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Memorandum of Economic and Financial Policies of the Government of Honduras

I. PROGRAM OBJECTIVES

1. Over the last four years, economic performance in Honduras has been strong. Output has grown rapidly at over 6 percent per year, inflation remained in single digits, and poverty declined. Since 2007, however, world oil and agricultural prices have surged, and remittances decelerated, especially in 2006–07. Credit to the private sector expanded rapidly, boosting domestic demand (both private investment and consumption) and imports, and the budget helped smooth the oil shock and social demands. Thus, pressures emerged on inflation, public finances, the energy sector, and the balance of payments.
2. The Government of Honduras has developed a stabilization program to address these pressing challenges. The program aims to preserve the conditions for sustained growth and poverty reduction through the consolidation of macroeconomic stability. Within a context of a slowdown in the global economy, the program seeks to achieve real GDP growth of about 5 percent in 2008, maintain single-digit inflation, and strengthen the external position. The program also includes a comprehensive reform to put the energy sector on a sound footing.
3. To achieve these goals, the government is implementing a package of economic and financial policies. The 2008 budget will target a combined public sector deficit of 1½ percent of GDP, while increasing infrastructure and anti-poverty spending. The monetary program supports an expansion of bank credit in line with growth objectives and maintains international reserves at 4 months of nonmaquila imports. Exchange rate policy will be managed to help maintain external competitiveness. The package will support a decline in the external current account deficit to 6 percent of GDP over the medium term.
4. The government will continue to refine its medium-term policies for poverty alleviation and growth and, in coming months, plans to finalize a program that could be supported under the Poverty Reduction and Growth Facility. To this end, in consultation with the Honduran society, the government will develop an agenda to: strengthen the medium-term fiscal framework; implement a comprehensive wage policy consistent with a steady increase in key social and infrastructure spending; improve the energy sector; enhance the transparency of the budgetary process; improve public sector institutions and fight corruption; further modernize the financial system, and continue to enhance the investment climate and overall competitiveness.

II. ECONOMIC AND FINANCIAL POLICIES

A. Fiscal Policy

5. The 2008 budget (prior action) aims at containing the overall fiscal deficit at 1½ percent of GDP, down from 2¼ percent of GDP in 2007. This is consistent with a recovery in priority spending, with public investment rising 1¾ percent of GDP in 2008. Fiscal consolidation will continue in 2009, with the overall deficit target contained at about 1½ percent of GDP, helping public debt (both external and domestic) to remain stable at 22½ percent of GDP and locking in the benefits of substantial debt relief obtained in recent years. To attain these targets, the 2008 budget includes the following key actions:

- **Stabilizing the wage bill.** The central government wage bill will be held constant at 9.2 percent of GDP in 2008 and 9.1 percent of GDP in 2009 (indicative target). To this end, the Government will strictly adhere to the 2006 wage agreement with teachers; grant wage increases for other civil servants, in line with projected inflation; and offset increases in employment in 2008 in priority sectors of the central government with retirements and other steps consistent with the findings of ongoing censuses and audits to keep employment at the level of December 2007. Actions will be taken to tighten payroll control, through: (i) setting up a centralized unit for payroll monitoring at the Ministry of Finance by end-April 2008; (ii) fully integrating payroll management modules of the health ministry and the civil service with the integrated system of financial management, SIAFI by end-August 2008, with the design of the module for the education sector completed by January 2009; (iii) finalizing a census and auditing of teachers by end-August 2008 and start acting on any irregularities by end-September; and (iv) extending the census and audit to the rest of the central government, starting with the health sector, by end-September 2008.
- **Further strengthening tax policy and administration.** The Government will make permanent an income tax surcharge (*Aporte Solidario Temporal*) of 5 percent in the 2008 budget and submit to congress a draft anti-tax evasion law in May to improve tax administration. It will also enforce strict compliance of regulations for the sales and income tax exemptions by June 2008. The annual yield from this strategy is estimated at 0.6 percent of GDP.
- **Strengthening the operating balance of the main public enterprises.** Key actions include: (i) implementing a tariff policy that covers operational costs over time and gradually modernizing ENEE (see below); (ii) introducing new temporary charges for international calls (US\$0.03 per minute), and the adoption, by the state company (HONDUTEL), of increased charges for fixed lines—increasing revenue by about 0.3 percent of GDP; and (iii) completing financial audits for the two largest public enterprises (ENEE and HONDUTEL) by June 2008 and designing modernization plans for 2009 by October 2008.

- **Increasing priority spending.** Current primary spending of the central government will be contained at 15.8 percent of GDP (indicative ceiling), consistent with a redirection of spending to priority sectors. Anti-poverty spending will increase to 7.0 percent of GDP (indicative floor) and public sector investment will increase to 6.5 percent of GDP, with the investment plan placing priority on basic infrastructure such as roads, energy, and ports.
- **Targeting subsidies to the poor.** The direct electricity subsidy and the *Bonochenta* will be limited to users consuming less than 150 kwh per month (from 300 kwh) in April. The direct fuel subsidy will be capped at L1000 million (0.4 percent of GDP) for 2008 and targeted to the poor. The Government will appoint a technical group to strengthen the targeting of the overall subsidy policy, and prepare by July 2008, a report with recommendations to improve delivery of subsidies and identify enhanced schemes to better target direct fuel subsidies.
- **Adopting a policy of new lending consistent with loan recovery by the public pension funds.** This policy is in line with the budget proposals of the public pension institutes and will result in fiscal savings of 0.8 percent of GDP in 2008. This measure will help contain the lending program of public pension institutes to their members, thus limiting the risk in their portfolios and protecting their financial integrity.
- **Reliance on external financing.** The Government intends to substantially reduce domestic financing, helping crowd in private investment. The policy of contracting external financing only on concessional terms will be maintained (performance criterion, ceiling). Concessional financing from *Petrocaribe* for US\$350 million in 2008–09 has been obtained; about US\$140 million of these resources have been earmarked in the 2008 budget for projects on transmission and distribution of energy during the period 2008–09, and the rest will be earmarked for energy projects on hydroelectric generation and other infrastructure projects in poor areas. To maintain transparency, the government has established a trust fund at the central bank to manage the resources from Petrocaribe; and the central bank will report periodically on the operations of the trust to a blue ribbon committee comprising civil society members. In addition, the Government intends to use one-time proceeds of 0.6 percent of GDP from the sale of a mobile phone band to finance already budgeted investments in productive infrastructure projects, mostly roads.

B. Monetary, Exchange Rate, and Prudential Policies

6. Monetary policy will contain inflation at 8–10 percent in 2008, consistent with the adjustment of energy prices, a sustainable expansion of bank credit to the private sector, and strengthened net international reserves (NIR). The central bank has raised its policy interest

rate (by 25 bps to 7¾ percent in February) and is taking measures by an amount equivalent to 2 percentage points in reserve requirements (either by increasing obligatory investments with a monetary effect or through additional sales of central bank bills to nonbank local investors), to bring NIR at end-March to the level of end-2007 (prior action). The central bank began raising obligatory investments by 5 percentage points in March (starting with 2 percentage points and subsequent monthly increases until June), which can be met with government paper to facilitate the repayment of arrears to private generators. To protect growth in a context of deteriorating external conditions, the central bank is reducing reserve requirements (by 5 and 10 percentage points for local and U.S. dollar deposits, respectively, in monthly steps over the period March–November) to those banks directing credit to productive sectors. Starting end-February, the central bank intends to maintain the stock of open market bills at or above a monthly indicative target to meet the program targets. The effectiveness of the recent reforms on reserve requirements will be assessed during the first review of the program and amended, if needed.

7. The central bank will aim to preserve the stability of the current exchange rate system, which allows the value of the currency to be determined within a band (± 7 percent from a mid-point). Consistent with this framework, the central bank will use more actively its monetary and exchange rate policy instruments, in a manner consistent with safeguarding external competitiveness and helping protect the economy against external shocks and achieving the reserve target in the program. This policy will be underpinned by prudent monetary and wage policies and will be adjusted as necessary in the event of adverse external developments. The Fund will undertake a study by end-May to assess the exchange rate system and adequate responses to external shocks.

8. The central bank monetary program is consistent with a prudent expansion of bank credit to support the program objective for growth. To encourage banks to internalize risks from a rapid credit expansion and reorient credit toward productive enterprises, the *Comisión Nacional de Banca y Seguros (CNBS)* will issue stricter norms for loan classification and raise loan provisioning (mainly for consumption credit) in March 2008 that will be implemented during 2008. These measures are equivalent to about 0.2 percentage points of risk-weighted capital asset ratio. The CNBS will also issue a regulation on risk-based supervision to improve its supervisory capacity and facilitate observance of the new classification and provisioning norms (structural performance criterion, April 2008). Looking ahead, the CNBS will develop a medium-term reform agenda, based on the findings and recommendations of the recent FSAP update.

C. Energy Policy

9. A center piece of the government program in 2008 is to implement a broad based strategy to strengthen the energy sector, expected to be supported by the World Bank and the IADB. This strategy is designed to: (i) put ENEE on a sustainable financial footing;

(ii) improve the corporate governance of ENEE; (iii) reduce distribution losses and fraud, through congressional approval of anti-theft legislation in April 2008; and (iv) address a chronic under-investment in the sector. Of key importance from a macroeconomic perspective, is:

- **Implementing a tariff structure that covers operational costs.** The Government will raise electricity tariffs by an average of 11 percent to cover ENEE's operational cost at current bunker prices (US\$72 per barrel), when a revised tariff structure, that better focuses subsidies on the poor, comes into effect in April (structural performance criterion). This revised tariff, set in accordance with the electricity law, will be adjusted periodically to fully pass-through any changes in international bunker prices. Government transfers will continue to cover ENEE's financial cost and investments in 2008, but will be phased out in the medium term as the company further improves its revenue stream.
- **Resolving payment arrears.** The 2008 budget authorizes the issuance of government bonds (L4 billion or 1½ percent of GDP) to clear payment arrears of ENEE with private generators. Upon transfer of these funds from the central government to ENEE, all public sector arrears with ENNE (½ percent of GDP) will be cleared. All arrears as of end-March 2008, of ENEE with private generators will be cleared by end-June 2008 (structural performance criterion). The new tariff policy will ensure that ENEE no longer falls into arrears with the private sector (quantitative performance criterion). The public sector will remain current on payments for electricity consumption.

D. Institutional Strengthening

10. The Government will implement a strategy to fight corruption and strengthen public institutions, which was presented to the international community in September 2007. Key actions include: providing legal protection to public employees involved in anti-corruption cases; reducing partisan influence in employment policy; disclosing financial statements of political parties and its financing, as well as on cabinet and high-level officials. With World Bank assistance, corporate governance and the AML/CFT framework will be strengthened.

III. PROGRAM MONITORING

11. The program will cover the economic program from January–December 2008 and will be monitored through quarterly reviews, with indicative targets for end-March and test dates for end-June, end-September, and end-December 2008 (Table 1). Prior actions and structural performance criteria are set out in Table 2. The definitions and reporting procedures are described in the attached Technical Memorandum of Understanding.

Table 1. Honduras - Performance Criteria and Indicative Targets
(Cumulative flows from end-2007; millions of Lempiras, unless specified)

	Indicative target end-March	2008		
		Performance criteria		
		end-June	end-September	end-December
Quantitative performance criteria				
Overall balance of the combined public sector (ceiling)	-2,060	-484	-1,897	-4,099
Net domestic financing of the combined public sector (ceiling)	1,866	-1,090	-2,452	-3,481
Net international reserves of the central bank; in millions of U.S. dollars (floor) 1/2/	2,473	2,593	2,623	2,726
Net domestic assets of the central bank (ceiling) 1/	-31,078	-34,320	-36,036	-34,241
New arrears of ENEE with the private sector (continuous ceiling)	0	0	0	0
Contracting of nonconcessional external loans (continuous ceiling)	0	0	0	0
External arrears of the combined public sector (continuous ceiling)	0	0	0	0
Indicative targets				
Central government current primary expenditure (ceiling)	8,815	19,664	29,336	41,899
Anti-poverty related spending (floor)	3,345	6,537	11,334	18,581
Wage bill of the central government (ceiling)	5,238	11,978	17,237	24,512

1/ The end-June performance criterion for net international reserves will be adjusted downwards by up to US\$80 million if the foreign exchange proceeds from the sale of the mobile phone license are unrealized by that date. Conversely, the end-June performance criteria for net domestic assets of the central bank will be adjusted upwards by up to the same amount.

2/ Prior action for end-March.

Table 2. Honduras - Prior Actions and Structural PCs

Fiscal Policy	
Congressional approval of the 2008 budget consistent with a combined public sector deficit of 1.5 percent of GDP and the current expenditure indicative targets	Prior Action
Monetary Policy	
Raise the policy interest rate by 25 bps and policy measures equivalent to 2 percentage points in reserve requirements (either by increasing obligatory investments with a monetary effect or through additional sales of central bank bills to non-bank local investors)	Prior Action
Bring NIR at end-March 2008 to the level of end-December 2007	Prior Action
Energy Sector	
Eliminate arrears of ENEE to generators (end-June, 2008)	PC
Implementation of a tariff policy in the electricity sector to ensure operational cost recovery (April, 2008, see details in MEFP, paragraph 9)	PC
Financial Sector	
Issue a regulation on risk-based supervision (see details in MEFP, paragraph 8, April 2008)	PC

Technical Memorandum of Understanding

1. This memorandum sets out technical understandings between the Honduran authorities and the Fund for monitoring the economic program during 2008 supported by a Stand-By Arrangement. It defines the concepts used to assess observance of quantitative performance criteria and benchmarks specified in Tables 1 and 2 of the Memorandum of Economic Policies (MEFP). It also specifies the frequency of the data to be provided to the Fund for monitoring the program.

I. FISCAL TARGETS

2. **The deficit of the combined public sector (CPS)** will be measured from the financing side, and corresponds to the net borrowing requirements of the CPS, from both external and domestic sources. The combined public sector comprises the nonfinancial public sector (NFPS) and the operating result (quasi-fiscal balance) of the central bank. The NFPS covers the central government (including its agencies), local governments and decentralized agencies, the social security institute (IHSS), the pension institutes for executive branch staff (INJUPEMP) and teachers (INPREMA), and the public enterprises.

3. **The deficit of the central government** will also be measured from the financing side. The central government includes the executive, judicial, and legislative branches of government. It consolidates the operations of trust funds created to support agricultural loans and so-called deconcentrated agencies.

4. **The current primary expenditure of the central government** is defined as total current expenditure less interest payments.

5. **The central government wage bill** is defined as all central government wages and salaries including severance payments, plus employer social security and pension contributions, and other remunerations (such as special bonuses and performance related remuneration to teachers under the *PASCE*).

6. **Anti-poverty spending** comprises all spending on programs and projects of the Poverty Reduction Strategy (whether financed by domestic savings, HIPC debt relief, grants, and external loans), as defined in the relevant annex of the 2003 PRSP and the latest update to the PRS. Programs and projects in the PRSP will be labeled in the 2008 budget and tagged through the SIAFI. Anti-poverty spending will be presented by economic classification, type of program, and source of financing.

7. **The operating surplus of the public enterprises** is the difference between the operating revenue (excluding interest earnings and transfers) and the operating expenditure (excluding interest payments and transfers) of the enterprises. For the purposes of the program, the public enterprises comprise the State Electricity Company (ENEE), the State

Telecommunications Company (HONDUTEL), the State Water and Sewerage Company (SANAA), and the State Ports Company (ENP).

8. **Net domestic financing of the CPS** comprises the operating result of the central bank and the change relative to end-2007 in the stocks of: (1) outstanding indebtedness of the NFPS (direct bank credit plus bank holdings of public sector bonds less deposits) to the domestic financial system (central bank, commercial banks, and other financial institutions); (2) outstanding public sector bonds held outside the financial system; (3) outstanding deposits held abroad; (4) outstanding suppliers' credit and floating debt (uncashed and undelivered checks, and unpaid invoices and orders) of the central government, and unpaid orders of the rest of the NFPS (all domestic debt is in domestic currency); and (5) proceeds from the sale of the mobile phone license.

9. **Discrepancies.** The authorities will undertake periodic reconciliations to minimize discrepancies between above-the-line and financing data. If needed, these reconciliations should be carried out prior to completion of the first and second reviews under the program.

II. MONETARY TARGETS

10. **Net International Reserves (NIR) of the central bank.** For program purposes, NIR will be measured as gross international reserves that are readily available (including the balance of the Trust Fund instituted to manage financing from Petrocaribe) minus short-term reserve liabilities (including purchases and credits from the Fund), as described in the international reserves table prepared by the central bank according to the new monetary statistics presentation (MEMF). Readily available reserves also exclude those assets that are pledged or otherwise encumbered, including but not limited to reserve assets used as collateral or guarantee for a third-party external liability. NIR excludes (1) any conversion of short-term reserve liabilities; (2) foreign assets stemming from foreign currency deposits of financial institutions at the central bank; and (3) transfer to the central bank of foreign currency deposits of HONDUTEL, INJUPEMP, and IHSS held abroad, which amounted to US\$121 million at end-2007. NIR will be valued at current exchange rates.

11. **Net domestic assets (NDA) of the central bank** will be measured as the difference between currency issue and NIR, both measured on the basis of end-of-period data.

12. **Prior action.** Monetary measures equivalent to 2 percentage points in reserve requirements (MEFP ¶6) will be defined over a base of end-December local currency deposits. The stock of central bank bills in the hands of nonbank local investors will be defined as the total stock of central bank bills less the stock in the hands of commercial banks (otras sociedades de deposito).

13. **Adjustor:** The end-June performance criterion for the floor on net international reserves of the central bank will be adjusted downwards by the amount of the proceeds from the sale of the mobile phone license that are unrealized by that date, or the amount of the

proceeds that are realized in lempiras, by up to US\$80 million. Conversely, the end-June performance criterion for the ceiling on net domestic assets of the central bank will be adjusted upwards by up to the same amount.

III. EXTERNAL TARGETS

14. **External debt.** As indicated in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted by the IMF Executive Board on August 24, 2000, debt will be defined as a current (not contingent) liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property. (b) Under the definition of debt set out above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

15. **Stock of external debt arrears.** For the purpose of the program ceiling, external debt-service arrears are defined as overdue debt service arising in respect of obligations incurred directly or guaranteed by the public sector, except on debt subject to rescheduling or restructuring, as indicated by the respective creditors.

16. **Borrowing on nonconcessional terms.** For the purposes of the program, this ceiling applies to the contracting or guaranteeing of nonconcessional external debt by the CPS or any other agencies on their behalf. The ceiling applies not only to debt as defined above, but also to commitments contracted or guaranteed for which value has not been received.

17. **Concessionality** will be based on a currency-specific discount rate based on the 10 year (6-month) average of the OECD's commercial interest reference rates (CIRR) for loans or leases with maturities greater (less) than 15 years, and following the methodology set out in the following Fund documents: SM/96/86 (April 8, 1996) and EBS/00/128 (June 30, 2000). Maturity will be determined on the basis of the original loan contract. Under this definition of concessionality, only debt with a grant element equivalent to at least 35 percent (referring to the difference between the nominal value and the net present value of debt) will be excluded from the debt ceiling. In determining whether multiple financing instruments would be considered as an integrated incurrence of debt for the purposes of assessing the concessionality of that debt, the elements that Fund staff would take into account include: (i) identical intended use or purposes for the financing; (ii) inter-related schedules for disbursement; (iii) cross-conditions for entry into legal effect, availability of funds and default; and (iv) identical parties to the financing.

18. **Excluded** from the external debt ceiling are: (1) the use of Fund resources; (2) debts classified as international reserve liabilities of the central bank; (3) short-term import financing (with a maturity of less than one year); (4) debts to restructure, refinance, or prepay existing debts; and (5) central bank instruments placed in the domestic market held by nonresidents.

IV. STRUCTURAL REFORMS

A. Energy Policy

19. **Arrears of ENEE** are defined as overdue payments (principal and interest) as stipulated in the corresponding contracts. With proceeds from the issue of government bonds authorized in the 2008 budget, ENEE will clear all arrears to generators by end-June 2008. No new arrears to the private sector shall accumulate during 2008.

B. Monitoring and Reporting Requirements

20. **The information required to monitor the compliance with quantitative and structural performance criteria and benchmarks** specified in the MEFP will be supplied to the Fund at least monthly (electronically, to the extent possible) within 45 days of the end of the previous month (unless otherwise noted) according to the following sources:

21. **The ceilings on the deficit of the central government and of the CPS** will be monitored below-the-line on the basis of the monthly reports *Financiamiento de la Administración Central* and *Financiamiento del Sector Público Combinado*, respectively, prepared by the central bank, which contain:

- **Net external financing** of the central government and the NFPS, respectively, with detailed information on disbursements, amortizations, exceptional financing, zero-

coupon bond, and accumulation of arrears. This information is prepared by the central bank and reconciled with the Ministry of Finance.

- **Net domestic financing** of the central government and the NFPS, respectively, with detailed information on: (1) net domestic financing from the central bank and the rest of the financial system to the central government and the NFPS, as contained in the *Panorama Financiero* monthly report; (2) net placement of bonds (including stabilization bonds) by the central government and the NFPS outside the financial system, as reported by the central bank with data from the Public Credit Directorate of the Ministry of Finance; (3) change in foreign currency deposits held abroad by the central government and the NFPS; and (4) change in the outstanding stock of suppliers' credit and floating debt of the central government, as reported by the Treasury, and the rest of the NFPS as reported by the central bank. To monitor the net domestic financing to the CPS, the central bank will provide the Fund with detailed data on a cash basis on the operating revenue and expenditure of the central bank.

22. **The ceilings on the wage bill of the central government** will be monitored monthly on the basis of the ministry of finance report: *Información institucional por objeto de gasto - servicios personales y aportes patronales*.

23. **To complement the monitoring of fiscal performance, a breakdown of tax revenue** by type of tax will also be provided monthly to the Fund.

24. **Anti-poverty spending** will be monitored quarterly on the basis of the information provided by the ministry of finance. Anti-poverty spending will be obtained from the detailed central government report: *Cuenta Financiera*. The Ministry of Finance will also provide the breakdown between anti-poverty and other spending by expenditure category (i.e., wages and salaries, goods and services, current transfers, fixed capital formation, and capital transfers).

25. **The floor on NIR and the ceiling on NDA of the central bank** will be monitored on the basis of information produced by the central bank, in accordance with the new presentation of the monetary statistics (MEMF). This information will be provided within two weeks of the end of the previous month.

26. **The ceilings on the contracting of nonconcessional external debt and on the nonaccumulation of external payments arrears** will be monitored with information provided by the Ministry of Finance. The accounting of nonreschedulable external debt-service arrears by creditor (if any), with detailed explanations, will be transmitted by the Ministry of Finance on a monthly basis within four weeks of the end of each month. Moreover, a loan-by-loan accounting of all new loans contracted or guaranteed by the public sector, including detailed information on the amounts, currencies, and terms and conditions, as well as relevant supporting materials, will be transmitted by the central bank on a quarterly basis within four weeks of the end of each quarter.