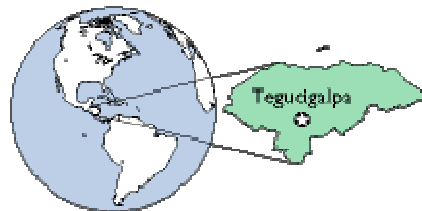


COUNTRY REVIEW

Honduras



24 March 2010

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EULER HERMES COUNTRY RISK GRADE: C

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Relatively low debt ratios after substantial debt relief via HIPC Initiative and Multilateral Debt Relief Initiative, based on sound performance under IMF PRGF (2004-07) and Stand-by which ended in April 2009.

Weaknesses

- Weak political institutions.
- Overvalued exchange rate within a de facto pegged exchange rate framework.
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Key Risks

- **Exchange rate depreciation**

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Tegucigalpa
Population:	7.32 mn (2008)
GDP:	USD 14317 mn (2008)
Currency:	Lempira (HNL)
Form of state:	Republic
Head of government:	President Porfirio Lobo
Next elections:	2013

Major Industries (% of GDP at market prices, 2008)	Global Assumptions	2009	2010
Agriculture & Fishing	13.1%	Real GDP grth (% yr/yr) *	-3.9
Mining & Manufacturing	22.2%	Inflation (% , av) *	0.9
Utilities	1.2%	Dated Brent (USD/b)	-0.1
Construction	6.5%	* Major economies	1.3
Services	56.9%		61
			72

Main Exports (% of total, 2008)	Main Imports (% of total, 2008)		
Maquiladora	54.7%	Consumer goods	27.6%
Coffee	10.3%	Raw materials	27.5%
Bananas	6.4%	Fuels & lubricants	22.1%
Palm oil	3.0%	Capital goods	17.5%
		Other	2.2%
Lead Export Markets (% of total exports, 2007)	Lead Import Markets (% of total imports, 2007)		
US	67.2%	US	52.4%
El Salvador	4.9%	Guatemala	7.1%
Guatemala	3.9%	El Salvador	5.2%
Mexico	3.3%	Mexico	4.5%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	10,915	12,414	14,317	14,450	15,094
Population (mn)	7.03	7.17	7.32	7.45	7.58
GDP per capita (USD)	1,553	1,731	1,956	1,940	1,991
Real GDP growth (% yr/yr)	6.6	6.3	4.2	-2.1	2.5
Inflation (% , eop)	5.3	8.9	10.8	3.0	6.3
Fiscal balance (% of GDP)	-1.1	-2.9	-2.4	-4.0	-3.7
Current account balance (% of GDP)	-3.2	-9.9	-12.6	-4.0	-4.8
External debt/GDP (%)	38	26	24	22	22
External debt/Exports of goods & services (%)	49	35	33	37	35
Interest payments/Exports of goods & services (%)	2	1	2	2	2
Foreign exchange reserves (USD mn)	2,629	2,528	2,437	2,109	2,000
Import cover (months)	3.3	3.2	2.6	3.3	2.6
Exchange rate assumption, HNL:USD (av)	18.90	18.90	18.90	18.90	19.50
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Two parties have dominated the political system since the return of democracy in 1982—the PN (Partido Nacional) and the PL (Partido Liberal)— though the PL has held power more frequently since the return of democracy in 1982, winning the presidency five times to the PN's three.

Porfirio Lobo of the PN (then in opposition) won the presidency by a large margin and a comfortable working majority in congress in the latest elections in November 2009. These were held on schedule, but only after then president Manuel Zelaya had been forcibly removed from office in June 2009 and replaced by an interim president Roberto Micheletti. This action triggered a domestic constitutional/political crisis and was widely condemned internationally by governments from across the spectrum, including both the US and Venezuela, leading to the suspension of multilateral finance and membership of the OAS (Organisation of American States).

Yet despite mass protests and demonstrations violent breakdown was avoided during interim rule and the elections were declared free and fair, paving the way for normalisation of international relations, under certain pre-conditions, laid out in the US-backed Tegucigalpa-San Jose agreement. These included the formation of a government of national unity and the establishment of a Truth Commission. President Lobo, inaugurated in January 2010, has duly appointed a unity (cross-party) government, notwithstanding his party's large majority, and the Truth Commission has begun work.

International relations are being slowly restored. Crucially, the US has announced its intention to restore funding and the IMF, World Bank and IADB have all normalised relations. The IMF will also send a staff mission to review the economy shortly. Nonetheless, some countries have adopted a more wait-and-see approach, including Brazil, and OAS membership has not been restored as yet, though normalisation with all but the most radical looks like only a matter of time.

Domestically the president will need to tread carefully to ensure credibility of institutions and avoid any breakdown of the national unity government, but with a comfortable majority in congress, achieved at the expense of a heavy defeat for the then governing PL, both should be feasible and policy implementation should be reasonably effective.

Economic Stability

The economy has a narrow export base made up of a high proportion of primary commodities and a maquiladora sector (export processing zone) that accounts for more than 50% of total goods exports. However, workers remittances are the single largest source of export earnings and are the equivalent of 20% of GDP. As a relatively open economy (exports of goods and services are almost 50% of GDP) that is also heavily dependent on the US (which accounts for more than 70% of exports and is the primary source of workers remittances) economic performance is particularly vulnerable to the US recession, as well as commodity prices.

Annual average growth of real GDP per head during 1999-2008 was a moderate 2.1%. Annual average real GDP growth in 2004-08 was 5.9%. In 2009, however, real GDP contracted by 2.1%. Global recession and domestic political instability lowered the growth of the maquiladora sector, tourism and workers remittances, investment and consumer spending. With some upturn in the global economy, and more particularly in the US, evident and a return to a more stable political outlook, we expect growth of 2-3% in 2010.

The fiscal deficit widened to over 4% of GDP in 2009 (2.4% 2008). Revenues were down 10%. Expenditure also fell, but by less than 1% as current spending grew by 9%, while capital spending was down 36%. A deficit of 3.5-4% of GDP is likely in 2010, as expenditure and revenues pick up. Current spending needs to be reined back, however, as the IMF noted at the end of the mission's visit in March. The public debt-GDP ratio increased to 25% at end-2009 and will probably rise to 27% in 2010, but remains relatively low, having been lowered sharply from 58% in 2004 as a result of external debt reduction under the HIPC and MRD initiatives. Over three-quarters of the debt is external.

Monetary policy has maintained a stable exchange rate to anchor inflation expectations and since the political crisis erupted to maintain overall stability. The new government will probably maintain the current exchange rate at least until international relations have been fully normalised. However, the exchange rate is becoming increasingly overvalued having appreciated by 15-20% since 2005 and some controlled flexibility may be introduced before too long. Domestic credit expansion also accelerated during the crisis, as the central bank provided credit to the public sector. Inflation, which accelerated sharply through 2007 and much of 2008, under pressure from higher oil and food prices,

fell equally sharply to 3% yr/yr at end-2009 (from a recent peak of 14.1% in August 2008), well below the 8-10% target range. Some pick-up in inflation can be expected in 2009. The policy interest rate was cut aggressively from 9% at the start of December 2008 to 3.5% in June 2009, but capital outflows contingent on the political crisis forced the central bank to raise rates to 4% in July and 4.5% in August. As capital flows normalise external pressure on interest rates will ease, but rising inflation will exert upward pressure.

There was a marked deterioration in the external current account balance in the two years to 2008, as the deficit widened to 13.8% of GDP in 2008. In 2009 both exports and imports fell sharply, however, but the latter by more than the former and the trade deficit shrank sharply. And, although workers remittances also fell (by 11%) the current account deficit also narrowed sharply to 4% of GDP. In 2010 while much depends on commodity prices, including oil, we expect the deficit to widen to 4.8% of GDP. Net FDI inflows were almost halved in 2009, hit by global recession and the political crisis but will probably cover 65-70% of the current account deficit in 2010. FX reserves fell from USD2.5bn before the political crisis to USD2.3bn in early February 2010 but have shown signs of stabilising since then. FX reserves at current levels cover 2.6mo of imports, 280% of external debt (short and medium term) falling due in 2010 and 180% of the sum of our projected current account deficit for 2010 plus principal repayments on medium-term plus short term debt outstanding at end-2009.

Total external debt outstanding at end-2009—mostly owed to the official sector—was 22% of GDP and 37% of export earnings. We estimate the ratio of interest payments to exports of goods and services at around 2%.

Structural Business Environment

The Structural Business Environment is well below average in our assessment. Based on data and definitions from the World Bank's 2010 Doing Business Survey, of ten areas surveyed two—Closing a Business and Trading Across Borders—were weaker areas, ranking below average and five—Starting a Business, Employing Workers, Protecting Investors, Paying Taxes and Enforcing Contracts—were very weak. The World Bank Institute's Governance Research Indicator puts regulatory quality below and rule of law and control of corruption well below average for the Latin American region. However, regulatory quality is above average for the lower middle income group of countries, though rule of law and control of corruption are well below. Transparency International's Corruption Perception Index, 2009, assigns Honduras a score of 2.5—on a scale of 1 (bad) to 10 (good)—and a ranking of 130 out of 179. As a broad measure of the pro-business environment The Heritage Foundation 2010 Index of Economic Freedom ranks Honduras 99 out of 179.

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Charts

