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

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Going Out: China’s Aid, Investment, and Finance to Developing Countries
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China, an Emerging Global Creditor

Figure 2.1: The Rise of China as a Global Creditor (Cross-border claims by nationality, US$ billions)

Source: BIS, CEIC 2017

Note: Chinese banking statistics are sourced from CEIC's balance of payments data and BIS locational banking statistics.
Policy Banks Loan Helped Fuel Latin American FDI and Trade

Figure 2.2: Chinese Finance Fuels its Global Trade and Investment (US$ billions)

Global Financial Crisis

Source: BIS, CEIC 2017

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

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

**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)

<table>
<thead>
<tr>
<th>Dependent Variable:</th>
<th>Primary Budget Balances (FE)</th>
<th>Primary Budget Balances (FE)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Basic Model</td>
<td>Conditional Model</td>
</tr>
<tr>
<td>Independent Variable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chinese Bilateral Loans</td>
<td>-0.131*** (0.044)</td>
<td>-0.137*** (0.040)</td>
</tr>
<tr>
<td>Partisanship</td>
<td>0.583* (0.299)</td>
<td>0.537* (0.281)</td>
</tr>
<tr>
<td>Chinese Loans * Partisanship</td>
<td>-0.167*** (0.051)</td>
<td></td>
</tr>
<tr>
<td>Global Growth</td>
<td>0.212** (0.085)</td>
<td>0.265*** (0.093)</td>
</tr>
</tbody>
</table>

*p<.1; ** p<.05; *** p<.01 (two tailed tests)
Figure 1: Marginal Effect of Partisanship on Latin American Budget Balances

Source: Model 4 in Table 1
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)

- Brent Crude Oil, LHS
- Chinese Loans, RHS
- BIS Cross-Border Lending, RHS
- Primary Fiscal Deficit (t-1), RHS

2008 global financial crisis
Composition of Venezuela’s Foreign Debt (% GDP)

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.
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