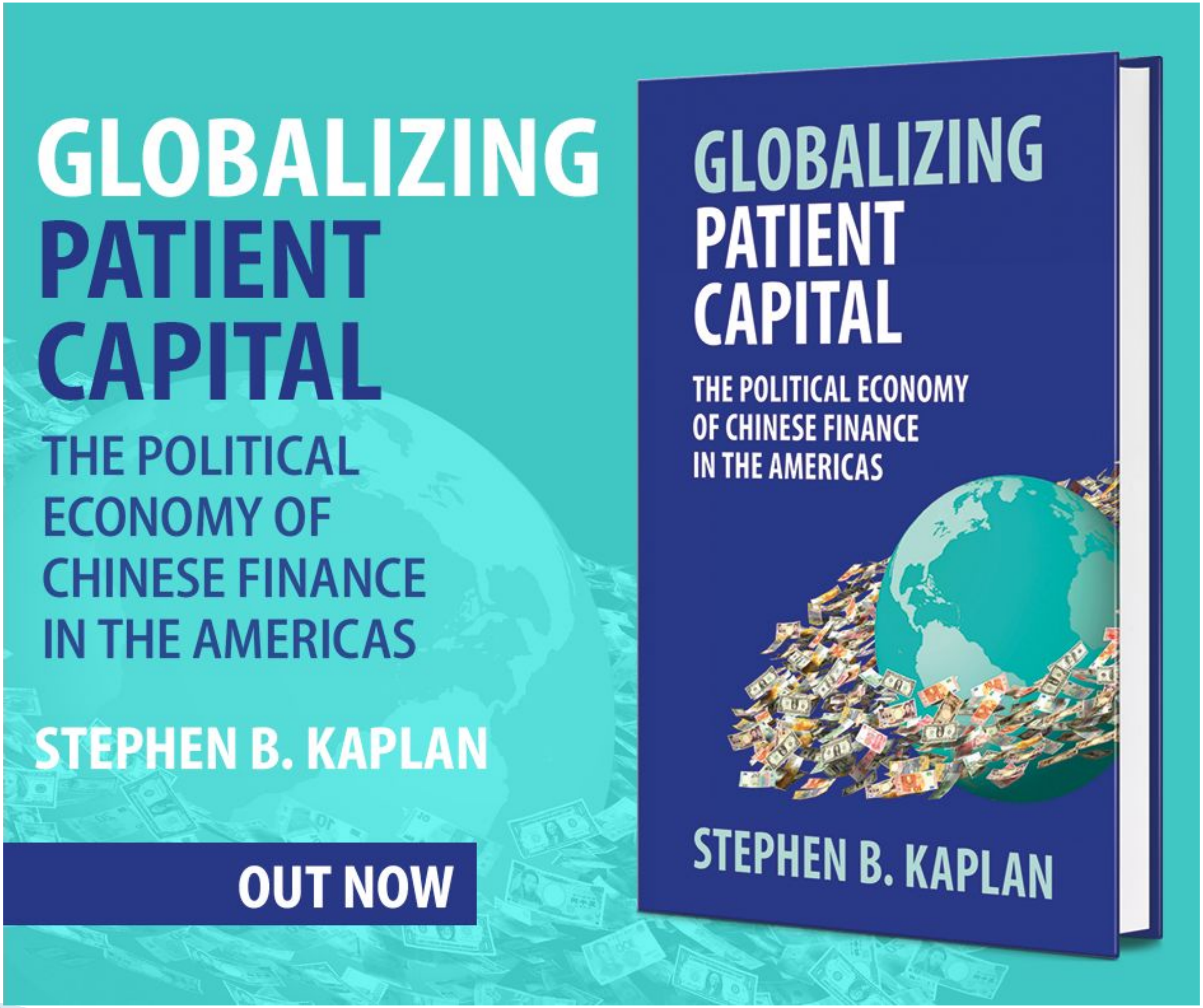
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Globalizing Patient Capital: The Political Economy of Chinese Finance in the Americas

Ciclo de Conferencias del China-Mexico
Universidad Nacional Autonomía de Mexico (UNAM)

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September 21, 2022

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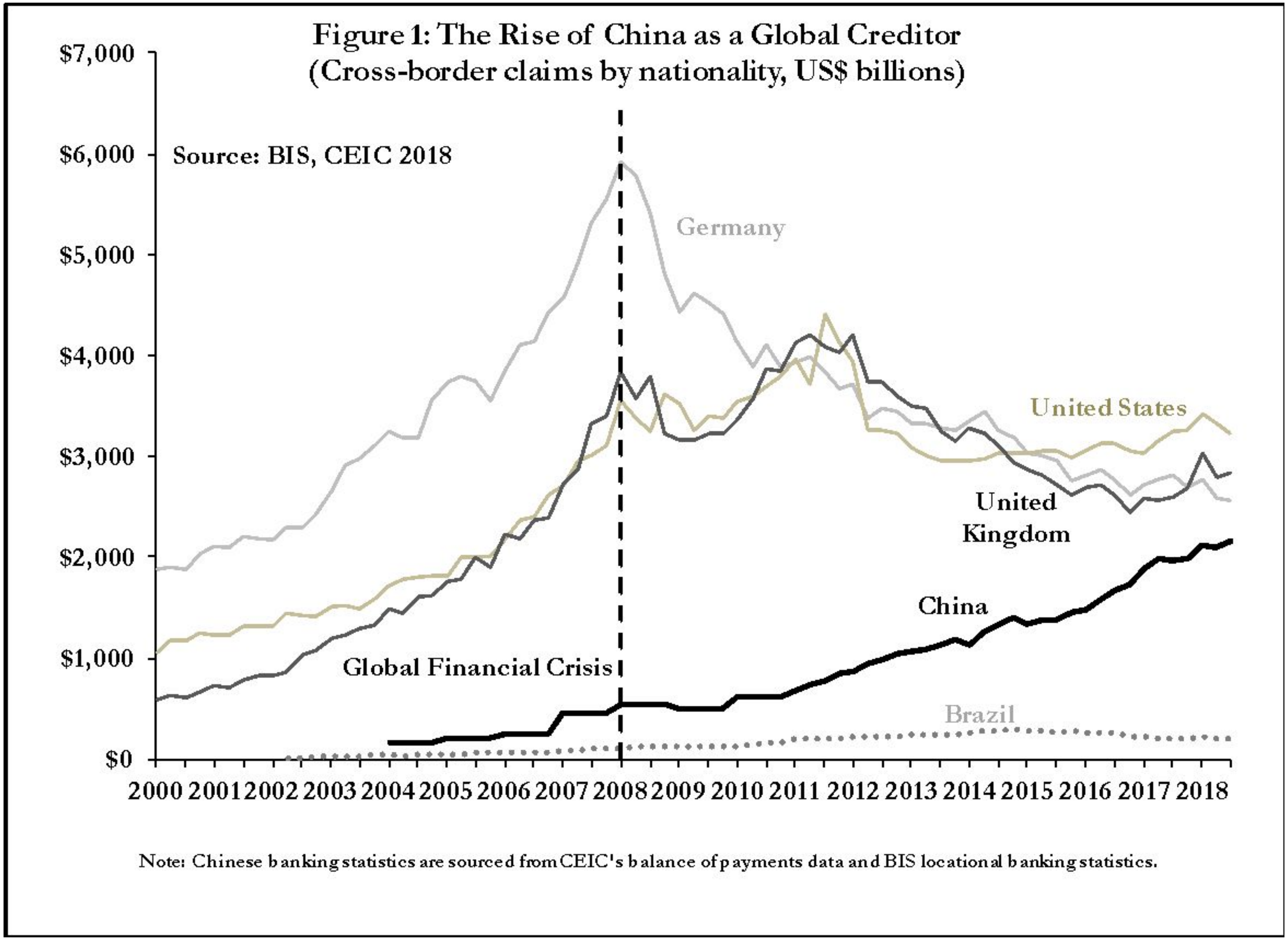
China, an Emerging Global Creditor



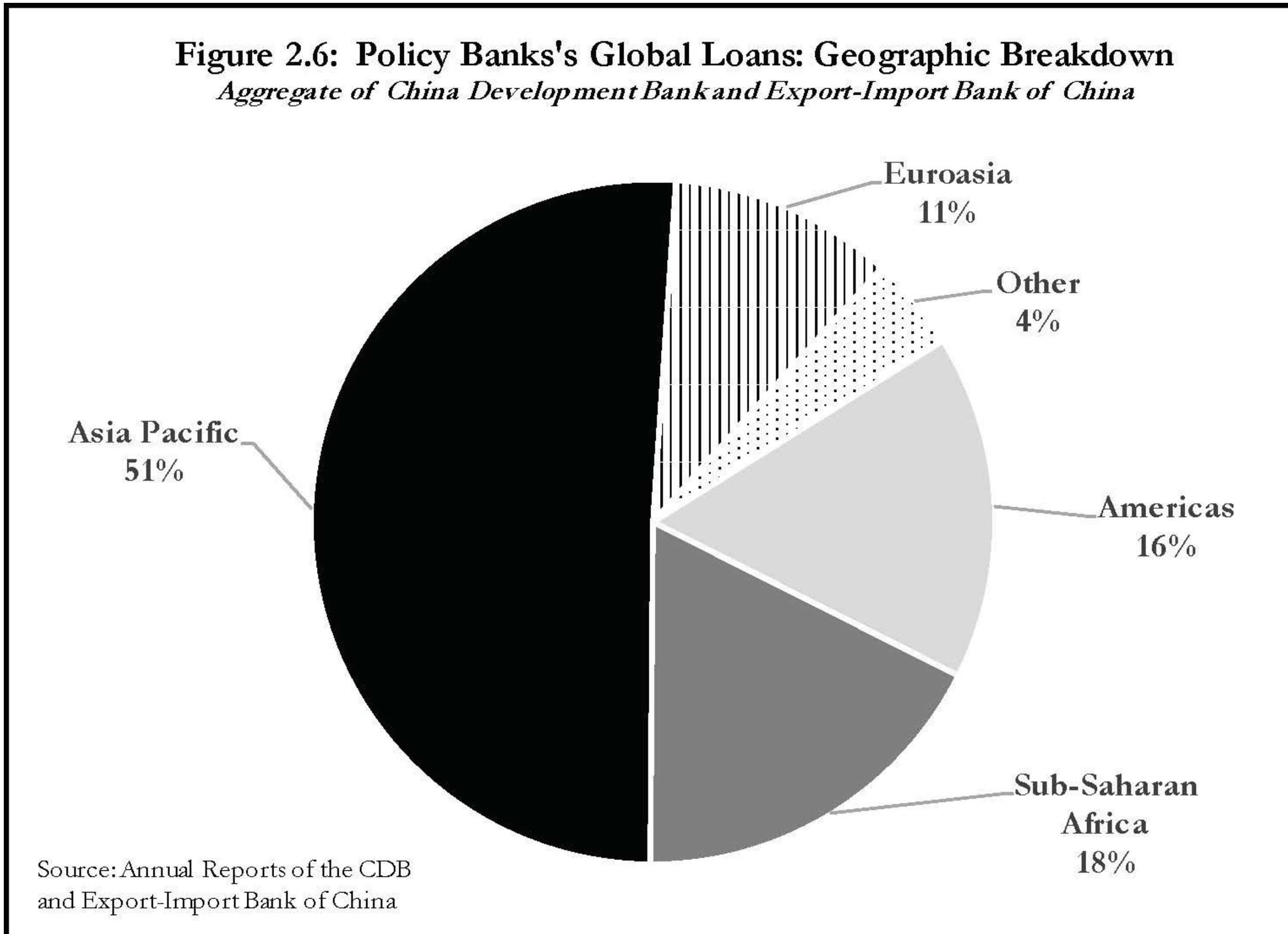
China's 19th National Communist Party Congress

- President Xi Jinping boldly promised to make China a "leading world power" by 2050.

- "Blazing a new trail for other developing countries to achieve modernization…"

- China "offers a **new option** for other countries who want to speed up their development while preserving their independence."

China's Policy Banks: Global Loans, Geographic Breakdown



Theoretical Framework

- How much room do states have to maneuver under financial globalization?
  - *Mosley 2000, 2003; Wibbels 2006; Kaplan 2013; Brooks, Cunha and Mosley 2015.*

- *Mundell-Fleming Trilemma*: In a world of global capital mobility, governments face a trade-off between national macroeconomic policy autonomy and exchange rate stability.
  - Frieden 1991; Helleiner 1996; McNamara 1998; Broz and Frieden 2001.

- *Key assumption*: capital is private and would thus exit countries when faced with financial instability and currency depreciation that erodes profits.
  - Capital's exit threat would compel government to raise interest rates and constrain fiscal expenditures to re-attract investment.

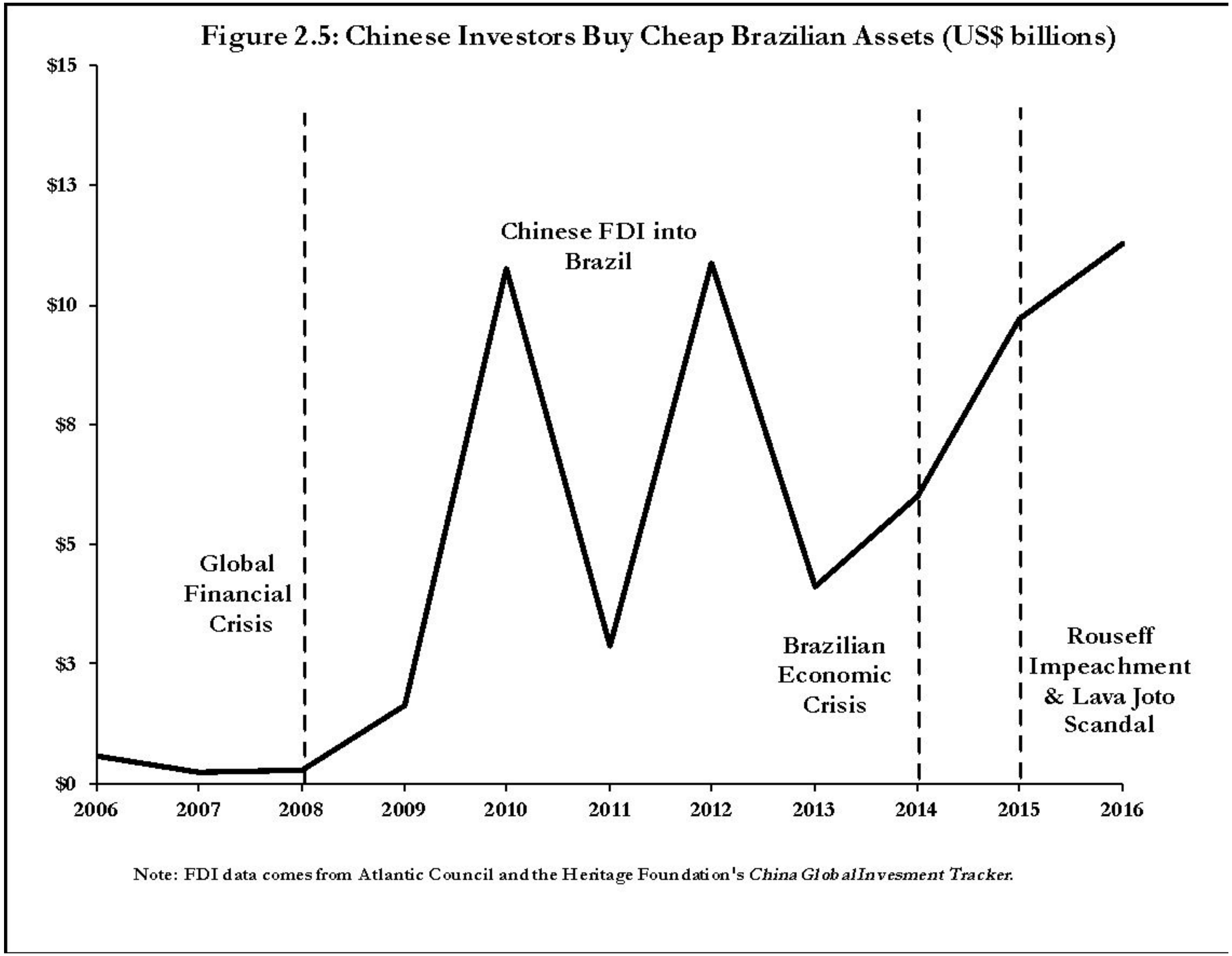
- China's *patient capital* has changed the basis of the trilemma by eliminating the capital exit threat/allowing for greater policy maneuverability.
  - Capital controls limit overseas private investment; restricts ability of residents to invest in financial assets overseas; minimum short-run financial connections between China and the rest of the world.

China's Patient Capital: How Does It 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.

China's Patient Capital



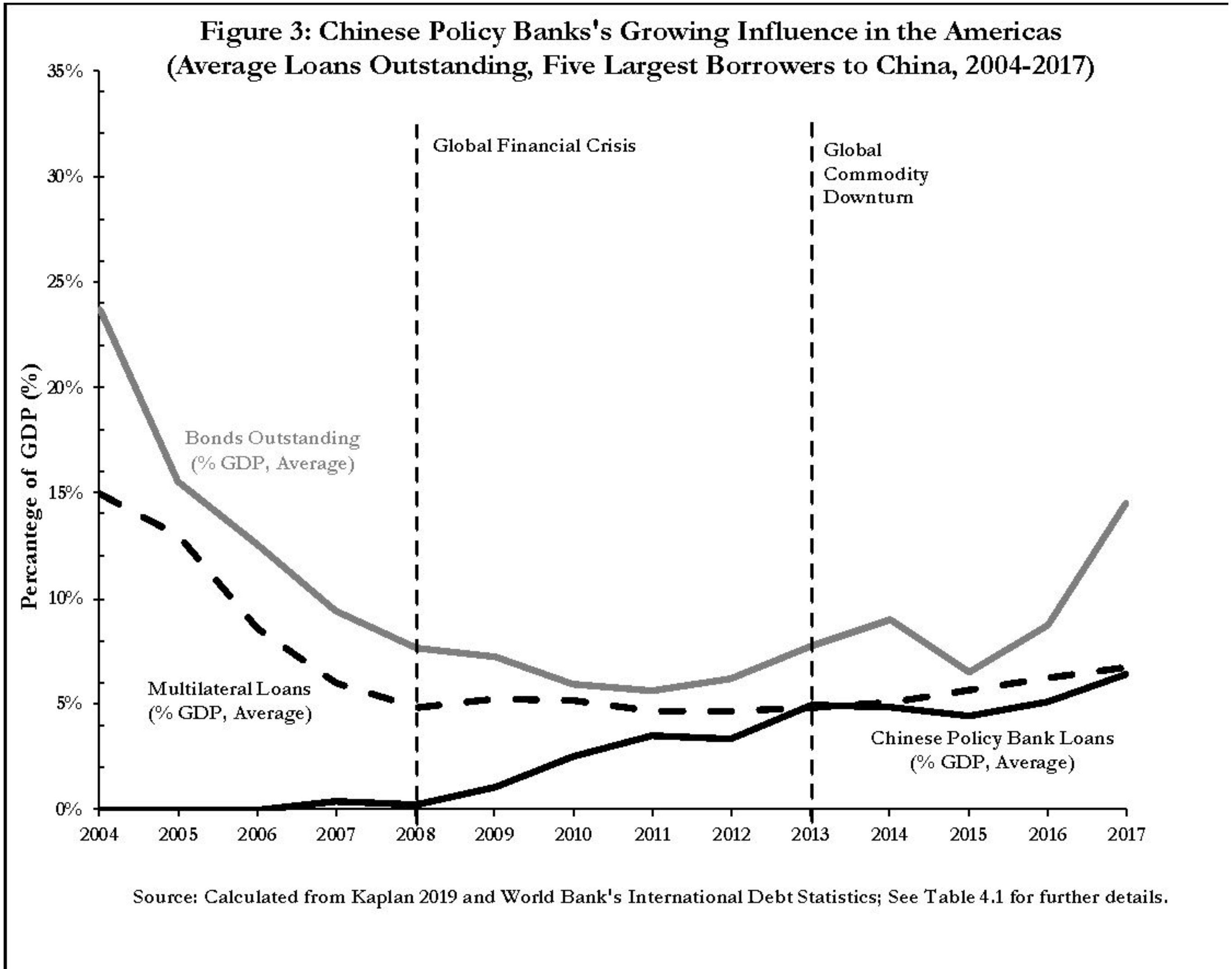
China's Patient Capital: Commercial vs. Policy Conditionality

- Non-conditional lending?

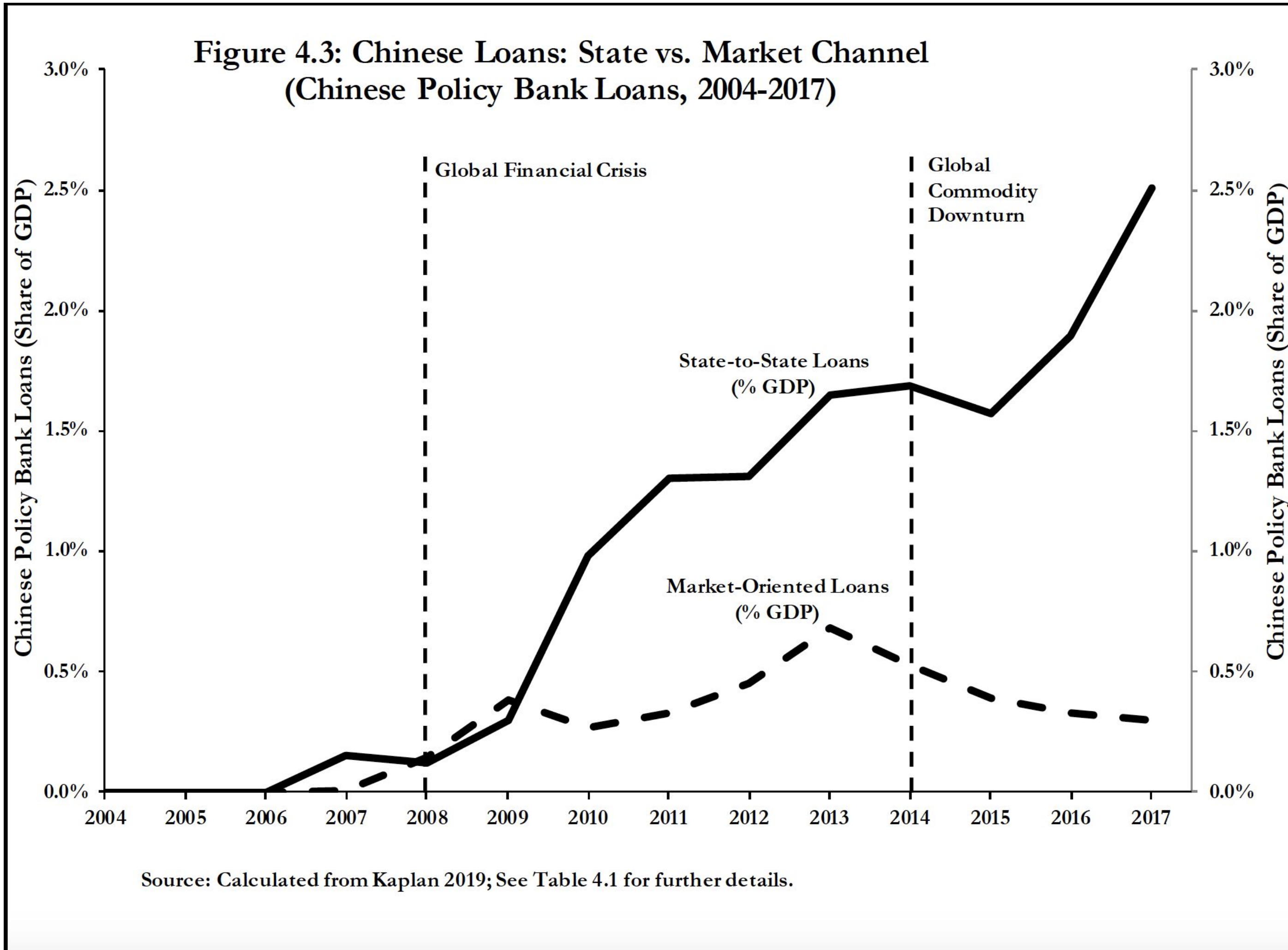
  - Unlike Western stringent policy conditionality:
    - Chinese investors tend not to impose onerous policy conditions.
    - Official doctrine of non-intervention in domestic affairs.
      - Five Principles of Peaceful Coexistence.
    - Aimed at market maximization rather than profit maximization.

  - Commercial conditionality: financing is instead secured through loans collateralized by:
      - Less transparency, what's in the "fine print"?
      - Future commodity deliveries.
      - Guaranteed contracts with Chinese firms, contractors, or suppliers.
      - Commitments to buy Chinese machinery.

Latin America's Shifting Debt Composition



State-to-State vs. Market Channel



Investment Channel: A Tale of Two Projects

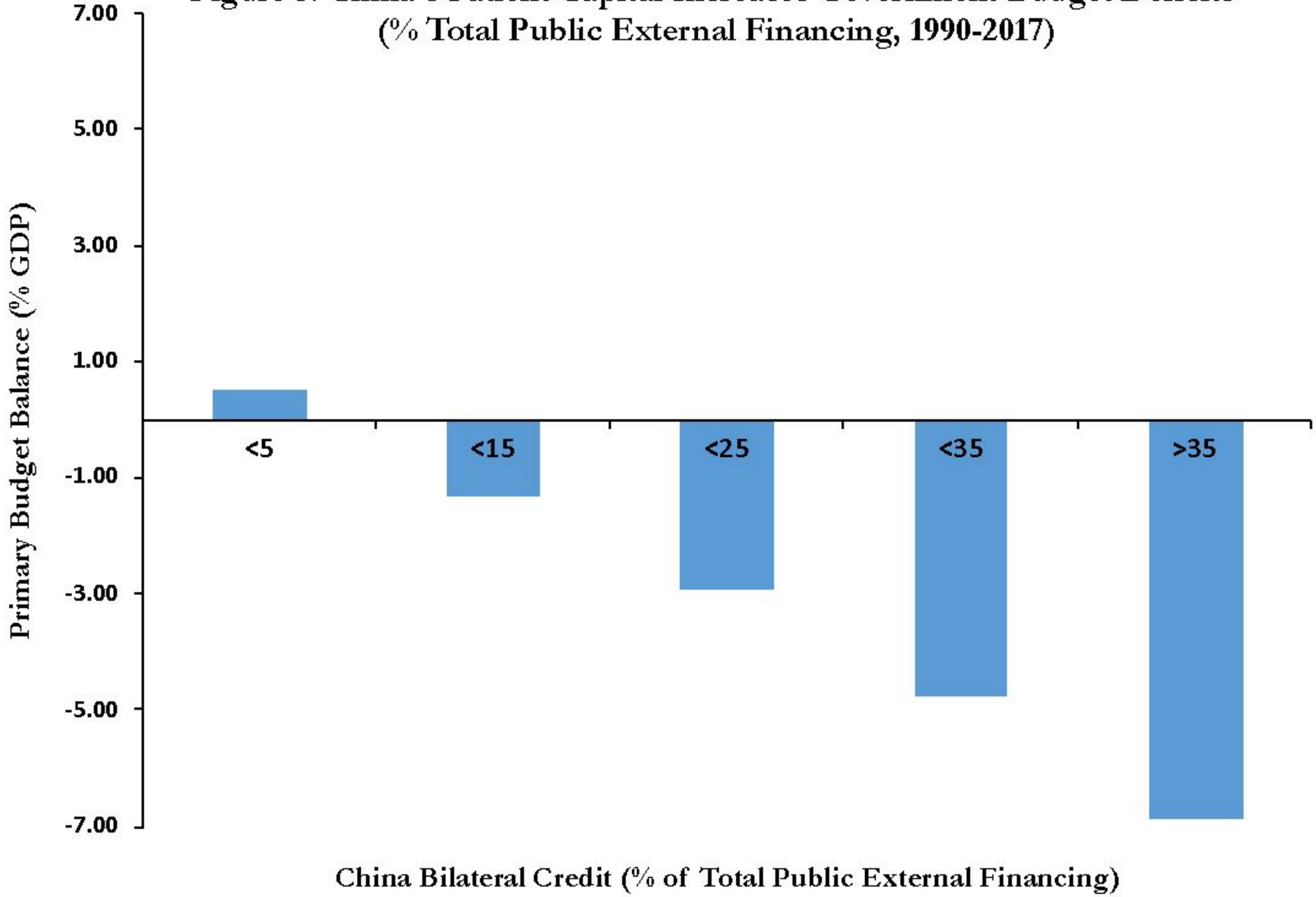
State-to-State Channel - Hydropower Stations, Santa Cruz, Argentina

- Project terms: Direct contracting with Chinese banks if concessional (Article V of Law 27)
- State indebtedness: Argentina provides a state guarantee of the loan.
  - 23 percent of loan paid for Chinese machinery /equipment (e.g turbines)
  - 77 percent funneled paid for fungible civil works projects; spending discretion.
- Transparency: Suspended under Supreme Court legal ruling because of environmental concerns; eventually reduced number of turbines and generating capacity.

Private Procurement Channel – Cauchari Solar Park in Jujuy, Argentina

- Project terms: Privately managed auction system, called RenovAr; Shanghai Electric Power Construction won the bid for the $390 million solar park.
- State indebtedness: Loan flows directly to corporate enterprises with winning bid rather than through Argentine government, leaving little room for spending discretion.
  - China Exim Bank's preferential export buyer's credit - Chinese machinery / equipment
- Transparency: Compelled local community consent, received training to work in plant construction and operations, and participated in the profits (Provincial Law, 5915).

Figure 5: China's Patient Capital Increases Government Budget Deficits
(% Total Public External Financing, 1990-2017)

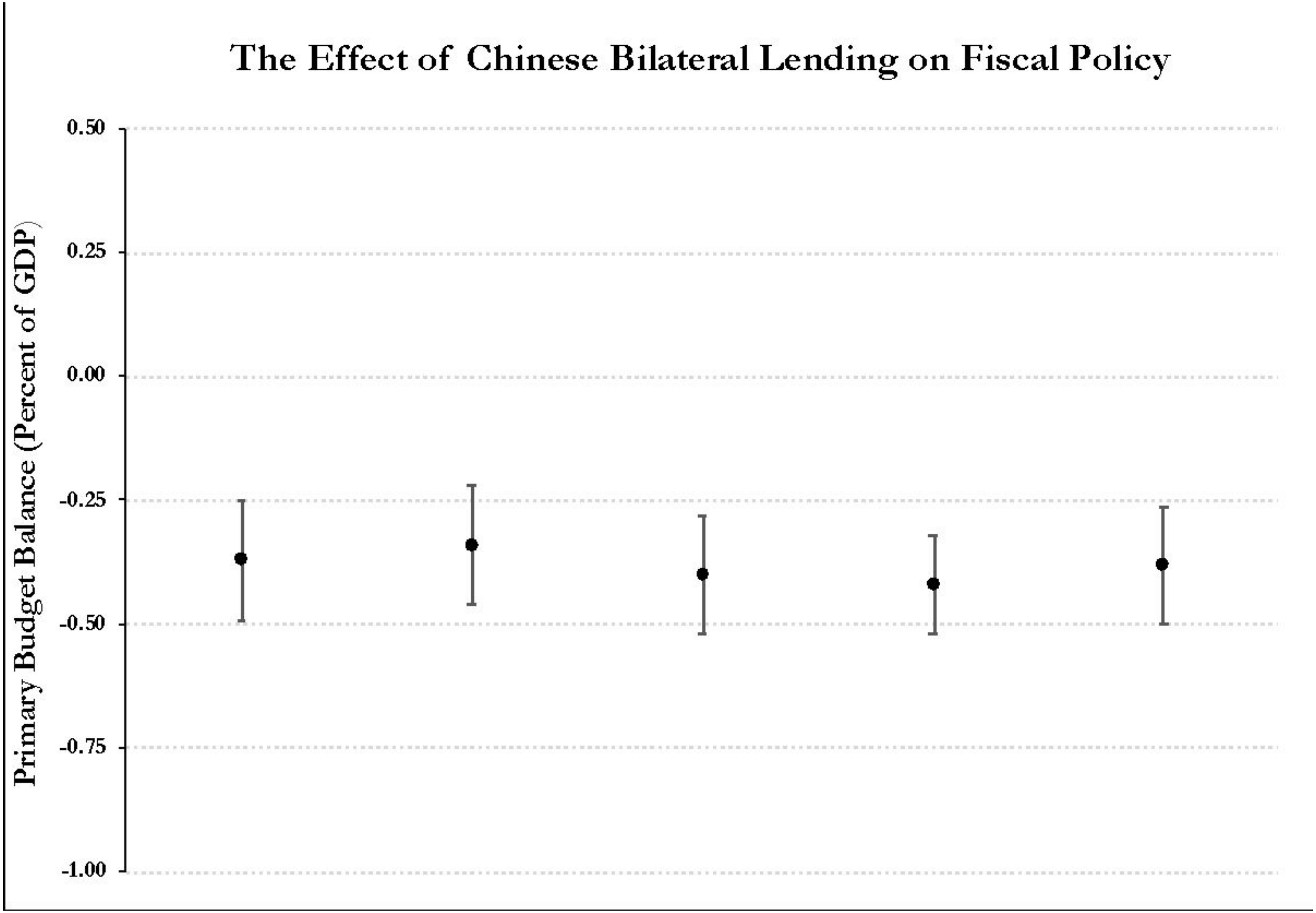


Source: Kaplan 2019, ; using fiscal and debt indicators from CEPAL and the World Bank.

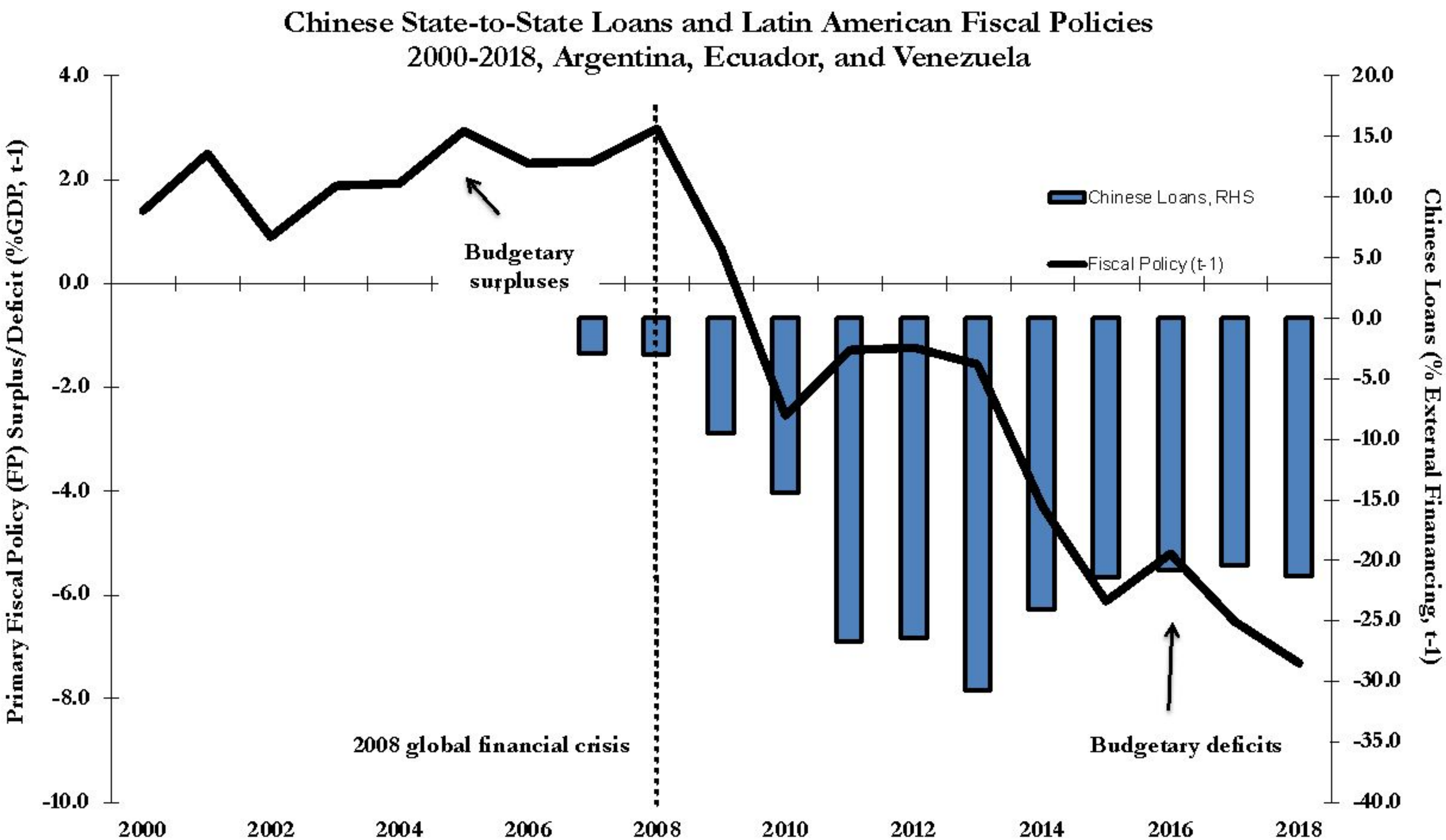
Patient vs. Impatient Capital

Table 4.1: The Effect of External Financing on Fiscal Latitude

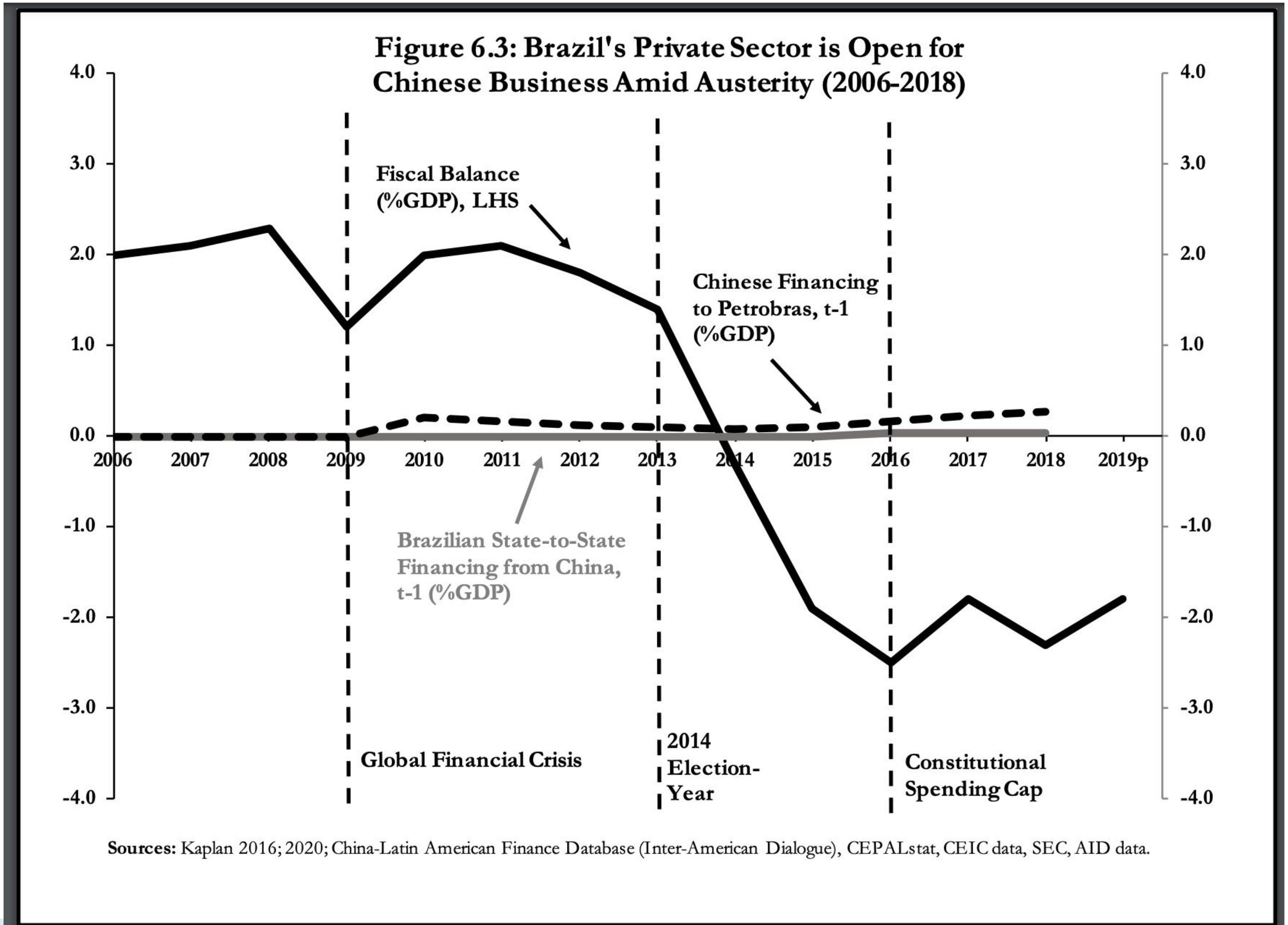
	(1) FE	(2) FE	(3) FE	(4) FE	(5) FE	(6) FE
Chinese StS / Debt	-0.029*** (0.010)					
Chinese StS / GDP		-0.138** (0.055)				
Bonds / Debt			0.016*** (0.005)			
Bonds / GDP				0.023* (0.011)		
Multilateral Loans / Debt					0.030* (0.017)	
Multilateral Loans / GDP						0.019** (0.008)


The Effect of Chinese Bilateral Lending on Fiscal Policy
Primary Budget Balance (Percent of GDP)
0.50
0.25
0.00
-0.25
-0.50
-0.75
-1.00

Patient Capital Enhances Policy Flexibility



The Null Case: Brazil Targets Fiscal Discipline



Commercial Conditionality

1. Tools for Promoting Chinese Commerce

- Bilateral Tied-aid
- Chinese Foreign Content
- Commercial Interest Rates
- Currency Promotion

2. Tools for Managing Sovereign Risk

- Administrative Channels
- Commodity Guarantees: Commodity-backed Loans
- Cross-default Clauses
- State-backed Commercial Insurance

Cross-Default Clause

ANEXO I

FOLIO 3197

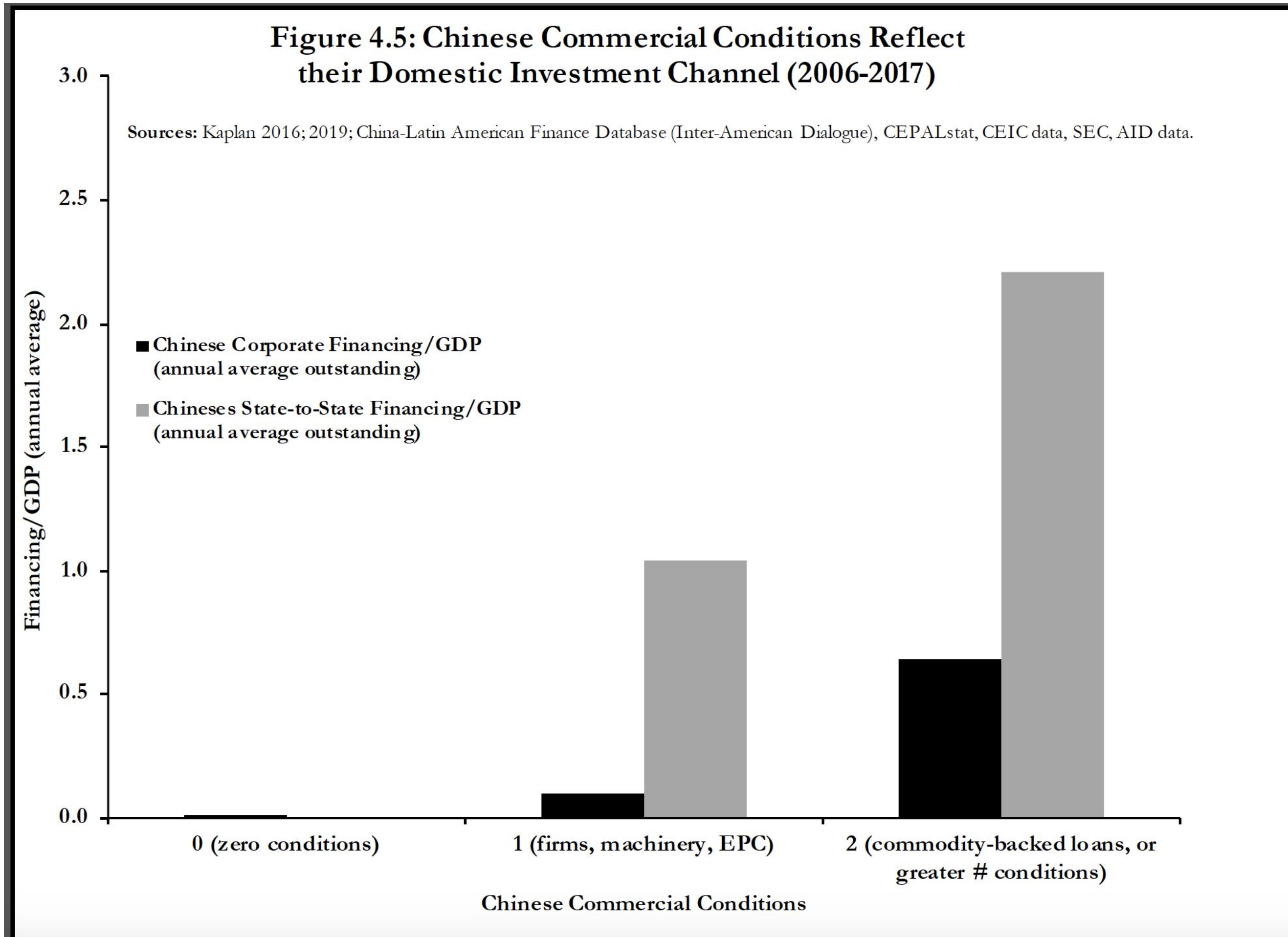
under or in connection with any Finance Document is or proves to have been incorrect or misleading in any material respect when made or deemed to be made.

21.4 **Cross default**

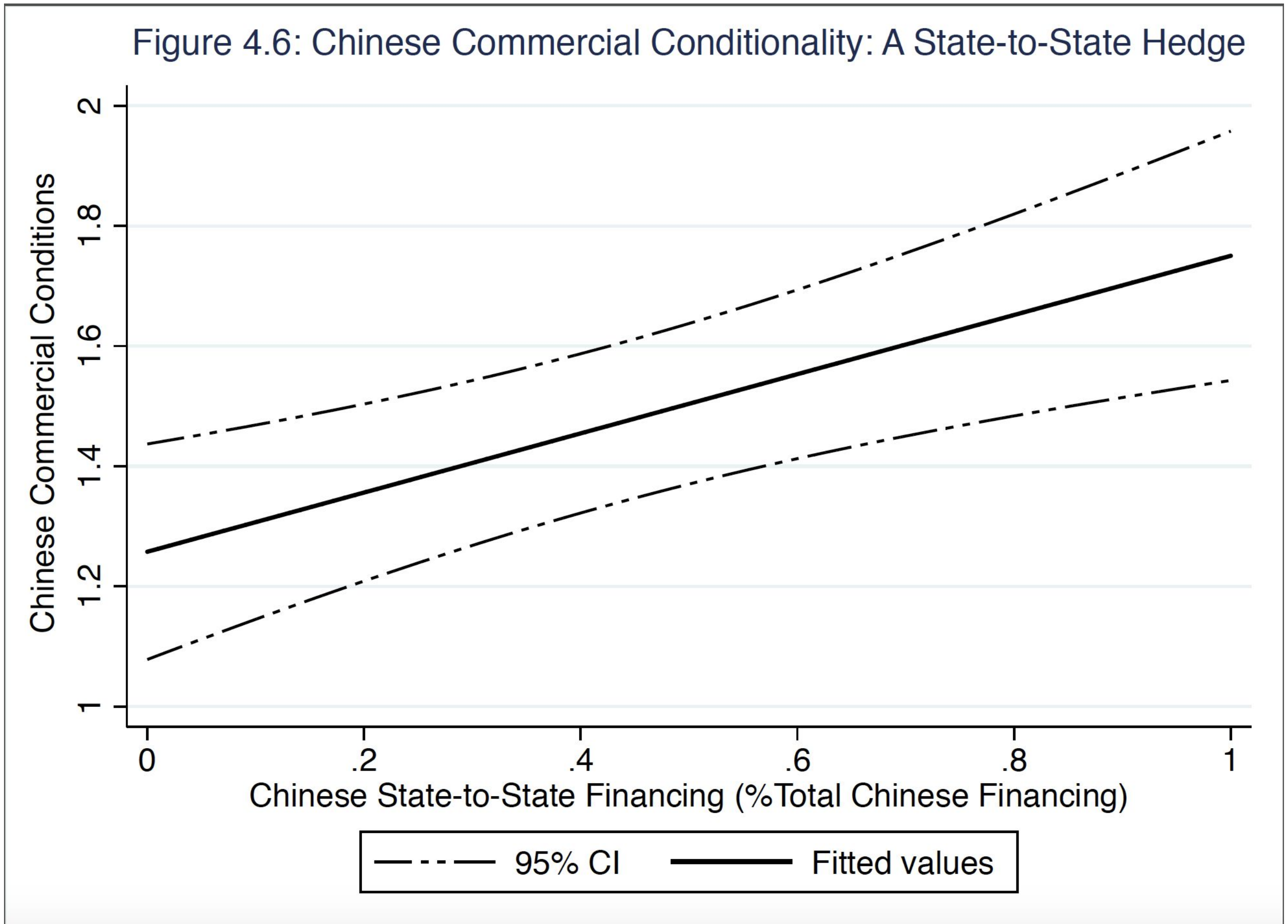
(a) Any event or condition occurs that results in the acceleration of the maturity (other than by optional or mandatory prepayment or redemption) of any of Argentina's Performing Public External Indebtedness having an aggregate principal amount of US$25,000,000 or more, or Argentina fails to make any payment of principal, premium, prepayment charge or interest when due or declares a moratorium or suspension of payment on any of its Performing Public External Indebtedness having an aggregate principal amount of $25,000,000 or more and that failure continues past the applicable grace period, if any.

(b) There is an event of default (however described) under the Belgrano Facility Agreement.

Hedging State-to-State Risk with Commercial Conditionality



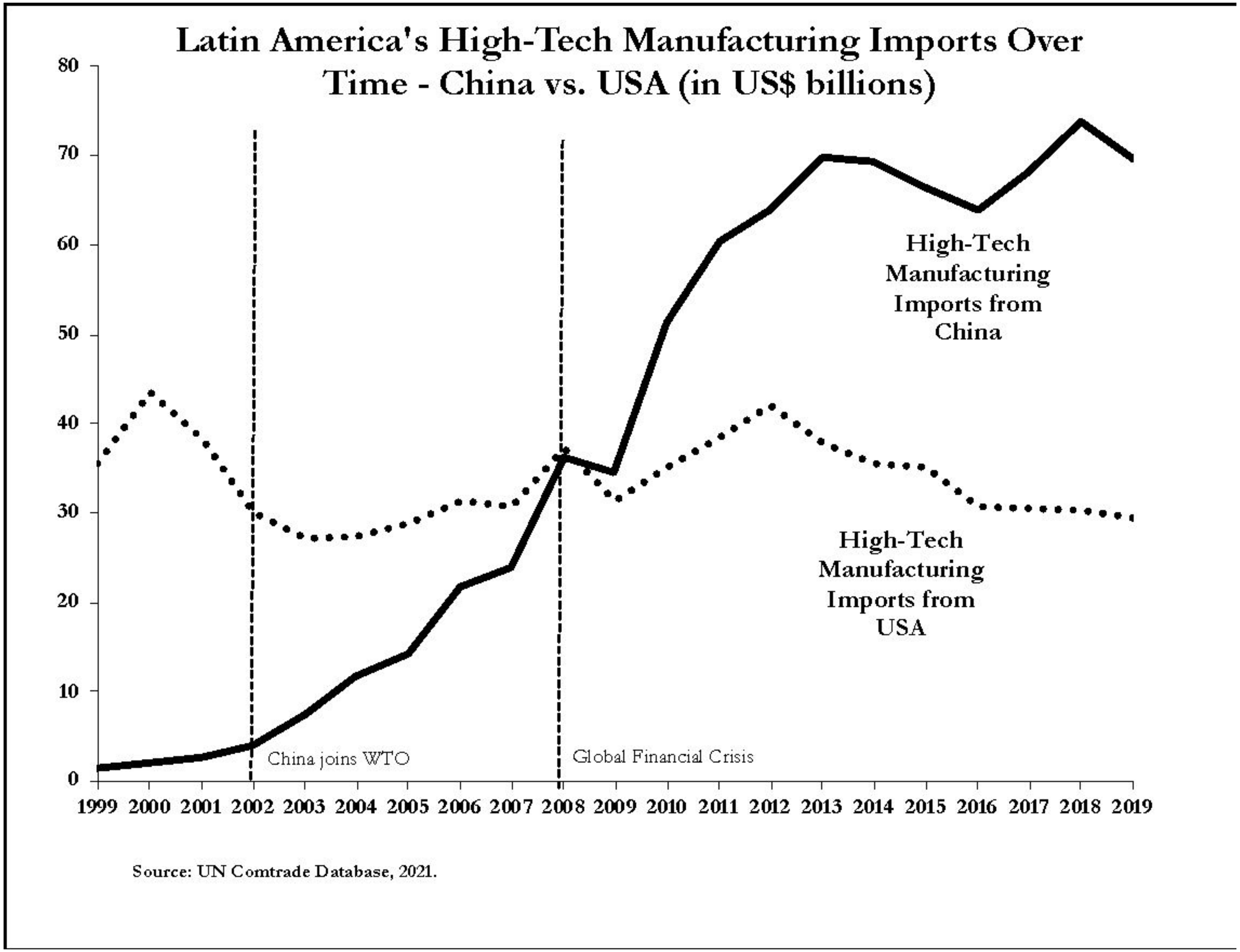
Hedging State-to-State Risk with Commercial Conditionality



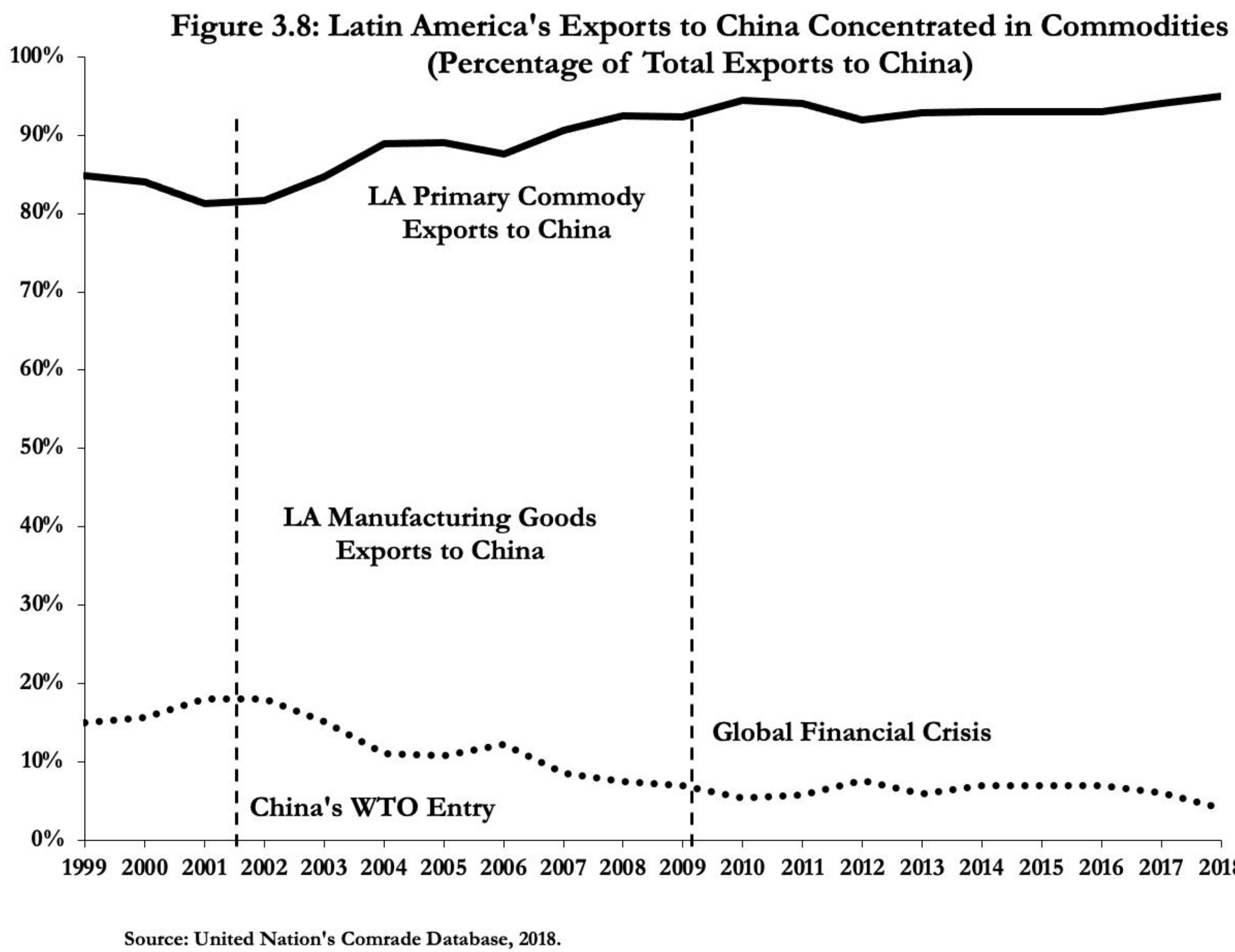
Debtor Perspective: Costs & Benefits

- Benefits
  - *Long-term financing* better aligns with region's development horizon.
  - Addresses *infrastructure deficits*. Latin American investment was a mere 0.6 percent of GDP in the 2000s compared to 3 percent rates in 1980s.
- Costs
  - *Commercial conditionality* – loans are tied to Chinese firms, products, and machinery.
    - Similar to trade, Latin America negotiates to increase its share of **<u>local content</u>**.
  - *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?
    - Reinforcing commodity dependency?
  - *Indebtedness*: lack of policy conditionality creates moral hazard.

Intensifying the Middle-Income Trap?



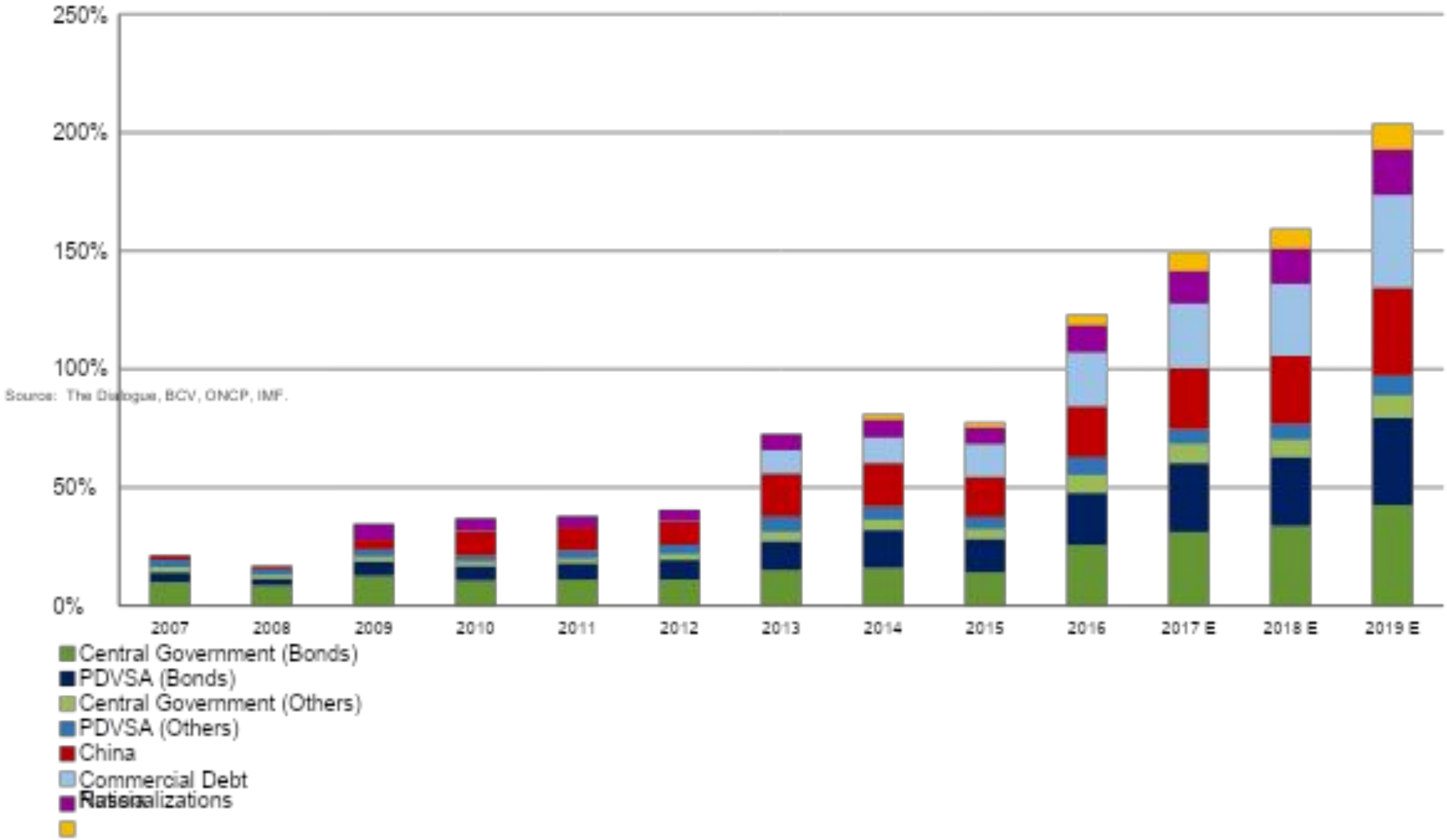
Reinforcing Commodity Dependency?



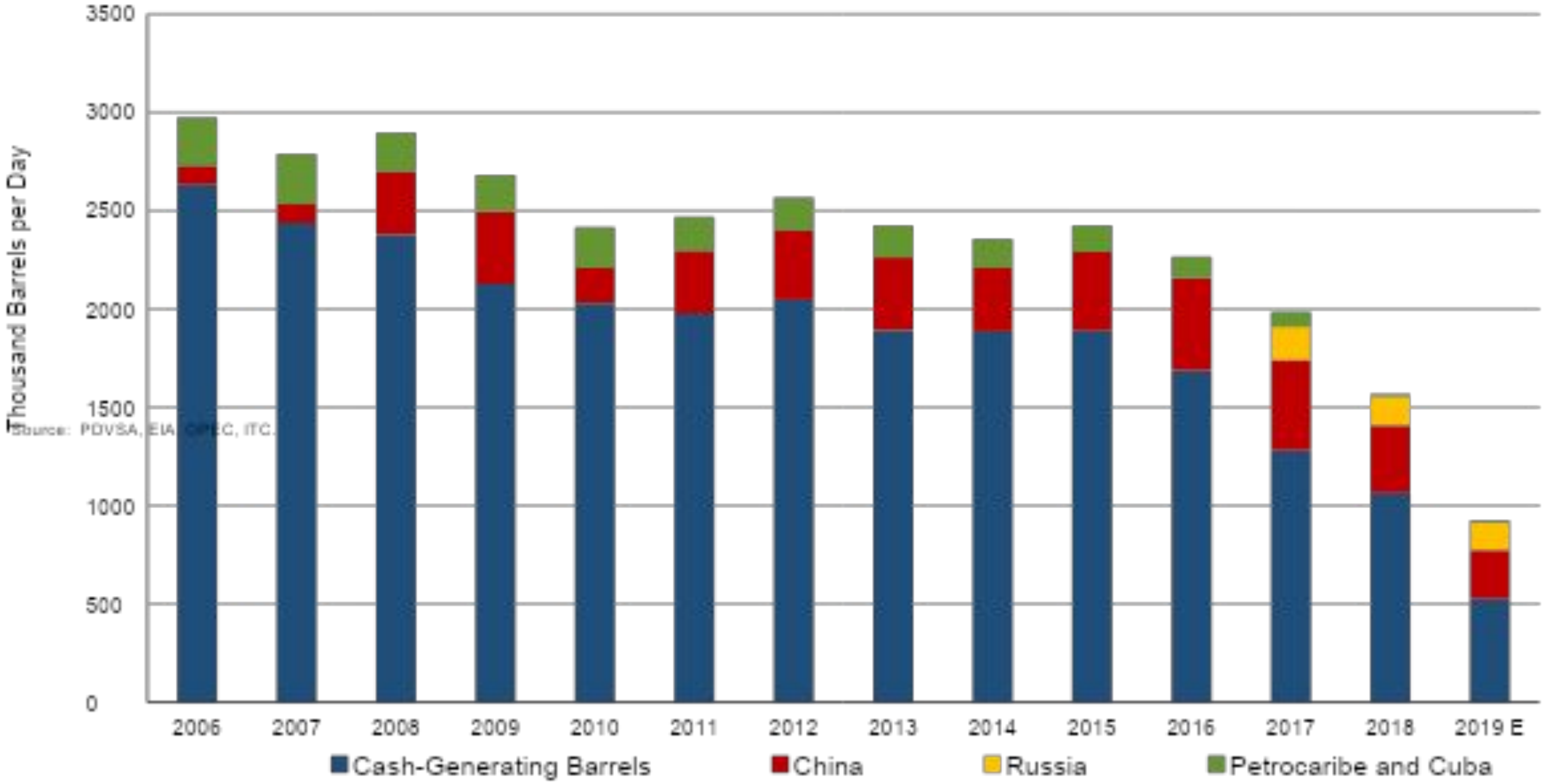
Latin America's Debtor Perspective

- 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 humanitarian crisis and dwindling state-oil production (below 350,000 barrels per day in 2020; less than 15% 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 that have accumulated— equivalent to the country's reserves. Its arrears reportedly total more than $6 billion.
    - China has been lending defensively, renegotiated terms of old loans, reportedly rolling-over $5 billion in Venezuelan lending in September 2018 and extending a debt moratorium in 2020, but has balked at being a lender of last resort
      - Policy banks might need their balance sheet reserves to help address domestic financial pressures back home.

Composition of Venezuela's Foreign Debt (% GDP)



PDVSA'S Cash Flow in Exported Barrels per Day



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 and COVID pandemic.
  - 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 in Argentina, Brazil, Peru, and Jamaica.
    - $40 billion in Latin America funds; $40 billion in Silk Road Fund.
    - Only deployed $2 billion in Latin America; 5% of Chinese capital committed to funds.
- Moving toward multilateralism.
  - Acquiring new investment partners, including Chinese commercial banks, multilateral institutions (i.e. World Bank, Inter-American Development Bank), and local development banks to share investment burden.
  - Asian Infrastructure Investment Bank (AIIB), operating with private procurement through international bidding.
    - $18 billion paid-in capital; signed cooperation agreement with World Bank in 2017.

"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