The Geopolitics of Honduras's Special Economic Zones

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Background

The newly elected government of Xiomara Castro in Honduras is walking a political tightrope. In an environment of severe economic and fiscal challenges occasioned by the effects of Covid-19, the impact of Russia's invasion of Ukraine on food and fuel prices, and the lingering devastation of Hurricanes Eta and Iota, the Castro government is seeking to implement a left-leaning economic and social agenda and an anti-corruption campaign without inducing capital flight. The Castro government should also carefully navigate its relationship with the United States because it substantially depends on U.S. trade and investment, cooperation on immigration matters, and hopes to secure significant development assistance.

In this balancing act, the threat of switching diplomatic relations from Taiwan to the People's Republic of China (PRC) has been both a source of leverage and a safety net for the Castro government. As a candidate, Castro pledged to recognize the PRC, but her choice of Salvador Nasralla as vice president, and her desire to maintain good relations with the United States as long as possible, leveraging the positive orientation of the Biden administration toward her posture against corruption, has led her to delay diplomatic rapprochement with the PRC.

The Western hemisphere is the focal point of the PRC's efforts to diplomatically isolate Taiwan, and eventually, to bring it back under the mainland's control. Following Nicaragua's recognition of the PRC, Taiwan was left with only 14 countries around the world formally recognizing it, eight of which are in Latin America and the Caribbean. With the PRC offering a range of gifts and other incentives for countries that drop their recognition of Taiwan, the pressure is growing on Taiwan's remaining allies. Honduras is one of the last countries in Central America that maintains recognition of Taiwan, Guatemala and Belize being the other two. Yet the country's position vis-à-vis Taiwan has been imperiled by Castro's campaign promise and subsequent election.

Flips in recognition from Taiwan to the PRC are about more than diplomatic relations. The trajectory of past countries that have switched, including Costa Rica, Panama, the Dominican Republic, and El Salvador, show that the change opens the door for a rapid expansion of PRC influence in the country by allowing for nontransparent memorandums of understanding that open the local market to Chinese companies, opportunities for China deals for politically connected business elites, and other moves. To this end, the Biden administration has a strong interest in helping to preserve U.S. influence in Honduras vis-à-vis the PRC by heading off recognition of the PRC by the Castro government in Honduras.

Doing so will depend on more than diplomacy. It is imperative for the Biden administration to work with the Castro government to strengthen the ties of the Honduran government with the U.S. economy in a way that shows the benefits of a transparent, rule-of-law approach to economic relations supported by strong institutions. Concepts such as "nearshoring," leveraging Honduras's integration into the U.S. economy through the Central America-Dominican Republic Free Trade Agreement (CAFTA-DR), have been discussed in this regard, yet such an approach requires motivating investors to bet significantly on a country before their concerns about institutions and insecurity have been fully resolved. While the United States has worked through entities such as the Development Finance Corporation (DFC) to channel more private sector capital to Honduras, the number of bankable projects that DFC has been able to bring to date have been too few and too slow in implementation.

As the United States looks for options to achieve these strategic goals in Honduras, it should pay more attention to the innovative hubs already established in the country and whose existence is currently in doubt: Honduras's many types of special economic zones (SEZs) and in particular, the Zones for Employment and Economic Development (known as ZEDEs by their acronym in Spanish). These zones, designed to provide assurances to investors to foment the safe deployment of private sector capital in the country, should receive focus as a means of not only supporting Honduras's development needs and associated policy objectives, but in the process, also providing alternatives to more predatory investment strategies offered by the PRC and its companies as it seeks to flip the diplomatic orientation of the country away from Taiwan.

ZEDES, the "Nearshoring" Moment, and Geopolitics

The Covid-19 pandemic and Russia's devastating war in Ukraine have snarled global supply chains and disrupted the global economy as never before. The golden age of globalization that marked the preceding two and a half decades, in which countries pursued economic integration and trade flows with minimal concern for security and geopolitics, is arguably now over. Indeed, the luxury of focusing on minimizing production costs and maximizing economic efficiency over geopolitical risk was an aberration from most of human history.

With the global economy shaped once again by conflict and the return of great power rivalry, policymakers and business leaders have begun focusing on how to diversify supply chains serving North American consumers away from the PRC, and to "nearshore" them to the Americas—in the name of greater economic security. A related concept, divorced from the component of geographic proximity, is "friendshoring." The latter seeks to extricate supply chains from states hostile to the United States such as the PRC and refocus them on countries whose combination of political orientation, institutions, respect for rule of law and intellectual property reduce vulnerability to disruption. Geopolitical considerations are pushing a realignment in the global investment landscape, with legislation before the U.S. Congress potentially facilitating further movement in that direction.

Honduras is not only on the front line of the current struggle between the PRC and Taiwan, with significant implications for the United States, but with its proximity to the United States, integration into the U.S. market through CAFTA-DR, and relatively pro-U.S. democratic government, it is also strategically positioned as a potential beneficiary of nearshoring and friendshoring. Taking advantage of this opportunity will depend on the ability of the country, and particularly the current Castro government, to present Honduras as an environment safe for the deployment of private sector capital, especially that originating in the United States and Europe.

A key challenge for Honduras, however, is that its macroeconomic environment is not attractive for foreign direct investment. The country ranks 92nd in the world in the 2022 Economic Freedom Index and 20th in Latin America and the Caribbean, with declining scores in rule of law, property rights, and government efficiency. Honduras ranked 133rd in the World Bank's last Ease of Doing Business Index. Entrenched corruption and government red tape further hold back investment opportunities.

Despite such challenges, Honduras has established an innovative framework for providing legal and institutional security to investors interested in leveraging the country's proximity to the United States and access to its market through CAFTA-DR in the form of a unique type of SEZ called ZEDEs. ZEDEs are geographic areas recognized and protected by Honduras's constitution, which provide autonomy for zone administrators to provide public services and efficient arbitration of legal proceedings in a way that helps address investor concerns about inefficiency and lack of predictability in Honduras more broadly.

Adopted in 2013 through an amendment to the Honduran Constitution, ZEDEs have the legal character of special administrative subdivisions of Honduras. Within their borders, ZEDEs are free, to some degree, to adopt custom-tailored taxation systems and legal regimes, albeit subject to oversight by a national committee. Such "tailorability" of the legal and administrative system is a defining attraction of the ZEDEs, enabling them to borrow from other legal systems, such as French, U.S., or Japanese law, in establishing the framework most conducive to the specific types of investment that the zone is attracting and nurturing. ZEDEs do not, however, substitute foreign legal systems for Honduran ones, with the zone remaining subject to Honduran constitutional law.

It is likely that ZEDEs, by contributing to greater rule of law, expediting processes, improving the efficiency of public administration, and otherwise increasing the attractiveness of the investment climate, can serve as an accelerator of nearshoring and friendshoring, attracting more badly needed investment to Honduras. In the process, ZEDEs can also facilitate deployment of the type and requisite volume of private sector capital to strengthen the integration of the Honduran economy with that of the United States, producing positive economic results that not only fortify democracy and political stability in the country and help address the "root causes" of immigration, but also help reduce the government's temptation to change diplomatic relations to the PRC out of economic necessity.

Chinese Advancement through SEZs

Not only are Honduras's ZEDEs an attractive vehicle for bringing more investment and prosperity to countries such as Honduras, and integrating them into a U.S.-oriented, democratic, rule-of-law based economic system, but they are possibly the counterweight to SEZs that the PRC is seeking to establish or leverage throughout the region to advance its own economic interests and influence, with very different implications for the local populations involved.

A key example of China's attempt to use its own concept of SEZs to advance its interests is in El Salvador, which changed relations from Taiwan to the PRC in August 2018. Months before the flip, El Salvador's then-president Sánchez Cerén announced the creation of a group of SEZs around La Unión, where it later emerged that PRC-based investors were interested in building a port, as well as an array of related activities. The SEZ had a number of troubling characteristics, oriented to uniquely benefit PRC-based investors. No company paying taxes in El Salvador could buy into the SEZ, sidelining many U.S. and European companies and leaving the SEZ wide open for Chinese state-owned enterprises. Moreover, the land proposed for the zone comprised a massive 14 percent of the country's territory and nearly half of its coastline. Previously, the PRC had shown interest in infrastructure investments and port concessions in land now encompassed by the SEZ. Worse, the territory was a political stronghold of Sánchez Cerén's FMLN party, with the implication that the FMLN's privileging of Chinese access to the area would be repaid by investments that would benefit the incumbent president's party in upcoming elections, which they otherwise appeared destined to lose (and they did).

The structure of the deal as a quid pro quo also bore an eerie similarity to the ill-fated Hambantota port project in Sri Lanka, where Chinese firms built a new port in a zone dominated by supporters of the ruling party despite an existing port in Colombo. The new Chinese-built port in La Unión, with its own questions of economic viability, could have presented the incoming Salvadoran government with the temptation to turn the new port over to the Chinese to escape from the associated debt, as it did in Sri Lanka. Fortunately, the project was blocked, although talk of developing the area into a multimodal commercial hub remains on the table.

Beyond El Salvador, the PRC has also proposed the construction of SEZs in Costa Rica and Trinidad and Tobago and has also sought to leverage existing SEZ laws for their operations in Panama and elsewhere. In contrast to the transparent, rule-of-law oriented ZEDEs in Honduras, the PRC has generally sought to use such zones to exempt their companies from the local labor laws and other protections. In other words, competing SEZ models reflect more than just economic choices for countries—they are also strategic concerns that have implications for the United States, competition with China, and even recognition of Taiwan.

Competing for the Future

ZEDEs in Honduras are a powerful tool for leveraging the imperatives of nearshoring in a way that benefits the Honduran people and likely strengthens its institutions and democracy over the long term, while giving the country alternatives to the lure of recognizing the PRC and China's more self-serving model of SEZs. Despite the powerful appeal of ZEDEs and their proven track record attracting hundreds of millions in investments, the future of ZEDEs in Honduras is uncertain. ZEDEs have been a political target of the Castro government in part because the autonomy of ZEDEs protect the companies within them from the politics and rent-seeking behavior of Honduran politicians, with a populist discourse characterizing the zones as a type of foreign enclave that undermines Honduran sovereignty.

On April 21, 2022, the Castro government passed a ZEDE repeal bill that sent a strong message to investors about a potential lack of investment security in Honduras. If the Castro government's actions deter future investment in Honduras, as they likely will, it will contribute to a reinforcing spiral of deepening economic crisis and hardship. Further, it could also unleash an array of costly legal battles that will prejudice the reputation of the country as a target for Western investment for years to come. It is also likely that the fallout from these consequences could unleash economic trends that make an eventual turn to the PRC more likely, just as occurred in Nicaragua in December 2021 when the dictatorship of Daniel Ortega and Rosario Murillo knew that it was running out of market-oriented economic options.

Were Honduras to follow a similar trajectory, it would also be a lost opportunity to demonstrate the value of SEZs across the region as vehicles to bring prosperity, strengthen institutionalization and rule of law, address the “root causes” of immigration, and bolster Western, market-oriented democracy as a bulwark against the economic and political distortions wrought by predatory PRC investment.

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