

# **Economic and Financial Reform in Honduras: Challenges and Opportunities to 2025**

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*This paper reviews Honduras's vital statistics and recent economic and political events that impact the economy. Honduras, the poorest country in Central America with almost two-thirds of the population living in poverty, has the highest level of income inequality in Latin America. In addition to being vulnerable to external shocks that include acts of nature, the country faces major challenges regarding crime, violence, and endemic corruption. Using a framework that assesses the performance of a national economy that participates in today's globalized world, I identify the strengths and weaknesses of Honduras towards the end of enhancing the future performance of its economy.*

## **INTRODUCTION**

While the economies of most of Europe and the United States continue to heal a decade after the Great Recession, Latin America experienced impressive growth for the decade ending in 2013, with only a brief downturn in 2009 (United Nations, 2013). The favorable international economic environment until 2008 -- in particular the double digit growth of Gross Domestic Product (GDP) in China (and the resulting boom in international commodity prices) -- along with more responsible economic policies and/or improvements in the legal and tax environments for business in some countries in Latin America, i.e., Brazil, Chile, and Peru, resulted in higher regional economic growth rates and improved living standards from 2000-08.

The International Monetary Fund recently raised its forecast for global growth in 2017 to 3.6% and to 3.7% in 2018 (Zumbrun, 2017). However, GDP growth has slowed in China (from 7.3% in 2014, to 6.8% in 2015, to 6.7% in 2016, and growth is estimated at 6.8% in 2017); slow -- though increasing -- growth continues in Europe and Japan (approximately 2% annual growth in these regions) and growth about 2.2% is expected for the US in 2017 (The Economist, 2017d). Negative growth in Brazil, Venezuela, and Argentina reduced Latin American regional growth to 1.2% in 2014, -0.4% in 2015, and -1.0% in 2016.

As a result of the sluggish growth in the world economy since the Great Recession, i.e., less than 3% per annum over the interval, the budget shocks -- along with major corruption scandals and governance issues in the large Latin American countries (Argentina, Brazil, Mexico, and Venezuela) -- have increasingly caused Latin American voters to reject the leftist populist governments that were in power over the last decade and a half, and have been turning to center-right leaders who promised to improve the performance of their economies and to restore confidence in the institutions of their countries (New York Times, 2016a; Rathbone, 2016). This is already the case in Argentina, Brazil, Paraguay, Peru and, most recently, in Chile (Bonney and Londoño, 2017).

The ongoing economic and political crises in Brazil -- the region's largest economy -- warrant additional comment: in 2015 GDP declined by more than 3.8%, followed by a decline of 3.6% in 2016, with GDP expected to turn slightly positive in 2017. In 2015 and 2016 the country was mired in one of the worst recessions since the 1930s with unemployment in excess of 9.0%, annual inflation around 10%, and a fiscal deficit above 8.0% of GDP (United Nations, 2016; Jelmayer and Lewis, 2016). In 2016 and 2017 the country was also in the midst of political and constitutional crises with the removal of President Dilma Rousseff from office and, though her replacement, Michel Temer, has been weakened by investigations over corruption allegations, he will survive politically until elections in 2018.

This paper begins with a summary of Honduras's vital statistics, and is followed by a review of the main political events of the past that shaped some of the major institutions of the country and the current -- both domestic and international -- political and economic environment that affects the performance of the Honduran economy that triggered some of the recently implemented reforms that are discussed in Part 3. This section of the paper concludes with data that provide some measures of Honduras's relative material wellbeing -- or more precisely lack of wellbeing -- as compared with neighboring countries in Central America. Part 2 provides a review of research regarding the "ingredients" judged to be important for a well-performing national economy that is participating in the wider global economy at the end of the second decade of the 21st century. These "ingredients" are used in the next section to assess the current state of the Honduran economy -- both its strengths and weaknesses. I conclude by summarizing the "assets" the country can draw on to the end of improving the performance of its economy and increasing living standards and highlighting the country's most glaring "liabilities" that are impeding a more prosperous future.

## **VITAL STATISTICS, A SUMMARY OF HONDURAS'S PAST POLITICAL AND ECONOMIC HISTORY, AND SOME CURRENT COMPARATIVE MEASURES OF WELLBEING**

### **Vital Statistics**

The Republic of Honduras, administratively comprising 18 departments, is bordered on the southeast by Nicaragua, on the north and east by the Caribbean Sea, on the west by El Salvador and Guatemala, and, through its 163km-southwest coast on the Gulf of Fonseca, the country also enjoys access to the Pacific Ocean. With the second largest land area in Central America -- about 112,000 square km -- Honduras is slightly larger than the US state of Tennessee. The country lies between 13-15 degrees north of the equator. In mid-2017, Honduras's population was approximately 8.1 million people and its population growth rate in 2015 was estimated at 1.4% per annum (p.a.) -- above the Latin America average of 1.1% p.a. In 2016, the country registered a net out-migration rate of 1.1 per 1000 of population, with almost 600,000 Hondurans -- about 7% of the population -- living in the US, of which more than 60% are unauthorized.

Life expectancy at birth in 2016 was reported at approximately 71 years, about nine years less than in the United States, and the infant mortality rate in Honduras was 18 per 1000 live births, about triple the US ratio. In 2015 about 55% of Hondurans lived in urban areas, well below the 82% US rate. The country's ethnic breakdown is 90% mestizo (mixed Amerindian and white), 7% Amerindian, 2% black, and 1% white. Honduras registers greater than 88% literacy for those 15 years and older, and in 2013 the country spent 5.9% of its GDP on education, above the US rate of 4.9%. The World Bank classifies Honduras as a lower middle-income country, with per capita GDP in 2015 estimated at US\$4,900 on a purchasing power parity (ppp) basis (Central Intelligence Agency, 2017).

Turning to the composition of GDP in 2016, agriculture accounted for 13.8% of GDP (but employed 39% of the approximate 3.6m people in the labor force); industry for 26.6% of GDP (and 21% of the labor force); and services for approximately 59.6% of GDP. In 2015, Gross Fixed Capital Formation as a percentage of 2015 GDP was reported at 25.2% (United Nations, 2016). Coffee and banana exports still account for almost 40% of Honduras's total export revenue.

### **A Brief Summary of Honduras's Political and Economic History: 1502-2016**

In 1502, on his fourth and final voyage to the New World, Christopher Columbus landed near the northern coast of Honduras. By 1524, Gil Gonzalez Dávila became the first Spaniard to enter Honduras as a conquistador, and he was followed by Hernán Cortés, who brought forces from Mexico. Many regions in the north and the east of the country, notably the Miskito Kingdom, never fell to the Spanish, and found support from northern European privateers and pirates. The Honduran areas controlled by the Spanish were incorporated as a province into the Kingdom of Guatemala, part of the Spanish empire in the New World, that continued for three centuries. The Spanish were attracted to Honduras by silver mining. Regarding its conquests in the New World, it is well-known that among Spain's most potent weapons in subduing the indigenous people of the Americas were the infectious diseases carried by the Spanish colonizers that were inflicted on the native population.

The Captaincy General of Guatemala, also known as the Kingdom of Guatemala, was an administrative division of the Spanish Empire in Central America established in 1609 that included, at times, the present-day nations of Costa Rica, Nicaragua, Honduras, El Salvador, Guatemala, and the Mexican state of Chiapas. It was established to deal with foreign threats to the area from the Caribbean, with Spain granting the area autonomy in administrative and military matters. After this administrative division was dissolved in September 1821 with the Act of Independence of Central America, Honduras became part of the First Mexican Empire, but, with the overthrow two years later of the Empire's monarchy, Honduras joined the fledgling United Provinces of Central America, later known as the Federal Republic of Central America. Less than fifteen years later, in 1838, Honduras became an independent republic. Though independent, Honduras remained one of the most regional-centric Central American countries, however elusive it proved to be. (Please see below).

Serious involvement of the United States in Honduras began during the first half of the 19th century, as western expansion of the United States was facilitated by the remarkable improvements in communications and transport technologies -- the invention of the telegraph by Samuel Morse in 1837 and the completion of the transcontinental railroad in 1869. At least a decade before the 1849 California gold rush, US enterprises established vast fruit plantations through land-grants made by the Honduran authorities that complemented financial incentives provided to US infrastructure companies in return for developing the country's northern region that included a planned railroad from the north coast to the capital. The start of the California gold rush further increased US interest in Central America for a transoceanic route, though the candidate countries for this venture were Nicaragua and Panama, with the latter country ultimately prevailing with the construction of the Panama Canal.

Banana-exporting companies such as Cuyamel Fruit Company, United Fruit Company and Standard Fruit Company were the dominant players in the Honduran economy until the 1950s, and the term 'banana republic' -- "a pejorative description of a servile dictatorship that abets and supports, for kickbacks, the exploitation of large-scale plantation agriculture, especially banana cultivation" -- was coined in 1904 by the American writer O. Henry, that accurately reflected the then "realpolitik" of Honduran-US relations.

Over this interval of almost a century, with strong support from the United States, Honduras was governed almost uninterruptedly by military governments, which, from time to time, were deposed by coups engineered by opposing factions in the military. In addition, Honduras was also involved in a brief one week war against El Salvador -- the Football War in 1969 -- that resulted from a disputed border and illegal immigration to Honduras from El Salvador. After the Organization of American States brokered the cease-fire, 130,000 Salvadoran immigrants were expelled from Honduras.

Following the severe damage inflicted by Hurricane Fifi in September 1974 that killed more than 8,000 Hondurans and destroyed the entire banana crop, Honduras's physical infrastructure -- including a modern telecommunications system -- was rebuilt by the last two military governments under Colonel Melgar Castro (1975-78), who was ousted by his successor General Paz García (1978-82). In 1979, the country began its return to civilian rule with the election of a constituent assembly in April 1980 that was charged with writing a new constitution, and general elections were held in November 1981. Roberto

Suazo was elected President promising an ambitious program of economic and social development, underwritten by US development aid.

Honduras played an important role in the US attempt to oust the Sandinistas from neighboring Nicaragua during the 1980s. The conservative Honduran government and military shared US concerns over the Sandinistas' military buildup, and both the United States and Honduran governments viewed US assistance as critical in deterring Nicaragua, through both the buildup of the Honduran armed forces and the introduction of a US military presence in Honduras.

In 1982 Honduras signed an agreement with the United States that provided for the stationing of a "temporary" US military presence in the country. The primary mission of the task force was to support US military exercises and other military activities and to demonstrate the resolve of the United States to support Honduras against the threat from Nicaragua. The United States spent millions of dollars in building and upgrading several air facilities -- some of which were used to help support the Contras, who were composed of former members of the Nicaraguan National Guard (who fled to Honduras after the overthrow of Nicaraguan President Somoza), by disgruntled peasants from the north, and by indigenous groups from the Mosquito coast many of whom, after rejecting Sandinista efforts to incorporate them into the national mainstream and demanding autonomy, were forcibly relocated by the Nicaraguan government.

Throughout the 1980s, Honduras's military was involved in a web of regional conflicts that included Nicaragua and El Salvador, that spilled over causing increasing domestic political unrest with trade unionists and leftwing sympathizers that culminated with death squads to eliminate alleged subversive elements. Human rights issues dominated the Honduran political scene throughout the 1980s and 1990s that included abuses such as "disappearances" of Honduran citizens between 1981-84, the assassination of deposed armed forces chief General Gustavo Alvarez in 1989 by left-wing guerrillas, along with the release of various reports carried out by NGOs and international organizations such as Amnesty International and the Inter-American Court of Human Rights, respectively, detailing human rights violations by the armed forces and right-wing death squads, and finding the government guilty of the "disappearances" that were carried out between 1981-84.

With the civil war in Nicaragua looking like a military stalemate with both sides economically exhausted as foreign sources of financial and military support dried up, the "planets were aligning" for a negotiated end to that long conflict. In 1987 Costa Rica's newly elected president, Oscar Arias Sánchez, promoted a comprehensive regional peace plan that would embrace all of Central America. The Arias Plan had the following planks: "amnesty for persons charged with political crimes, a negotiated cease-fire, national reconciliation for those countries with insurgencies (Guatemala, El Salvador, and Nicaragua), an end to all external aid to insurgencies (United States support to the Contras based in Honduras and Soviet and Cuban support to guerrillas in Guatemala and El Salvador), and democratic reforms leading to free elections in Nicaragua" (Merrill, 1993).

In the wake of the end of the fighting in Nicaragua, in February 1989 a summit of Central American presidents held in El Salvador reached agreement on the demobilization of the Contras based in Honduras, and the last of the Contras fighters left Honduras by June 1990. The previous January, President Rafael Callejas took office promising to redirect the economy to concentrate on economic growth after more than a decade of political, social, and civil strife. Honduras and the other Central American states turned their efforts to regional integration, particularly economic integration. In 1990 the Central American presidents signed a Central American Economic Action Plan (Plan de Acción Económica de Centroamérica), which included economic integration commitments and guidelines. In September 1992, Honduras's long-time border conflict with El Salvador was resolved when the International Court of Justice (ICJ) awarded Honduras approximately two-thirds of the disputed territory.

Both nations agreed to accept the ruling, which was viewed by many as a victory for Honduras. In addition, with the end of the hostilities in Nicaragua and El Salvador, US annual foreign aid levels to Honduras declined from \$213m in 1990 to \$60m in 1993, of which only \$2.6m was targeted for military aid. Prodded by the Clinton Administration's concern against human rights abuses, during the 1990s, both of President Callejas' successors, Carlos Reina (1994-98) and Carlos Flores (1998-2002), implemented

important reforms to “demilitarize” Honduran society by, among other actions, ending compulsory military service, placing the armed forces under civilian control, transferring control of the police from military to civilian authorities, and reforming the judicial system. Readers interested in a more detailed survey of Honduras from pre-Columbian society to the mid-1990s are referred to Merrill (1995).

Honduras’s forward progress was abruptly halted when “mother nature” did not cooperate as is so often the case in Central America. (Please see the next section). On October 29, 1998 Hurricane Mitch struck Honduras. After assessing the damage caused by the hurricane, the newly-installed president, Carlos Flores, estimated that Mitch erased 50 years of economic development in Honduras. The storm destroyed about 35,000 houses and damaged another 50,000, leaving up to 1.5 million people homeless, or about 20% of the country's population. Mitch directly caused \$2.0 billion in damage, with an additional \$1.8 billion in indirect costs. Most of the damage was in ruined crops, and cash crop exports were cut by 9.4% in 1999, largely due to the storm. Over 70% of the transport infrastructure was damaged, including highways and most bridges. Widespread areas experienced power outages, and about 70% of the country lost access to water after the storm. Throughout the country there were at least 7,000 fatalities. Following the storm, officials in Honduras requested international assistance, which totaled \$2.8 billion over several years. Due to the heavy damage inflicted by the storm, the name Mitch was retired from the Atlantic hurricane naming list.

The first years of the 21st century in Honduras were characterized by a proliferation of gang-related violence and extra-judicial killings of street children by death squads, some at the hands of police officers. As is well-known the Northern Triangle countries have long histories of armed conflict and political repression. A legacy of conflict and authoritarian rule has inhibited the development of democratic institutions and the rule of law. Add to this societies that have been stressed by economic factors such as poverty, inequality, and unemployment -- resulting in few opportunities for increasingly youthful and growing populations -- and this dangerous mix of ingredients nurtures widespread and indiscriminate violence. This led the newly elected President Ricardo Maduro, in January 2002, to the dismay of many both in the country and abroad, to re-engage the military in fighting crime. Throughout the Maduro years in office (2002-6) the levels of violence increased in Honduras, partly explaining the loss of the ruling party candidate for President in favor of the Liberal Party candidate, Manuel Zelaya, in December 2005.

Regional integration was strengthened when, in April 2006, the Honduran Congress gave its approval to the 2003 free trade agreement between five Central American countries and the United States (CAFTA), that later included the Dominican Republic as well. This was preceded in January 2002 by the restoration of Honduran diplomatic ties with Cuba, which were severed in 1961 when Cuba was expelled from the Organization of American States (OAS).

While Honduras was always considered a firm ally of the US, in October 2007 President Zelaya initiated the first visit to Cuba in 46 years by a Honduran president, which could not have been viewed favorably by the US. This was followed, in August 2008, with Honduras becoming a member of ALBA, Venezuelan President Hugo Chávez’s Bolivarian Alliance for the Americas, an anti-American alliance of leftist leaders in Latin America. Zelaya justified joining the group because of insufficient support from the international community to fight chronic poverty in Honduras. That same year Honduras joined Petrocaribe which provided subsidized oil shipments by Venezuela to 18 Caribbean Basin countries.

Though national elections were not due until November, in June 2009 Honduras’s Supreme Court ordered the arrest of Manuel Zelaya for allegedly organizing mob violence and violating the Constitution (O’Grady, 2009). On June 28, the Honduran army forced President Zelaya onto a plane to Costa Rica, Latin America’s last military coup to date. Zelaya allegedly ran afoul of a constitutional provision enacted in 1982 when civilian government was being restored. The provision not only prohibited the re-election of a sitting president but also stipulated that any current office-holder who advocated changing that provision “shall immediately be dismissed” from office (The Economist, 2017b).

Following the coup the OAS suspended Honduras’s membership in the organization and 29 countries severed diplomatic ties with Honduras. The initial US position -- ironically one also supported by Cuba and Venezuela -- was in favor of restoring Zelaya to his position, but, later in seeking a compromise, deferred to the decision of Honduras’s Congress and Supreme Court. On October 30, a month before

national elections, an agreement was reached: the removal of a proposed referendum to reform the Constitution that would permit the President to succeed himself; the formation of a national unity government by November 5; and the appointment of a committee to oversee the implementation of these accords.

In the meantime, the collateral economic damage was palpable: there was a collapse in tourism, frequent curfews, and a decline in public investment because foreign aid was suspended, all of which translated into lost national income, an estimated contraction in 2009 GDP of -2.5%, that was, of course, partly the result of the global financial crisis. Of equal importance was the return of the army to the political scene, having submitted to civilian authority for almost two decades. All the “ghosts of the past” seemed to be re-appearing: the threat of Communism, human rights violations, circumventing the rule of law, back-room deals among political elites, and, of course, all of this under the watchful eyes of the US (The Economist, 2009).

The election was won by a conservative rancher, Porfirio Lobo Sosa, winning 55% of the vote, with neither deposed-President Manuel Zelaya nor interim-President Roberto Micheletti on the ballot. This was followed by a decision by Congress not to permit President Zelaya to return to office, who went into exile in the Dominican Republic. In 2010, the Supreme Court dismissed charges against six military commanders who were instrumental in expelling President Zelaya from the country in 2009; the US resumed aid to Honduras that was suspended after the coup and endorsed the election result; diplomatic relations with Honduras were restored by all 29 countries who severed ties after the coup; and the “Truth Commission” that investigated President Zelaya’s removal from office concluded that, indeed, he was removed by a military coup. In order to placate the US, President Lobo granted amnesty to deposed-President Zelaya in May 2011, who returned from exile in the Dominican Republic with his wife, Xiomara Castro, a hard-left populist, who was one of three candidates for president in the November 2013 poll that was won by the National Party candidate, Juan Orlando Hernández, who previously served as president of the Honduran Congress.

Exacerbating the chronic and endemic corruption in Honduras (see below) the country was now facing the unintended consequences of Mexico’s “War on Drugs”, initiated by Mexican President Felipe Calderón (2006-12). His large-scale deployment of Federal troops against the Mexican drug cartels resulted in the death of over 60,000 people by the end of his term in office, with the murder rate decreasing during his last two years in office. As a result of Mexico’s actions in conjunction with the Clinton/Bush era “Plan Colombia”, a US foreign aid, military and diplomatic initiative aimed at combating Colombian drug cartels that was supplemented 15 years later by the Obama Administration’s “Peace Colombia” program, Honduras became a major trans-shipment point for illicit drugs from Colombia, Mexico, and Peru. This triggered an explosion of gang-related violence, domestic abuse, and a general absence of security, which, in conjunction with the ongoing political and socio-economic problems in the region, resulted in a massive migration of Hondurans (and nationals from the other Northern Triangle countries) -- many of whom were unaccompanied children -- to the US via Mexico. In addition, since the 2009 coup, journalists, judges, labor and indigenous leaders, human rights defenders, environmental activists, and, most recently, anti-drug officials have been assassinated by targeted killings, and their murders have been largely unsolved (Malkin and Arce, 2016a).

In order to improve conditions in the Northern Triangle countries to the end of reducing the flow of migrants, the Obama Administration responded with the “Alliance for Prosperity” initiative, a \$1bn program to improve education, public safety, access to justice, and upgrade institutions such as tax agencies (The Economist, 2015a). However, even with the Hernández administration’s crack-down on crime -- the homicide rate declined from 91 per 100,000 population in 2012 (before he took office) to 42 per 100,000 in population in 2017 -- his government faced criticism over government corruption and human rights abuses by the security forces.

The drug-related corruption extended to Honduras’s elite families, including the arrest of former-President Porfirio Lobo’s son in Haiti on drug-related activities, who pleaded guilty to cocaine trafficking, and was sentenced to 24 years in prison in the US (Arce, 2016; Amey, 2017). Anti-corruption movements were formed to protest the web of well-connected business groups and politicians who were allegedly

skimming government funds that should have been used for health, education, and infrastructure projects (Miller and Trinkunas, 2015). In one of the accusations, Mr. Hernández and his party allegedly defrauded the national health service of \$300m in bribes paid by suppliers of medicines and medical devices while he was the Speaker of Congress (The Economist, 2015b). These scandals were made public just when the Obama administration was requesting Congressional authorization for the program's funding.

In October 2015 the Honduran government accepted the missions sent by the OAS and the United Nations to investigate the allegations of human rights abuses by the Honduran security forces and to make recommendations for reforms to address the corruption and human rights issues. The US Congress, for its part, made its approval of the "Alliance for Prosperity" funds to Honduras conditional on their ability to demonstrate credible progress on improving human rights, reducing the level of corruption, and enhancing the rule of law (Malkin and Arce, 2016b).

President Hernández, despite the continuing Constitutional ban on re-election, cleverly manipulated the Supreme Court to permit him to run in the November 2017 presidential elections even though two-thirds of Hondurans oppose re-election of sitting presidents. As of this writing (December 2017), although Honduras's electoral court declared President Juan Orlando Hernández the winner of last month's disputed election, runner-up Salvador Nasralla has alleged fraud and challenged the vote count. After three weeks of uncertainty and violent protests, at least 17 people died. Complicating the unstable environment, the Organization of American States, the leading regional body in the Americas, citing election "deficiencies" urged the country to organize a new vote (De Córdoba, 2017). The United States, despite the widespread voting irregularities, has recognized Mr. Hernández as the winner, leading Mr. Nasralla to abandon his challenges of the vote (Webber, 2017). Needless to say, Honduras is certain to experience continued political instability as a result of the tainted election.

### **Central America: A Brief Survey of Honduras's Neighborhood**

The data presented in Table 1, below, provide a snapshot of Honduras's relative position with its regional neighbors for some generally accepted indices of "quality of life" and economic wellbeing.

According to The Economist (2011), the isthmus of Central America is the "most routinely murderous region on earth". One of the symptoms -- some might argue causes -- of living in a "bad neighborhood" is an elevated homicide rate, and Honduras has one of the highest rates in the world -- reported in 2012 at 91.0 per 100,000 of population -- almost twenty times the US rate, which itself is three and a half times the rate in the European Union. President Juan Orlando Hernández has boasted that the murder rate has receded to 42 during his tenure in office, though, if confirmed, it would still 50% above Latin America's high average (The Economist, 2017c). More about this below.

As one of the three countries in the infamous Northern Triangle along with El Salvador and Guatemala, Honduras is being undermined and overwhelmed by egregious levels of violence, insecurity, and endemic corruption that have their origin in drug mafias and criminal gangs permeating all of Honduras's institutions and branches of government (Malkin and Arce, 2016a; New York Times, 2016b). Violence in the region is not only at a high level, but it is increasing. Central America's Northern Triangle region is among the most violent in the world, leading to massive outflows of people from these countries. In the last five years, the US and Mexico have returned 500,000 refugees to Central America, including 40,000 children (Kristhof, 2016).

Natural disasters are also part of the landscape. Four of the seven countries in the region have been classified as among the most vulnerable in the world to destructive weather or other acts of nature including hurricanes, floods, landslides, earthquakes, and volcanic eruptions (The Economist, 2011).

Then, of course, there are the social and economic metrics illustrated by the data in Table 1, where, clearly, Honduras appears to be considerably worse off than its regional neighbors judging by all the metrics -- save the education expenditures to GDP ratio.

Civil wars plagued many Central American countries during the 1970s and 1980s that were linked to the then ongoing Cold War between the US and the Soviet Union with the dictators being backed by the former, and the guerrillas supported by the Soviet Union and its regional proxy, Cuba.

Over the last few decades, Central American countries -- and in particular the countries of the Northern Triangle -- have been in the frontline of the drugs trade and organized crime since the region is wedged in between the world's largest cocaine-producing countries (Colombia, Peru, and Bolivia), Mexican cocaine traffickers, and the world's largest consumer market for cocaine, the United States. Along with the increased violence and insecurity that accompanies the drugs trade, according to the World Bank, the economic cost imposed on the economies of the region by the drug-related crime and violence was estimated at approximately 8% of the region's GDP, about twice the relative cost of the US's annual defense budget (The Economist, 2011), and an estimated 6.5% of GDP in Honduras (The Economist, 2017a).

**TABLE 1**  
**CENTRAL AMERICA: A SNAPSHOT OF THE REGIONS**

Country	GDP per Capita (2015 US\$, ppp)	Population (Millions, 2015)	Population Below Poverty Line (% of Population)	Education Expenditures (% of GDP)	Physician Density Rate (per 1000 Population)	Homicide Rates (per 100,000 Population)
Belize	8,400	0.35	41.0	6.2	0.83	34.4
Costa Rica	15,500	4.81	21.7	7.6	1.13	10.0
El Salvador	8,300	6.13	31.8	3.5	1.50	64.2
Guatemala	7,700	16.34	59.3	2.9	0.93	31.2
Honduras	4,900	8.08	62.8	5.9	0.70	74.6
Nicaragua	5,000	6.08	29.6	4.5	0.90	11.5
Panama	21,800	3.93	23.0	3.3	1.65	17.4

a. Latest available data

Source: Central Intelligence Agency (2017);

<http://data.worldbank.org/indicator/VC.IHR.PSRC.P5?locations=HN-US-EU>

## THE METHODOLOGICAL FRAMEWORK

Before discussing the areas in which reform will be needed to improve the long-term performance of the Honduran economy to the end of raising living standards, it is worthwhile reviewing some of the alternative “paths to prosperity” that have been proposed by the leading development experts -- individuals and institutions -- over the last half century.

The ideas of Raúl Prebisch (1959) and Hans Singer (1964) provided the intellectual firepower for the development blueprint anchored in “import substitution” because their thesis was based on the declining terms of trade for primary products and the dynamic benefits to the economy of a vibrant manufacturing sector. These concepts became operational policy in most of Latin America in the 1960s-70s, ensuring a large and growing role of the state in the economy through supportive taxes and subsidies if not direct ownership of productive capacity.

The role of state involvement in the economy for development purposes that is a corollary of the Prebisch-Singer thesis was actually the foundation of the work proposed earlier by Paul Rosenstein-Rodan (1943) and P.C. Mahalanobis (1955), which stressed increasing returns to scale and kick-starting

growth through large-scale investments and accelerating economic development by government encouragement of heavy industry, respectively.

These “inward” winds of economic development shifted in favor of more “outward” and “market-oriented” strategies that were advanced during the 1970s by Balassa (1971), Bhagwati (1978), Krueger (1978), and Little, Scitovsky, and Scott (1970). The “market-based” approach to improving the performance of the economy and to enhancing living standards reached its zenith with the views of a group of Latin American economists and policymakers, the World Bank (1991), and various academic and “think tank” development experts such as John Williamson (1994) with the so called “Washington Consensus” of the 1990s. For example, in its 1991 World Development Report, the World Bank articulated four broad requirements that characterize a national economy as “battle ready” to meet the challenges of the fiercely competitive world economy at the end of the 20th century. They included:

- A stable macro-economy characterized by both fiscal and external balance and low and stable inflation;
- The adoption of a competitive micro-economy that includes a substantial reduction in state ownership and management of productive assets and the elimination of price distorting subsidies and taxes;
- Strong global linkages that include adherence to GATT (now the WTO), low and uniform tariff rates, absence of non-tariff barriers, a uniform and market-determined exchange rate, a liberalization of the rules governing capital flows and foreign direct investment and;
- An active government policy that promotes social and economic investment, especially in the areas of education, infrastructure, and health.

In its 1997 World Development Report (World Bank, 1997), the Bank expanded the reach of the fourth requirement to include the promotion and enforcement of property rights, reducing the level of corruption in the country, and ensuring a reliable legal system -- some of the so-called “second tier” reforms.

The “Washington Consensus” (WC), which was originally compiled in 1990 and published by John Williamson (1994), enumerated a list of desirable conditions that, if adopted and adhered to, would, over time, put reforming countries on the path to success in the global economy.

**TABLE 2**  
**MODIFIED “WASHINGTON CONSENSUS”**

a.	Fiscal and monetary discipline
b.	Redirection of public expenditure priorities towards health, education, and infrastructure
c.	Tax reform and improved tax administration
d.	Unified and competitive exchange rates
e.	Modernization of government and "quasi" government institutions
f.	Deregulation
g.	Trade liberalization and regional integration
h.	Privatization
i.	Elimination of barriers to foreign direct investment
j.	Banking reform and financial liberalization

Since the late 1990s, because of its alleged failure to address the issue of poverty reduction directly, the Washington Consensus was subjected to heated intellectual debate within academia and the major international organizations such as the World Bank (Beattie, 2000). Nevertheless, this framework continued to assume a central role in the debate on development strategies for low- and middle-income developing countries during the first decade of the 21st century. Readers interested in this debate are referred to Rodrik (2010) for a review of this subject. (Please see Table 2, above, for a list of its main points).

In light of the experience of the late 1990s (increasing poverty rates and stalled economic growth due to an adverse external environment), proponents of the Washington Consensus amended the original framework to ensure that fiscal policy is counter-cyclical to support economic growth in an economic downturn, and to focus on reducing income inequality by ensuring that the poor have access to assets, i.e., education, land titling, micro-credit and land reform, that will enable them to work themselves out of poverty (Williamson, 2003).

While the “reform decade” of the 1990s did restore growth in GDP and GDP per capita in Latin America when compared with the “lost decade” of the 1980s -- growth in GDP and GDP per capita from 1991-98 was 3.5% and 1.7% p.a., respectively compared with 1.0% and -1.0% p.a. in the 1980s (United Nations, 1998) -- many observers of Latin America contended that the “neoliberal” reforms of the 1990s have not only failed to deliver sustained growth, but have made the region more vulnerable and increased unemployment, poverty and inequality. As a result, some political pundits asserted that Latin America, in the first few years of the new century, was returning “to populist and/or anti-market leftist nationalism” (The Economist, 2003). However by 2016, in many of the largest countries in South America, in particular Argentina, Brazil, and Peru, where, after a decade and a half of “populist” (and failed) policies, voters have again abandoned these politicians and are electing more centrist -- and market-friendly -- governments (Rathbone, 2016). In Venezuela, with annual inflation at more than 800% and a decline in GDP by 18% in 2016, the leftist-populist Chávez-Maduro regime appears to be nearing its endgame.

In a review article of economic development blueprints, Dani Rodrik (2010) assessed the experience of China, which over the last three decades arguably has had the most successful growth and poverty reduction program in recorded history, and notes that there does not appear to be any single orthodox Western economic plan that was adhered to by Chinese economists and policymakers.

Rodrik also observed that even in (now relatively prosperous) Chile -- admitted to the Paris-based club of “rich” countries, the Organization of Economic Cooperation and Development (OECD) in 2010 -- during the 1970s-80s a strict universally scripted development plan was abandoned and a more heterodox (and indigenously articulated) strategy was adopted even during the tense Pinochet era.

It now appears, according to Rodrik, that a more fruitful approach to prescribing a successful path to economic growth and development is one that is based on “diagnostics”, as proposed by Hausmann, Rodrik, and Velasco (2008) and Hausmann, Klinger, and Wagner (2008). In place of a “boiler plate” set of rules and a rigid, unyielding approach to growth these development economists propose to identify a country’s binding constraints and then prioritize the policy reforms given the political and social realities of the country involved. These authors argue that the earlier, carefully scripted paths to growth and development have not lived up to their expectations:

“The currently prevailing view, as reflected in the World Bank’s (2005) report on the lessons from the 1990s or by the blue-ribbon Commission on Growth and Development (2008), accepts the importance of outward orientation but places much less emphasis on trade liberalization and is much more willing to condone a measure of industrial promotion in order to achieve and sustain high growth” (Rodrik, 2010; p. 40).

Rodrik praised China’s so-far successful development approach of grafting a market system on top of a heavily regulated state sector (that was the orthodoxy of an abandoned Communist economic system) with China’s development plan evolving over time as their binding constraints change: first in agriculture; then in industry; then in foreign trade; and eventually in finance, the environment, and pension reform.

It is important to note that despite its impressive poverty reduction cum economic growth program now in its fourth decade, China enjoys enormous leverage in the world because of its population of 1.4bn people -- almost 20% of the world’s population -- that is increasingly willing and able to become “21st century consumers”. China’s voracious appetite for fuel and non-fuel minerals (Sohn, 2008a; Sohn, 2008b), “first world” foods and diets, electricity and other infrastructure goods, along with its still large though increasingly more expensive labor force, provides it with enormous “monopoly-like” and “monopsony-like” power on world resource, factor, and product markets. The market access that it

provides for the goods and services of global companies confers on China tremendous leverage regarding the terms it dictates for foreign (inward and outward) investment, the aid programs it operates, and its managed foreign exchange and capital account regimes. On the other hand, problems abound: the simmering problems of its unreformed banking system, chronic overcapacity in its resource and manufacturing sectors, the widespread corruption in the country, its continuing debt problems which recently reached 255% of GDP, and most recently, the growing divide between China's rural and urban areas, which includes the intractable issue of internal migration from the country-side (The Economist, 2016; Kynge, 2016; Financial Times, 2016; Magnier and Cui, 2017). To be sure, particularly in the wake of the 2008-9 global financial crisis and the need for substantial global rebalancing, China's trade, savings, investment, capital account, and exchange rate policies are exacerbating the adjustments that are needed and increasing the political and diplomatic tensions in the world. The jury is still out whether China's one-party political system can be maintained with continuing globalization and technological change.

Nevertheless, over the last few years, after a prolonged internal debate, even the thinking of the International Monetary Fund, in juxtaposing the harsh economic and financial consequences of the 1997-98 Asian crisis with the relative calm in China in the aftermath of the 2008-09 global financial crisis, has evolved on the need for, and desirability of, capital account liberalization as the complement of already liberalized current accounts for developing countries. This new 'institutional view' recognizes that liberalizing "developing countries capital accounts before they have reached a certain level of financial and institutional development is highly risky" (Plender, 2012).

Daron Acemoglu and James Robinson (2012) argued in favor of the critical role played by economic institutions in explaining the enormous differences in living standards across the world. They contend that these institutions determine the economic incentives and the resulting allocation of resources, investment, and innovations needed for growth. Ultimately, it is politics that shape these institutions and their evolution. It will, of course, be interesting to track, during the next few decades, the evolution of China's political system, especially in the wake of slower growth since 2010 and a rebalancing of China's economy away from exports and investment towards consumer spending -- and if the changes that are introduced support the "right" economic institutions as argued by Acemoglu and Robinson. It is important to note a major new study by, arguably the leading economic historian of our time, Joel Mokyr (2017), on the role of institutions -- more broadly described as "culture" (beliefs, values, and preferences) -- in nurturing, if not provoking, economic growth and development that led to the sustained rise in living standards in western Europe and its offshoots in the New World since the Industrial Revolution.

The winds of globalization have shifted in the second decade of the 21st century as the growth in world trade slows due, in part, to economic, social, and political stresses in the developed countries, the result of anemic growth in GDP growth, increasing income inequality, and continuing lower employment participation rates even as official unemployment rates are normalized, and continuing technological change in the manufacturing and service sectors. Though some proposals to continue liberalizing global and regional trade and investment have been withdrawn (at least temporarily), in 2017 both Canada and Japan concluded important bilateral trade agreements with the EU (Rao and Ewing, 2017). The June 2016 vote in the Brexit referendum in the UK and the election in November 2016 of Donald Trump in the US serve as examples of the political backlash resulting from the above social and economic stresses. Failure to complete the Trans-Pacific Partnership (TPP), a regional initiative among twelve Asia-Pacific economies including the US, the Transatlantic Trade and Investment Partnership (TTIP), involving the US and the EU, and the ongoing negotiations to seek revisions to the North America Free Trade Agreement with Canada and Mexico are recent examples of the populist pressures driving current US trade policy.

In the next section -- which takes the measure of the Honduran economy -- I rely heavily on the "ingredients" prescribed in the market-based and outward-looking approach to economic growth and development noted in the above-mentioned World Bank reports, while at the same time being mindful of the contributions made by those advocating a more tailored approach to development that identifies binding national constraints and priorities in the quest for economic modernization over the next decade,

in addition to the important role of institutions cited by Acemoglu and Robinson, and most recently by Mokyr, that was discussed above. The emphasis in the next section is on the current state of the economy and the recently re-elected Hernández administration's program of economic, financial, political, and technological change for Honduras.

## **THE STATE OF THE HONDURAN ECONOMY: STRENGTHS AND WEAKNESSES**

### **Macroeconomic Stability**

With a view towards improving the performance of the Honduran economy during the next decade it is useful to take the measure of the current state of the economy following the World Bank's "recipe" described in Part 2, above. The first of the four broad requirements needed for a well performing national economy is macro-economic stability, generally characterized by both fiscal and external balance, low and stable inflation, and high levels of employment.

It would be of interest to examine these macro-variables over the last six years, that is, how the Honduran economy performed over the 2011-16 period. The beginning year, 2011, was the second year that positive GDP growth was restored to the region after the end of the Great Recession in the US and the global financial crisis. However, by 2011 regional GDP growth was declining -- though it was still positive until 2015 -- as a result of slow growth in the global economy and the precipitous decline in world commodity prices. This decline triggered serious domestic imbalances in four large Latin American economies -- Brazil, Argentina, Mexico, and, the most serious, in Venezuela -- that, arguably with the exception of Argentina, continued in 2017. Over this interval Honduras experienced higher -- and much more stable -- annual growth than the region as a whole, in part because its economy is much less dependent on energy and other mineral exports than the above-mentioned "giants" that dominate the Latin American regional economy. However, when compared with the Central America group, Honduras's annual GDP growth underperforms this region every year from 2011-16, and in some years by as much as 1% lower annual growth.

In fact, since the turn of the century, it appears that the Honduran economy is more affected by the performance of the US economy -- its most important trading partner, and its major source of tourism revenue and international remittances (which reached 18% of Honduras's GDP in 2015) -- than the performance of the regional economy of which it is a part.

According to the data in Table 3, below, since 2013, the arguably negative correlation between the GDP of Honduras and the Latin America and Caribbean region is the result largely of the continuing economic recovery in the US and the serious economic and political problems in the large regional "neighboring" countries mentioned above. The International Monetary Fund projects annual GDP growth in Honduras at 3.8%, its current potential growth rate, to the end of the decade (IMF, 2016).

According to the IMF, in addition to the very unstable growth that plagued Honduras for decades, more recently the economy was impaired by chronically weak public finances reaching a "peak of instability" in 2013 with a government deficit of 7.9% of GDP and a current account deficit of 9.6% of GDP (Table 3) (IMF 2016). Following a comprehensive fiscal reform program approved by Congress in December 2013, both of these deficits receded in advance of the adoption of the Fiscal Responsibility Law (FRL) in April 2016, which was designed to ensure more prudent fiscal discipline.

It is important to recall that Honduras qualified as one of 39 countries to participate in the Heavily Indebted Poor Countries (HIPC) Initiative launched in 1996 by the World Bank and the IMF whose aim was to ensure that no poor country faces a debt burden it cannot manage. The HIPC Initiative, in 2005, was supplemented by Multilateral Debt Relief Initiative (MDRI), which, under certain conditions, permitted 100% debt relief on eligible debts for countries completing the HIPC Initiative process. In 2007, Honduras received full debt relief from its World Bank, IMF, and IADB loans, resulting in a sharp reduction in Honduras's debt to GDP ratio from 63% in 2004 to 25% in 2007 (World Bank, 2015). However, by 2014, because of the above-mentioned deterioration in its public finances, Honduras's debt ratio was again above 40%.

As a by-product of the fiscal reform program, the chronic growth in Honduras's debt and debt-service ratios began to slow. According to the World Bank, Honduras's debt to GDP ratio is expected to peak at 50.8% in 2017 and gradually decline to 35.9% by 2034 (World Bank, 2015). A Debt Sustainability Analysis that was carried out jointly by the World Bank and the International Monetary Fund in 2014 concluded that Honduras has a debt distress level that is moderate. However, as is well known, the "dynamics of debt" are vulnerable to policy-related actions and exogenous shocks -- such as changes in international oil prices and in global growth, especially in the US, through the outsized importance of foreign remittances received by Honduras -- that affect the country's GDP growth and fiscal balance (World Bank, 2015).

The FRL, whose objective is to institutionalize fiscal discipline, transparency and stability, sets a ceiling for future fiscal deficits at 1% of GDP, after permitting a slightly higher deficit over a two year transition period, and prioritizes spending on infrastructure projects in government spending. Needless to say, all future national budgets submitted to Congress must be consistent with the provisions written into the FRL. In order to generate a positive "primary balance" by 2017, the government was expected to raise more money in tax revenue and to reduce public sector expenditures. (More about this below).

During the 1990s and most of the next decade Honduras experienced unstable and high annual rates of inflation. Since 2009 annual inflation has been contained to single digits and has been generally trending down (please see Table 3, below), due in large part to lower priced oil imports in recent years. As a result annual inflation rates in Honduras are now aligned with regional inflation rates. Most recently the Central Bank of Honduras has adopted, in conjunction with the above-mentioned FRL, a formal annual inflation target of 4.5%. According to the IMF, targeting inflation provides Honduran authorities with the necessary tools to respond to external shocks and it gives the Central bank a clear mandate to maintain price stability (IMF, 2016).

Turning to the rate of unemployment, while the national estimates presented in Table 3 report that Honduras's unemployment rate correlates well, though not perfectly, with the broader regional rate, even though very recently Honduras's unemployment rate was below -- by 2.0% or more -- the broader Latin America and Caribbean region metric. This is most likely the result of the ongoing -- though weak -- recovery in the US, and, on the other hand, the continuing economic problems in the largest Latin American economies, Brazil and Venezuela. It is also important to note that Honduras's urbanization rate of 55% is well below the regional average of 80%, recalling that Latin America is the most urbanized region in the world (<http://www.atlanticcouncil.org/publications/articles/urbanization-in-latin-america>). This suggests that the actual unemployment rate in Honduras is considerably higher than the corresponding Latin American rate if only because of the much larger percentage of the population living in rural areas who are typically outside of the formal economy, working mainly in subsistence farming. According to the World Bank (2015), only 20% of Honduran workers are employed in the formal economy. Of course, one of the main challenges facing Honduras in the medium-term is integrating its large rural population into the modern economy either by encouraging migration to the cities and/or extending the formal economy to the rural areas through economic development, such as promoting international tourism in Honduras's coastal areas. (More about this below). These activities would create employment opportunities that would advance a key development objective of reducing the country's extremely elevated poverty rate. (More about this below).

With regard to Honduras's gaping current account deficit as a percent of GDP (please see Table 3 below), the last time it was less than 4% of GDP was in 2009 -- which could qualify as Honduras's "annus horribilis", when GDP declined by 2.5%, the result of the global economic and financial crisis and the domestic shock from the coup that ousted President Manuel Zelaya. Since 2009 the current account deficit as a percent of GDP increased until 2013, when it reached almost 10% (Table 3), the year Honduras's public finances reached their "peak of instability" that was mentioned above. However, as growth -- though weak -- was restored in the US (along with an increase in remittances to Honduras) that was complemented by a lower oil import bill due to a sharp decline in international oil prices, as Table 3 shows, the current account deficits in 2014 and 2015 receded to lower, though still elevated, levels. This is a matter of concern to the IMF because of Honduras's limited ability to attract offsetting capital flows,

particularly inflows of foreign direct investment, currently less than one-third the level of annual remittances (World Bank, 2015). (More about this below). However, as the World Bank (2015) cautions, it is important to remember that a large current-account deficit is not necessarily a source of concern -- especially for developing countries -- “provided that the borrowing is used to fund productive investments in the economy”.

### **The Adoption of a Competitive Microeconomic Environment**

According to the World Bank (1991), improving the microeconomic foundation of the national economy includes, among other things, a substantial reduction in state ownership and management of productive assets; deregulation to the end of reducing burdensome costs to business and promoting competition; the reduction and/or elimination of price distorting subsidies and taxes; increasing the efficiency of public sector spending and modernizing government institutions; and introducing banking reform and, when prudent, financial liberalization. These institutional changes, if correctly implemented, will reduce the cost of providing public sector services, reward consumers with lower prices, and increase the level of economic activity and the percentage of the population that is engaged in the formal economy.

Compared with the other countries in Central America, according to the United Nations (2016; Table 7b), Honduras, over the last three years, had the highest ratio of tax revenue to GDP despite having the lowest per capita income level in the region (Table 1, above). It is useful to recall that even with the highest ratio of tax revenue to GDP in Central America, Honduras’s public sector deficits were unsustainable, implying a tax administration that is inefficient and poorly structured, and/or public sector expenditures that are inefficient and/or marred by corruption. Because of its large informal economy, the level of GDP officially reported in Honduras is likely to be much below the “shadow” unofficial level that would capture much of the economic activity currently escaping the official national accounts and, in many cases, avoiding and/or evading taxation. In 2014, according to the IMF (2016), total tax revenue collected by the government was 16.7% of GDP, of which 5.3% was raised through personal and corporate income taxes, 0.1% from property taxes, 10.2% from value-added taxes (VAT), 0.7% from import tariffs and 0.5% from other taxes.

**TABLE 3**  
**MACROECONOMIC DATA: HONDURAS AND LATIN AMERICA, 2011-2016**

<b>Macroeconomic Variable</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
Gross Domestic Product (annual % change):						
Honduras	3.8	4.1	2.8	3.1	3.6	3.6
Latin America and Caribbean	4.5	2.8	2.9	0.9	-0.5	-1.1
Gross Fixed Capital Formation (% of GDP):						
Honduras	24.4	24.4	21.8	22.1	25.2	26.4
Latin America and Caribbean	21.1	21.3	21.3	20.8	19.4	18.4
Central Government Balance (% of GDP):						
Honduras	-3.2	-4.4	-7.5	-3.9	-1.0	-1.2
Latin America and Caribbean	-2.5	-2.1	-2.9	-2.7	-2.7	-2.8
Consumer Prices (annual % change):						
Honduras	6.8	5.2	5.2	6.1	3.5	3.0
Latin America and Caribbean <sup>a</sup>	5.1	4.1	2.7	3.4	2.7	3.5
Unemployment Rate (Annual%): National Estimate						
Honduras	4.3	3.8	4.1	5.5	4.6	4.7
Latin America and Caribbean	6.6	6.4	6.2	6.2	6.7	8.1
Central Government Expenditure (% of GDP):						
Honduras	NA	NA	24.9	23.1	22.6	22.6
Latin America and Caribbean	26.4	25.0	25.6	25.4	25.5	25.6
Current Account Deficit (% of GDP):						
Honduras	-8.0	-8.6	-9.6	-7.5	-6.3	-3.7
Latin America and Caribbean	-1.9	-2.3	-2.7	-3.1	-3.4	-2.2

a without high income countries

Source: United Nations (2013-16); IMF (2016);

[http://data.worldbank.org/indicator/;](http://data.worldbank.org/indicator/)

[http://estadisticas.cepal.org/cepalstat/Perfil\\_Regional\\_Economico.html?idioma=english](http://estadisticas.cepal.org/cepalstat/Perfil_Regional_Economico.html?idioma=english)

In 2013 Honduras legislated a number of reforms to improve the equity and efficiency of the tax system to the end of enhancing government tax revenue. By 2014, a year after the reforms were approved, tax revenue increased by 1.7% of GDP relative to the previous 3-year average (World Bank, 2015). With the assistance of the Inter-American Development Bank, SAR (Servicio de Administracion de Rentas), a new tax administration was designed in February 2016 to strengthen the tax compliance of high-income taxpayers, and is expected to be fully operational in 2017. The IMF also cited inefficiencies in the tax system that should be addressed by the government. These inefficiencies are referred to as “tax expenditures”: foregone revenue that resulted from the array of exemptions, waivers, concessions, and legislated “loopholes” that amounted to 6.5% of GDP (IMF, 2016). That said the IMF recognizes the political obstacles that need to be overcome in order to reduce -- not to mention eliminate -- these exemptions and waivers in the tax code.

In addition, the government has also enhanced its oversight of the nation’s payroll and procurement systems, the putative source of much of the country’s public sector corruption. The 2015 budget also included measures to contain public spending, among which was a hiring freeze on new public sector staff. The objective of improving the efficiency of public sector spending is to free up government funds that can be directed to projects that have the potential to enhance the long-term growth rate of the economy at large. Examples of these projects include improving the quality and accessibility of the nation’s educational and health care systems, as well as improvements of, and extensions to, the country’s transport and communications infrastructure, particularly in the desperately poor rural areas. (More about this below).

“Root and branch” reform of ENEE, the State-owned electricity sector is ongoing. Rationalization of the sector includes “unbundling” of the sector’s three distinct activities: electricity generation, transmission, and distribution, and where technically possible, introducing private sector participation in the latter two activities. There is already private sector participation in electricity generation that is promoting competition and increased efficiency in this segment of the sector. In addition, in June 2016, a new regulatory commission, CREE, implemented a new tariff scheme based on “cost recovery”, the universal “best practice” protocol in the power sector that is in place in most developed countries.

In 2013 ENEE registered a loss of US\$230m, about 1.8% of GDP. The losses derive from two sources: technical and non-technical inefficiencies. The former includes reducing distribution losses and identifying pricing and cost distortions that can be remedied, provided there is no political push-back. The latter include “human failures” such as weak administration, theft, and billing errors. Reducing both of these inefficiencies would go far towards increasing the resources that could flow to accelerate the electrification of the country’s under-served rural areas. For example, while in 2001 43% of rural households had electricity, a decade later that percentage had increased to only 55% (IMF, 2016). For its part, the Heritage Foundation, the Washington-based conservative think tank, while conceding that ENEE is being overhauled, criticized the Honduran government in its 2017 Index of Economic Freedom for maintaining price controls on basic food stuffs, water, telecoms, and port services.

Regarding the fairness of the State-subsidies for electricity, gas, and transport that account for about one-third of the public transfers, i.e., approximately 0.5% of GDP, a World Bank (2015) asserted that these transfers were mostly regressive since the sectors to which these subsidies were directed were under-utilized by Honduras’s poorest citizens.

The World Bank’s Doing Business project provides objective measures of the ease of doing business that focuses on business regulations and their enforcement across 190 economies and looks at domestic small- and medium-size companies and measures the regulations applying to them through their life cycle. In its 2017 report, Honduras ranked 105th, and within Central America, only Belize and Nicaragua ranked lower. The country performs particularly poorly in the following categories: starting a business (148th), arranging for electricity (144th), protecting minority investors (132nd), paying taxes (153rd), enforcing contracts (151st), and resolving bankruptcy (139th).

Concerning its competitive ranking in Central America, according to the World Economic Forum’s Global Competitiveness Index, Honduras is listed above Nicaragua and El Salvador but below Costa Rica, Guatemala, and Panama, and with respect to its global competitiveness position, Honduras was ranked 88th out of 138 countries ([reports.weforum.org/global-competitiveness-index/competitiveness-rankings/](http://reports.weforum.org/global-competitiveness-index/competitiveness-rankings/)).

Regarding Honduras’s financial sector, the World Bank (2015) cited the need for “financial deepening” because the country’s domestic financial markets are shallow: there is no secondary market for government debt; and bank loans were overly concentrated geographically: in 2013, 90% of the total were centered in three provinces, and almost half of all lending was concentrated in residential housing and consumer financing. Adding to this the IMF (2016) warned Honduras that it must deepen its capital markets for long-term financing and for risk-sharing, the latter to be used mostly by insurance companies. The IMF recognizes that Honduran pension funds have surplus funds to invest, but have few long-term financial instruments to invest in.

Turning to “financial inclusion” -- the extent to which ordinary Hondurans are engaged in the banking sector -- the IMF (2016) reported that only 30% of adults have a bank account in a formal financial institution, as compared with 40% in Central America and more than 50% in Latin America as a whole. With respect to the penetration of credit cards, according to the World Bank (2015), only 6% of Hondurans had credit cards compared with 22% in Latin America as a whole. For the purposes of context, in the United States, almost 93% of households had bank accounts and approximately 72% of consumers had at least one credit card.

## Global Linkages

Despite the general backlash over globalization in recent years -- exemplified by the June 2016 Brexit referendum in the United Kingdom and the victory of Donald Trump in the November 2016 US presidential elections that were both triggered largely by poorly-managed immigration and trade policies that were amplified by the wave of refugees fleeing from war- and violence-torn areas, reduced labor force participation rates particularly among the young and unskilled, stagnant wage growth for a decade, and increasing income inequality -- in the opinion of most economists, adhesion of the national economy to the larger global economy is still indispensable for improving a nation's material well-being. It is without doubt that the successful development model implemented by China over the last four decades is, in part, due to China's re-engagement with the world economy after decades of economic autarky.

Consumers benefit from liberalized trade by having more choice of goods, often at lower prices and/or with higher quality. More competition faced by domestic producers from imported goods reduces domestic producers' pricing power and provides crucial incentives to enhance efficiency and productivity. The prospects of higher exports (in part to pay for increased imports) raise both national employment and income.

Liberalization of the capital account provided the domestic banking system is sufficiently strong, along with a unitary and market-based exchange rate, confers benefits to both borrowers and investors alike. Lower interest rates for borrowers, and improved risk/reward tradeoffs for investors, as well as greater discipline with the public finances imposed by these open capital markets complement the benefits provided by a liberalized trade account. It is important to note that policy experts are still debating the cost/benefit calculus for developing countries of full capital account liberalization in the wake of the Asian financial crisis at the end of the 1990s and the financial meltdown in the US and Europe a decade later (Beattie, 2011; Plender, 2012). Finally, providing a "state-of-the-art" legal, tax, and regulatory environment for foreign investment is critical for attracting and maintaining much-needed financial capital, new technology, and managerial talent for the national economy.

The main issues discussed in this section focus on the outlook for foreign direct investment (including its role in the "Honduras 2020" development plan that was designed to reduce poverty levels and child migration to the US, in part, by promoting the country's export and tourism sectors), a description and analysis of the perennial trade and current account deficits including the critical role played by remittances from abroad, and a brief review of the role that international trade plays in the Honduran economy is provided.

Honduras's balance of trade has been negative for the last quarter century. In 2014, exports were valued at \$4.53bn and imports at \$7.98bn. Over the last three decades, according to the World Bank, exports as a percentage of GDP doubled, increasing from 23% to 45%. While this trend indicates the increasing integration of the national economy into the world economy, the data display a great deal of volatility in this ratio, suggesting that the Honduran economy is highly vulnerable to external shocks. For example, Honduras's agricultural sector lost nearly one-third of its revenue over the past two decades, in part due to the declining prices of the country's main export crops, bananas and coffee. The ratio of imports to GDP rose even more, however with less volatility, with changing international oil prices acting as the main driver of the import bill.

Since the turn of the century Honduras diversified the destination of its exports from 62 to 101 countries and increased the number of exported products from 495 in 2000 to 1162 in 2012 (World Bank, 2015). Nevertheless, four commodities continue to dominate the export structure and they comprise almost half of total exports: coffee (28.5%), bananas (10.8%), palm oil (7.0%), and sugar (1.3%). The importance of coffee in Honduras's exports in particular, and in the economy in general, cannot be underestimated. According to the World Bank (2015), since 2011 Honduras is the largest coffee producer in Central America; one in 10 Honduran workers are employed in the sector; and 90% of the crop is exported. With almost 45% of Honduras's exports sent to the US and 41% of Honduras's imports originating in the US, as was mentioned above the US has an out-sized influence on the Honduran economy, even before incorporating the role of remittances in the economy.

In addition to its membership in the World Trade Organization and as a signatory to CAFTA-DR (please see above), Free Trade Agreements (FTAs) have also been signed with Chile and Mexico. Honduras has also concluded bilateral FTAs with Canada, Colombia, Panama, Peru and Taiwan, and, in late 2016, a Free Trade Agreement was reached between South Korea and six Central American countries, including Honduras. It is important to note that the temporarily “comatose” state of the much-trumpeted Trans-Pacific Partnership (TPP) plays to the benefit of Honduras, which is not a party to this proposed trade agreement. Since “maquila” (comprised mostly of textile, machinery and equipment) exports constitute almost 50% of Honduran exports, and putative TPP members account for about 75% of Honduras’s “maquila” exports, a high proportion of these Honduran exports would have been threatened if the TPP treaty had been adopted. Earlier, Honduras had expressed an interest in joining the TPP, if only for the enhanced access it would provide to Japan’s market, especially for Honduran coffee exports.

Between 1975-2000, according to the World Bank, foreign direct investment (FDI) flows were almost never more than \$100m a year (that is, the FDI to GDP ratio was below 2% of GDP)! However, since the turn of the century, only once has the annual FDI flow been below \$300m, and most recently annual FDI flows have been above \$1bn. Since 2000 as a percent of GDP, FDI was never below 3%, and most of the interval it has been above 5% of GDP, about the average for Central American countries (World Bank, 2015). With annual flows ranging between \$100m to \$1bn, it is important to appreciate that Honduras’s official annual GDP level in 2015 was reported at only \$20bn, less than 12 hours worth of 2015 US GDP!

That said, FDI flows are the largest source of financing for Honduras’s three-decades long current account deficit -- about 70% of the deficit -- regularly amounting to about 5% of annual GDP. Readers should recall that the current account deficit -- the difference between national saving and investment -- includes the trade balance, income balance, and the transfer balance (remittances). With the first two components firmly negative for Honduras, the current account deficit as a percent of GDP, as large as it has been for Honduras (please see Table 3, above), would be dramatically higher if not for the large annual remittances Honduras receives from abroad, to be discussed below.

The new development initiative discussed above, “Honduras 2020”, was launched in March 2016. Its two major focuses are to reduce poverty levels and child migration to the US, and it plans to generate 600,000 new jobs by expanding the textile, manufacturing, tourism, and business service industries. A third of the projected new 600,000 jobs would be generated by increased apparel exports to the US. Presumably, expanding these targeted sectors will be dependent on attracting the required FDI flows which are certainly affected by the ease or difficulty of doing business in Honduras as discussed above and by providing the appropriate investment environment by adopting a “state-of-the-art” governance regime. (Please see below).

As noted above, in 2016, of the more than 600,000 Hondurans living in the US who comprise more than 80% of Honduran emigrants, between two-thirds and three-quarters of them are undocumented. This increasing community of expatriates provides another link between the US and Honduran economies. According to migration experts the “cocktail” of the appalling conditions of poverty combined with drug-related violence and insecurity result in this “least bad” choice of “life in the shadows” in the US. The “upside” for Honduras of this (mostly illegal) migration to the US are the remittances that flow back to Honduras. Recent reports indicate that the illegal migration from the Northern Triangle countries are beginning to slow as the stricter Trump Administration immigration and border control policies are implemented. Needless to say, at this writing it would be premature to speculate on the effect these new policies will have on future remittances from the US to Honduras (Semple, 2017).

Remittances are Honduras’s second largest source of foreign exchange in the current account balance, equal to approximately three times the value of annual FDI flows (World Bank, 2015). During the 2009-14 period, annual remittances averaged more than 16% of Honduras’s GDP, with \$3.3bn flowing into Honduras in the peak year of 2014. These flows support personal consumption expenditures, and, as a result, contribute to GDP growth. It is worthwhile noting the importance of these remittances for the national economy by considering that for Panama, revenue from tolls paid by ships transiting the Panama Canal comprise about 10% of annual GDP (Sohn, 2016), and the Great Recession in the US from 2007-09 -- as painful as it was -- reduced US GDP only about 3.2%!

### **An Active Government Policy to Promote Social and Economic Investment**

The last of the four World Bank “ingredients” to be included in the recipe for a well-managed national economy is an active government policy that promotes social and economic investment, especially in the areas of poverty reduction, health, education, and physical infrastructure, including transport, telecommunications, and energy. For many of the world’s countries during most of the second half of the 20th century rapid economic growth led to increased living standards that were accompanied by marked improvements in public health systems, nutrition, greater access to education, and, as a result of these, significant increases in life expectancy and reductions in infant mortality and adult morbidity rates (Gordon, 2016).

The United Nations Development Programme in its Human Development Report 2016 (UNDP, 2016) ranked Honduras 130th out of 188 reporting countries in its key metric, the Human Development Index. For the purposes of comparison with its neighbors, El Salvador ranked 117th, Guatemala, 125th, and Nicaragua, 124th. The index measures the average achievement in three basic dimensions of human development: life expectancy; education levels; and the standard of living (measured by GDP per capita).

While Honduras has, for the most part, avoided the worst of the political and social turmoil that plagued neighboring Nicaragua for almost two decades, violence, gangs and drugs, corruption, violations of human rights, and the weak rule of law have always been part of the landscape in Honduras, and since the 2009 coup that ousted President Zelaya (see above) these issues have assumed “center stage” in Honduras. To address these serious concerns, in early 2016 the Honduran government and the OAS agreed to establish the Mission to Support the Fight Against Corruption and Impunity in Honduras (MACCIH). The commission’s mandate includes providing “technical advice, supervision, and oversight of the state institutions responsible for preventing, investigating, and prosecuting corruption”. The government has made the reduction of crime and violence one of its top priorities, and to this end it is implementing serious reform of the police force and introducing a comprehensive and coordinated plan with the other Northern Triangle countries to fight gang violence and drug trafficking (IMF, 2016).

The World Bank’s Worldwide Governance Indicators (WGI) for 2016 reports country percentile rankings against the world (and various regions) for six measures of “good government”. In all six categories (voice and accountability; political stability and absence of violence; the rule of law; control of corruption; government effectiveness; and regulatory quality) Honduras’s ranking was below (and for some, significantly below) its regional average, and in three categories -- political stability and the absence of violence, the rule of law, and control of corruption -- Honduras ranked second lowest in Central America, just above Guatemala. Since 2010 marginal improvements have been recorded in only two categories: political stability and absence of violence, and the control of corruption. Honduras’s ranking in Transparency International’s 2016 “Corruption Index”-- 123rd out of 176 countries and slightly above Guatemala and Nicaragua -- testifies to the degree of corruption, lack of transparency and accountability in government, and the weak rule of law in the country.

In September 2000, building upon a decade of major United Nations conferences and summits, world leaders came together at the United Nations Headquarters in New York to adopt the United Nations Millennium Declaration. The Declaration committed nations to a global partnership to reduce extreme poverty, and set out a series of eight time-bound targets -- with a deadline of 2015 -- that have become known as the Millennium Development Goals (MDGs). Many of the aid programs -- with multilateral institutions such as the World Bank and the International Monetary Fund and bilateral programs with individual countries -- with which Honduras has participated since the the 1990s are structured around these MDG goals. Therefore, the remainder of this section highlights the progress made by Honduras in meeting a number of the MDG targets.

According to the World Bank, Honduras’s poverty rate, based on its national poverty line, increased from 59.2% of the population in 2008 at the inception of the global financial crisis to 66.5% in 2012, and retreated only modestly in 2014 to 62.8%. Over the same interval there has been a similar lack of improvement in reducing the percentage of the population, about 16%, that is living in extreme poverty, that is, at less than US\$ 1.90 a day. In 2014, Honduras had the highest poverty rate in Central America (Table 1, above). The inability to bring down the the national poverty rate to less extreme levels on a

sustained basis is, of course, one of the major challenges facing Honduras's government over the medium term. (More about this, below).

While Honduras is the poorest country in Central America, in cooperation with the IMF and World Bank as described above, it is making progress in stabilizing its economy and introducing much-needed structural reforms to increase the economy's growth potential. One of the demographic variables that is critical to improving living standards in developing countries over the long-term is the total fertility rate (the number of children per woman). During the last half century, the country has made considerable progress -- along with its regional neighbors -- in reducing its total fertility rate. Over the 1970-75 interval Honduras's fertility rate was 7.1 as compared with 6.5 for the Central American region as a whole, and for the 2010-15 interval, Honduras's fertility rate declined to 2.5 children per woman, slightly above the region's 2.4 average.

One of the important metrics that contributes to lowering the national fertility rate is a country's infant mortality rate (number of deaths per 1,000 live births): in 1995, the rate in Honduras was 36.9 while two decades later the rate declined to 17.4, a reduction of more than 50%, comparable to the reduction in this metric for the Latin American and Caribbean region as a whole.

Another of the United Nations' stated Millennium Development Goals is achieving universal primary education. Honduras has made considerable progress in addressing this serious deficiency which has implications for the productivity of its labor force. In 1991 the primary school completion rate was 64.1% (for the relevant age group), and it increased by more than 40% by 2015, to 92.5%. However, Honduras's rate in 2015 was still below the 99% average rate reported for the region as a whole. Despite the improving primary school completion rate it is also important to note that nothing in the data presented mentions anything about the "quality" of the education.

Turning to some MDG's which affect the "quality of life", 73% of the population had access to water in 1990 -- as compared to the regional average of 85% -- with the percentage increasing to 91% a quarter of a century later as compared to 95% in the region as a whole. Concerning sanitation, 48% of the population had access to sanitation in 1990 compared with 67% in the region, and by 2015 Honduras now has virtually the same rate, about 83%, as the region as a whole. Judging by the above data it appears that Honduras has made considerable progress over the last quarter of a century in providing its population access to these two essential "quality of life" amenities.

Regarding the provision of physical infrastructure -- electricity, transport, and communications -- which simultaneously increases the efficiency of the economy and confers "quality of life" benefits to residents, there has been progress in this area as well. From 1990 to 2014, annual per capita electricity consumption (in kWh) in Honduras increased from 368 to 630, an annualized growth rate of 2.2%, compared with the Latin America and Caribbean region, where per capita electricity consumption increased from 1167 to 2129 kWh over the same interval, an annual rate of increase of 2.4%. In 2013, about 82% of the population had access to electricity (CIA, 2017), the third lowest rate in Central America, slightly above Guatemala and Nicaragua. While variations in weather could explain some of the difference between Honduras's per capita electricity consumption level and the larger Latin America regional average, the substantial disparity in per capita electricity consumption can more likely be attributed to the much higher poverty rate, the lower urbanization ratio, and, more generally, the lower standard of living in Honduras compared with the Latin American and Caribbean region as a whole.

Honduras's transport infrastructure viewed through the lens of paved roads also lags behind most of its neighbors. In 2012, only 23% of Honduras's roads were paved. The corresponding metric for Nicaragua was 14%; Costa Rica, 26%; Mexico, 36%, and the United States, 65% (CIA, 2017). The low percentage of paved roads adversely affects the economy by increasing costs and delays to businesses and consumers.

Turning to communications infrastructure, with regard to the percentage of Hondurans using the internet, in 2015 only 20% of the population reported using the internet, about the same percentage as Nicaragua, but much below the regional average of about 50.2% (CIA, 2017). In 2015, per 100 of population, Hondurans had 5.9 fixed telephone subscriptions with an average in the Latin America region of 17.4 telephone subscriptions. The corresponding metrics for the United States were 87.4 internet users

and 38.4 fixed line subscriptions in 2015. It is important to point out that as a result of the introduction and rapid adoption of cellular phones, fixed telephone subscriptions in the US peaked at 68 in 2000, and the rate is receding in both Honduras and the Latin America and Caribbean region, having also peaked at 11 and 18, respectively, in 2008. Mobile cellular subscriptions (per 100 of population) in Honduras were 95.5 in 2015, approaching the penetration rates of both the US and the Latin America and Caribbean region.

The last two components in the World Bank's fourth "ingredient" was expanded to include the "second tier" reforms (World Bank, 1997) -- public security and governance -- that affect the quality of life directly, and the economy, indirectly. Drugs-related activities breed insecurity, kidnapping, theft, murder, extortion, and corruption, all, regrettably, in abundance in Central America. According to the United Nations Development Program, Latin America is the only region in the world where the murder rate increased from 2000-10 (The Economist, 2014), and the isthmus of Central America, as mentioned earlier, is considered to be the "most routinely murderous region on earth" (The Economist, 2011).

That said, although the homicide rate that appears in Table 1 from 2013 has receded over the past five years, with the general lack of security in Honduras and other Northern Triangle countries it is not an exaggeration to say these countries are becoming "failed states". It is interesting to compare Honduras's homicide rate with the rate in Nicaragua, given that per capita GDP levels are so similar. (Please see Table 1, above). While Nicaragua, using per capita GDP (at market prices), is the second poorest country in Central America it has the second lowest homicide rate, after Costa Rica (Table 1, above). While many associate crime with poverty, Nicaragua appears to have severed that relationship.

Experts attribute the lower level of overall violence in Nicaragua -- relative to its neighbors -- to the policy of "community policing" which is practiced by the National Police, an institution that is a product of the 1979 Sandinista revolution and the subsequent civil war. According to The Economist (2014a), "instead of mano dura -- the iron-fist policies of its northern neighbors -- it offers a 'friendly hand' to prevent gang penetration in Nicaraguan society. After Mexico's former President Felipe Calderón declared war on drugs in 2006, Mexico began squeezing its cartels at home, and the drug-related violence moved south, transforming Central America from a passive transit route into a central theater in the war on drugs.

Honduras, El Salvador, Guatemala and Belize responded by militarizing their response with funding and training from United States, under a new program called the Central American Regional Security Initiative (CARSI). Nicaragua, in part because of its tense relations with the United States in the wake of the civil war in the 1980s, was not included in this program, forcing it to choose a different path.

## CONCLUSION

Over the last quarter century political leaders and policymakers in virtually every country in the world have been confronted with the same question: In the wake of widespread political, technological, and institutional change around the world, for countries that are firmly anchored in the global economy of the 21st century, what adjustments are required in a country's economic and financial policies that will lead to improvements in material wellbeing for the population at large? From China to Brazil, Russia to South Africa, Japan to Australia, India to North Africa, and, even from the United States to Western Europe, all have struggled, or are struggling, with the same "existential" problem: how can countries increase -- or, in the worst case, maintain -- living standards for the bulk of their populations, given the "cards they have been dealt"?

The objective of this paper is to present the predicament of Honduras, a poor country that is located, on the one hand, in one of the most violent regions of the world and, on the other, at the crossroads of today's global economy: near the southern rim of the large and wealthy North American continent and near the northern boundary of the equally large though much less prosperous South American landmass, and, simultaneously, strategically positioned -- like Costa Rica, Nicaragua, and Panama -- with sovereign access to both the Atlantic and Pacific Oceans. Historically, Honduras has been an underdeveloped area, in part because of its rugged topography. Its lack of good ports on the Pacific coast maintained its relative

isolation from the mainstream of economic activity. The capital, Tegucigalpa, is located high in the central mountains, removed from the isthmus's main north-south transportation routes. If the appropriate modern transport infrastructure is in place despite the adverse topography, can Honduras's favorable geographical position be exploited to facilitate trade with the Americas, Europe and the Asia-Pacific region as is already the case with Panama with its canal, and Nicaragua, which continues to pursue the dream of a parallel canal involving China?

Can Honduras use this favorable geographical position and its relatively low-wage (and low-skilled, even by Asian standards) labor force to improve the performance of its national economy? To be sure, the country's endemic institutional failures characterized by chronic violence, widespread corruption, the absence of the rule of law, poor governance, along with increasing physical and economic insecurity combine to deter foreign investment on the one hand, and on the other, encourage the country's talented young people to seek better lives through (increasingly illegal) migration, precluding improvements in material well-being for its predominantly poor population.

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