The Rise of Patient Capital: The Political Economy of Chinese Finance in the Western Hemisphere

IIEP China Conference

Going Out: China's Aid, Investment, and Finance to Developing Countries

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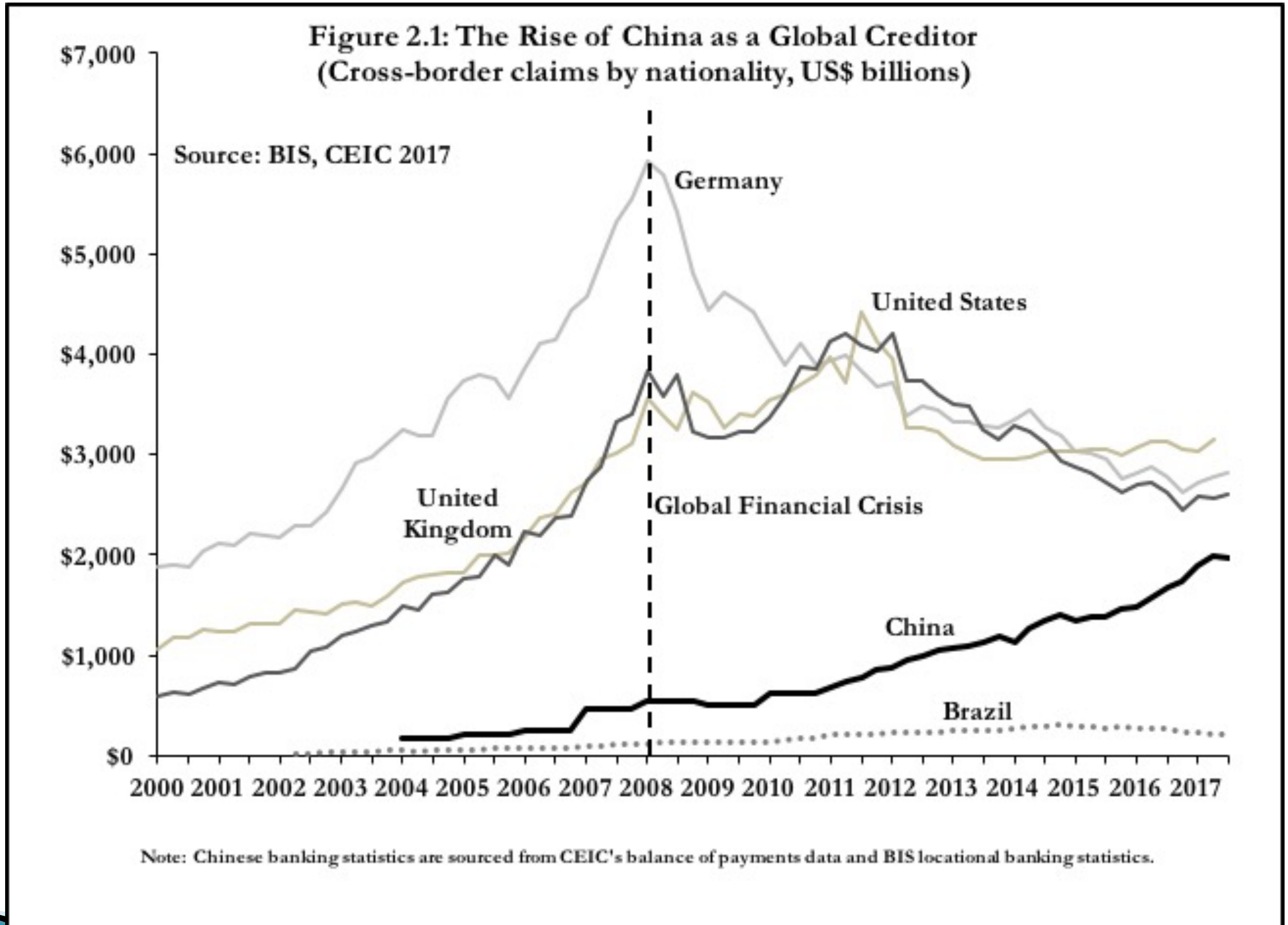
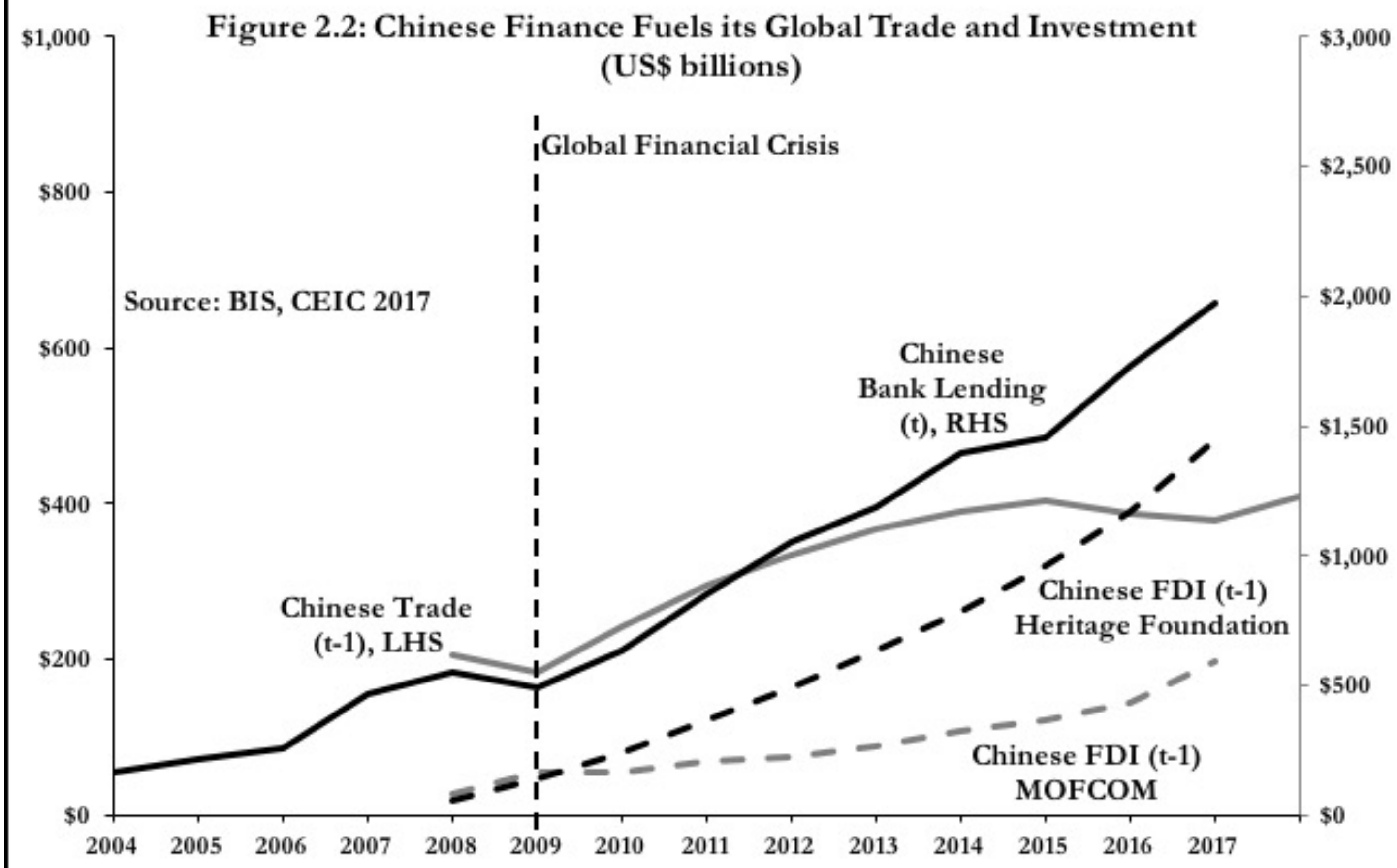
China, an Emerging Global Creditor



Policy Banks Loan Helped Fuel Latin American FDI and Trade



Note: Chinese banking statistics are sourced from CEIC's balance of payments data and BIS locational banking statistics.

Patient Capital's Characteristics

- Non-Conditional Lending
  - Unlike Western stringent policy conditionality:
    - Chinese investors tend not to impose onerous policy conditions.
    - Official doctrine of non-intervention in domestic affairs.
      - Five Principles of Peaceful Coexistence.
    - Financing is instead secured through loans collateralized by:
      - Future commodity deliveries.
      - Guaranteed contracts with Chinese firms or contractors.
      - Commitments to buy Chinese machinery.

How Does China's Patient Capital Compare to Market-Based Credit?

- Long maturity structure
  - Similar to other bilateral lenders, but China is unique in its scale.
  - Average maturity of Chinese loans is 17 years, compared to only 5 years for private creditors.
  - Reflects infrastructure-oriented nature of global financing.

- High risk tolerance
  - Chinese policy bank investors are more likely to stay with their investment through good times and bad.
  - Gaining cheap assets, market share, or improving key logistical skills such as marketing, distribution, and local engineering capabilities are key to promoting internationalization of Chinese firms.
  - Compared to Western finance's emphasis on profitable projects, policy banks are charged with catalyzing finance in "strategic credit spaces," to create economic activity in risky environments.
    - Risk appetite is not limitless, however, as policy banks have become awash in risk in places like Venezuela and Pakistan.

Chinese Growing Share of Latin America's External Financing

Table 1: Chinese Policy Bank Loans to Major Latin American Central Governments (State-to-State Loans)

(Pre- and Post-Crisis Averages: Argentina, Brazil, Bolivia, Ecuador, and Venezuela)

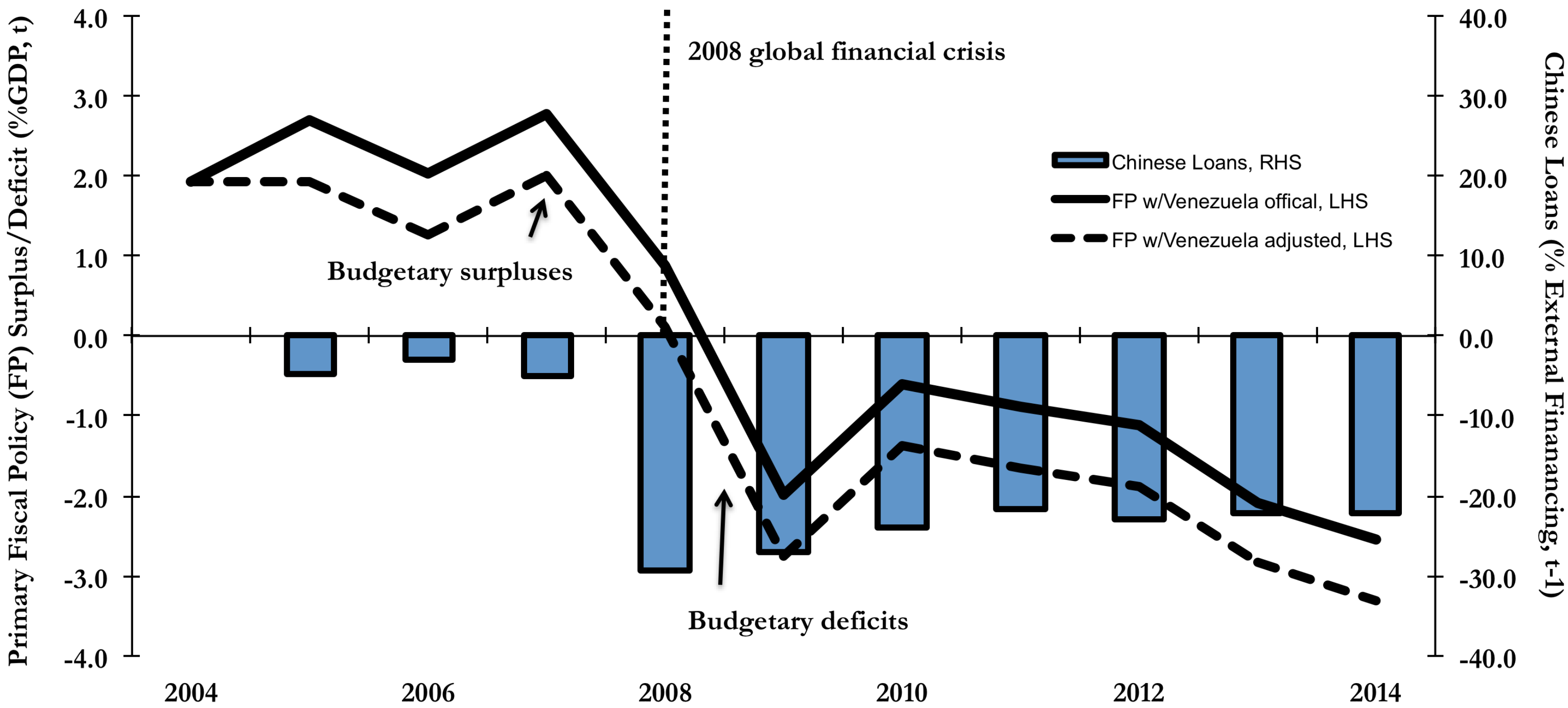
	Total Chinese Loans (US$billion)	Total Chinese Loans (% GDP)	Total Chinese Loans (% External Financing)	Primary Fiscal Deficit (%GDP)	Primary Fiscal Deficit (pp change)
Argentina					
Pre-2008 (t-5)	$0.00	0.00%	0.00%	2.52%	
Post-2008 (t+5)	$8.22	1.49%	12.03%	0.24%	-2.28%
Bolivia					
Pre-2008 (t-5)	$0.00	0.00%	0.00%	1.38%	-0.28%
Post-2008 (t+5)	$0.44	1.75%	6.51%	1.10%	
Brazil					
Pre-2008 (t-5)	$0.00	0.00%	0.00%	2.38%	
Post-2008 (t+5)	$0.89	0.05%	0.51%	1.76%	-0.62%
Ecuador					
Pre-2008 (t-5)	$0.00	0.00%	0.00%	1.35%	
Post-2008 (t+5)	$2.82	3.23%	26.37%	-2.12%	-3.47%
Venezuela					
Pre-2008 (t-5)	$1.33	0.52%	4.69%	1.24%	
Post-2008 (t+5)	$19.19	5.32%	45.12%	-4.05%	-5.29%

Note$_1$: *Central government debt calculations do not include state-owned enterprises (SOEs). These funds, however, may be indirectly transferred to the central government, at which point they are calculated in our debt estimations. For example, the joint China-Venezuelan Fund (FCCV) includes concurrent investments from the Venezuelan government's development fund, FONDEN, which receives transfers from state-owned oil company PDVSA. Data is collected from a variety of sources, including central governments debt statistics from regional finance and planning ministries, U.S. SEC filings of foreign governments, investment bank reports, CEIC Data, MOFCOMM, AidData, and Inter-American Dialogue's China-Latin American Database.*

Note$_2$: *In Brazil, transactions involving PréSal Petróleo (PPSA) are classified as state-to-state in light of the 2010 law that created a social fund to funnel pre-salt proceeds to social spending.*

Patient Capital Enhances Policy Flexibility

Figure 1: Chinese State-to-State Loans and Latin American Fiscal Policies (2004-2014, Argentina, Ecuador, and Venezuela)



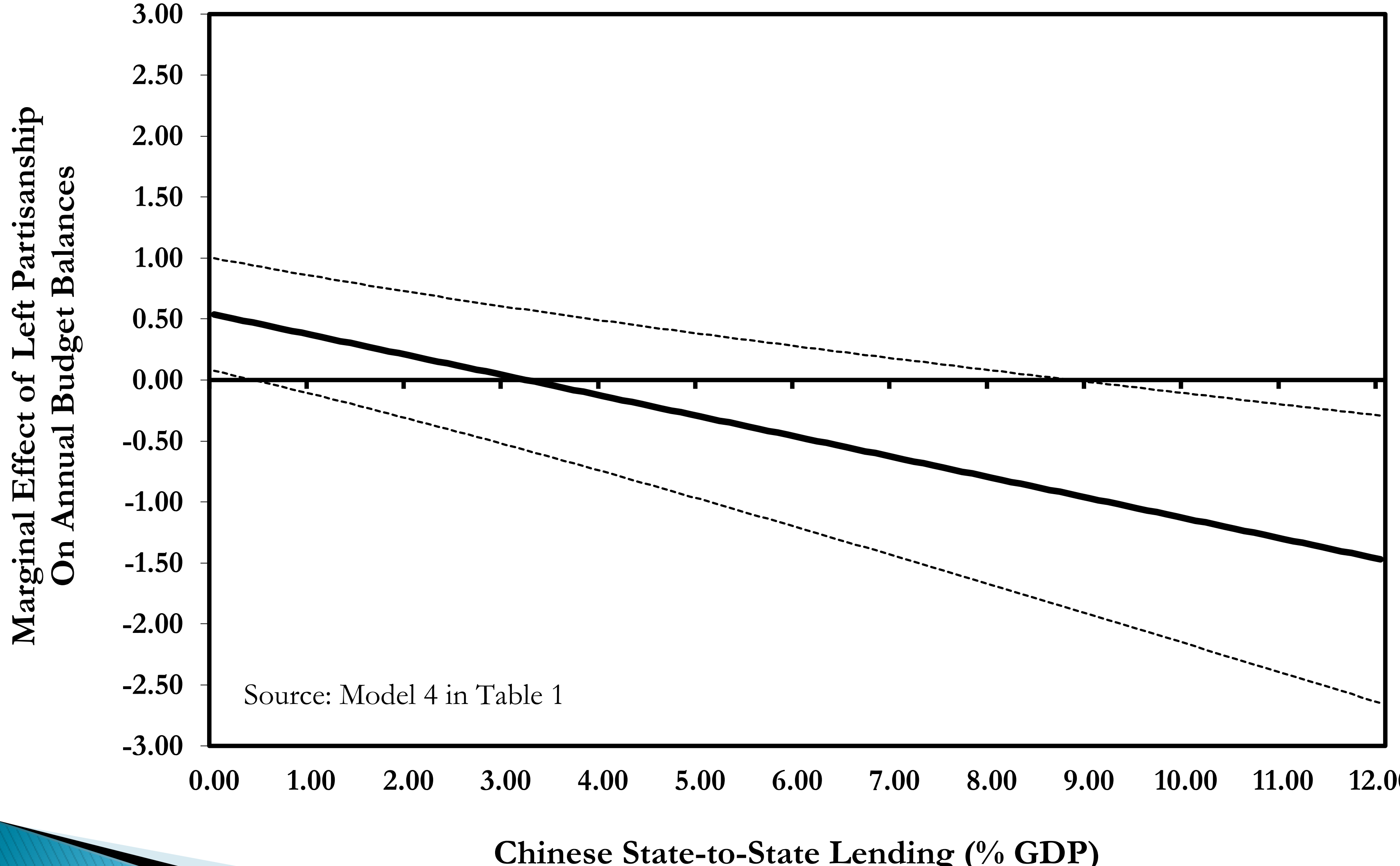
Chinese State-to-State Lending Delivers Greater Fiscal Latitude

(17 Latin American countries, 1990-2015)

Dependent Variable:	Primary Budget Balances (FE) *Basic Model*	Primary Budget Balances (FE) *Conditional Model*
Independent Variable		
Chinese Bilateral Loans	-0.131***	-0.137***
	(0.044)	(0.040)
Partisanship	0.583*	0.537*
	(0.299)	(0.281)
Chinese Loans * Partisanship		-0.167***
		(0.051)
Global Growth	0.212**	0.265***
	(0.085)	(0.093)

*p<.1; ** p<.05; *** p<.01 (two tailed tests)

Figure 1: Marginal Effect of Partisanship on Latin American Budget Balances



Latin America's Debtor Perspective

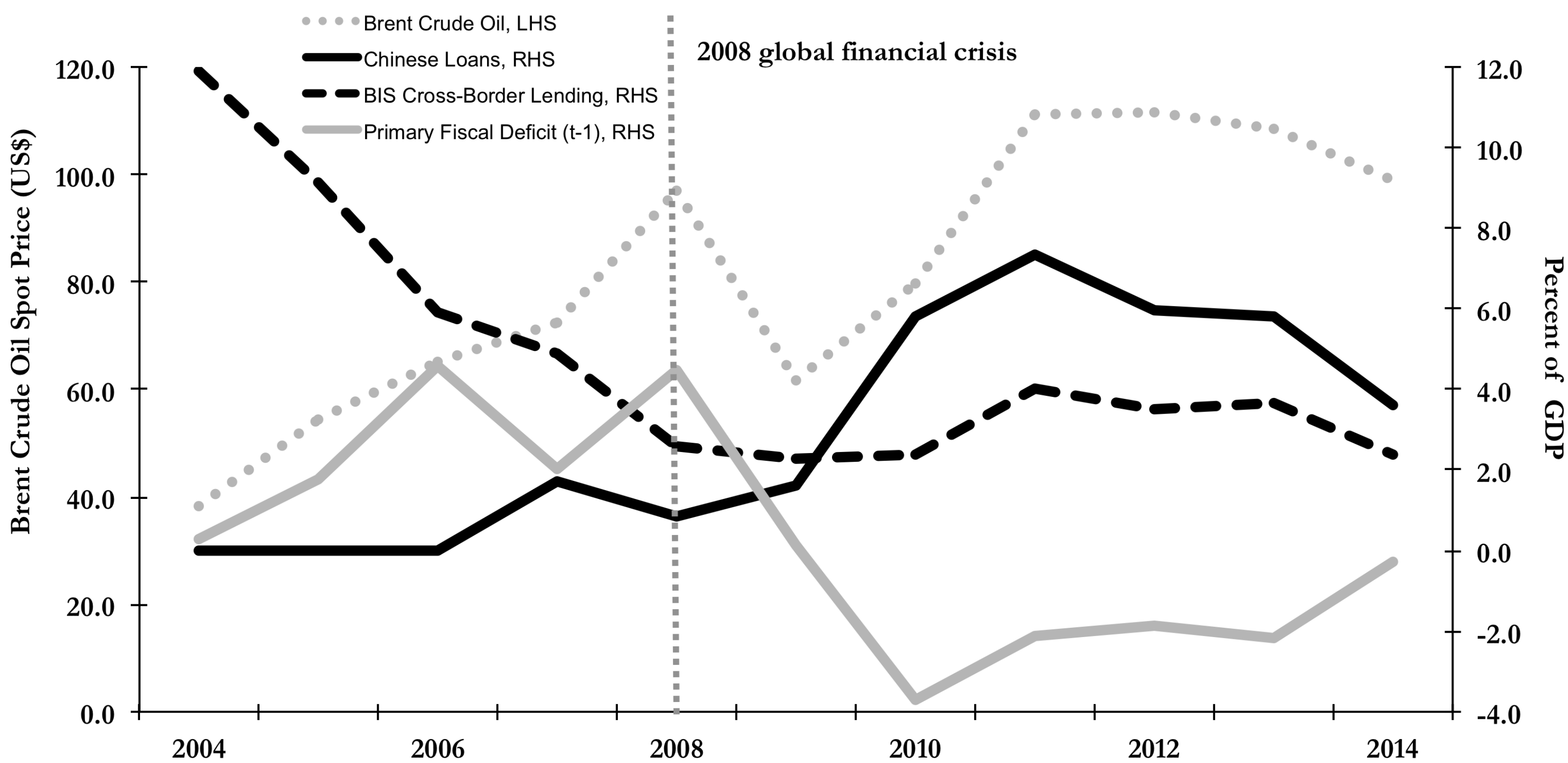
- Benefits
  - *Long-term financing* better aligns with region's development horizon.
  - Addresses the region's *infrastructure deficit*. Investment was a mere 0.6 percent of GDP in the 2000s compared to 3 percent rates in the 1980s.
    - Chinese policy banks have primarily targeted the energy sector; the onus is on Latin America to identify railway, highway, port, and airport projects.
- Costs
  - *Commercial conditionality* – loans are tied to Chinese firms, products, and machinery.
    - Latin America must negotiate to increase its share of local content.
  - *Middle income trap* – industrial upgrading is a key feature of China's LA development plan, but only 1/10th of Chinese FDI has been destined for LA manufacturing sector; 2/3 of the investment has gone to Brazil.
    - How does LA compete when its labor costs are higher than Africa and S.E. Asia?

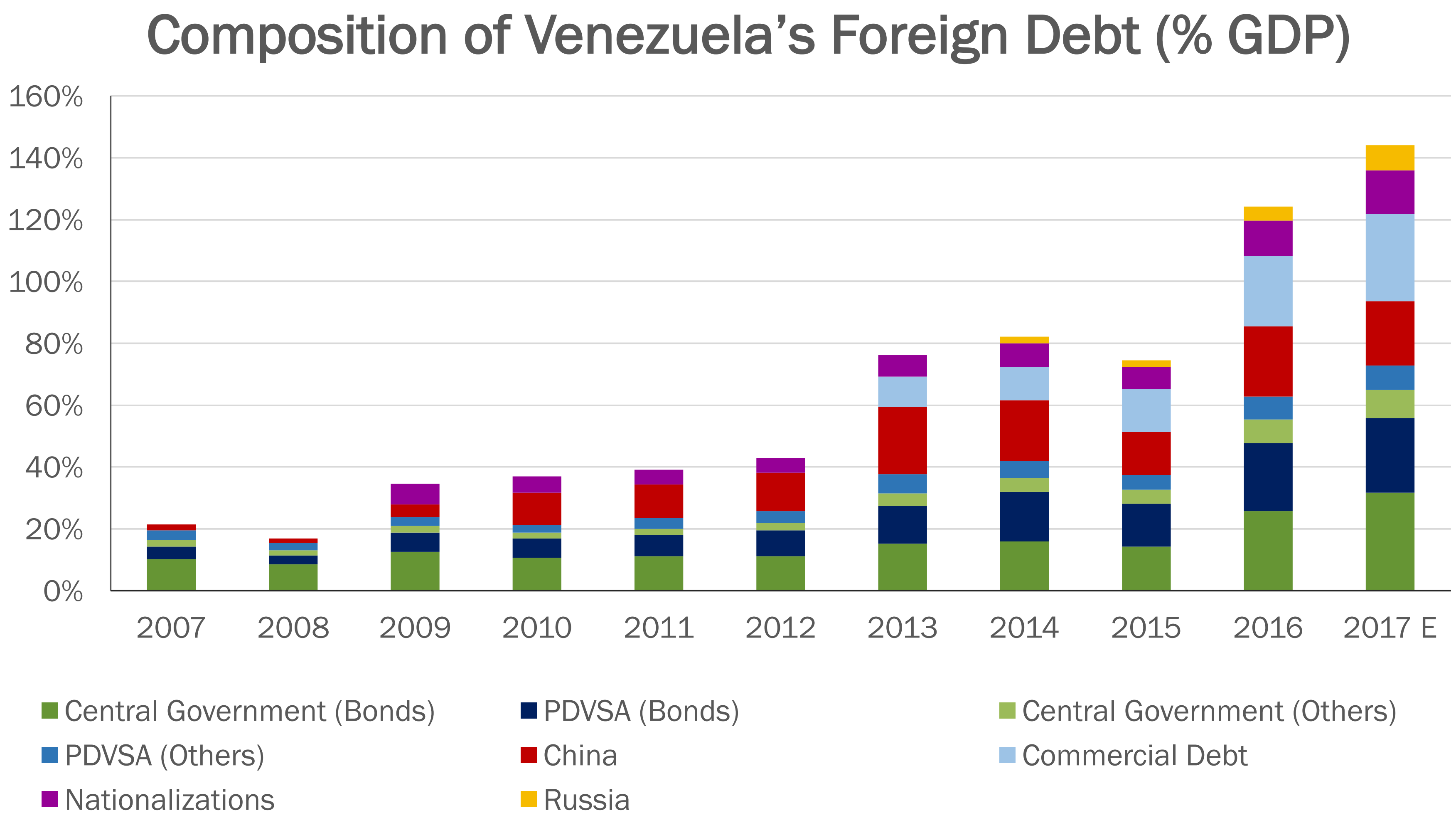
Latin America's Debtor Perspective

- Costs
  - *Indebtedness*: lack of policy conditionality creates a moral hazard problem.
    - Venezuela – After receiving China's state-to-state financing for more than a decade, Venezuela avoided the austerity that would have typically come with first the global financial crisis, and then the 2014 commodity downturn.
    - The country is now struggling to repay its outstanding Chinese debts (totaling $17-$20 billion) amid its historic crisis and dwindling state-oil production (nearing 1 million barrels per day; less than half of 2013 output).
    - Current sanctions impeding creditors from refinancing Venezuela's debt, the government lacks new financing options.
      - This means it will be difficult for Venezuela to pay the more than $10 billion in foreign debt obligations coming due this year — equivalent to the country's reserves. Its arrears reportedly total as much as $6 billion.
    - China has been lending defensively, renegotiated terms of old loans and reportedly rolling-over $5 billion in Venezuelan lending in September, but its balked at being a lender of last resort.
      - Policy banks might need their balance sheet reserves to help address domestic financial pressures back home.

Venezuela's Financing Shift and Fiscal Policy

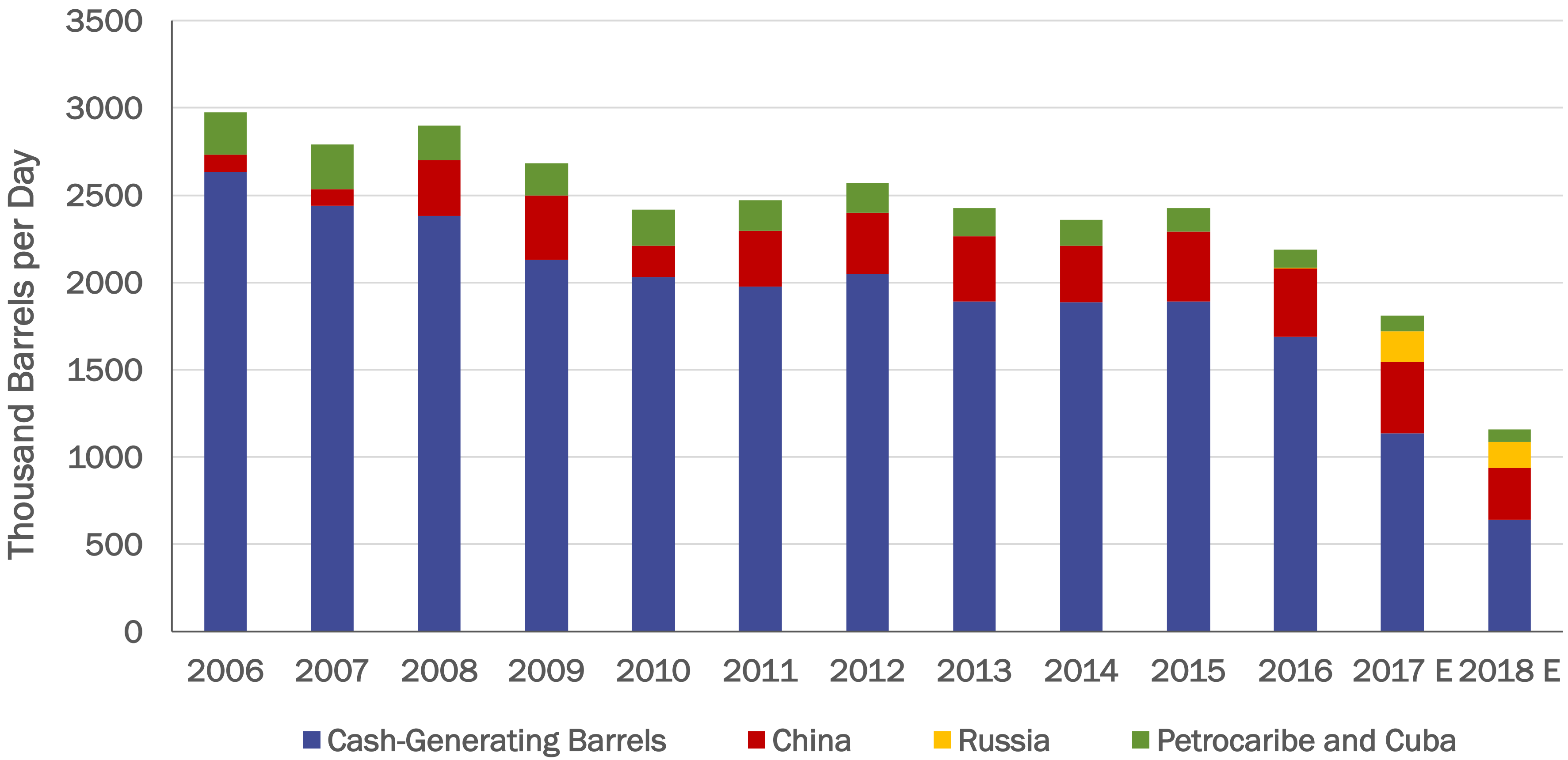
Figure 2: Oil Prices, Public Financing, and Fiscal Policy in Venezuela (2004-2014)





Source: Penfold 2018; The Dialogue, BCV, ONCP, IMF.

PDVSA's Cash Flow in Exported Barrels Per Day



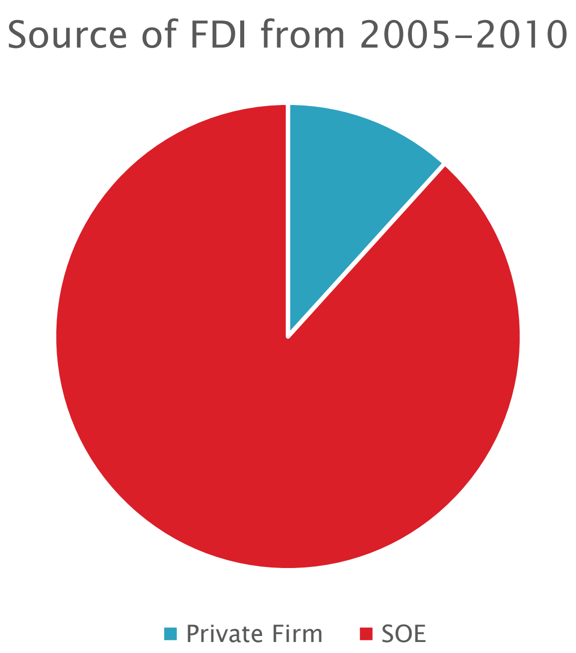
Source: Penfold 2018; PDVSA, EIA, OPEC, ITC.

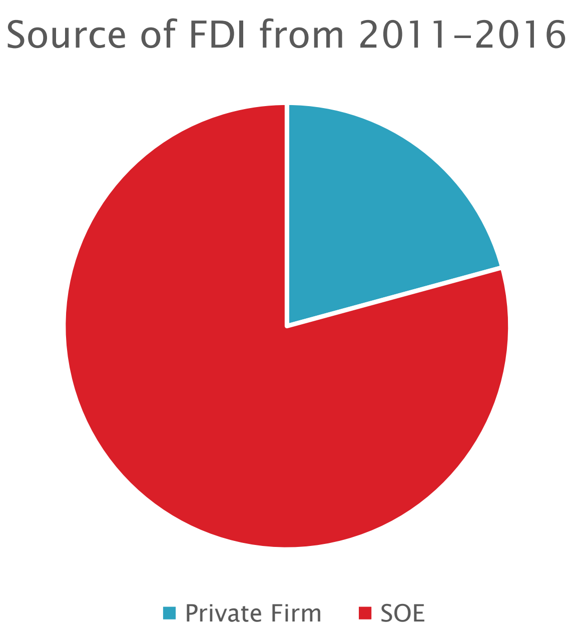
China's Creditor Perspective:
How Ensure Good Outcomes without Conditionality?

- How ensure prudent governance that leads to successful investments, given non-intervention principle?
  - Administrative guidance, monitoring, and state-to-state diplomacy aimed at ensuring success on commercial project level.
- Sustained expansion of government debt in heavy industry and infrastructure yielded high growth, but also non-performing loans.
  - Compared to low yielding U.S. Treasury investments, investing in project finance globally has a higher return. From a portfolio perspective, China can absorb some bad loans.
  - But, it's easier to administratively control local governments domestically, than national governments internationally.
  - What does China do when it misprices investment risk repeatedly in places like Venezuela, Indonesia, and Sri Lanka?

China's Diversified Strategy

- The private sector is accounting for a larger share of FDI to Latin America.





China's Diversified Strategy

- China is also altering its investment channel to have more of a market-governance character in the wake of the 2014 commodity downturn.
  - China is increasingly using equity rather than debt financing.
  - Diversifying exposure away from sovereign government to firm level.
  - State-backed equity funds now directly invest in manufacturing, logistics, agriculture, and even technology.
    - $45 billion in Latin America funds; $55 billion in Silk Road Fund.
- Moving toward multilateralism.
  - Acquiring new investment partners, including Chinese commercial banks, multilateral institutions (i.e. World Bank,IDB), and local development banks to share investment burden.
  - Asian Infrastructure Investment Bank (AIIB), operating with private procurement through international bidding.
    - 70% of projects reportedly jointly financed with World Bank.

China's Diversified Strategy

- Chinese loans are commercial, more than geopolitical in Latin America.
  - Three-quarters of Latin American policy bank loans have targeted energy sector, which has an electric generation capacity that's better than Emerging Asia or Africa.
  - 80 percent of policy bank loans during the past two years went to centrist / center-right governments in Argentina, Brazil, and Peru. These are also not autocracies!
  - Growing presence of Chinese commercial banks in Latin America.
- Growing role of Western sovereign risk metrics.
  - Sovereign risk analysis increasingly in places like *Sinosure* are using Western tools to evaluate sovereign risk.
  - Increasingly China is investing in market-oriented economies like Brazil, Colombia, Chile, Argentina, Mexico, and Peru.

"The old saying holds. Owe your banker one thousand pounds and you are at his mercy; owe him 1 million pounds and the position is reversed."

–John Maynard Keynes