Chapter 7

Honduras—Using maquilas and international agreements to boost the garment industry

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Summary

This case study examines the role of foreign direct investment (FDI) in Honduras in the textile and apparel global value chain (GVC). The study shows how the Honduran government's establishment of special economic zones (SEZs) for export-oriented production, known as *maquilas*, and signing of preferential trade and investment agreements jointly helped attract foreign investment and led to the development of the Honduran textile and apparel industry. The Honduran SEZ program was formally established in 1976. After a slow start, it took off in the early 1990s as more foreign manufacturers moved their labor-intensive operations serving the US market to Honduras. The government established maquilas as geographically limited enclaves with dedicated infrastructure, streamlined public administration, and generous fiscal incentives to attract FDI. A series of trade and investment agreements helped lower the cost of importing raw materials and enabled duty-free exports to the US market for certain textile and apparel goods. As a result, this small Central American republic managed to become a leading exporter of textile and apparel products to the United States.

Honduras's role in the global textile and apparel value chain

The global textile and apparel value chain

The textile and apparel value chain is characterized by a highly globalized production and trade network.[1] The industry is identified as a buyer-driven value chain, a feature common in labor-intensive GVCs. Its lead firms tend to have extensive global sourcing capabilities and to perform the most valuable activities in the value chain themselves, and they are typically headquartered in the leading markets—Europe, Japan, and the United States. A complex network of contractors in developing countries carries out the production stages, making finished goods for foreign buyers, and the large retailers or marketers that order these goods supply their specifications (Fernandez-Stark, Frederick, and Gereffi 2011).

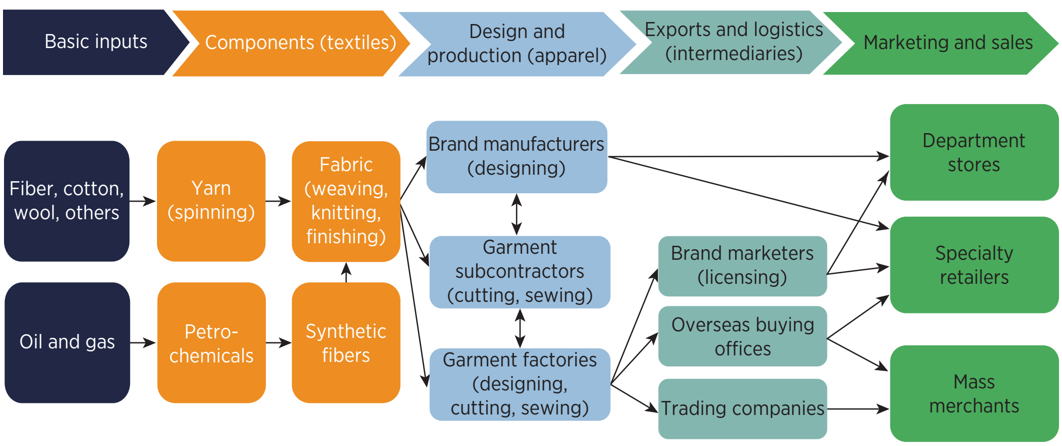
The textile and apparel GVC is also highly consumer driven. Given the global demand for textiles and the variety of specifications required by consumers (such as size, suitability for various occupations and types of weather, and cultural and personal preferences), along with the relatively low unit price of each garment, the industry is among the least concentrated. Global buyers decide what is to be produced, where, by whom, and at what price. Consequently, many lead firms have to rapidly adjust their production to meet consumer tastes, and they tend to outsource the manufacturing process to a global network of suppliers (Fernandez-Stark, Frederick, and Gereffi 2011).

Conventional textile manufacturing consists of a long process to convert natural fibers into useful products such as fabric, home textiles, and apparel. Technical textiles, made with the use of special finishing effects, require a process with yet more steps. The processing stages in textile manufacturing, from fiber production to finished fabrics, are continuously subject to enhancements in process control and evaluation.

The textile value chain comprises a number of networks and components, which can be organized into five main parts (figure 7.1). Its production process involves processing raw materials, creating components such as fabrics and textiles, producing apparel, exporting and logistics, and, finally, marketing the apparel. From an activities viewpoint, Honduran firms work primarily to assemble final products (cutting and sewing), with activities outside of manufacturing (design, branding, sourcing and logistics coordination, and sales and customer acquisition) performed elsewhere (Bamber and Frederick 2018). The different stages can be described as follows:

- *Input supply*. The product at this stage usually consists of various natural or artificial fibers (yarn or thread). These fibers may be processed or unprocessed. Most of the time, the raw material from which this fiber is made is a natural resource such as cotton, oil, or rubber.
- *Component network*. This stage involves the processing of the fibers. The product is manufactured mainly from imported components or raw materials. The main activities at this stage are spinning yarn, weaving, knitting, and finishing fabric.

FIGURE 7.1 The textile and apparel value chain



Source: World Bank elaboration of Frederick 2010, Gereffi and Frederick 2010, and Gereffi and Memedovic 2003.

- *Production network*. At this stage apparel manufacturers, such as garment factories or garment subcontractors, design, cut, and sew the fabrics produced.
- *Export networks and logistics*. Some garment firms sell their finished products directly to wholesalers (such as overseas buying offices or trading companies) or to retailers. In other cases, brand marketers collect final products and conduct quality inspections before selling the goods to department stores or retailers.
- *Marketing and services*. This final stage includes the marketing and retail sales of apparel products.

Lead firms in the contemporary textile and apparel GVC have significant market power. This power is reflected in their size (as measured by sales) and in the combination of high-value activities they carry out, including design, marketing, consumer services, and logistics.

Four types of lead firms dominate the value chain: mass merchants, specialty retailers, brand marketers, and brand manufacturers (Gereffi and Memedovic 2003). Each type of firm has its own brands and operates in its own part of the value chain (table 7.1). The retailer category is divided between mass merchants (such as Walmart) that sell a diverse array of products and specialty retailers (such as H&M) that sell only apparel items. Such companies do not own their manufacturing facilities; rather, they license final products with their own branding. Brand marketers (such as Nike) source their products through original equipment manufacturers or full-package producers. The buyer provides detailed garment specifications, and the supplier is responsible for acquiring the inputs and coordinating all parts of the production process: purchasing textiles, cutting pieces, assembling garments, washing and finishing them, and packaging and distributing them. Finally, brand manufacturers (such as Zara) are actively involved in manufacturing and directly coordinate the supply of intermediate inputs to their production networks (Gereffi and Frederick 2010).

Since the 2007 global financial crisis, top exporter countries in the textile and apparel GVC have begun to focus on their domestic markets to avoid the slowdown in global exports. This shift aims to accelerate the process of upgrading from assembly and full-package supply to original design manufacturing and

TABLE 7.1 Brand types and lead firms

Brand type	Lead firm type	Sample firms
Private label Firm owns or licenses branded products but does not own the manufacturing of these products.	**Mass merchant** Department stores that carry private labels or licensed brands that are available exclusively in their stores.	Marks & Spencer, Target, Tesco, Walmart
	Specialty retailer Retailers that develop labels that include their name.	Gap, H&M, Limited Brands, Next
National brand Firm develops labels that include its name.	**Brand marketer** Firms that own brand name but do not manufacture branded products ("manufacturers without factories"). Products are sold at a variety of retail outlets.	Diesel, Hugo Boss, Levi's, Nike
	Brand manufacturer Firms that own brand names and manufacturing. They typically coordinate a supply of intermediate inputs to their production networks to sell their products in the home or neighboring countries.	Fruit of the Loom, Zara

Source: Gereffi and Frederick 2010.

original brand manufacturing. Although many apparel manufacturers have quality management or ISO (International Organization for Standardization) 9000 standard certifications, the importance of product and process standards is comparatively low in this sector because apparel does not pose a significant health or safety risk to users (Bamber and Frederick 2018). The distribution of production networks and buyer-supplier relationships in this GVC has been driven by tariffs, trade and investment agreements, and government intervention in the textile and apparel supply chain. Import tariffs on apparel products are among the highest for all imported goods in key consuming markets such as Europe and the United States.

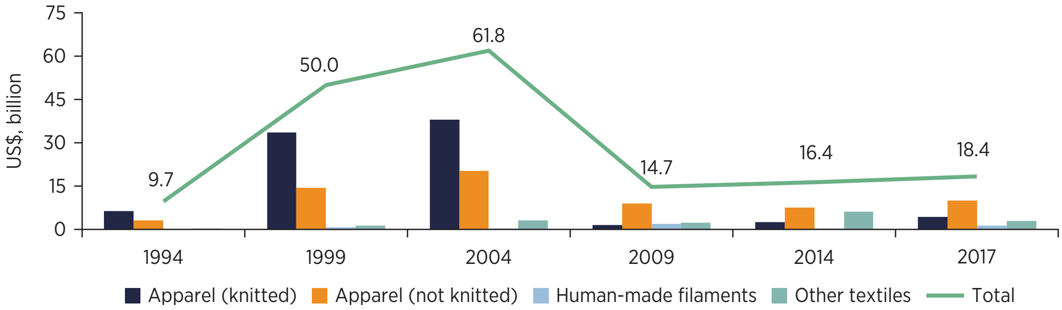
Honduras's participation in the textile and apparel value chain

Participation in the global textile and apparel value chain generally requires the presence of three factors: favorable trade and investment agreements, low-cost labor, and proximity to end markets (Keane and te Velde 2008). Building on these three factors through designated economic processing zones, locally referred to as maquilas, Honduras has been able to attract several large textile and apparel manufacturers into the country and has started participating in the value chain. Honduras fares well among the top 10 apparel suppliers to the United States. The apparel producers' cost in Honduras is US$2.78 per unit (measured in square meter equivalents), making it the fifth-cheapest supplier to the United States. Additionally, relative to its major competitors and neighbors (such as El Salvador and Guatemala), labor costs in Honduras remain competitive even with an increase of 7 percent in its minimum wage.

Honduras's participation in the textile and apparel GVC is concentrated in the components and production phases. The Honduran market for textiles is relatively small, and local companies have little expertise in branding, marketing, or retailing. Although the country's supply chain participation expanded over time (from basic sewing to cutting, dyeing and washing, trimming, finishing products, and producing fabrics and yarn), Honduras still relies mainly on low-cost labor working in the cutting and sewing stages of apparel production (Bamber and Frederick 2018). Despite some local production of fabrics, many firms rely on imported fabrics (often from the United States[2]) to produce apparel (Bilandzic et al. 2007). Most Honduran products are then exported on to lead firms (brand marketers, wholesalers, or retail companies) in Central America or the United States.

Honduras exports a wide range of textile and apparel products. The country is one of Latin America's leading exporters of textile products (including silk, wool, cotton, vegetable textile fibers, human-made filaments, wadding, carpets, special woven products, and textile fabrics). In 2017, Honduras exported about US$15 billion in apparel articles, split between general apparel, knitted wear, human-made filaments, and other types of textiles (figure 7.2). With regard to specific articles, Honduras is the top T-shirt exporter, the second-largest exporter of sweatshirts, and the fifth-largest exporter of cotton shirts to the United States (AHM 2018). Honduras is also the third-largest exporter of knitted garments to the United States, making it the largest exporter in this category after the "big two" clothing exporters, China and Vietnam. Knit T-shirts alone make up 16 percent of Honduras's total exports, exceeding the share of coffee, and knit sweaters make up 13 percent. Honduras's preferential

FIGURE 7.2 Honduran textile and apparel exports, 1994–2017



Source: World Bank elaborations on United Nations Comtrade data.

treatment by the United States has pushed the country to advance in the components and production phases of the textile value chain, making Honduran employees highly specialized in low-skilled activities, particularly sewing. However, the presence of large brands in the country has led it to expand into the exporting and marketing phases by implementing higher standards for employee work and for productivity, driving domestic innovation.

The textile and apparel industry constitutes an important part of the Honduran economy. In 2018, 127 textile and apparel firms were located in Honduras's maquilas, with an export volume of US$3.5 billion. Jointly, these firms made up 82.5 percent of maquila exports (Central Bank of Honduras 2018). Of this export volume, approximately US$660 million was exported to the United States. Many of these factories are subsidiaries of large US companies and supply high volumes of relatively simple inputs, with little value added locally. Maquilas overall account for more than 26 percent of Honduras's total manufacturing sector output and make up 4.4 percent of total gross domestic product (GDP) (Central Bank of Honduras 2018). The maquilas employ about 7,500 workers, or 30 percent of the labor force of the Honduran manufacturing industry (Central Bank of Honduras 2018).

Honduras's concentration in narrow segments of the textile and apparel GVC leaves the country vulnerable. The spread of the textile and apparel industry through Honduras's maquilas has brought many new opportunities and increased employment. However, the industry's dependence on imported inputs and its narrow concentration in the components and production phases have made the country susceptible to global supply shocks. This concentration is also gradually decreasing Honduras's general competitiveness and reducing its pool of investors. The low-skilled workforce available forces maquilas toward more traditional garment and assembly operations and prevents them from developing more sophisticated textile products. To further upgrade its activities in the textile and apparel GVC, Honduras needs to strengthen the quality of its workforce. It may also need to attract more investors in higher-value segments (such as design, marketing, consumer services, and logistics) to help further expand its economic activity into additional stages of the GVC.

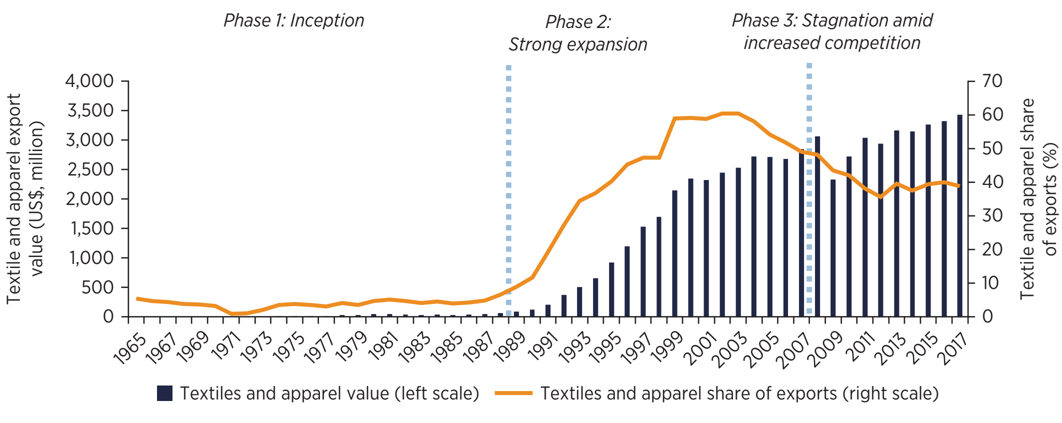
The development of Honduras's textile and apparel industry

Honduras's involvement in the textile and apparel GVC can be divided into three phases (figure 7.3):

- *Phase 1: Inception* (mid-1960s to late 1980s). Honduras's textile and apparel industry entered the GVC when the country established its first maquilas and enacted its first investment laws in favor of export-oriented companies. This change attracted some FDI and allowed established export-oriented companies to develop further.
- *Phase 2: Strong expansion* (late 1980s to mid-2000s). A combination of a more active maquila industry, several trade and investment agreements, and fiscal incentives led to a large inflow of FDI. As a result, the textile and apparel industry grew rapidly and became the largest exporter and the largest manufacturing employer in Honduras.
- *Phase 3: Stagnation amid increased competition* (mid-2000s to today). Following the global financial crisis, both FDI inflows and the share of Honduran exports derived from textiles and apparel started to stagnate. Greater regional competition led to a further loss of competitiveness for Honduras's maquilas.

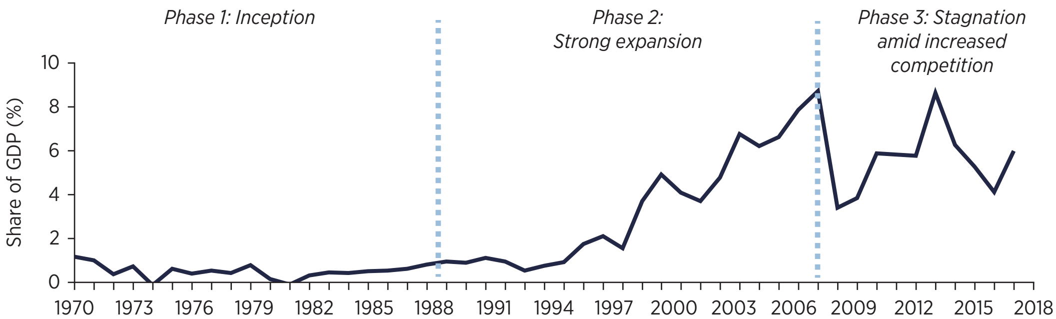
These three phases also show the important role that FDI inflows played in the export development of Honduras's textile and apparel industry (figure 7.4). During the inception phase, Honduras saw very limited inflows of FDI. However, in phase 2, overall FDI inflows increased from about 1.0 percent of GDP in 1988 to 8.7 percent in 2008. Following the financial crisis (phase 3), aggregate FDI inflows declined dramatically (to 3.4 percent in 2009). Although most FDI inflows

FIGURE 7.3 The three stages of Honduras's textile and apparel industry, 1965–2017



Source: World Bank elaborations on United Nations Comtrade data.
Note: Exports include textile fibers (SITC 26), yarn products (SITC 65), and apparel and clothing (SITC 84). SITC = Standard International Trade Classification.

FIGURE 7.4 Total foreign direct investment flows into Honduras, 1970–2018



Source: World Bank elaboration on World Development Indicators data.
Note: Foreign direct investment includes many sectors other than textiles and apparel.

initially went to the maquilas, stagnation led to a decline in their share of FDI. In 2015, only US$160 million out of US$850 million in FDI (19 percent) flowed to the maquilas (WTO Secretariat 2016).

Phase 1: Inception (mid-1960s–late 1980s)

In 1976, the country established its first SEZ-maquila program with the First Free Zone Law. (Free zones are also known as ZOLIs, for *zonas libres*.) This law established dedicated infrastructure for the maquilas and ensured that they could streamline public administration and offer fiscal incentives to attract FDI and technology for labor-intensive and export-oriented production. Companies operating under the free zone status had to be involved in the mechanical, physical, or chemical processing of raw materials or semiprocessed or finished goods and export at least 95 percent of their annual output; in return, they were allowed several incentives (including exemption from the payment of duties, charges, and consular fees for a 15-year period).[3] The zone covered a publicly owned enclave near Puerto Cortés and was later extended in 1979 to include other counties (Amapala, Choloma, La Ceiba, Omoa, and Tela). The law distinguished between "industrial companies" and "commercial and trading companies." Free zone status was allowed only to the latter, which "primarily engaged in export activities" and allocated "no less than 50 percent of annual sales to export or re-export." Although this law was neutral as to the country of origin of investors, in practice only foreign investors received the incentives, whereas local companies were not allowed to operate within the zones (Farole and Akinci 2011).

A range of preferential trade and investment agreements further helped establish textile and apparel production in Honduras. In the early 1970s, Honduras signed the Multi Fibre Arrangement, which helped establish quotas and preferential tariffs on apparel and textile items imported from Honduras by Canada, the United States, and many European nations. Then, in 1984, the Caribbean Basin Initiative (CBI) came into effect. This initiative, a unilateral and temporary program initiated by the United

States, offered preferential market access to clothing and apparel exports from several countries in the Caribbean and Central America. Through this program, Honduran producers did not have to pay duties on reexported inputs, such as textiles and fabrics of US origin. This change enabled manufacturers to conduct the most labor-intensive operation along the value chain (sewing) in lower-cost countries without having to pay import duties. In 1984, Honduras also passed the Temporary Importation Regulations Law, which allowed export-oriented companies with operations outside the free zones to import machinery and equipment free of duties. Although this policy aimed mainly to create a domestic base of suppliers, most of its beneficiaries were larger, export-oriented foreign companies (Engman 2011).

About this time, Honduras also began to prioritize public infrastructure and investment promotion. The government invested heavily in infrastructure, especially in roads between the city of San Pedro Sula and the maquila (Puerto Cortés). In addition, a national export and investment promotion agency, the Foundation for Investment and Development of Exports, was established in 1984. This agency aimed to promote investment in Honduras, develop the country's export markets, and work closely with the government and other private organizations to improve the country's business climate. It also supported entrepreneurs by facilitating their investment and exports, accomplished by establishing export promotion offices in the United States to expand Honduran producers' networks and connect them with leading US-based textile companies.

Phase 2: Strong expansion (late 1980s–mid-2000s)

The main catalyst for FDI in Honduras's textile and apparel industry came in 1987: the establishment of export processing zones (EPZs).[4] In 1987, Honduras enacted the EPZ law (also known as the ZIP law, for *zonas industriales de procesamiento*), which allowed privately owned and managed SEZs to be established anywhere in the country. Within these SEZs, exporting firms enjoyed duty-free entry into US markets for certain manufactured goods assembled there (including textiles and apparel).[5] This measure allowed the agglomeration of investors to take place on the basis of market factors rather than only within publicly designated areas, and it enabled domestic investors to act as catalysts for FDI. Domestic investors provided the up-front investments to establish and operate these industrial parks, which then attracted foreign investors. During this time, the government proved to be a key facilitator of domestic investment in the maquilas by setting up a program in which it bought loans at a premium from domestic firms suffering from debt crises in exchange for agreements to invest in free zones and other infrastructure (Farole and Akinci 2011).

Maquilas further developed with the establishment of the Asociación Hondureña de Maquiladores (AHM) in 1991. The AHM was founded to assist and support private investors and shape the business environment to further attract FDI. It actively lobbied the government to provide greater regulatory flexibility for the private sector within the SEZs. The changes it brought about allowed zone operators to strengthen the investment climates in their zones by ensuring that SEZ firms faced limited regulatory burdens and minimal government interference. The AHM is an industry body; its members pay US$1,000 to apply to join, followed by a US$110 monthly fee. Along with providing statistics about the maquila industry, it has six main functions (Bilandzic et al. 2007; Viery 2014):

1. Promote and stimulate the maquila industry.
2. Propose and negotiate the formulation and execution of national policies.
3. Develop international market programs to increase development.
4. Propose incentives for the industry, such as administrative or credit-related incentives.
5. Assess and guide associates to ensure that their products and services meet market standards.
6. Sustain relationships with international institutions whose interests parallel the AHM's.

A continuing set of trade and investment agreements reduced Honduras's trade costs even more. Honduras signed several preferential trade agreements during this period with its largest trading partner, the United States. In 1990, the Caribbean Basin Economic Recovery Expansion Act made the incentives in the CBI permanent, thereby ensuring duty-free access to the US market for most Honduran goods. Another important step came in 1994, when Honduras joined the World Trade Organization (WTO). This move further reduced trade costs by allowing Honduran producers to enjoy most-favored nation treatment, thereby receiving the best trade terms given by its trading partner to the other 152 members of the WTO. Additionally, in 1995 Honduras signed a bilateral investment treaty with the United States that aimed to protect US investments and to assist Honduras in developing its private sector and building a business environment to attract FDI. About the same time, Honduras signed several bilateral investment treaties with China, European countries, the Republic of Korea, and countries in Latin America such as Chile, Cuba, and Ecuador. Two other important trade agreements were passed in 2000. In that year, the United States signed the Caribbean Basin Trade Partnership Act (CBTPA), which extended preferential tariff treatment to garments assembled from US fabric (which had been excluded from the CBI). This change allowed for duty-free exports to the United States of garments that were made using US yarns and fabrics, which encouraged Honduran companies to use more local content in their production and led to significant Honduran investment in textile mills. Finally, in 2005, a free trade agreement was signed between the United States and regional actors; the Dominican Republic–Central America Free Trade Agreement (CAFTA-DR) spurred significant investment from the United States into Honduras (Janesen et al 2007).[6] As a result of its preferential access to the US market via CAFTA-DR and the CBTPA, Honduras became the seventh-largest apparel exporter to the United States (Engman 2011).

The EPZ law, the AHM, and trade policy jointly triggered investment from local entrepreneurs to develop the industrial parks; and they helped catalyze inflows of foreign investment, especially from North American multinationals. Domestic investors jointly established 23 industrial parks in Honduras, located mainly in the north of the country, that hosted 225 maquila firms. In the early 1990s, more than 52 percent of FDI into Honduras went to the maquilas, which accounted for more than 44 percent of all national investment (AHM 2018). The EPZ law and the AHM also helped many new foreign companies settle in the country. By 1998, more than 60 percent of all apparel firms in Honduras were foreign owned, and most of them were from North America or Asia (table 7.2). The textile and apparel industry also accounted for the country's largest source of FDI, receiving almost 64 percent of total FDI in the manufacturing sector over the period 2004–07 (table 7.3).

This phase was marked by the continuous growth of exports in the maquilas and a boom in job creation. SEZ exports expanded quickly, rising by a factor of approximately 10 between 1993 and 2006 in US dollars (Engman 2011). This growth continued until the third phase began in 2007. During this time, Honduras's producers started to excel at producing small orders for expedient delivery to the US market, taking advantage of their proximity to the United States and the speed to market it enabled.[7] This proximity was a key comparative advantage, given the rapid shifts in

TABLE 7.2 Apparel firms in Honduras's maquilas, by origin, 1998

Origin	Number	Share (%)
Foreign owned	125	62
North American	75	37
Asian	50	25
Honduran	67	33
Other (including joint ventures)	11	5
Total	203	100

Source: IBP USA 2001.

TABLE 7.3 Foreign direct investment in manufacturing activities, 2004–07 (US$, million)

Activity	2004	2005	2006	2007	Average share, 2004–07 (%)
Textiles	92.2	76.3	127.3	197.6	63.7
Input services	20.7	22.9	32.0	20.0	12 3
Commerce	−3.3	8.0	16.3	5.8	3.5
Agriculture and fishery	7.7	7.8	8.2	4.3	3.6
Cardboard products	3.8	3.3	−9.1	1.9	0
Plastic products	0	0.6	0.4	0.1	0.1
Chemical products	0	2.7	0	0	0.3
Furniture and wood products	0.5	−0.4	0.5	−1.5	−0.1
Tobacco	22.4	53	-0.1	−3.6	3.1
Electronic components	28.7	65.3	2.3	−5.3	11.7
Other industry	2.2	3.9	6.9	0.2	1.7
Total	174.9	195.8	184.7	219.6	

Source: Central Bank of Honduras 2007.
Note: Negative numbers indicate disinvestments in a particular sector.

consumers' tastes as well as retailers' efforts to minimize the cost of their inventory. According to the AHM, Honduras was the fourth-largest supplier of clothing products to the United States (with 5.9 percent market share) and the world's largest importer of US yarn. Out of all maquila workers, 77 percent were employed in the textile and clothing sector; this increase in employment boosted female participation and benefited low-skilled workers in the SEZs (Walker and Michel 2019).

However, the maquila model also led to a widening divide between the economies of the SEZs and the rest of the country. Qualifying for SEZ status required a certain minimum level of investment, employment creation, and export orientation. Even though Honduran enterprises were not formally excluded from the SEZs, in practice most small and medium enterprises were unable to meet these minimum conditions (Hernandez Ore, Sousa, and Lopez 2015). As a result, only large investors were able to obtain the extensive fiscal benefits (often with no sunset clauses) associated with the SEZs. In addition, maquila firms were allowed to pay workers less than the national minimum wage. As a result, the average market wages were about 25 percent lower in the SEZs than in the rest of the country (237 Honduran limperas per month in the maquilas versus 318 Honduran limperas per month in the rest of Honduras) (Viery 2014).

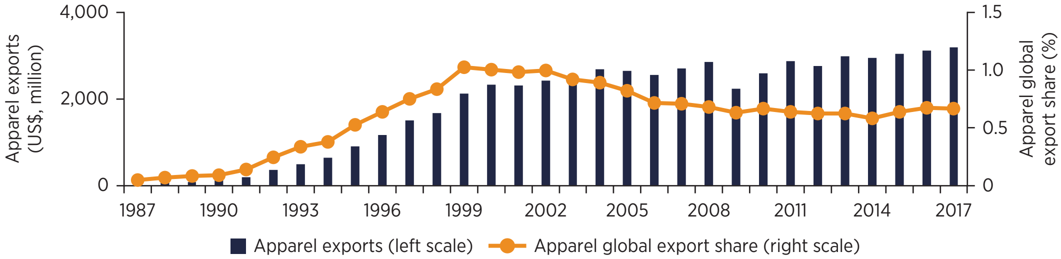
Backward linkages were further constrained by the rules of origin set out in many trade agreements. For instance, the CBI's rule of origin allowed local producers to export only a limited number of products. SEZs also established perverse incentives to import goods rather than use local products because imports were exempt from customs taxes or value added taxes whereas the government imposed a 12 percent tax on domestically produced inputs used in the maquilas. This difference created unfair competition and widened the divide between the SEZs and the domestic economy.

Phase 3: Stagnation amid increasing competition (mid-2000s–today)

The Honduran textile and apparel industry entered a third phase in the mid-2000s, when the industry faced increased global competition. Three global dynamics increased Honduras's competition. First, China's accession to the WTO in 2001 led to a large drop in that country's trade costs with the United States and caused a surge in Chinese exports to the American market (Liu and Gu 2007). At the same time, WTO rules around discriminatory trade practices meant that the Honduran government was forced to phase out its fiscal incentives scheme. Second, a range of other Asian countries, including Bangladesh, Cambodia, and Vietnam, started competing in the North American apparel market, which resulted in a global decline in apparel prices. Third, retail-oriented branded apparel chains (such as Zara) gained market power, shifting their strategy to a "fast fashion" model in which the value chain was leveraged to produce trendy, fashion-oriented apparel at affordable prices. This shift increased the importance of lead times and quality and resulted in some reshoring of production from Honduras to the producers' countries (such as Spain, in the case of Zara).

The business environment in Honduras continued to lose competitiveness in this period because of several negative shocks. The global economic downturn hit Honduras at the end of 2008, leading to significant appreciation of the domestic

FIGURE 7.5 Apparel exports and world export share, Honduras, 1987–2017



Source: World Bank elaborations on United Nations Comtrade data.
Note: Apparel is defined using Standard International Trade Classification 84 (apparel and clothing).

currency, the lempira, and affecting US sales of textiles and apparel—and thus most SEZ exports (figure 7.5). As a result, Honduras's global market share in apparel went from a high of 1.0 percent in the late 1990s to about 0.6 percent in 2017.[8] The downturn thus exacerbated the decline caused by Asian competition and the shift of US clothing assembly to Asia. These events exposed Honduras's vulnerability to global supply shocks and the country's dependence on imported inputs in light of its narrow concentration in the component and production phases. They also led to a significant drop in the number of employees at the maquilas, from 134,000 workers in 2007 to 100,000 workers in 2009 (Engman 2011). Many unemployed workers from the maquilas moved to the informal sector or left the country to seek employment in the United States.

During this period, Honduras initiated a range of interventions to help restore its economy. The Honduran constitution was amended, allowing for the creation of the State Secretariat for Economic Development, which replaced the State Secretariat for Industry and Trade, and established employment and economic development zones as administrative subdivisions in Honduran national territory. The country also entered into a wider selection of preferential trade and investment agreements with several Central American countries, Korea, Panama, and Peru. In addition, the National Investment Council was created as a public-private entity aiming to promote investment in several priority sectors, including textiles and apparel (WTO 2016).

Current challenges

Honduras still enjoys several advantages in textile and apparel production. Its maquilas currently see their success as based on a number of strengths:

- Proximity to the US southern and east coast markets
- Competitive labor costs and relatively high labor productivity compared with both neighboring countries and major exporting countries such as Bangladesh, China, and Vietnam (IFC, forthcoming)

- Preferential market access, secured by international trade and investment agreements such as CBTPA and CAFTA-DR
- Investment in port infrastructure that has led to efficient trade logistics[9]
- A critical mass of maquilas based around San Pedro Sula, forming clusters and economies of scale
- Several influential industrial families with long histories in textile and apparel production, leading to deep industrial knowledge and relational ties to global producers

However, the sector also faces several significant challenges. In the immediate term, the COVID-19 pandemic has had a major negative impact on the sector. The global shock caused by the pandemic initially led to a strong decline in Honduras's textile and apparel exports. However, the pandemic also brought new opportunities, most notably in the personal protective equipment (PPE) subsector. As a result, many apparel firms are adjusting their product portfolios to include more PPE production (box 7.1).

BOX 7.1 The impact of COVID-19 (coronavirus) on Honduras's textile and apparel industry

The COVID-19 (coronavirus) crisis has significantly affected the global textile and apparel industry. Because of the pandemic and the associated lockdowns, global demand for textiles and apparel has declined. This shift has forced many leading brands and retailers, including those that source significantly from Honduras, to cancel and delay orders. In addition, the sector faced several supply shocks when some global fabric suppliers initially closed their factories or reduced their suppliers, causing a ripple effect among the major apparel supplier countries. The resulting declines in worldwide apparel exports have been significant. According to the Office of Textiles and Apparel, US apparel imports from the world declined by 42.8 percent between March and May 2020.

In response to these developments, Honduras's textile and apparel exports declined rapidly. Honduras initially announced temporary factory closures. Many businesses eventually opened up again, but at severely reduced capacity. As one of the top 10 exporters of textiles and apparel to the United States, Honduras experienced a sharp initial decline in exports in April and May (figure B7.1.1). Production increased again from a low of US$19 million in April to US$247 million in October, reaching a level similar to that in 2019. However, in November Honduras adopted a second COVID-19 lockdown, which resulted in another considerable decline in exports compared with 2019.

However, the COVID-19 crisis also provided opportunities for apparel companies, most notably in the manufacture of personal protective equipment (PPE). Several factories have turned to producing PPE, especially masks and medical gowns, which has buffered the COVID-19 shock. Early in the pandemic, factories in Honduras were mandated by the government to produce 9 million masks for domestic use. An estimated 18 million masks have been produced so far, alongside a growing number of medical gowns.

Several companies have been able to use PPE production to increase their output. For example, Grupo Karim initially suffered a 12 percent reduction in orders because of the pandemic.

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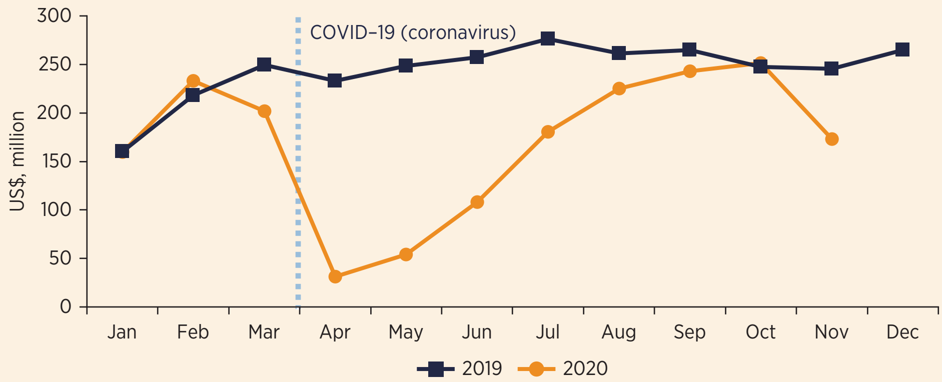
BOX 7.1 The impact of COVID-19 (coronavirus) on Honduras's textile and apparel industry *(continued)*

FIGURE B7.1.1 Honduran textile and apparel exports to the United States, 2019–20



Source: World Bank calculations using United Nations Comtrade data.

However, it then gained new customers from the United States that sought PPE. The company secured orders from two large retailers, Staples and Kohl's, to supply masks. Similarly, the Kattan Group is aligning its production to a post-COVID-19 environment. It produces medical gowns, a business it has been able to expand because of increased demand in the United States. It has also begun making polypropylene gowns (which are easier to clean, a useful feature in a COVID-19 setting). The company recently signed a contract to supply 2 million gowns per month to a customer in the United States.

Honduras appears well placed to address opportunities to supply the US market with PPE. Although such orders account for a small percentage of their overall capacity, several apparel companies believe PPE will remain an important product for the foreseeable future. They also note that Honduras is well situated to serve the US market in general given its proximity and speed-to-market advantage. As a result, many apparel firms are readjusting their product portfolios to include more PPE in comparison with the traditional products that have been the sector's lifeblood.

Source: IFC, forthcoming (including interviews with Grupo Karim, EU Light Manufacturing, Elcatex [Elasticos Centroamericanos y Textiles], the Asociación Nacional de Industriales, and the Asociación Hondureña de Maquiladores).

The Honduran textile and apparel industry also faces some major challenges that need to be addressed in the medium term. Its dependence on imported inputs and its narrow concentration in the components and production phases have left the country vulnerable to global supply shocks, led to a gradual decline in general competitiveness, and reduced its pool of investors (Farole and Akinci 2011; USITC 2004). Honduras also needs to attract investors in higher-value segments, including design, marketing, consumer services, and logistics, to expand its economic activity to additional stages of the textile and apparel GVC.

Workforce training is needed beyond what is currently offered through the AHM and at the factory level. The maquilas still employ a very low-skilled workforce and remain focused on traditional garment and assembly operations, which prevents them from developing more sophisticated textile products. Under the AHM, some training has occurred.[10] More advanced training is also carried out by individual factories, with approximately 99 percent of the needed training delivered in-house. Nevertheless, as Honduras moves up the textile and apparel value chain to more advanced manufacturing processes, new training curricula—in soft skills such as professional, managerial, and technical skills—will be required (IFC, forthcoming).

Slow customs clearance is also cited as a continuing inhibitor of Honduras's participation in the textile and apparel GVC. Although Honduras's port is efficient, there are significant delays in customs in the broader region. These inefficiencies work against the speed-to-market advantage that Honduras enjoys with the United States. The Northern Triangle region of El Salvador, Guatemala, and Honduras needs to improve its customs administration through regional integration. Although Honduran customs has been integrated with that of El Salvador and Guatemala, this integration should be expanded to Nicaragua and other nearby countries. Companies also report that, although customs procedures at the regional borders are electronic in theory, in practice they are still paper based, which slows the clearance process (IFC, forthcoming).

Although the Honduran government has in recent years simplified the administrative procedures for establishing a company, bureaucratic red tape is still prevalent. According to the 2019 World Bank Doing Business Report (World Bank 2019), the average time required to start a business in Honduras is 13 days, and doing so requires 11 procedures. This measure also needs to be improved upon (IFC, forthcoming).

Furthermore, Honduras needs to reduce the cost and improve the reliability of its electricity service. At 15 US cents per kilowatt-hour on average, energy costs are high in Honduras. Given that energy costs represent approximately 10–15 percent of the average garment company's operating costs, this expense cuts into factories' cost competitiveness. Electricity distribution is also a problem, with much power lost from the grid. Frequent outages further increase costs and operating inefficiencies because of the need for backup generators. To fill the void in electricity provision, most companies also invest in their own supplemental energy, including by installing solar panels. In fact, Honduras has the most solar panels installed in Latin America. In some factories, 100 percent of roofs have solar installations (IFC, forthcoming). The Honduran government should liberalize the power sector to allow private competition to bring costs down.

Although the textile and apparel industry is a key priority for the Honduran government, it currently lacks a coherent strategic vision for the industry. Under the country development program known as Honduras 2020, Honduras is focusing on increasing annual exports to 7.4 billion Honduran limperas and adding 200,000 jobs within the country by 2020 (AHM 2018). Although the country's mix of apparel products continues to be dominated by knits, and cotton knits in particular, there has been a push in recent years to increase the production capacity for other fabrics, particularly woven textiles. To accomplish this shift, the AHM estimates that at least US$250 million in new investment will be needed in the coming years. In addition, the Honduran government is investing US$3.4 billion to develop its synthetics industry, partly by recruiting production technicians and by engaging in public-private partnerships with selected domestic and multinational companies to train their employees in synthetic production methods. However, the Honduras 2020 program does not set forth a road map for increasing the country's overall competitiveness. Likewise, the government's role in attracting new investment is seen as facilitating the industry's needs rather than driving the effort. The government could play a more prominent role in investment promotion, but it has been unable to do so effectively. As a result, the private sector is filling the void by organizing itself and by asking the government to play more of a role (IFC, forthcoming).

Finally, more should be done to use regional integration to stimulate growth within the textile and apparel sector. To further grow the industry, intraregional trade and customs integration is vital. The three Northern Triangle countries—El Salvador, Guatemala, and Honduras—make up the Central American Customs Union. This three-country bloc allows 95 percent of products manufactured within them to circulate duty free among the member countries. The union also establishes common taxes and broader crossing administration, which is meant to shorten bureaucratic processes and decrease transit times. Although the bloc has made progress, including in the digitalization of customs procedures, there is still work to be done: operators within the sector note inefficient regional customs as a continuing challenge. Regional integration should encourage the development of vertical value chains within Honduras as the global textile and apparel sector further consolidates and major US brands and retailers shorten their supply chains.

Conclusion

This case study shows how the government of Honduras's establishment of maquilas and signing of preferential trade and investment agreements jointly helped attract foreign investment and led to the development of Honduras's textile and apparel industry. This approach has increased Honduras's integration with international markets, taking advantage of its preferential market access to the United States, and brought about workforce development and linkage programs over time. With the establishment of the maquila program and SEZs, more and more foreign manufacturers were able to extend their labor-intensive operations into the US market by taking advantage of dedicated infrastructure, tailored fiscal incentives, and trade agreements that favored their entrance into the US market. Despite a turbulent political environment, this small Central American republic managed to become a leading exporter of clothing and apparel products to the United States.

Honduras has shown the importance of SEZs in catalyzing FDI. SEZs in Honduras have allowed domestic parties to invest and operate during all three phases of the industry's development. The SEZs have also provided resilient infrastructure and a generous incentives regime encouraging foreign investors to enter the country and focus on manufacturing activities. However, the SEZs have dissuaded firms from upgrading and have excluded small and medium enterprises from some of their incentives, shunting FDI into low-value-added functions in textile and apparel manufacturing because of Honduras's lack of workforce development. Honduras is still very concentrated in narrow segments of the textiles and apparel GVC, which leaves it vulnerable to shocks. Over the three phases of the industry's development, maquilas became more and more independent in importing fabrics. Also, the increasing number of maquilas in the country led Honduras to supply more of its own inputs. However, lacking the capacity to carry out the entire value chain, the country is very sensitive to competition and shifts in international trade and has not been able to attract a very diverse pool of investors. Honduras has scope to diversify within the textile GVC, particularly into the production of synthetic fabrics. Although the country has worked to make its textile industry more competitive, it cannot stop there; the global, rapidly changing economy requires firms to continually upgrade their skills and seek more sophisticated advantages.

An important lesson comes from the way the Honduran government shifted policies over the three phases of development to increase participation by the domestic private sector. When the main concern was to attract FDI, in the first phase, the country focused on maximizing linkages. In the second phase, the country boosted the benefits of existing FDI by increasing backward linkages. It was not until the third phase, after the signing of several international agreements and a range of negative macroeconomic events, that the domestic private sector saw an unprecedented loss of competitiveness.

One of the challenges facing Honduras is to develop a stronger strategy for upgrading. Although the maquilas still face several hurdles, the companies working in them need longer-term visions to exploit the country's competitive advantages at producing textiles and apparel. The AHM and the Honduran government should provide incentives to move these textile companies along the value chain. This shift could be achieved by improving managerial skills and increasing Honduran firms' presence in the parts of the value chain that add more value: design, production, branding, and retail. For instance, developing stronger linkages with Mexican suppliers or building strategic alliances with East Asian firms in the fast-fashion segment could strengthen the Honduran textile value chain.

SEZs have played a catalytic role in Honduras's industrialization, diversification, and trade integration, leaving the government to establish more comprehensive policy reform that could benefit all investors and entrepreneurs.

Notes

1. The analysis in this case study is based on a combination of literature reviews and interviews conducted by the authors between January and March 2020 with representatives of multinational corporations, domestic firms, and trade associations affiliated with the Honduran garment industry, as well as government officials.
2. Honduras is the top global buyer of yarn from the United States. Its purchases represent US$1 billion in imports, equivalent to 23 percent of the United States' total yarn sales (AHM 2018).

3. According to a modification made by government decree in 2020, this time period can, upon lapsing, be extended for an additional 10 years.
4. Export processing zones are a subtype of SEZs. They are thus referred to henceforth as SEZs.
5. Such companies were also exempt from all federal and municipal taxes as well as from any domestic duties and charges associated with trade, and no time limit was attached to these fiscal incentives. The law also extended fiscal incentives to real estate developers who invested in the physical infrastructure of these industrial parks.
6. Under the so-called yarn forward rule of origin, the agreement covers textile and apparel products made using US, Central American, or Dominican yarns and fabrics.
7. In addition to the country's proximity to the United States, Honduras has the best, most efficient, and largest deep-water port in Central America, Puerto Cortés. This port earned the US Customs-Trade Partnership Against Terrorism certification, which improved its security and reduced the likelihood that products sent from it would be examined at a US port of entry.
8. Still, Honduras remains among the top 10 exporters of apparel to the United States, accounting for about 3 percent of US apparel imports.
9. According to the IFC (forthcoming), Honduras has the best and most efficient port in Central America. Transit times of 48 to 72 hours to the United States and efficient processing through Honduras's major port ensure a significant competitive advantage in speed to market.
10. A training program called Procinco was established in 2004 to focus on four main training areas: productivity, health and safety, human resources, and legislation and compliance.

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