Euler Hermes Economic Research

Country Report

Honduras

Deteriorating public finances

General Information

GDP	USD17.967bn (World ranking 108, World Bank 2012)
Population	7.94 million (World ranking 96, World Bank 2012)
Form of state	Democratic Constitutional Republic
Head of government	Juan Orlando Hernandez
Next elections	2017, presidential and legislative

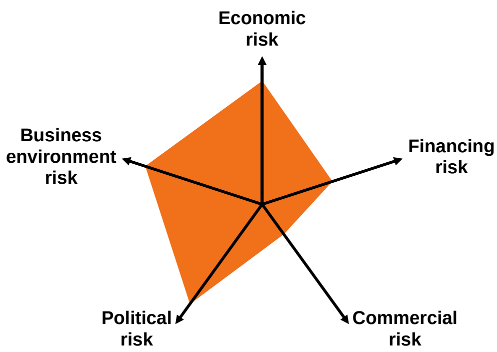
Strengths

- Sound financial sector
- Free trade agreement with the US and Canada
- Relatively low public debt, due to external debt reduction under the HIPC and MRD initiatives in 2004-2007

Weaknesses

- High dependence on US economy (50% of in foreign trade) and on commodity prices
- Highest murder rate in the world and widespread poverty
- Increasing dollarization of loans
- High current account and fiscal account deficits
- Exposure to natural disasters
- Weak business environment, low rule of law and high corruption

Country Rating C3



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
United States	50%	1	47%	United States
Germany	8%	2	8%	China
El Salvador	5%	3	7%	Guatemala
Guatemala	4%	4	6%	El Salvador
Mexico	4%	5	6%	Mexico

By product (% of total)

Exports		Rank		Imports
Articles of apparel & clothing accessories	22%	1	19%	Petroleum and related products
Coffee, tea, cocoa, spices	20%	2	9%	Textile yarn and related products
Electrical machinery	8%	3	5%	Road vehicles
Vegetables and fruits	6%	4	4%	Cereals and cereal preparations
Vegetable oils and fats	5%	5	4%	Electrical machinery

Source: UNCTAD (2012)

Economic Overview

Gradual recovery in 2014 and 2015

Highly dependent on US economic performance (50% of exports), Honduras' economy slipped into recession in 2009, with real GDP contracting by -2.4%. Honduras recorded a rapid recovery, with an annual average economic growth rate of +3.8% between 2010 and 2012. However, in 2013, activity decelerated to +2.6% because of a drop in coffee output (6th world producer and 30% of employment) due to leaf-rust disease. Short-term indicators suggest the economy is recovering gradually. Over January-September, the economic activity index (a proxy of GDP) accelerated to +2.7% y/y, against +2% y/y a year ago, driven by the return to standard coffee production, strengthening activity in the U.S. and a recovery in business confidence after the Presidential elections held in late-2013. Euler Hermes expects growth to reach +2.7% in 2014 and +3.0% in 2015.

The new government commited to fight criminality and improve business environment

International relations have been restored since the coup in 2009, but political stability has not been entirely achieved. The presidential elections held in late-2013 were declared transparent but the results led to large protests as the opposition denounced irregularities.

The President's agenda focuses on fighting criminality, one of Honduras' major issues. Indeed, with powerful drug gangs, Honduras has the highest murder rate in the world (90.4 homicides per 100000 people). According to the World Bank, the cost of violent crime is close to 10% of GDP per year. Alongside, the country needs to address the low business environment to become more attractive to foreign companies (ranked 104 out of 189 economies). Rule of law and perception of corruption remain the most important areas of concern.

Contained oil prices will ease inflation in 2015

Inflation ended 2013 at +4.9% y/y, within the target set by the Central Bank at 5.5% +/-1pp. For 2014, target range was widened to 6.5% +/- 1pp, due to increasing bottlenecks in the supply side (notably for edible products) and, especially, the increase of the headline VAT rate from 12% to 15% implemented in January 2014. Also, several VAT exemptions were removed while VAT rate for Alcoholic beverages was increased to 18%.

Consumer prices have thus accelerated since the beginning of 2014, bringing the inflation to +6.3% y/y in October, mainly driven by Food and Beverages (+7.7% y/y), Alcohol and Tobacco (+12.3%) and Clothes (+8.3%). Euler Hermes expects inflation to reach +6.5% y/y by the end of this year. On average, consumer prices should rise by +6.2% in 2014, before easing gradually in 2015 to +5.7% notably thanks to the softening of oil prices (petroleum products accounts for 15% of total imports).

Consolidation of public finances is undertakern...but might be complicated

The fiscal balance deteriorated sharply in 2013 to -7.6% of GDP against -4.2% in 2012. The Presidential elections held in late-2013 drove up current expenditure (+15% y/y), while the increased losses incurred by the electricity state enterprise continued to weigh heavily on the budget. The new Government has started introducing measures to improve fiscal consolidation. A new legislation for the electricity sector and a pension reform have been approved in combination with measures to strengthen tax administration and improve discipline in the budgeting process. However, broadening the tax base might prove difficult with approximately 70% of workers

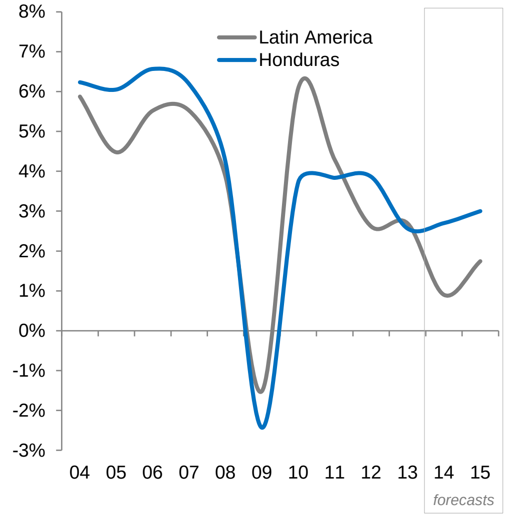
Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	3.9	2.6	2.7	3.0
Inflation (%, yearly average)	5.2	5.2	6.2	5.7
Fiscal balance* (% of GDP)	-4.2	-7.6	-5.2	-5.0
Public debt* (% of GDP)	34.8	43.5	46.3	50.0
Current account (% of GDP)	-8.6	-9.0	-8.5	-7.8
External debt (% of GDP)	27.0	31.5	33.9	38.5

** includes: Central Government, Local Government, Social Security Funds, Nonfinancial Public Corporations*

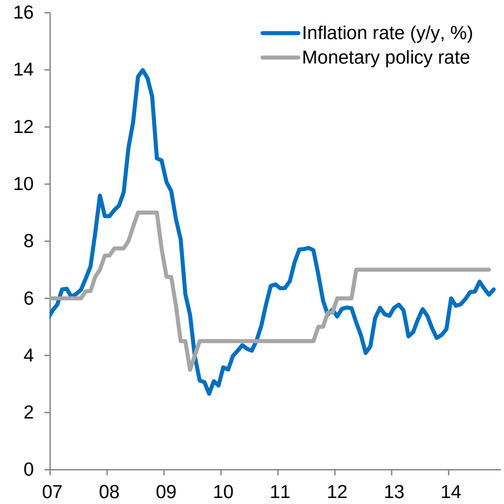
Sources: National sources, IHS, WEO-IMF, Euler Hermes

GDP growth (%)



Sources: National sources, IHS, Euler Hermes

Inflation rate (y/y) and policy rate



Sources: National sources, IHS, Euler Hermes employed in the informal sector. As of October 2014, fiscal revenues have increased by +20% y/y on the back of the rise in VAT rates. Alongside, total expenditure has slightly contracted (-0.3% y/y) exclusively thanks to a decrease investment spending (-24% y/y). Euler Hermes expects the fiscal deficit to narrow to -5.2% of GDP in 2014 and to -5% in 2015.

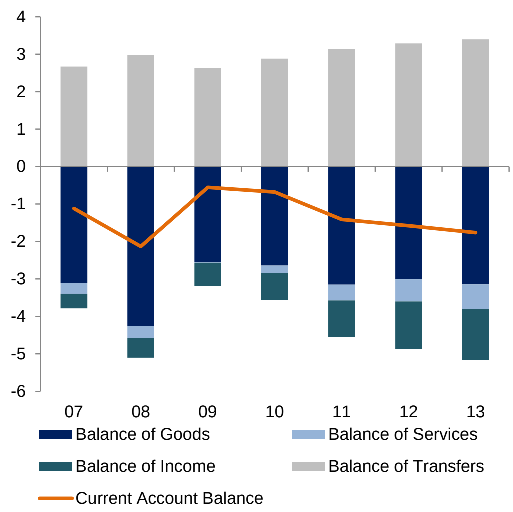
Public debt is currently at relatively low levels thanks to substantial debt relief initiated in 2006 (public gross debt was reduced from 57% of GDP in 2005 to 23% of GDP in 2008). However, as a consequence of repeated fiscal deficits, the public debt is increasing again (43.5% of GDP in 2013) and Euler Hermes expects it to pursue this trend over next years, reaching 50% of GDP by 2015.

External financing could become problematic

Over 2013, exports of goods contracted by -6.6% penalised by stagnating raw material prices, and especially a drop in coffee production due to leaf-rust. As imports registered a more moderate contraction (-3.6%), the trade deficit remained very elevated at -USD3.1 billion, which represents -20% of GDP. The deficit in the income balance also widened due to large profit repatriation from US companies. Although large worker remittances inflows (17% of GDP) partially offset this deterioration, the current account deficit widened to -9% of GDP in 2013, after -8.6% in 2012 and -3.8% in 2009. Euler Hermes expects it to narrow slightly in forthcoming quarters. Exports will benefit from the recovery in coffee production while the contained oil prices should ease energy imports. However, the external deficit will remain elevated at -8.5% of GDP in 2014 and nearly -8% in 2015.

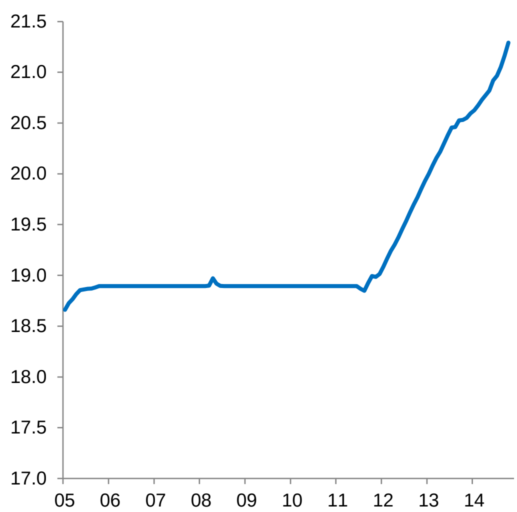
Although FDI inflows cover 68% of the current account deficit, the latest developments in the exchange rate front raises some concerns. In 2011, the monetary authorities abandoned the fixed exchange rate regime and introduced controlled flexibility which allows the lempira to fluctuate by +/-7% against the USD with respect to a base price set by the Central Bank. Despite this welcomed step toward a more flexible exchange rate, the lempira remains overvalued against the USD given the significant spread in inflation. Downward pressures on the national currency led the authorities to modify in June 2013 the methodology used to calculate the base rate. Consequently, the lempira accelerated its depreciation against the USD (-4.5% on average in 2013, and -3.5% since the beginning of 2014). As the normalization of the U.S. monetary policy might tighten external financing conditions, the authorities may struggle to defend the exchange rate regime given the relatively low level of foreign exchange reserves (USD2.9 billion or 3.5 months of import cover). This is even more problematic than the share of credits in foreign currency have been growing very rapidly (+20% y/y in September against +10% y/y for credit in national currency), reaching 30% of the total credit and 16% of GDP.

Current account balance in bn USD



Sources: National sources, IHS, Euler Hermes

Exchange rate (HNL/USD)



Sources: National sources, IHS, Euler Hermes

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Country Risk Analyst:
Daniela Ordóñez
daniela.ordonez@eulerhermes.com