

C HAPTER 3

HONDURAS' ECONOMIC DEVELOPMENT STRATEGY

To understand the present situation of Honduras, we should look at the political and economic history of the Central American region in general. The Central American nations share the same history, language, and traditions. They are all small countries linked by geographic and cultural circumstances and are currently trying to join efforts to improve their economic status and make better use of development opportunities on a regional basis.

3.1 Political and Economic History of the Central American Region

There are six moments that stand out in the Central American historical calendar between 1821 and 1994 (Table 3-1). The first one was in 1821, when the Central American countries declared their independence from Spain, followed by a period of uncertainty about their national status.

The second one was in 1870, when these small economies were ushering in the period of liberal revolutions and the dominance of coffee and bananas in the economy of the region. The third was in 1930, marked by the beginning of the world economic depression. The fourth was in 1944, when democratic reform movements shook the foundations of authoritarian "*caudillismo*" to its roots.¹

The fifth was 1979, the year of the fall of Nicaraguan dictator Somoza,² at the hands of the Sandinistas.³ This year also marked the beginning of the worst political

¹ *Caudillismo* designates a charismatic political-military leader at the head of an authoritative power.

² President Somoza was effectively dictator of the country from 1967 to 1979. He was the last member of the Somoza family to be President, ending a dynasty that had held power since 1936.

³ The Sandinistas are a leftist political party that was swept to power in 1979 in a popular revolution that overthrew the Somoza dictatorship.

and economic crisis, which “marked a watershed in the region’s development” (Bulmer-Thomas, 1987). Finally the sixth moment in the region was 1994, when after the fruits of the peace accords of Esquipulas II,⁴ the Presidents of the Central America countries decided to sign the Central American Alliance for Sustainable Development (ALIDES),⁵ a development strategy that aims to consolidate the democratic transition in the region, as well as to promote a more sustainable development.

Table 3-1 Historical Summary of Central American Political Economy

Year	Event
1821	Independence from Spain
1824-1838	Central American Federal Republic
1870	Liberal Revolutions and Dominance of Coffee and Bananas in the Economy
1907-1918	Central America Court of Justice
1930	World Economic Depression
1951	Central American States Organization (ODECA) <i>First Constitutive Charter</i>
1960	Central American Common Market (MCCA)
1962	Central American States Organization (ODECA) <i>Second Constitutive Charter.</i>
1979	Fall of Somoza in Nicaragua and beginning of worst politico-economic crisis
1987	Esquipulas II Peace Treaty Signature
1991	Tegucigalpa Protocol Signature
1993	Central American Integration System (SICA)
1994	Central American Alliance for Sustainable Development (ALIDES)

Source: Alfaro-Acuña (2000).

⁴ The Esquipulas Peace Agreement was an initiative in the mid-1980s to settle the military conflicts which had plagued Central America for many years.

⁵ ALIDES is a regional development strategy composed of three Presidential Summits held in 1994: (1) Guacimo Declaration; (2) Managua’s Summit of Sustainable Development, and (3) International Conference of Peace and Development in Central America, Honduras. It was signed by Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama and is founded in four pillars: (1) democracy, (2) socio-cultural development, (3) sustainable economic development, and (4) environmental protection.

3.2 Historical Summary of Honduras' Economic Development

Honduras' mountainous topography might help explain much of its history and economic development status. The area has been under-populated since pre-colonial times. The great Maya civilization was represented in the City of Copan in northwestern Honduras but most of the other Mayan cities lay more to the north in Guatemala and the Yucatan Peninsula.⁶ European immigrants to the area were few in number because the region lacked vast mineral wealth compared to other areas of the American Continent.

Extensive mountain ranges kept Honduras from being considered as a site for a canal across the Central American Isthmus in the nineteenth century. Panama was the selected place for the inter-oceanic canal that links the Pacific and Atlantic Oceans commonly known as the Panama Canal. Lack of large areas of flat land for plantations also led to the fact that Honduras never produced a powerful landholding oligarchy like those that controlled the economies and politics of many of the countries of Central America, and as a result it has a more egalitarian society with a less rigid class structure than its neighbors.

During the first half of the twentieth century, the Honduran economy was so dominated by the export of bananas that foreign banana companies often exercised as much power as the national government. Increased nationalism and economic diversification have strengthened national institutions in recent decades, but Honduras remains sensitive to external forces.

By the early 1950s, the economy had begun to diversify. Although bananas were still the most important crop, other agricultural products, such as coffee and cotton, became significant export products. For the first time in more than half a century, bananas accounted for less than 50 percent of export earnings at the end of the 1950s.

Politically, the period from 1956 to 1958 marked a return to the instability that had characterized Honduras in the past. A coup in 1956 ousted the elected president and

⁶ The Yucatán Peninsula separates the Caribbean Sea from the Gulf of Mexico. The peninsula comprises the parts of southern Mexico, the northern part of Belize, and Guatemala's northern territory.

marked a turning point in Honduran history. For the first time, the armed forces acted as an institution rather than as the instrument of a political party. For decades to come, the military would act as the final arbiter of Honduran politics.

During the 1960s and early 1970s, Honduras and the Central American region experienced a relative period of economic progress. In the 1980s, as explained above, the Central American countries experienced the worst economic crisis which was unfortunate because all these countries are rich in natural resources and have an increasing intra-regional market, but as a result of the socio-political situation their economies declined sharply during that time frame (Acuña-Alfaro, 2000).

In the early 1990s, most of Central America implemented comprehensive macroeconomic adjustment and structural reforms, which were often supported by financial and technical assistance from the IMF, the World Bank, and the Inter-American Development Bank. Macroeconomic adjustment continued during the second half of the 1990s, but at a slower pace, while structural policies were strengthened on several fronts, including privatization, financial sector reform, and trade liberalization. As a result, economic performance improved considerably: growth increased, inflation declined, the external position strengthened, and the incidence of poverty decreased (IMF, 2000).

We will begin our discussion of Honduras' current development strategy in the new millennium by presenting a discussion of three major influencing factors: the Central American Free Trade Agreement between the United States, Central America, and the Dominican Republic (CAFTA),⁷ the Poverty Reduction Strategy Paper (PRSP), and the Heavily Indebted Poor Countries (HIPC) initiative.

3.3 CAFTA, PRSP, and HIPC

According to the World Bank, in the early 1990s, Honduras reconsidered its inward-looking policies and embarked in a process of reform including the reduction of trade barriers, more flexible exchange rate arrangements, financial market liberalization,

⁷ CAFTA is a free trade agreement originally between the United States, the Central American countries of Guatemala, El Salvador, Honduras, Nicaragua, and Costa Rica. When the Dominican Republic (DR) joined the negotiations in 2004, the agreements became to be known also as DR-CAFTA.

adjustments of public utility tariffs, and the development of a legal framework to strengthen property rights (World Bank, 2004a).

The Honduran Minister of Foreign Affairs recently declared that “with assistance of the United States, Honduras holds currently an integral strategy to reduce poverty and increase economic development” (La Prensa, 2006). In 2006, the Honduran poverty level is approximately 60% and a remaining 20% of the people live under extreme poverty (Jimenez, 2006). Honduras has solicited the Inter-American Development Bank (IDB) to approve a request to condone the debt that currently amounts to US\$1,400 million. The Honduran Minister of Finance expressed that the debt relief might come through by October of 2006 (La Tribuna, 2006b). This debt relief, the largest for Honduras, would allow the government to channel resources toward poverty reduction programs.

One major factor in the economic strategy for Honduras is CAFTA. CAFTA is expected to have a positive impact on trade and investment in Honduras and to benefit the economy and the fight against poverty. Increased market access is a main reason for this positive impact. CAFTA has consolidated and increased the access that Central American producers have to the United States market, while opening the access to American products.

Negotiations between Central America and the United States concerning the entry into force of CAFTA concluded in 2003. The United States and the other participating countries, except Costa Rica, have ratified the trade agreement. CAFTA has not gone into effect as planned because some of the countries involved have not yet implemented some regulatory requirements of the agreement.

Honduras negotiated with the IMF a macroeconomic program to be supported through a Poverty Reduction and Growth Facility (PRGF) and an agreement was approved by the IMF Board in 2004.⁸ The goal of this economic program is to reverse Honduras’s fiscal deterioration and create the basis for faster growth and reduce poverty along with a Poverty Reduction Strategy Paper (PRSP) and the United Nations

⁸ The Poverty Reduction and Growth Facility is an instrument of the International Monetary Fund which lends to the world’s poorest countries. It was created in 1999.

Millennium Development Goals (MDG).⁹ The PRSPs are prepared by the member countries through a participatory process involving domestic stakeholders as well as external development partners, including the World Bank and International Monetary Fund. The PRSP describes the country's macroeconomics, associated external financing needs, and major sources of financing.

In addition, in 2005 Honduras was able to comply with all the reforms needed to reach the Heavily Indebted Poor Countries (HIPC) status and benefits from this program are now available. The HIPC Initiative is a comprehensive approach to debt reduction for heavily indebted poor countries pursuing adjustment and reform programs supported by the IMF and the World Bank (IMF, 2005a). The HIPC Initiative was proposed by the IMF and World Bank, with the goal of ensuring that no poor country faces a debt burden it cannot manage. The Initiative involves coordinated action by the international financial community, including multilateral organizations and governments, to reduce to sustainable levels the external debt burdens of the most heavily indebted poor countries.

3.4 Honduras' Economic Development Strategy and PRSP

The main objective of the economic development strategy contained in the PRSP is to reduce the proportion of the population living below the poverty line from 64% in 2002 to 42% in 2015 (Table 3-2). To reach this goal Honduras needs a more accelerated and equitable economic growth (IMF, 2004).

As part of the economic strategy Honduras needs to:

- Strengthen the macro-economic framework;
- Implement structural reforms to increase competitiveness;
- Invest on the quality of human capital especially in education and health;
- Strengthen social protection networks;

⁹ The Millennium Development Goals are eight goals that the United Nations member states have agreed to try to achieve by the year 2015 including issues on: poverty, education, gender, child mortality, maternal health, HIV/AIDs, environmental sustainability, and global development partnerships.

- Reinforce gender equity;¹⁰ and
- Work towards sustainable development.

The economic strategy under this agreement is to increase annual growth to 4.5% by 2006 (Table 3-2), and reduce inflation gradually to the rates similar to those of Honduras main trading partners in 2008.

As part of the goals, the country needs to reduce overall fiscal deficit from 3.0% of GDP in 2004 to 1.7 % in 2006 to allow an expansion of credit to the private sector. Deficit reduction is needed through measures on revenue and expenditure. Greater discipline in setting public sector wages is expected to reduce current expenditures. Additional reforms in human resources are needed to reduce labor costs and increase labor productivity in the public sector. The resulting increase in public savings should allow for the expansion in public investment within an overall deficit reduction context.

Institutional Framework for the PRSP

In 2002, the Government worked jointly with the civil society to establish the operational framework for the PRSP. As a result, there is a well-defined institutional framework in place, and mechanisms for targeting the PRSP and interfacing it with the decentralization process have been established.

The goal is to achieve poverty reduction in the most efficient manner possible, focusing principally on the most vulnerable groups. The most important aspects of this operational framework are the definition of the Social Cabinet's functions, the establishment of the Consultative Council, the creation of the Inter-Institutional Technical Support Group, and the creation of the Poverty Reduction Fund.

The implementation of the macroeconomic framework for the PRSP economic development strategy is subjected to discussion at all levels. Consultations ensure the participation of the civil society and donors. Table 3-2 presents a revised version of the indicators and their corresponding goals for 2015 in accordance with the PRSP. Table

¹⁰ Gender equity strives to guarantee women with effective equal opportunities, especially for those living in poverty and in the rural areas.

3-3 presents a summary of the PRSP policy and the legal and administrative measures recommended for immediate action.

Elasticity between Growth and Poverty

One of the objectives of the PRSP is to remove obstacles that do not allow the poor to benefit from growth. These measures should protect the poor from the impact of growth and at the same time, stimulate growth itself. Among the main obstacles are:

- Weak human capital due to the poor quality and lack of education and health services;
- Lack of access to markets; and
- Biases against using the productive factors to which the poor can gain access.

One of the most critical challenges to the PRSP is to double the elasticity between growth and poverty. The PRSP defines elasticity as the degree to which the proportion of people living under the poverty line is reduced when the real per capita GDP increases by 1% (World Bank, 2004a). In the 1990s, Honduras had an elasticity of 0.65. To reduce the proportion of poor from 64.5% in 2001 to 42% in 2015, a sustained 3% reduction in the percentage of poor is needed per year. To achieve this, a two point annual reduction in the poverty rate would be needed.

Table 3-2 Revised PRSP Goals and Indicators in Honduras

GOAL	INDICATOR	Real	Revised PRSP Goals	
		2002	2006	2015
Real GDP growth	% of real GDP growth	2.7	4.5	4.5
Per capita GDP growth	% of per capita GDP growth	0.3	2.2	2.4
Social spending	Spending on poverty as % of total central government spending	33.3	43.7	44.0
Reduce poverty by 24 percentage points	Poverty rate	63.9	57.3	42.0
95% net coverage in the 2 first cycles of basic education	Net coverage rate	88.9	92.5	95.0
Reduce infant mortality and under 5 by half	Infant mortality rate/ 1000 live births	34	27	18
Reduce malnutrition in children under 5 by half	Child malnutrition rate	32.9	27.0	18.0
Reduce maternal mortality by half	Maternal mortality rate / 100,000 live births	108	93	70
Raise women's human development index by 20%	Human Development Index (HDI) relative to gender (poverty literacy education life expectancy etc.)	0.64	0.69	0.76
Reduce the nation's environmental vulnerability	% of total surface national parks with management plans	n.a.	100	100

Source: World Bank (2004c).

Table 3-3 PRSP Policy, Legal, and Administrative Measures in Honduras — 2003-2015

OBJECTIVES	COMMITMENTS
A. ECONOMIC REACTIVATION AND EMPLOYMENT GENERATION	
To have a macroeconomic framework to help validate more sustained public investments in social programs and projects, and generates confidence and certainty for private investment.	<ul style="list-style-type: none"> • Sign and implement the PRGF with the IMF
To strengthen productive investments and a trade opening, as the basis for increasing employment opportunities and improving their quality.	<ul style="list-style-type: none"> • Apply the Administrative Simplification Law and National Competitiveness Strategy • Implement land registry programs • Continue applying laws that protect copyrights • Strengthen bilateral and multilateral negotiation mechanisms for resolving trade disputes • Strengthen participation in the Central American integration scheme • Eliminate obstacles to free trade and cooperation with other countries and regions of the world • Promote clusters of agro-industry, tourism, light assembly, forestry and mining
To successfully integrate, coordinate and sustain actions aimed at reducing poverty in rural areas, increasing employment and improving income distribution.	<ul style="list-style-type: none"> • Strengthen land-titling for the agrarian reform sector, ethnic groups and independent peasants • Complete agrarian and forest land registry, and modernize the registration of rural properties • Achieve real coordination of the PRONADERS projects, on the basis of concrete objectives • Focus development actions on border towns • Promote policy of gender equity in agriculture
To promote the development of intermediate cities, helping convert them into regional development areas.	<ul style="list-style-type: none"> • Develop policy of differentiated support for micro, small and medium scale urban enterprises • Regionalize support economic development based of productive and human resources
B. DEVELOPING HUMAN CAPITAL	
Education and Culture	
Improve the educational levels of the Honduran people through providing better quality, more efficient and more equitable education at different levels, and promote moral and cultural values.	<ul style="list-style-type: none"> • Expand reforms in the areas of regulation, planning, administration and information • Consolidate decentralization of education sector • Improve the quality, relevance and coverage of education at different levels • Strengthen community participation in different aspects of the educational system • Reform legal framework of the culture sector, including the publishing and sports sub-sectors

Table 3-3 PRSP Policy, Legal, and Administrative Measures in Honduras — 2003-2015 (Cont.)

OBJECTIVES	COMMITMENTS
Health	
Guarantee access to quality and equitable health services by the nation's poor	<ul style="list-style-type: none"> • Extend health sector reforms to regulation, planning, administration and information • Focus sector actions on protecting the human environment, and providing primary health care • Approve Water and Sanitation Framework Law
Housing	
Generate conditions that guarantee most Hondurans access to dignified housing	<ul style="list-style-type: none"> • Approve the Housing Sector Modernization Law • Strengthen and harmonize sector regulations, with the different structures involved • Harmonize the construction of human settlements with reducing ecological vulnerability
Social Protection Networks	
Reduce risk factors to specific vulnerable groups, and improve the coverage of basic needs for the population living in rural and marginal urban zones	<ul style="list-style-type: none"> • Expand the School Snack Program • Link support to extremely poor groups with family-centered programs • Improve coordination, efficiency and impact of programs and projects to relieve extreme poverty
C. JUSTICE AND CITIZEN SECURITY	
Generate the conditions needed for a surveillance system that truly guarantees and protects the rights of people, legal security for investment and a peaceful life in society	<ul style="list-style-type: none"> • Approve/implement Legal Service, Judicial Council Laws, Penal Code, Notary Public Law, • Strengthen Citizen Security Councils • Assure coordination between Supreme Court, Public Ministry and National Security Ministry
D. OTHERS	
Environmental	
Reduce the nation's ecological risk and vulnerability	<ul style="list-style-type: none"> • Improve comprehensive planning and management of water resources • Strengthen forestry sector; improve management
Gender Equity	
Support the comprehensive development of poor women, through their full and effective participation in society	<ul style="list-style-type: none"> • Implementation of National Policy for Women • Reform the Domestic Violence Law and Equal Opportunities Law
Decentralization	
Achieve effective decentralization and municipal development, to reduce poverty and modernize public administration	<ul style="list-style-type: none"> • Implementation of Decentralization and Local Development Program

Source: World Bank (2004c).

3.5 Key Determinants of Growth in Honduras

To reach the goal of economic growth and poverty reduction, Honduras needs to establish greater fiscal discipline and external balance. Honduras experienced some growth in the 1960s and 1970s, but during the “lost decade” of the 1980s it went through a major decline period.¹¹ The economy improved in the 1990s but Honduras still lagged behind in per capita average growth compared to other countries in the region during all four last decades on the 20th century.

During the 1960s and 1970s when other Latin-American countries were experiencing dynamic growth, Honduras only reached 1.8% annual growth in per capita terms. A growth analysis determined that the main reason for this problem was Honduras’s low factor productivity growth.

Loayza, Fajnzylber, and Calderón (2004) in their study about economic growth in Latin America and the Caribbean (LAC) correlated growth to twelve key explanatory variables, which are considered as the most significant and major influences on economic growth. The authors also considered three different scenarios to make forecasts about economic growth. The first scenario assumes that the explanatory variables continue to evolve over the next decade according to the normal trend. The second scenario assumes the implementation of policy reforms that raise all the explanatory variables to the top 25th percentile of their distribution in Latin America and the Caribbean. The third scenario assumes the implementation of even more aggressive reforms, that is, the explanatory variables are adjusted to the top 25th percentile of their global distribution (World Bank, 2004a).

According to the experts (World Bank, 2004a, 2004b, 2004c; IMF, 2004, 2005a, 2005b, 2006), the key elements for the strategy to accelerate growth are:

- Increase in public investment to meet key infrastructure needs (i.e. roads, telecommunications, low income housing);
- Increase private investment in electricity generation, telecommunications, tourism, maquila and agriculture, attracted by CAFTA and an easing of credit conditions;

¹¹ The lost decade of the 1980s was characterized by macroeconomic instability in the area.

- Reforms in governance and transparency designed to improve the overall investment climate;
- Structural reforms to improve the efficiency of the public sector and restore a sound financial sector; and
- Entry into force of the CAFTA, which is expected to open up further access to foreign markets and promote a more competitive environment for domestic producers.

According to the result of the simulation presented by Loayza et al. (World Bank, 2004a) and following the first case scenario, Honduras will be unable to significantly accelerate its per capita growth if it lets its growth-determining variables evolve in their traditional trend. This would only increase annual growth from the average of 0.1% obtained in the 1990s to 0.5% projected for 2001-2010.

By implementing reforms, as demanded by the second scenario, the values of the explanatory variables can be raised to the top 25th percentile of the Latin America and the Caribbean distribution; Honduras could be able to reach a significant increase in growth in the coming decade, to an average of 2.8% per year.

If Honduras is to reach its Millennium Development Goals of reducing extreme poverty in half by 2015 it needs to grow at a faster rate (World Bank, 2004a). The third scenario prognosticates that this goal might be reached in principle if the explanatory variables are raised in reference to worldwide standards, to an average growth rate of 4.5 percent (Table 3-2).

The previous analysis concludes that if Honduras keeps its traditional growth trend in all policy areas it would place itself on an unacceptable slow growth path that would require additional efforts to try to obtain significantly faster growth. The authors conclude that “this additional effort would have its greatest impact on growth if invested in human capital development, infrastructure development, financial market development, and improved governance” (World Bank, 2004a).

3.6 Education and Growth

The growth simulations presented in the World Bank policy review identify “education improvement as the single most important growth determinant for Honduras” (World Bank, 2004a). In order to improve its education standards, Honduras would need to make similar efforts at the technological level to prevent bottlenecks that could later paralyze growth. For Honduras and other countries that find themselves behind technologically, the most important policy is possibly their basic education policy, paired with an open trade policy. Honduras’ slow progress in basic education especially among the extreme poor is notorious (IMF and IDA, 2005). Therefore, the emphasis of this final discussion on Honduras economic development strategy is on the Honduras educational system.

Compared to other Latin American countries, Honduras has made stable improvement in its educational indicators since 1960 but at a lower rate than the rest of the region. The average number of years of schooling of the adult population increased from 1.69 in 1960 to 4.08 in 2000; that is equivalent to an increase of 2.39 years, compared to an average gain of 2.8 years attained by the other countries in the area.

Honduras also needs to make major improvements in educational coverage and efficiency. Among the weak points identified are:

- Low coverage of pre-school education;
- Low internal efficiency at the elementary level, which translates into low completion rates;
- Low coverage of high school education; and
- Substantial inequities across the urban/rural area divide at the high school level.

The education system in Honduras is characterized by extremely high drop-out rate, in the latest data 2001 one student out of two makes it to grade six, one student out of five reaches grade nine, and less than one student out of 10 reaches grade 12. Only one student out of three completes elementary education in six years and less than one out of 10 completes middle school education in the expected nine years (World Bank, 2004a).

From the above data we conclude that even though the gross enrollment rates at the elementary level in Honduras are comparable to those in other Latin American countries, the high desertion rates at the elementary level and the low coverage at the high school level cancel out this gain, with the consequence that its net enrollment and completion rates at the high school levels results in Honduras having one of the worst rates in Latin America. In 2000 only 17.1% of the adult population had some secondary or tertiary education (World Bank, 2004a). This is less than half the average for Latin America (35.4 %).

Clearly, investment in human capital, especially in terms of education, is crucial to the economic and social development of Honduras. In order to increase the educational level of its workforce, Honduras needs to raise the completion rate in elementary education and expand the educational coverage in secondary education. Improving the education level of the workers, will have a significant effect on the country's economic growth and distribution of skills. The country can work towards its goal of lowering the poverty levels that have plagued it throughout its modern history by accelerating economic growth and reducing the current inequality in the distribution of skills and associated income opportunities.

3.7 Summary

In conclusion, the economic development strategy of Honduras revolves around the measures presented in the Poverty Reduction Strategy Paper. According to this document, Honduras needs to implement aggressive reforms to overturn its pattern of slow growth. Among the key elements needed to accelerate growth are: increased public and private investment especially in areas attracted by CAFTA. In addition, fiscal discipline and external balance are two major factors in the economic development strategy of Honduras as described in the compromises detailed in the Poverty Reduction Strategy Paper.