended to stay poor in Honduras**

*(Intra-generational mobility in Honduras between 2003 and 2011, based on initial conditions of household head, % of population)*



Source: World Bank staff estimates based on EPHPM. Notes: *Chronic* refers to households who were poor in all three periods (income below US\$4 a day per person). *Upward* refers to households poor in 2003 but not poor in both 2007 and 2011. *Downward* refers to those who were not poor in 2003 but fell into poverty. *Vulnerable* are those that have moved into and out of poverty. *Non-vulnerable* are those who remained non-poor throughout the period. Education, sector and gender variables refer to the characteristics of the head of household in 2003.

<sup>15</sup> A synthetic panel was constructed based on Dang et al, 2011.

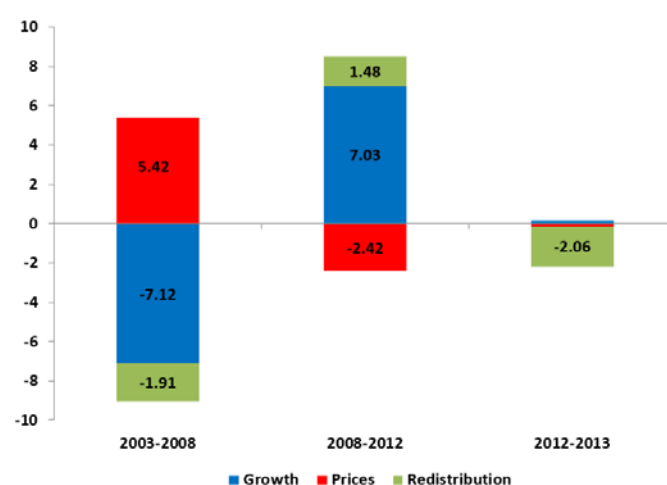
<sup>16</sup> The poverty gap measures the distance between the income of those living in poverty and the income needed to exit poverty (\$4/day). World Bank tabulations using SEDLAS (CEDLAS and the World Bank).

## What Drives Poverty Reduction in Honduras?

### *Economic Growth and Employment*

Up until 2012, household income growth, rather than changes in the income distribution, had been the key drivers of poverty trends; however, evidence suggests that changes in income distribution played a dominant role in the poverty reduction seen in 2013 (Figure 40). The growth elasticity of poverty measures the percentage change in the poverty rates associated with each percentage change in economic growth. In Honduras, a 1 percent increase in GDP growth was associated with a 0.39 percent reduction in the poverty rate, well below the 2 percent estimated average elasticity for LAC as a whole.<sup>17</sup> Nevertheless, economic growth via household income growth had a significant impact on poverty over the 2003-2012 period, but these changes were undermined by the small changes in income distribution and the opposite effect of the price level. A decomposition analysis can shed light on the relative contribution of income growth, changes in the prices and income distribution to poverty rates. Gains in overall official poverty reduction that occurred in Honduras before the crisis (2003-2008) were mainly due to income growth and shifts in the distribution of incomes but these gains were mitigated by higher prices. This situation reversed during the 2008-2012 period, where both weaker economic growth and a worsening distribution of income led to increases in poverty. Practically the entirety of poverty reduction seen in 2013 is attributable to improvements in the income distribution.

**Figure 40: Income growth was the major driver of poverty fluctuations between 2003 and 2013**  
(Contribution of income growth, income distribution and prices to reduction of official poverty, %)



Source: World Bank staff estimates based on EPHPM.

**Changes in poverty rates are particularly sensitive to changes in labor income and remittance income (Figure 41).** Falls in the labor income of men has been a consistent driver of poverty and extreme poverty increases throughout the decade, contributing between 3 and 4 percentage points to poverty increases between 2003-08 and 2008-2012 respectively. During 2003-08, when growth rates were high, increases in the employment of women reduced poverty by 2.4 percentage points and extreme poverty by 2.5 percentage points. Similarly, remittances contributed to poverty reduction during this period; however, during 2008-2012, when remittances fell as a result of a weak US labor market, the reduction in remittance income was the second primary driver of the observed rise in poverty rates, being associated with a poverty increase of two percentage points and an increase of 2.3 percentage points in extreme poverty.

<sup>17</sup> Cadena et al. (2013).



**Figure 41: Higher employment has been a key factor reducing poverty, while lower earnings for men and lower remittances post-crisis undermined earlier poverty reduction**

*(Contribution of income sources to poverty reduction, total poverty and extreme poverty: 2003-2013)*  
**(a) Total Poverty** **(b) Extreme Poverty**



Source: World Bank staff estimates based on EPHPM. The category “Other” includes changes in the demographic composition of households, receipt of public transfers and other sources of non-labor income.

**Low and stagnating levels of labor productivity help explain Honduras’ modest progress in reducing poverty (Figure 41).** Perhaps reflecting a shortage of technological growth in the agricultural sector in Honduras, agricultural workers, accounting for 61 percent of the extreme poor in 2013, are the least productive in the economy, and have realized only very small gains in labor productivity in recent years. While workers in the manufacturing and services sectors are more productive and have seen larger gains, their productivity levels remain well below the LAC averages for all sectors. Low and stagnant labor productivity implies that the poor increase their labor income mainly through increased labor hours rather than through wage growth.

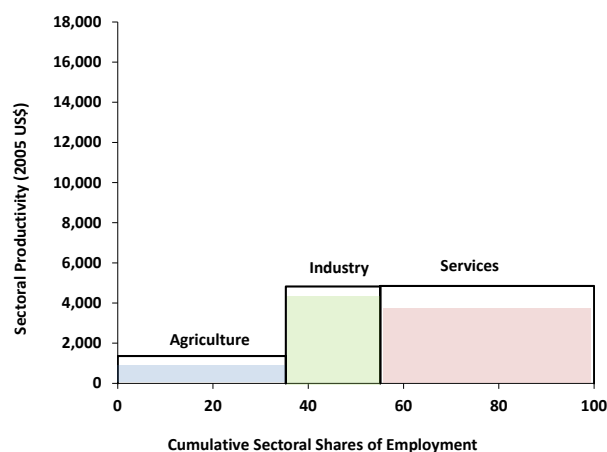
**Economic growth has helped create new jobs in Honduras, but these jobs are in low productivity sectors such as agriculture and commerce.** Between 2003 and 2013, employment grew at an annual rate of 5.1 percent, outpacing population growth and rising faster than in other Central American economies such as El Salvador (1.7 percent). However the majority of new jobs created between 2003 and 2013 were in low-productivity sectors such as agriculture, which accounted for one in every three new jobs created over the period, and informal commerce, which accounted for a fifth of all new jobs. Only one fifth of workers in Honduras are employed in the formal sector, which tends to be more productive and have higher wages than the informal sector.

**High minimum wage legislation fails to cover many of the poorest and may also discourage firms from creating more jobs, particularly in the formal sector.** Minimum wages in Honduras are higher than in all of its neighboring countries, including Panama, an upper-middle-income country.<sup>18</sup> Though it is not well-enforced, even among formal-sector workers, Honduras’ high minimum wage presents potential challenges to Honduras’ ability to be competitive internationally. Moreover, due to the prevalence of the informal sector, the minimum wage does not provide an effective wage floor for workers, especially the low-skilled. The combined impact of these high

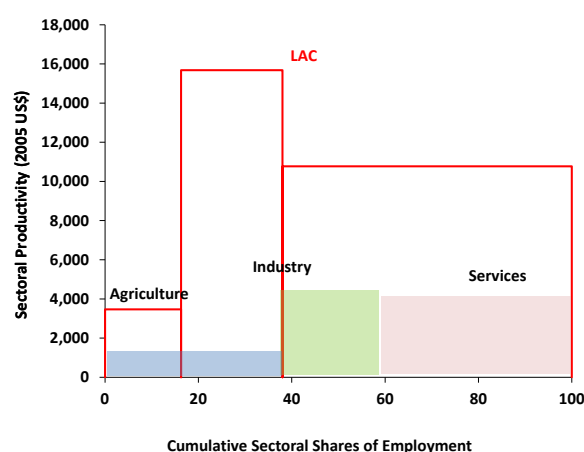
<sup>18</sup> Based on the *Doing Business* project.

minimum wages may be to reduce formal employment opportunities while simultaneously increasing income inequality by increasing the gap in earnings between formal and informal workers.

**Figure 42: Agriculture employs almost half of Hondurans, but sector productivity is very low** (*Employment and productivity by sector, colored boxes represent 2003 and outlined boxes 2011*)



**Figure 43: Compared to the LAC average productivity in Honduras is low across all sectors** (*Sectoral employment and productivity, 2011; colored boxes represent Honduras and outlined boxes represent LAC*)



Source: World Bank estimates based on World Development Indicators. Notes: Sector productivity is calculated as the ratio of sector's value added and the number of employees working in that sector. The shares of employment are the fraction of the workforce that works in that sector.

## Remittances and Social Programs

Since 2000, immigration from Honduras has grown substantially, resulting in increased inflows of remittances (Figure 44). There were over half a million Honduran-born immigrants living in the U.S. in 2013, constituting over 83 percent of Honduran international migration.<sup>19</sup> This is relatively recent migration, growing at an annualized rate of 5.2 percent per year between 2000 and 2012 and with over 25 percent immigrating since 2006. It is also mostly undocumented, with estimates ranging from 60 to 77 percent, implying significant limitations on earnings potential. Even so, remittances skyrocketed during the pre-crisis period, rising from less than US\$1 billion in 2000 to US\$3.2 billion in 2013, the equivalent of 17 percent of GDP. Studies in other countries suggest that, while the receipt of remittances is often associated with positive outcomes, such as increased school attendance, remittances can also lead to decreases in labor supply and “Dutch disease” resulting in real exchange rate appreciation.<sup>20</sup> It is important to closely study the impact of Honduras’ significant migration outflow and remittance inflow on both economic and social outcomes.

<sup>19</sup> Estimates based on Migration Policy Institute and KNOMAD data.

<sup>20</sup> For example, Acosta (2006) and Lopez, Molina and Bussolo (2008).

### Fluctuations in remittance inflows have a significant effect on poverty rates in Honduras.

A decomposition analysis for the 2003-2008 period shows that remittances were second only to share of household members employed in contributing to falling poverty rates, while their reduction was one of the lead drivers of the increase in poverty between 2008 and 2012. Beyond their direct contribution to household incomes, rising remittance levels also supported domestic economic growth by stimulating consumer demand. However, remittance inflows are vulnerable to shocks in foreign labor markets, and the sharp decline in remittances following the global financial crisis contributed to rising poverty rates. As noted in Part I of this report, during the global financial crisis remittance inflows fell sharply as labor market conditions deteriorated in the host countries for Honduran migrants, especially the United States. Just as increasing remittances had supported poverty reduction in the pre-crisis period, falling remittances were a key contributor to rising poverty rates in the years following the crisis (Figure 41).

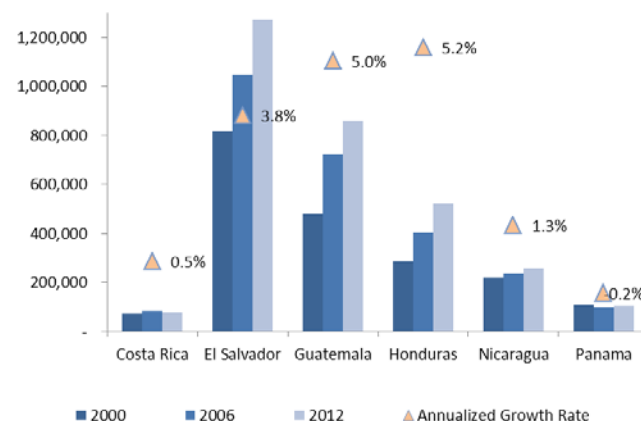
### Social transfer programs have expanded in recent years, but to date they have had only a marginal impact on poverty rates.

Transfers accounted for 1.6 percent of GDP in 2012, but the bulk of this spending has not been accurately targeted to low-income households. Electricity, gas and transport subsidies account for almost one-third of public transfers (or 0.5 percent of GDP), yet these programs tend to be regressive as they miss the poorest, who often have limited access to these services. Other programs are more effectively targeted, and in 2013 overall social transfers accounted for 11.3 percent of the income of households in the bottom quintile, up from 0.3 percent in 2003.<sup>21</sup> Decomposition analysis reveals that public transfers have had a modest but positive impact on extreme poverty over the past decade.

### Transfer programs could play a more significant role in poverty reduction if the

**Figure 44: Honduran immigration to the United States has grown significantly between 2000 and 2012**

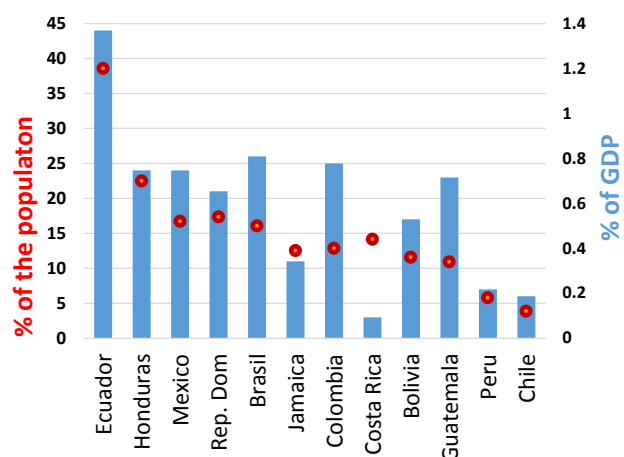
*(Immigrants in the US, 2000, 2006 and 2012)*



Source: World Bank estimates based on Migration Policy Institute database (using US Census and ACS data).

**Figure 45: Bono Vida Mejor is large and well financed compared to similar programs in the region**

*(Conditional cash transfer programs in Latin America, coverage and expenditures, 2009; Honduras, 2012)*



Source: ECLAC (2011), "Conditional Cash Transfer Programs: The Recent Experience in Latin America and the Caribbean."

<sup>21</sup> For more on the impact of social transfers, see World Bank (forthcoming).

**government is able to build on recent reforms to improve targeting.** The conditional cash transfer program *Bono Vida Mejor* (formerly *Bono 10,000*), launched in 2010, provides resources to poor families with children to incentivize child health monitoring (for 0-5 year olds) and school attendance (primary level). *Bono Vida Mejor* has expanded quickly to provide benefits to around 23 percent of the population, with total program spending equal to 0.6 percent of GDP (5). Extreme poverty among beneficiaries of *Bono Vida Mejor* has fallen by 3 percentage points since 2010, while per capita consumption has increased by 7 percent, during a time when poverty rates have been rising nationwide.<sup>22</sup> Beyond its direct impacts on poverty, the program has helped to boost primary school enrollment by 2.8 percent and visits to health centers for children under three by 2.6 percent. While these effects have been positive, expanding the program while maintaining fiscal sustainability will require measures to more precisely focus its support. In addition, reforming less efficient subsidy programs could help to free up resources and expand the government's limited fiscal space.

## Conclusion

**Poverty trends in Honduras will continue to depend on economic prospects, including macroeconomic stability, employment dynamics, and developments among its major trade partners and remittance sources.** The reduction in poverty rates achieved in the mid-2000s underscores the critical role of economy-wide growth and highlights the importance of a sound macroeconomic environment for alleviating inequality and promoting shared prosperity. The poverty increases following the 2009 crisis, and in part associated with a fall in remittance income, show that poor Hondurans are exceptionally vulnerable to economic shocks in both foreign and domestic markets. This vulnerability to shocks is exacerbated by limited access to quality employment and low and stagnating levels of labor productivity, which constrain the growth of real income.

**Geographic disparity in poverty and access to basic goods and services remains significant.** Poverty rates are significantly higher in rural areas. About 65 percent of the rural households live in chronic poverty, a rate more than double that seen in the urban sector. In recent years most new jobs were created in low-productivity sectors such as agriculture, where the poor are concentrated, but with no commensurate rise in productivity. This remains a critical barrier to poverty alleviation in rural areas, and raising labor productivity in key sectors could have a significant impact on the incomes of the poor.

**Honduras made modest progress in promoting shared prosperity before the global financial crisis.** Income growth among those in the bottom 40 percent of the income distribution exceeded overall income growth between 2003 and 2008. However, between 2008 and 2012, the bottom 40 percent experienced a bigger decrease in their income than the average Honduran. As a result, poverty increased and the Honduran middle class contracted.

**Efforts to enhance the scope and targeting of government social assistance programs could help to reduce rates of extreme poverty by directly boosting the incomes of the poor.** The introduction of the *Bono Vida Mejor* conditional cash transfer program has had a tangible impact on extreme poverty reduction during a period in which nationwide poverty increased. Improved targeting could help to further alleviate poverty and expand program coverage. The successful

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<sup>22</sup> World Bank (2014b).

implementation of the government's fiscal consolidation agenda would free additional resources to support increased cash transfers, as would the reform of relatively inefficient subsidy schemes.

**The success of the government's renewed efforts to alleviate poverty will hinge on its ability to maintain its commitment to the fiscal reform agenda.** While some elements of the macroeconomic environment are beyond the control of policymakers, in the past decade, a lack of fiscal discipline persistently undermined macroeconomic stability in Honduras, leaving the country highly vulnerable to shocks. This was illustrated by its experience during the global financial crisis, when an unsustainable fiscal stance left the government ill prepared to combat the effects of a deteriorating external environment on income levels and poverty rates. Furthermore, efforts to accelerate human capital formation, promote productivity gains and support expanded social protection programs would help to improve the distributional equity of the returns to growth, ensuring that the poorest segments of the population are able to fully participate in, and benefit from, the continued development of the Honduran economy.

## Annex

### Annex 1: Honduras: Selected Economic Indicators, 2010-2016

	2010	2011	2012	2013	2014e	2015f	2016f
<b>National income and prices</b>	(Percent change, unless noted)						
GDP at constant prices	3.7	3.8	4.1	2.8	3.1	3.2	3.2
Domestic Demand	4.4	6.7	2.5	0.6	2.9	5.9	2.8
Private Consumption	3.6	3.6	4.3	3.8	2.7	8.9	3.7
GDP deflator	4.7	7.8	3.6	1.3	5.6	3.4	8.8
Consumer prices (eop)	6.5	5.6	5.4	4.9	5.8	4.5	4.9
<b>Combined public sector</b>	(Percent of GDP, unless noted)						
Revenue and grants	24.1	23.1	22.5	22.9	24.4	25.6	25.9
Noninterest expenditure	26.1	24.8	25.4	28.4	26.6	25.4	24.7
Primary balance	-2.0	-1.7	-2.9	-5.6	-2.2	0.2	1.1
Primary balance without interest earnings	-3.4	-3.0	-4.3	-7.1	-3.8	-1.4	-0.5
Interest payments	0.9	1.1	1.3	2.0	2.1	3.0	3.1
Public saving	2.6	3.1	1.8	-1.2	1.6	2.2	2.2
Capital expenditure	5.4	5.9	6.0	6.4	6.0	5.0	5.0
Overall balance	-2.8	-2.8	-4.2	-7.6	-4.3	-2.9	-2.0
<b>Savings and investment</b>							
Gross fixed capital formation	21.9	26.0	24.6	21.8	22.1	23.1	22.7
Private investment	11.9	21.5	20.7	16.7	18.2	19.2	18.7
Public investment	9.9	4.5	3.9	5.0	3.9	3.9	4.0
Gross national savings	17.5	18.0	16.0	12.2	14.5	17.1	16.7
Private savings	14.9	14.9	14.2	13.4	12.8	15.0	14.5
Public savings	2.6	3.1	1.8	-1.2	1.6	2.2	2.2
External savings	-4.3	-8.0	-8.6	-9.6	-7.6	-6.0	-6.0
<b>External sector</b>							
Net international reserves (millions of dollars)	2,719	2,821	2,571	3,056	3,515	3,828	4,134
GIR (in months of imports) 1/	3.3	3.3	3.1	3.6	4.2	4.6	5.0
Change in net international reserves	603	102	-250	485	459	313	306
External current account balance	-4.3	-8.0	-8.6	-9.6	-7.6	-6.0	-6.0
Exports, f.o.b. (annual percentage change)	29.8	27.3	4.8	-6.6	3.4	0.8	2.3
Imports, f.o.b. (annual percentage change)	20.8	24.9	2.2	-3.7	1.1	-1.9	5.0

Source: Honduran authorities and World Bank staff estimates.

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