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Introduction

China's Latin American Bankers

In the shadow of the old city's main Catholic temple, Mexican archeologists dig with their picks and trowels, hoping to unearth traces of Acapulco's past as a global trade hub. A mere five feet below ground, they uncover blue and white porcelain fragments. Ming Dynasty plates and platters soon return to the surface like the phoenix painted atop their finish. More than 400 years old, they arrived in the Pacific coast port aboard the Manila Galleon merchant fleet. Sailing between Asia and the New World in the sixteenth century, the fleet was emblematic of global exploration and exchange during the Age of Discovery. Crossing the Pacific more than 400 times over 250 years, the fleet delivered Chinese porcelain, silk, and spices to the New World.

The fragments of blue and white porcelain discovered on Mexico's Pacific coast are symbolic of renewed China–Latin America trade ties. At first, during the 1990s and prior to China's joining the World Trade Organization (WTO), China accounted for a mere 1.1 percent of Latin America's total trade. Following its WTO entry, these trade sherds grew into new riches reminiscent of the early days of globalization. China's Latin American exchange expanded to 5 percent of the region's total trade during the 2000s and the country became the top trade partner for Brazil, Chile, and Peru. After the 2008 global financial crisis curtailed US demand, China began investing overseas to create new opportunities for trade, doubling Chinese trade in the Americas to 10 percent of the region's total trade.

The financial crisis presented China with a chance to use its vast national savings to grow long-term commercial conduits for the region's commodities and energy supplies. With Western investors and bankers curtailing their balance sheets, China could gain market share in key

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geopolitically important sectors such as petroleum, raw materials, heavy extraction industries, construction, and infrastructure. While China's 2001 entry into the WTO had long ago forged its regional trade ties, its leadership hoped that such investments could also secure new export markets to replace those lost to the US recession.

To help cultivate opportunities for China's firms, China's leadership employed its policy banks, including the China Development Bank (CDB) and the Export-Import Bank of China (the Ex-Im Bank of China), to underwrite local infrastructure projects tied to Chinese content. Through such infrastructure financing, China has blossomed into Latin America's most important development banker, with outstanding regional loan commitments of $67 billion in 2017, compared to the World Bank's $54 billion in outstanding loan commitments that same year (see Chapters 2.3 and 3.1 for further details).[1] With the credit catalyst of policy banks, China's foreign direct investment (FDI) in Latin America also rocketed over the past fifteen years from virtually zero in 2005 to more than $120 billion today.[2]

In their efforts to promote markets and commerce, however, China's policy banks also had to manage their credit risk, which would ultimately prove more challenging than operating in the mainland's domestic environment, particularly given their aversion to using policy conditionality (i.e. requiring budget discipline) to promote debt repayment.

In the following pages, we explore the growth of China's policy bank lending globally and how this financing offered the promise of a decades-long elusive goal for many Latin American governments: greater state capacity. By examining China's approach to financing in Latin America, these pages also provides us with a new lens through which to evaluate China's foreign economic policy beyond Asia. Notwithstanding the tendency of policy banks to operate more commercially in Latin America than in China's neighboring regions, their financial relations pose a raft of regional political challenges, including navigating Latin America's century-old struggles with debt, dependency, and domestic industrial stagnation.

[1] The amount is tallied from the CDB and Export-Import Bank of China's annual balance sheets and is corroborated by extensive field research across Latin America's largest sovereign borrowers from China (see the discussion of the China Global Finance Index in Chapter 4 for more details).

[2] Avendano, Melguizo, and Miner, 2017; Scissors 2020, Dussel-Peters 2020b.

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1.1 BAMBOO ECONOMICS

When bamboo is planted, it cultivates roots for a few years before budding its hardy, adaptive woody stems. After sprouting, however, bamboo stalks grow faster than any plant in the world, taking root in a variety of climates from sub-Saharan Africa and the Americas to Southeast Asia. More durable than wood, brick, or concrete, bamboo also strengthens when woven together to yield furniture, fences, and boats.

In many ways, China's global economic emergence is reminiscent of the proliferant plant. In the prelude to its WTO entry, China slowly sowed its first seeds through budding trade relationships across the globe before blossoming into a fast-growing economic network of Chinese banking, investment, trade, and supplier ties in regions like Africa, Latin America, and Southeast Asia.

Initially cultivated by Deng Xiaoping's economic reforms in the late 1970s, China's global emergence helped breed three decades of spectacular, thriving growth that has uprooted the balance of global economic power in recent years.[3] Today, China accounts for almost a third of global output, a nearly fivefold increase from its 6 percent share during the 1980s.[4] Let us briefly explore how China became a focal point of the global economy before examining its Latin American integration more closely.

In the wake of the country's WTO entry, China's initial economic expansion was primarily built on providing an export platform for global trade. Maintaining an undervalued currency was central to this development strategy. China sold renminbi for US dollars with the aim of suppressing the value of its currency and boosting its export competitiveness.[5]

As a by-product of its currency interventions, China acquired a vast arsenal of US dollar reserves – which at its 2009 peak amounted to $4 trillion, or 49 percent of China's gross domestic product (GDP). For many years, these massive dollar reserves were invested into US Treasury securities, which helped keep interest rates low and ease the US fallout from the financial crisis. Notwithstanding the simultaneous gains steady US demand bestowed on its own export competitiveness, China incurred a large opportunity cost by holding low-yielding US assets rather than

[3] China's average annual growth rate surged from 5 percent in the 1960s and 1970s to a whopping 10 percent over the next three decades (World Development Indicators).

[4] International Monetary Fund, calculated at purchasing power parity.

[5] Kaplan 2006, 2016.

investing in high-return projects, either domestically or globally. Hoping to improve its investment return, China saw in the 2008 global financial crisis a rare opportunity to buy cheap foreign assets.

With Western capital reeling from the 2008 global financial crisis, China intensified its "go global" strategy to expand its international economic influence.[6] Nearly a decade earlier, President Jiang Zemin had implemented this strategy to promote the economic interests of the Chinese state globally by internationalizing Chinese investment and lending. Concerned about scarcity of food and resources, China had aimed to secure long-term access to energy and raw materials by enhancing its global economic ties. The policy also sought to use overseas investment to improve the competitiveness of Chinese firms. However, it became explicitly linked to China's vast foreign currency holdings in 2009, when Premier Wen Jiabao declared that the government should use its reserve holdings to promote outward investment:

> Beijing will use its foreign exchange reserves, the largest in the world, to support and accelerate overseas expansion and acquisitions by Chinese companies. We should hasten the implementation of our "going out" strategy and combine this utilization of foreign exchange reserves with the "going-out" of our enterprises.[7]

China also aimed to diversify its investments beyond developed countries, as foreshadowed by CDB chief Chen Yuan, who declared at the time, "I think we should not go to America's Wall Street, but should look more to places with natural and energy resources."[8] Since the 2008–9 global financial crisis, China's state-backed capital has made considerable inroads internationally as the country has expanded its cross-border lending to become one of the top five financial creditors on the globe. Between 2009 and 2018, China's commercial and policy banks increased their global financial claims by more than three fold to $2.1 trillion (see Figure 2.2).[9] Global lending from the CDB and the Export-Import Bank of China (Ex-Im Bank of China) accounted for about one-quarter of these global financial flows. These two policy banks also made Latin America – a region with abundant natural resources yet

[6] The 1998 "go global" strategy was officially incorporated into China's policy framework under China's 10th Five-Year Plan from 2001 to 2005.

[7] Jamil Anderlini, "China to Deploy Foreign Reserves."

[8] *Economist*, July 21, 2009.

[9] These financial claims of internationally active Chinese banks, including the CDB and the Ex-Im Bank of China, are comprised of both bank loans and securities (Bank of International Settlements' (BIS) locational banking statistics).

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scarce capital – a prime target for China's resource-oriented investment strategy, channeling about one-sixth of their total global bank loans to Latin America (see Figure 2.6).

1.2 OPENING THE CHINESE WINDOW OF FINANCIAL OPPORTUNITY

The Chinese government learned a key lesson from the 2008 global financial crisis about the weakness of the Western financial system, particularly its tendency toward short-term decision-making and excessive financial volatility. China was not on the sidelines during the crisis, but rather, in mid-2008, its government and commercial banks held upward of $470 billion in total US bonds, which accounted for more than one-tenth of China's total foreign exchange reserves.[10] Many of these bonds were from Freddie Mac and Fannie Mae, two of the major investors in mortgage-backed securities, meaning that China learned about the dangers of securitization and market volatility firsthand.

China was exposed not only to financial volatility but also to economic volatility. The export slowdown caused many of China's small and medium-sized enterprises to close their doors, forcing more than 2 million migrant workers to return to their rural homes.[11] For a government that prioritizes social stability, this was scary and only added to its concerns about the social and political impact of unfettered market capitalism.

For two decades prior to the 2008 global financial crisis, market volatility had catalyzed political turnover throughout the developing world. After the global financial crisis, it became clear that the developed world was not immune to financial volatility either. It exposed deep-seated economic and political vulnerabilities, which made the Chinese government more circumspect of market capitalism. According to Larry Summers, who served as President Obama's chief economic advisor in the wake of the 2008 global financial crisis, the crisis likely reinforced China's commitment to state-led capitalism.

> I think the big lesson that it probably took from the Asian financial crisis, and even more the 2008–9 financial crisis, was that we were not as smart as they might have thought we were, and I think they might [have] supposed that in the

[10] Research Center for the State Council, 2008. www.drcnet.com.cn/DRCNet.Channel.Web/gylt/20081210/gylt_29.htm

[11] Jiang Shixue. "The Global Financial Crisis in Chinese Perspective." Chinese Academy of Social Sciences, 2017.

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world of Keynes, Friedman, and Samuelson, and whomever else, that there lay a great economic understanding that was the root of prosperity; and I think given that our style of capitalism seems to have been prone to create what they fear most, uncontrolled disorder, they are less confident that we know what we're doing ... they are much more willing to indulge in their traditional practices which have been associated with the fastest growth the world has seen than pursue our ideas.[12]

Chinese scholars have also discussed how the crisis reinvigorated their faith in state capitalism. Ru Xin, former vice president of the Chinese Academy of Social Sciences (CASS), suggests the crisis has strengthened China's "determination to walk on the path of socialism with Chinese characteristics." Ru provided a further warning to Chinese political and economic elites:

Never take capitalism as a panacea. Never believe in the "invisible hand" in a blind way. Otherwise, we shall suffer a great deal.[13]

By comparison, China has offered the world a unique form of finance that is less susceptible to such criticisms. Based on China's own development experiences, it has marketed its long-term infrastructure financing around the globe. The next section previews this book's theory about China's unique form of patient capital and its expected effect on national economic governance.

1.3 CHINA'S PATIENT CAPITAL: FINANCING NATIONAL DEVELOPMENT

Long-term investors come in all shapes and sizes ranging from individuals (i.e. parents invest in their children's education) and firms (i.e. venture capitalists invest in innovative ideas) to nonprofit institutions (i.e. social entrepreneurs invest in social returns) and governments (i.e. states invest in military technology to increase their national security). Patient capital is a particular form of long-term investing first associated with the East Asian development model during the second half of the twentieth century.

While many mainstream economists in the West often portrayed the success of the East Asian development model as a product of its export

[12] "The Asian Financial Crisis, 20 Years On: A Conversation with Lawrence H. Summers," The Wilson Center, January 8, 2018.

[13] See footnote 11.

orientation, other scholars at the time pointed to the active role of national governments.[14] State-directed financing of strategic industries fostered a long-term relationship between the state, bankers, and firms that guaranteed access to financial capital for industrial development.[15]

This pioneering scholarship about the role of the state in fostering East Asian industrialization helped foment a comparative political economy (CPE) literature about distinct models of economic development. According to this scholarship, domestic banks in coordinated market economies rely more heavily on nonmarket governance and coordination because states use their financial systems to catalyze the long-term provision of capital and investment in their domestic economies.[16] Taking its cue from this seminal CPE literature, a more recent developed country literature has also examined national differences in domestic financial systems.[17]

At the turn of the twentieth century, the concept of patient capital resurfaced among development practitioners who used the term to bridge market-based investment approaches with long-term philanthropy. For example, the nonprofit social impact fund Acumen invested in the Kenyan firm Advanced Bio-Extracts (ABE) to support the long-term development of an African-farmed botanical extract as a cheap malarial treatment.[18]

In my earlier scholarship, I applied the concept of patient capital to China's globalization of its state-led financing in developing countries.[19] Cutting across the fields of international political economy (IPE) and CPE. I argued that China deployed a unique form of patient capital internationally as it externalized its domestic approach to financial development. While patient capital shared the long-term horizon of the aforementioned investors, its risk tolerance and lack of policy conditionality differentiated China's state-led capital from other creditors.[20] It even varied from Japan's private-sector approach to global finance, which was historically comprised mostly of commercial banks.[21]

[14] Rodrik, et al. 1995.
[15] Wade 1990, 1998.
[16] Hall and Soskice 2001; Rosenbluth and Schaap 2003.
[17] Hardie, Howarth, Maxfield, and Verdun 2013; Hardie and Maxfield 2013; Deeg, Hardie, and Maxfield 2016.
[18] Thomas Friedman, *New York Times*, April 20, 2007.
[19] Kaplan 2016.
[20] Ibid.
[21] See Chapters 2.2 and 3.3.1 for further details.

Recently, Chinese policymakers have also begun to employ the term "patient capital", but mostly to describe the country's long-term equity investments.[22] By contrast, I have defined patient capital as a characteristic of China's unique state-to-state debt flows, rather than its cross-border private equity flows or FDI. These equity investments, even when backed by Chinese policy banks, tend to be smaller in scale and less reflective of the large-scale, government-coordinated financial management discussed earlier. For example, in my interview with Dr. Fan Xiwen, the chief operating officer for China's sovereign equity funds for Latin America, he discussed how the banks' risk management guidelines limit their investment operations.

> We cannot invest more than 30 percent of the target company; this is something our shareholders want! We cannot invest more than $100 million in a single project . . . the fund doesn't have the authority.[23]

In this book, I further develop the theoretical concept of China's patient capital, discussing the underlying factors that endow it with its unique financial characteristics compared to traditional private capital. In Chapters 2 and 3, I examine how China's financial regulatory system places its policy banks in an unparalleled position globally. With the Chinese state's support, the CDB and the Ex-Im Bank of China can offer their clients long-term, risk-tolerant lending unbridled by the market's sovereign risk assessments or by Western multilaterals' short-term policy metrics.

Beyond the well-known explicit government subsidies China's Exim Bank receives for its concessional loans to developing countries, China's policy banks also receive sweeping implicit subsidies derived from China's underlying regulatory structure.[24] Domestic banking regulations consider policy bank bonds equivalent to sovereign government bonds, meaning a low-risk credit rating allows policy banks to fund themselves more cheaply than global commercial banks. This measure, along with a lack of regulatory transparency, allows policy banks to engage in riskier lending while still offering their clients competitive financing.

By comparison, Western bank regulators routinely evaluate their bankers' sovereign risk, which often limits their lending to riskier bank

[22] Lin and Wang 2017.
[23] Author's interview with Fan Xiwen, Chief Operating Officer, China–Latin American Cooperation Fund, January 14, 2020, Beijing, China.
[24] See Chapters 2.3 and 3.3.

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clients overseas. For example, in the United States, the Interagency Country Exposure Review Committee (ICERC) reviews the sovereign risk of countries with high exposure to the US banking sector, often requiring additional capital to cover potential loan losses overseas.

1.4 BANKING WITH STATE-TO-STATE DEBT VS. MARKET EQUITY

Notwithstanding the intrinsic differences between Chinese patient capital and Western bank capital, I anticipate that China's overseas bankers alter their financial tools (state-to-state vs. market-oriented) based on the economic institutional structure they encounter in each recipient country. When China's public bankers confront institutional architectures, such as public procurement and public-private partnership laws, that promote market investments locally through competitive public tenders, they are often prohibited from directly contracting with the central government. Policy banks tend to finance corporate enterprises (either a private firm or a separately managed state-owned enterprise) that have won government concessions through either project financing or direct equity financing.

Under these conditions, China's patient capital behaves fairly similarly to long-term, market-oriented equity investments. Their cheap underlying financing helps policy banks sustain a long-term horizon. However, competing in the private market also leads them to approach credit risk similarly to their corporate competitors. When bidding for public contracts through government tenders, they use sovereign credit ratings as a guide for their lending terms. In my interview with José Luis Morea, a cabinet-level official charged with managing Argentina's Public-Private Partnership (PPP) system, he highlighted how China's policy banks routinely use sovereign credit ratings as a "ceiling for their competitive bids" throughout the region, typically offering interest rates just below market interest rates.[25]

National governments that channel Chinese financing outside their balance sheet and toward corporate enterprises thus aim to lower their sovereign credit risk by adhering to the international investment community's standards of good governance. By targeting policy conditionality (i.e. budget discipline), national governments can lower their firms' domestic cost of market financing.

[25] Author's interview with José Luis Morea, Chief Executive Officer Banco de Inversión y Comercio Exterior (BICE) (Argentina's development bank), August 15, 2019.

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By contrast, when policy banks confront more flexible investment laws locally that allow them to directly contract with central governments, they channel their lending into government coffers through joint-development funds. China's patient capital exhibits not only a long-term horizon but also more risk tolerance and a lack of policy conditionality.

Benefiting from their implicit regulatory subsidy, policy banks can offer below-market infrastructure financing to promote a greater presence for Chinese firms in developing markets that commercial banks would otherwise deem too risky. According to Argentine president Alberto Fernández, "it is very difficult to compete against the Chinese because they have enormous price differentials with very cheap public works."[26]

By investing in large-scale state-to-state infrastructure projects, China's policy banks practice what I call *market maximization* rather than profit maximization,[27] using "development finance" to help their firms capture market share in strategically important yet burgeoning economic sectors. When I spoke with researchers from policy bank departments and government think tanks during my field research in China, they explained the strategic importance of underwriting state-owned firms to grow their global market presence, even if "in the beginning stages they will lose money" or "probably not get a return on their investment." For example, in my 2017 meeting with country risk officers from Sinosure, China's state-owned trade insurance company, they referred to this phenomenon as "lower profit money."

> To encourage firms to go abroad – we offer them "lower profit money" – the lending rate is lower than they could find in the market. We encourage them to go into areas where the political risk is high, but in these countries, they have growing markets and much potential, so we help commercial or state firms go abroad and get high profit from these markets. Sometimes, especially with fundamental construction projects such as a port, we help them build this infrastructure first, and then help other companies go into the countries so that we can help build their markets and find a good future for these firms.[28]

At the same time, China's policy banks operate under an official doctrine of nonintervention in domestic affairs, as stipulated in the country's

[26] Author's interview prior to his presidency, Buenos Aires, Argentina, August 21, 2014.
[27] See Chapter 1.6, 2.2.2, and 2.3.
[28] Author's interviews, Beijing, China, November 16, 2017.

Five Principles of Peaceful Coexistence.[29] Chinese bankers therefore do not impose the stringent policy conditionality that is typically required by Western multilateral institutions and often employed as a governance heuristic by market investors. Rather, they require what I refer to as *commercial conditionality* to both hedge financial risk and promote trade (see Chapter 1.6).

In the following pages, we examine how these two different channels (state-to-state debt vs. market-oriented equity) for China's global banking affect national-level economic policy decisions in recipient countries. China's patient capital, which is distinct from private financial capital, tends to endow national governments with greater policy discretion. However, when China's global financing is instead channeled directly to corporate enterprises, governments do not benefit from the loan directly, neither do they gain additional policy flexibility. Before analyzing these national governance implications, however, let us examine how China's patient capital alters the relationship between global investors and national governments.

1.5 PATIENT CAPITAL RELAXES THE TWENTIETH-CENTURY TRILEMMA

In a world characterized by global capital mobility, the political economy scholarship has long anticipated that governments will face a trade-off between national macroeconomic policy autonomy and exchange rate stability, known as the Mundell-Fleming trilemma.[30] That said, a key assumption of this seminal literature is that capital is private and hence it would exit countries when faced with financial instability and currency depreciation that erodes profits. During hard economic times, capital's exit threat would compel governments to keep interest rates in line with global levels[31] and constrain fiscal expansion to entice inflation-wary bondholders to remain vested in the economy.

However, I contend that China's emergence as a global creditor has changed the basis of this trilemma by eliminating capital's exit threat, creating more financial stability, and allowing for greater

[29] For further details, see China's Initiation of the Five Principles of Peaceful Coexistence, Ministry of Foreign Affairs, November 17, 2000.

[30] Frieden 1991; Helleiner 1996; Kahler 1998; McNamara 1998; Broz and Frieden 2001.

[31] According to interest rate parity, higher interest rates are necessary to offset an expected currency depreciation.

policy maneuverability. China's overseas investments have mainly been characterized by state-backed capital given the country's capital controls on private investment. The Chinese government heavily restricts the ability of China's residents to invest in financial assets overseas, meaning there are minimal short-run financial connections between China and the rest of the world. China's contribution to the international financial architecture thus includes long-run development finance, banking, and FDI,[32] but significantly less global bond financing.

Beyond its lack of short-term financing, I assert, China's mobile capital is a distinct type of long-term capital. It's a globalized form of China's domestic patient capital featuring a unique approach to managing credit risk compared to Western creditors. Whereas Chinese patient capital seeks to promote long-term commercial opportunities, many market-based creditors prefer short-term policy assurances that boost near-term financial returns. Other Western financial institutions such as the World Bank and the Inter-American Development Bank may share a long-term project financing window. However, they tend to have considerably less scale than Chinese loans. In fact, Argentina's former subsecretary for international financial relations, Augustin Simone, suggests that in the realm of infrastructure, "these multilaterals have lost relevance because their capacity to lend is small."[33] These creditors also place a big emphasis on policy conditionality, or debt sustainability metrics for evaluating a nation's macroeconomic environment (i.e. the budget framework and governance quality), which also makes this financing less attractive to some sovereign borrowers.

By delinking overseas lending from such short-term policy performance as budget discipline, China's patient capital features not only long-term maturity structures but also greater risk tolerance. Rather than exiting when governments miss short-term economic benchmarks, these investors often view cyclical downturns as an chance to gain cheap assets and exploit long-run business opportunities. China's Ministry of Commerce researchers confirmed this trend during our 2017 meetings, saying, "we have some patience for that risk."[34] China's big-ticket bank capital will enter the market with the aim of catalyzing a flurry of smaller-scale foreign direct and equity investments in key sectors.

[32] Stallings and Kim 2017.
[33] Author's interview, Buenos Aires, Argentina, August 7, 2019.
[34] Author's interviews, Beijing, China, November 2017.

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1.6 POLICY CONDITIONALITY VS. COMMERCIAL CONDITIONALITY

This book argues that China's more patient form of capital allows developing country governments greater fiscal policy space to pursue their domestic agendas. By escaping the budget constraints traditionally imposed by global capital markets[35] and international financial institutions,[36] national governments have greater scope to pursue higher budget deficits. As China's patient capital accounts for a larger share of a nation's external debt outstanding, I expect governments to gain more fiscal policy discretion than when relying upon conditionality-linked market and multilateral funding sources.

Chinese bankers view such conditionality as political, instead operating according to administrative guidelines that emphasize long-term commercial success. During my field research interviews with Chinese policy bankers between 2017 and 2020, many bank executives suggested that traditional Western lending is too conservative because of its emphasis on disciplined economics. Although Chinese policy bankers also demand a return on their capital, they incorporate a longer payback period in their lending structure to encourage *market maximization*. In other words, they aim to grow China's total corporate earnings within important markets, rather than boosting the profitability of a single project or firm.[37]

This foreign economic strategy has its roots in China's domestic banking, and hence it has a different underlying governance structure than Western banking. During its miracle growth years, China redirected its massive household savings into a sustained expansion of local government debt to invest in heavy industry and infrastructure. The reward was lofty investment-led economic growth, but it came at the cost of bad loans, which may account for as much as one quarter of total loans today.[38]

Compared to Western corporate governance's tendency to immediately recognize such balance sheet losses, Chinese policymakers often employ "evergreening strategies." They inject new funds to help delinquent borrowers repay their debts with the aim of extending the horizon

[35] Mahon 1996; McNamara 1998; Mosley 2000, 2003; Wibbels 2006.
[36] Thacker 1999; Vreeland 2003; Nelson 2015.
[37] See Chapter 2 for further details.
[38] Ibid.

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on delayed infrastructure projects.[39] Given this long-term balance sheet horizon, Chinese policy bankers often possess a more benign view of nonperforming loans than Western bankers and policymakers. For example, during my field research interviews with Chinese policy bank executives, one senior economist quipped,

> The private sector's risk management is very conservative; they are too cautious. To have a social impact, they should have a higher rate of nonperforming loans. Policy banks should be maximizing the losses they can sustain in order to maximize the social impact.[40]

Without the West's more stringent financial regulations or policy conditionality, how do Chinese policy banks mitigate their credit risk and ensure debt repayment? In structuring their loan contracts, China's policy banks employ what I call *commercial conditionality* as a mechanism for both risk management and trade promotion. They often aim to mitigate their credit risk by using one of two tools. Policy banks use natural resources for state guarantees, where the national government pledges land or commodities as collateral to cover debt repayments in the event of default. Or alternatively, these banks use loans-for-commodity deals that utilize the proceeds from separately contracted and pre-committed commodity sales to secure loan repayment.

While these financial vehicles are popularly understood as exchanging loans for commodities, they are a bit more complicated in their execution. They are based on two different transactions. Chinese policy banks lend developing country governments money, while Chinese importers simultaneously establish a daily purchasing agreement with state-owned commodity enterprises such as Petroleos de Venezuela, S.A. (PDVSA) in Venezuela. The state-owned oil or mining companies then use the cash they earn from their daily sales to Chinese importers to incrementally repay the loans over time until maturity. Their daily inflow of income from Chinese commodity purchases thus serves as collateral for policy bank loans to the national government.[41]

Policy banks also tie their overseas financing to a range of other commercial conditions, including local government purchases of Chinese machinery and materials and guaranteed contracting with Chinese

[39] See Chapters 2.3.1, 2.4.2, and 3.3 for further details.
[40] Author's interview with senior policy bank economist in China during the winter of 2019–20.
[41] Kaplan and Penfold 2019.

firms, to gain a foothold in key global industries such as energy or telecommunications.[42]

In this book, I show that policy banks tend to use more commercial conditions when they are lending via the state than when they are lending via the market channel. When Chinese financing takes the form of state-to-state lending, the funds directly enter government coffers, enabling incumbent politicians to increase their spending on their political agendas. The lack of policy conditionality also allows governments more fiscal discretion but exposes creditors to high repayment risk. Chinese policy banks thus use commodity guarantees and loans-for-oil deals instead of policy conditionality to mitigate their credit risk.[43]

By contrast, when policy bank loans are booked to a corporate entity (either a private firm or a separately managed state-owned enterprise) through government concessions, the central government does not benefit from the loan directly, keeping its spending in check.[44] Given their reliance on private-sector financing, however, national governments instead target policy conditionality to improve their credit standing. They hope to lower national financing costs to attract project finance from both global investors and the local business community.

Under these conditions, policy banks operate more like long-term equity market investors as discussed earlier. In competing with the private sector, they adhere to the same market performance metrics emphasized in sovereign credit ratings and investment bank reports. Policy banks also tend to have fewer commercial conditions beyond those that promote Chinese trade (i.e. contracting with Chinese firms and suppliers). Chapter 4's empirical tests support these patterns, finding fewer commercial conditions when policy banks lend to corporate enterprises than when they lend directly to the state.[45]

In summary, sovereign governments that borrow from China face the following policy trade-off. China's patient capital often helps insulate national governments from a reliance on potentially destabilizing Western financing by granting them more fiscal policy discretion.[46] However, Chinese bilateral financing exposes its debtors to a different set of

[42] Kaplan 2016.
[43] See Chapter 3.6 for further details.
[44] According to the International Monetary Fund's (IMF's) *Government Statistics Manual*, state-owned enterprises are not included in public debt calculations when they are a market producer or a producer that sells its goods for economically significant prices.
[45] For further details, see Chapter 4.3.4.
[46] For further details, please see Chapters 2 and 3.

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risks, including extensive commercial conditions and a growing debt burden. For example, commodity guarantees, loans-for-commodity deals, and pledged imports of Chinese capital goods might reinforce natural resource dependency and slow industrial development in developing countries.[47]

A growing developing country debt burden has also received considerable attention in recent years. This book also explores the extent to which China has contributed to this long-standing problem. Benefiting from the state's support and regulatory forbearance, China's policy banks have extended competitive financing to national governments without any policy conditionality. However, such fiscal discretion may sow the seeds for future debt problems. In some cases, national governments have interpreted the lack of policy conditionality as a tacit acceptance of an expanding state, creating a moral hazard problem by encouraging boundless spending and eventual debt restructurings.[48]

For example, national governments in Ecuador and Venezuela accrued sizable debts from China-infused credit lines and by 2016, they had earmarked about one-eighth and one-fifth of their total annual oil production for debt repayment to China. According to Ecuador's former energy minister, Dr. Alberto Acosta, President Rafael Correa wrongly concluded that there was "no limit for indebtedness with China." Rather, Dr. Acosta declared in our 2015 interview, "there is no miracle source where you turn a key to create dollars; it's done once the majority of petroleum is sold to China."[49] Faced with this mounting national debt, President Lenín Moreno, who succeeded Correa in 2017, both successfully solicited a $4.2 billion International Monetary Fund (IMF) loan and renegotiated Ecuador's debt with China. Similarly, Venezuela also restructured its debt with China when it entered into a bilateral debt moratorium in 2016, but its recent $5 billion IMF request was rebuffed due to the country's ongoing political crisis.[50]

47 See Chapters 3.6, 3.7, and 7.
48 Moral hazard is when an institution fails to bear the full consequences of its actions or change its behavior.
49 Author's interview, Quito, Ecuador, November 16, 2015.
50 The IMF cited the lack of clear recognition of the Venezuelan government among its members. While the United States recognizes Juan Guaidó, the speaker of the opposition-controlled National Assembly, as interim president, President Nicolas Maduro has nonetheless consolidated power, most recently by holding new legislative elections in December 2020. Guaidó, along with the main opposition parties, boycotted these elections, however.

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As China's policy banks move along their creditor learning curve, China's governance mixture of regulatory forbearance and nonintervention has managed to build strong financial cooperation throughout the developing world but also exposed China to growing indebtedness from Indonesia and Pakistan to Ecuador and Venezuela. Before returning to discuss this governance challenge, let us examine this book's exploration of China's relationship with Latin American sovereign borrowers, many of whom have turned to China to boost their state capacity.

1.7 CHINA'S LATIN AMERICAN ROOTS

En route to becoming a regional economic power, China applied its "bamboo economics" to Latin America, planting its trade roots before flourishing into firm shoots of commercial, banking, and investment bonds. Following its 2001 WTO entry, China nurtured its Latin American landscaping through trade, emphasizing complementarities between the two regions. Under an export-led model of economic growth, China imported the region's abundance of raw materials, agricultural goods, and energy supplies in exchange for its cheap manufactured goods.

For Latin America, its rising interdependence with China was a mixed blessing. China's demand for Latin American exports certainly buttressed the region's commodity-led growth cycle. However, its flood of cheap capital goods into regional markets left many of Latin America's industrial sectors struggling to get out from the weeds, raising concerns about the challenges of Chinese interdependence.

By 2009, China's regional commercial presence was striking, growing more than six fold in the decade since China had joined the WTO. Responsible for one-tenth of Latin America's global trade, China used its policy banks to expand both its regional trade and its investment ties. These cross-border banking flows, which had reached $67 billion outstanding and accounted for one-tenth of the region's external debt by 2017,[51] aimed to spur growth and development and, ultimately, demand for Chinese goods and services.

China's deep financial regional integration, which includes five of the top ten largest global borrowers from the CBD and the Ex-Im Bank of China,[52] makes Latin America an ideal region in which to observe how

[51] See Chapter 2.3.

[52] The top five Latin American borrowers to China are Argentina, Bolivia, Brazil, Ecuador, and Venezuela.

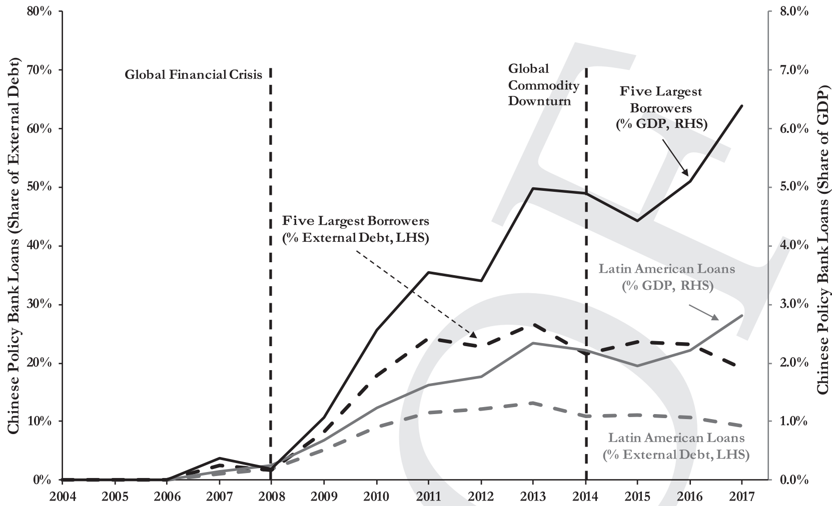

FIGURE 1.1 China's growing financial footprint in the Americas (China's Policy Bank Loans Outstanding, 2004–2017)

Note: Calculated from Kaplan 2021; See Table 4.1 for further details.

these policy banks behave outside of Asia. For example, these five largest Latin American borrowers from China have amassed outstanding loans tallying almost 7 percent of their GDP and one-fifth of their external debt. While these two major policy banks have slowed their new lending to Latin American governments recently,[53] their hefty outstanding loan commitments in terms of both GDP and external debt (see Figure 1.1) retain a considerable influence on national policymaking.[54]

1.7.1 Latin America's Quixotic Quest for State Capacity

At the beginning of the twentieth century, five Latin American nations were among the top thirty wealthiest countries on the globe.[55] Rich in commodities and natural resources, these countries had many global suitors that helped endow them with considerable state capacity. These countries surfed one of globalization's early commodity waves until an

[53] Between 2018 and 2019, there have been seven new sovereign loans to Latin America amounting to $3.2 billion (Gallagher and Myers 2020; China-Latin American Finance Database).

[54] Given its importance to this study, Figure 1.1 is also featured in the beginning of Chapter 4 as Figure 4.1.

[55] In 1913, Argentina, Brazil, Chile, Mexico, and Venezuela had per capita incomes ranging from $1,899 to $6,670, which was not too far behind top bread winner Australia with a per capita income of $9,369 (The Maddison Project).

economic swell upended commodity demand in the 1920s. Compared to the growing income and productivity gains of industrialized nations, Latin American incomes were squeezed by plummeting commodity proceeds and low productivity.

Against the mid-century backdrop of growing global inequality, Latin American nations began their quest to regain their state capacity. Regional development thinkers pondered how to close the income gap, with Raul Prebisch and his economist colleagues at the UN Commission for Latin America (ECLA) arguing for industrialization. Without an industrial base, they feared, commodity dependence would sow the seeds for a growing development chasm between Latin America and its northern trade partners from Europe and the United States. Promoting national industrialization, however, would require a greater role for the state in the economy, including financing large-scale investments and providing tariff protection to budding domestic industries.[56]

These import-substitution industrialization (ISI) policies also coincided with a broader global ideological trend that sought to bring the state back into economics. In the 1950s, Alexander Gerschenkron, a Federal Reserve Board economist and Harvard professor, wrote an influential essay entitled "Economic Backwardness in Historical Perspective." The essay identified common structural factors constraining development, including insufficient domestic savings, inefficient private investment, and over reliance on volatile foreign capital. Gerschenkron's solution was to employ high domestic savings to fuel investment-driven development, a prescription that was the precursor to the East Asian development model.[57]

At the same time in the United States, Keynesian economics, which also allowed for greater government intervention in the economy, became increasingly en vogue among policymakers in the wake of the Great Depression. When President Roosevelt entered office in 1933, his administration launched the New Deal, a series of government programs designed to mitigate the Great Depression's humanitarian crisis.

To implement this initiative, the New Deal's architects had to challenge the prevailing laissez-faire economic orthodoxy of the time by accepting a greater role for government in the economy.[58] They launched large-scale public works projects to ameliorate economic dislocations

[56] See Stallings 2020 for an extensive discussion of ISI's roots.
[57] Pettis 2013.
[58] Helleiner 2014, introduction.

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and provide social insurance and employment for the growing ranks of impoverished citizens. For example, the Roosevelt administration founded the Tennessee Valley Authority (TVA) to provide power generation and economic development to the Tennessee Valley, a region ravaged by the Great Depression.

More generally, during periods of economic and financial distress, Keynesian economists advocated for countercyclical fiscal stimulus to boost growth and employment, notwithstanding a possible long-run inflationary cost. For example, Keynesians credited World War II's deficit spending for bringing full employment back to the US economy.

New Dealers took these domestic views about the utility of government to the international stage, where they advocated for development policies during the foundation of the Bretton Woods economic system.[59] In light of the Depression's ripple effect throughout the globe, they supported state-led development endeavors in Latin America. Drawing a parallel between the finance-driven dislocations in the United States and the situation in Latin America, they cast blame on New York's financial elite for manufacturing the global crisis.[60] This solidarity was exhibited in a 1940s congressional debate on the merits of US lending to Latin America when a participant declared, "these are commodity countries. Many of them are in the kind of trouble Kansas would have been in if it were an independent nation and dependent wholly on its wheat crop."[61]

Inspired by such thinking, the Roosevelt administration crafted the Good Neighbor policy, promising noninterference and trade reciprocity throughout the region. Building on the rising popularity of the New Deal's commitment to public works, US policymakers also built a new Latin American financial partnership that featured a greater role for the public sector through bilateral loans, instead of the 1920s emphasis on private bond markets.

Roosevelt's economic team employed a combination of long-term loans for international development projects and short-term loans for commodity market stabilization to create new demand for Latin American export markets. In Brazil, for instance, the United States offered both bilateral loans and technical assistance to help the state-owned steel

59 See ibid., chapter 1, for more details about Bretton Wood's development foundations.
60 Ibid.
61 Quoted in ibid., 34.

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company, Companhia Siderúrgica Nacional, build the Volta Redonda steel plant in the state of Rio de Janeiro.[62]

Roosevelt's building of Latin American state capacity, and in turn the region's early foundations of ISI, was not simply diplomatic, however. "Tied aid" was a core feature of Roosevelt's flagship Latin American initiative, meaning that bilateral lending was linked to the purchases of US goods and services. Supporting the region's state-led development efforts thus also meant creating commercial opportunities for US industry. To foster industrialization, Latin American economies required machinery and capital good imports, creating new export markets for the United States that were vital to its economic recovery.[63]

By the end of World War II, however, the United States began to temper its Latin American economic engagement. While countering Germany's hemispheric influence had been a primary regional motivation in the prelude to World War II, the United States turned its attention to European reconstruction, particularly after the Cold War's outbreak in 1947. Bilateral capital and technical assistance from the United States now flowed to Western Europe, leaving mostly private-sector capital destined for Latin America.[64]

During the 1950s and 1960s, many Latin American countries intensified their push for industrialization. The increasing sophistication of their industrial structure necessitated an influx of technology, marketing, and management skills, which prompted Latin America's biggest manufacturers[65] to court US multinational corporations.[66] Benefiting from new capital and technology, large Latin American countries (e.g. Brazil and Mexico) cultivated a highly developed manufacturing sector with a "triple alliance" between the state, multinational corporations, and national economic elites.[67] However, such dependent development was not sufficient to benefit the majority of the population, with income inequality expanding during much of the ISI period.[68]

During the 1970s and 1980s, Latin American states either turned to the printing press or borrowed from commercial banks to expand

62 Ibid.
63 Ibid., 31–35.
64 Bulmer-Thomas 2014, 276.
65 By the 1950s, industry had become the leading sector in Argentina, Brazil, Chile, Colombia, Mexico, and Uruguay.
66 Bulmer-Thomas 2014, 298.
67 Evans 1979.
68 Stallings 2020.

their state capacity, which eventually led to the dual problems of hyperinflation and debt defaults during Latin America's "Lost Decade." These crises ushered in an era of market-led governance in Latin America characterized by the three pillars of the Washington Consensus: macroeconomic stabilization, domestic privatization, and trade and capital flow liberalization.

By the mid-1990s, these macroeconomic measures helped stabilize Latin American economies. However, without sufficient tax revenues or developed domestic bond markets, the region's governments increasingly turned to global capital markets to support their spending. Latin America's growing reliance on global capital markets,[69] relative to private banking or multilateral resources, made its governments susceptible to fiscal austerity pressures from sudden capital outflows.[70] To avoid cutting social spending, many national governments slashed infrastructure budgets to boost their public savings so that they could assuage bond investors' concerns about their debt repayment.

The 2000s commodity boom helped overcome these state capacity issues in many Latin American nations by lining government coffers with windfall revenues. Nonetheless, the region was once again dealing with severe capital exit after the 2008 global financial crisis. Improved macroeconomic governance and public savings helped the region navigate the crisis initially, but Chinese policy banks also emerged as a key new financing source.

In light of China's more agnostic view about fiscal expansion, Latin American governments hoped to take advantage of the country's lack of policy conditionality. Without perceived spending limitations, some Latin American leaders sought to alleviate their infrastructure deficits and their long-standing difficulties in sustaining state capacity.[71] However, China's use of commercial conditionality rather than policy conditionality risked exacerbating the region's chronic problems of debt and dependency.[72]

In recent years, China's regional financial commitments have increasingly fallen under the broad foreign policy banner of the Belt and Road

[69] In the wake of the 1980s debt crisis, Latin American bond issuance grew from US$0.6 billion in 1989 to US$37 billion by 1996, accounting for more than two-thirds of Latin America's total external public debt (Kaplan 2013).

[70] Ibid.

[71] Latin America's public investment in infrastructure was a mere 0.8 percent of GDP during the late 1990s and early 2000s, compared to 3 percent in the 1980s (World Bank 2007).

[72] See Chapters 3 and 7 for a longer theoretical discussion of these trade-offs.

Initiative (BRI), a program designed to invest between $500 billion and $1 trillion (or 3 to 7 percent of China's 2018 GDP) in long-run infrastructure financing across more than sixty neighboring Asian, European, and African countries. China considers Latin America a "natural extension" of the BRI initiative, with eighteen Latin American and Caribbean countries signing formal BRI agreements since Panama inked its deal in November 2017.[73] Chinese foreign minister Wang Yi claims Latin America has already become the second largest destination for Chinese overseas investment outside of Asia,[74] though it has been slowing in recent years.[75]

Many parallels have emerged between these new economic linkages and their historic roots during the dawn of globalization. When unveiling the BRI initiative in 2013, President Xi invoked the legacy of the Han Dynasty's Silk Road, a trade route linking China to Central Asia, Persia, and Rome. More recently during a 2017 speech, Xi also referenced China's sixteenth-century maritime voyages to Western seas, deeming these early pioneers "friendly emissaries leading camel caravans and sailing treasure-loaded ships."[76] These Western sea voyages included the maritime expeditions of the aforementioned Manila Galleon fleet, which connected East Asia and Latin America more than 400 years before China joined the WTO.

The nature of this trade was quite similar not only across time and space but also in its surrounding controversies. Chinese manufacturers crafted silk and porcelain goods for the American market, such as drinking gourds known as jícaras, in exchange for New World commodities like maize, sweet potatoes, and peanuts. However, one commodity was more important than all others: silver. China had a limited silver supply yet an unsaturated demand for the commodity because its money was standardized to silver. In a pattern eerily familiar to us today, the West consumed Chinese factory goods in exchange for "minted money."[77]

Trade thus created a development opportunity, supporting local industry by providing silk for New World weavers, but it also created

[73] Formal participation is not a requirement for participation in BRI, with countries such as Argentina, Brazil, Colombia, and Mexico nonetheless receiving Chinese investment and financing flows.

[74] This claim is corroborated in Chapter 2.3 and Figure 2.6.

[75] Gallagher and Myers 2020; China-Latin American Finance Database.

[76] "Full Text of President Xi's Speech at Opening of Belt and Road Forum." *Xinhuanet*, May 14, 2017.

[77] Gordon and Morales 2017.

a growing chorus of concerns about Western overconsumption and Chinese import competition. Even seventeenth-century Spanish barbers lobbied for protection from unfair competition from a mushrooming population of Chinese barbers.[78] In a period predating laissez-faire capitalism, liberal political systems, and Western-backed multilateral institutions,[79] global trade and finance proliferated from East to West, but so did early concerns about dependency.

1.8 PLAN OF THIS BOOK

Scholars and practitioners continue to debate the economic merits of Chinese trade and financial flows and the extent to which they represent a development opportunity for Latin America. In the following chapters, I examine China's economic expansion into the Western Hemisphere from both the creditor and debtor perspectives while making several contributions. First, this study brings new and original data to bear on the classic question of states' room to maneuver under financial globalization,[80] a question increasingly pertinent given the rise of state-led finance over the past two decades. Second, employing a mixed method approach, this book sheds light on the behavior of state-led financing, particularly how its commercial conditionality rather than policy conditionality affects national-level governance decisions. Finally, this volume makes several important theoretical contributions by disaggregating the structure of global finance. The globalization scholarship suggests that local state capacity and institutional development can mitigate "race to the bottom" pressures,[81] but this study finds that the type of international investment (state vs. market) can also influence the extent of policy discretion.

This investigation also has significant implications for international political economy scholars examining the growing economic influence of rising powers, including the global emergence of national development banks,[82] China's challenge to the US in the world economy,[83]

[78] Ibid.
[79] Ibid.
[80] Mosley 2000, 2003; Wibbels 2006; Kaplan 2013; Brooks, Cunha, and Mosley 2015.
[81] Frieden 1991; Rudra 2002, 2008; Kurtz and Brooks 2008; Wibbels and Ahlquist 2011; Carnes 2014.
[82] Sierra and Hochstetler 2017; Griffith-Jones and O'Campo 2019.
[83] Wise and Quiliconi 2007; Gallagher and Porzecanski 2010; Gallagher 2016; Myers and Wise 2017; Wise 2020.

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debt and development in non-democracies,[84] and the prospects for the Chinese renminbi becoming a major global reserve currency.[85] These studies break scholarly ground, exploring how the transfer of wealth from developed to developing countries is affecting the global architecture. My argument complements this literature by offering a systematic examination of how China's approach to global finance affects the policy choices of developing country governments.

This book's findings also contribute to our understanding of democracy and development,[86] particularly the relationship between financial crises and partisanship[87] and the sustainability of the Latin American left.[88] During the early to mid-2000s, the commodity boom provided a funding source independent from global markets that helped the left increase budgetary spending[89] and veer from the centrism[90] previously defined by the neoliberal consensus.[91] However, in the wake of the 2008 global financial crisis and the ensuing commodity correction, many governments lost revenues and thus their budgetary maneuverability.[92] I engage with this important issue, showing that the emergence of Chinese state-led financing endows governments with greater fiscal space or the ability to sustain their spending through such volatility.

Before examining this creditor-debtor relationship in more detail, let us briefly preview the road map for our forthcoming journey through this book's pages. In Chapter 2, I evaluate the Chinese government's motivations behind promoting overseas financing, trade, and investment before assessing the development consequences for Latin American governments in later chapters. Understanding China's goals as an international creditor helps us evaluate the sustainability of these investment flows over time, and ultimately the potential costs and benefits for Latin American debtors. The fact that five of the top ten international borrowers from China are in Latin America allows us to simultaneously evaluate China's global banking strategy and questions about its policy banks' lending

[84] Ballard-Rosa 2016; Ballard-Rosa, Mosley, and Wellhausen 2019.
[85] Helleiner and Kirchner 2014; Steinberg 2014; McDowell and Steinberg 2017.
[86] Stallings and Kaufman 1990.
[87] Broz 2013.
[88] Corrales 2009; Levitsky and Roberts 2011; Luna and Kaltwasser 2014.
[89] Murillo, Oliveros, and Vaishnav 2011.
[90] Baker 2008; Baker and Greene 2011; Hellwig 2014.
[91] Murillo 2002, 2009; Roberts 2002; Baker 2008.
[92] Some countries pursued tax reforms to raise revenue, but were often impeded by elections (Hallerberg and Scartascini 2017).

behavior outside of the Asian region. For example, are their operations more commercially oriented outside of East Asia, or does the country's geopolitics outweigh its geoeconomics?

Chapter 3 develops a theory about how China's emergence as a global creditor affects national policymaking. The IPE and CPE literature has long debated the extent to which international capital mobility constrains national autonomy, but has mainly focused on private capital flows. Incorporating China's state-led capitalism into this political economy framework, I expect Chinese credit to enhance national governments' room to maneuver. It is a distinct form of long-term capital, characterized by a risk-tolerant financial system that marshals China's patient form of domestic capital internationally. Its lack of policy conditionality endows governments with more fiscal space[93] to intervene in their economies.

For developing country governments facing strong redistributive pressures, sufficient fiscal space to supply more jobs, higher wages, and better public services is often key to political survival. To finance such domestic political agendas, however, developing country governments often must borrow externally to a much greater extent than rich countries. Compared to the austerity imposed by global financial markets, governments that directly access new income streams from China can enhance their budgetary sovereignty. However, patient capital has its costs. The fine print of these state-to-state deals often involve commercial conditions ranging from contracting with Chinese firms and suppliers to providing state guarantees or commodity collateral that could intensify developing nations' structural struggles with debt and dependency.

Chapter 4 employs an originally constructed dataset, the China Global Finance Index, to conduct cross-national tests spanning eighteen Latin American countries from 1990 to 2017.[94] The index characterizes Chinese policy loans by their financing channel (state-to-state vs. market-based) for each national-level investment project. To my knowledge, it's the first of its kind to classify policy bank loans by their investment channel.

I find that China's state-to-state loans, as a share of a country's external public debt, are positively correlated with budget deficits, supporting

[93] Fiscal space reflects availability of resources to fund governments' budget shortfalls.

[94] The quantitative analysis omits the Caribbean (i.e. Cuba, the Dominican Republic, and Jamaica) because of data limitations, but Jamaica – which has borrowed extensively from China – is included in the qualitative analysis in Chapter 5.

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the primary hypothesis that China's patient capital expands governments' fiscal policy space to spend on their political agendas. In exchange for this lack of policy conditionality, however, policymakers tend to have more extensive commercial conditionality. Notably, when Chinese financing is instead directly booked with corporate enterprises through private procurement in the marketplace, these commercial conditions are less extensive. China's patient capital behaves more like long-term equity capital, given the underlying private-sector competition promoted by domestic procurement laws. National governments do not gain fiscal space from Chinese loans and are more likely to comply with policy conditionality.

In Chapters 5–6, I conduct a comparative case study analysis across seven countries (Argentina, Bolivia, Brazil, Costa Rica, Ecuador, Jamaica, and Venezuela) using national-level government policies as the unit of analysis. These seven countries are similar along economic and political indicators. They are middle-income countries located in a similar geographic region (about 40 degrees of latitude from one another), yet they maximize the variation in the main independent variables:[95] national indebtedness to China and domestic governance structures for investment. I focus this investigation on these seven countries given their mixed-market orientation, based on the assumption that budgetary drift is more likely in these nations than in economies exhibiting more of a liberal market orientation, such as Chile and Colombia.

I exploit their variation across presidential administrations in both external financing (Chinese state-to state vs. market-oriented financing) and domestic governance structures (i.e. direct contracting with the government vs. private procurement) to examine how they interact to affect budgetary balances. Chapter 5 investigates ten presidential administrations with varied exposure to Chinese state-to-state financing over time, comparing periods of large-scale Chinese bilateral financing to periods of extensive multilateral financing (i.e. where countries have IMF / World Bank programs). By contrast, Chapter 6 explores another five administrations with varied exposure to market-oriented financing, examining how Chinese state-backed financing compares with private market financing when it is instead channeled to corporate enterprises through public tender.

[95] King, et al. 1994.

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By taking advantage of this comparative case design, we can observe whether a high share of Chinese state-to-state financing (as a percentage of external debt) increases national fiscal policy discretion. For example, Venezuela directly financed its government spending through direct contracting with a joint financing mechanism known as the China-Venezuela Fund. Venezuela used these credit lines to cover budgetary shortfalls in exchange for future oil delivery or non-tendered concessions to Chinese firms and machinery suppliers.

By contrast, in Brazil, the majority of Chinese investment projects have been market seeking and thus channeled through the private sector. To the extent that Chinese policy banks are involved in public financing projects in Brazil, they operate through government concessions rather than direct government-to-government lending like in Venezuela. Without China's non-conditional bilateral lending, the Brazilian government was able to employ a fiscal stimulus to offset the 2008 global financial crisis. However, the government has not had sufficient fiscal space to tread far from Western governance principles of budgetary discipline since that time – notwithstanding the Rousseff administration's limited fiscal drift during the 2014 presidential elections.

Throughout these chapters, this book's macroeconomic analysis suggests that Chinese financing could offer nations a development opportunity by exploiting Western finance's Achilles' heel: the maturity mismatch between capital market's short-term financing and debtor nations' long-term development goals. Chinese policy banks have the capacity to finance big-ticket public infrastructure projects over a long-term horizon. However, Chinese capital also has its drawbacks, given its tendency to secure its lending with microeconomic ties or commercial conditions embedded in its loan contracts.

Chapter 7 assesses the costs and benefits of these commercial conditions by employing extensive qualitative evidence, including more than 200 interviews with Chinese creditors and Latin American debtors, and in some cases, examining the original contracts.[96] This chapter also evaluates the extent to which China can foster good governance and sustainable development without policy conditionality. For example, these loan provisions, which typically involve some combination of Chinese foreign content and commodity guarantees, are designed to improve the competitiveness of Chinese firms globally. However,

[96] For a list of these field research interviews, please see Chapter 5's Appendix.

they may also impose costs on Latin American countries. Preferential treatment for Chinese capital inputs and machinery may undermine Latin America's industrial competitiveness. At the same time, commodity guarantees embedded in loans-for-oil agreements risk eroding commodity proceeds that could otherwise be channeled toward domestic spending or reinvestment in state energy firms. Perhaps, most importantly, China's tendency to focus on commercial rather than policy terms may encourage governments to spend beyond their means, catalyzing future debt problems.

How will China deal with the tensions between implicitly supporting state expansion with its lack of policy conditionality and mounting Latin American indebtedness? Notably, it was the 1980s Latin American debt crisis, along with the Reagan-Thatcher neoliberal nexus, that ushered in the Washington Consensus's small government era. During that crisis, which is also known as the "Lost Decade,"[97] Western banks first extended new money to Latin American borrowers in hopes of recovering their initial investments and avoiding further sovereign defaults that would undercut their profitability. The US government also engaged in regulatory forbearance,[98] helping catalyze long-term, defensive lending in the commercial bank sector that is reminiscent of China's patient capital today. However, even with the added safeguard of linking new lending to macroeconomic conditionality (i.e. budget discipline), banks' losses mounted by decade's end, forcing them to write off their bad loans.[99]

China could be headed for a similar situation with its cases of miscalculated investment risk building across the globe from Sri Lanka and Indonesia to Venezuela. China has reiterated its commitment to its non-interference policy; however, its use of commercial conditionality rather than policy conditionality has not fully protected its financial investments from moral hazard risk.[100] China's creditor learning curve has underscored that sovereign credit risk cannot simply be mitigated by collateralizing policy bank loans with natural resources.[101] Even when loan repayment is tied to national commodity income, loan profitability

[97] The 1980s debt crisis was dubbed the "Lost Decade" because of its lackluster per capita growth (Stallings 2020).

[98] The major US banks were not required to increase their reserves to offset restructured or past due loans from developing countries (Kaplan 2013).

[99] See Kaplan 2013 for further details.

[100] See Chapters 5 and 7.

[101] Kaplan and Penfold 2019.

PROOF

is dependent on prudent local governance that sustains state-owned enterprises' resource production.

In other words, without policy conditionality, the burden of local governance remains with sovereign borrowers. When there is substandard national resource governance, Chinese policy banks have little recourse beyond extending new funds in hopes of recovering natural resource collateral. As one former CDB official explained it to me in our December 2019 interview, "it's not like lending to one province of China; you cannot order another country to do what you think is right."[102]

On net, Chinese regulatory forbearance and subsidization of its state banking sector may have promoted the flow of policy bank credit to higher-risk emerging markets globally, but they have also increased nonperforming loans. Chinese policy banks have thus adopted a defensive lending posture with many of their major Latin American borrowers, including renegotiating the terms of state-to-state loans with Argentina, Ecuador, and Venezuela.[103] China's policy banks have also seemingly not heeded their Latin American lesson, increasing their bilateral loans outstanding to the Evo Morales government in Bolivia by four fold between 2015 and 2017 to $1.8 billion (or 5 percent of Bolivia's GDP), only to be faced with the prospect of yet another restructuring after Bolivia's 2019 political crisis that ousted President Morales.[104]

To mitigate its sovereign credit risk, China is experimenting with market-based solutions and moving incrementally in its international economic efforts, much as it did during its domestic development.[105] With an eye to diversifying its sovereign risk beyond debt financing, China has created more than $40 billion in state-backed Latin American equity funds. Not only are these state-owned asset managers an important part of China's 2013 Third Plenum market reforms, they also enable Chinese policy banks to increasingly engage with the private sector internationally by directly investing in Latin American corporate enterprises through equity purchases.[106]

102 Author's interview, December 16, 2019.
103 See Chapters 5.4.4, 5.5.2–5.5.4, and 7.4.
104 Morales's socialist party, Movement for Socialism (MAS), now under the leadership of former finance minister Luis Arce, regained power in the October 2020 elections. During the campaign, Arce announced his plans to renegotiate Bolivia's multilateral loans; please also see Chapters 5.5.1.
105 See Chapter 2.2.
106 For further details, see Chapters 2.5 and 7.1.1.

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Notwithstanding the lofty headline numbers, China's state-backed equity investors have deployed only $2 billion in Latin America, or about 5 percent of the total funds committed by their shareholders.[107] By comparison, Chinese policy banks have extended more than $20 billion in new bilateral loan commitments, or restructured debt financing, to governments in Bolivia, Ecuador, and Venezuela since 2015.[108]

China's gradual shift in investment tools is also timed to take advantage of a changing Latin American context where governments, including Argentina and Brazil, have increasingly employed private procurement. Both countries have passed public-private partnership laws in recent years to relieve budgetary pressure on the central government by financing and delivering public services outside the public balance sheet.[109] According to one senior Latin American official, infrastructure has "a lot of risk that is on behalf of the government," and these laws allow countries to diversify "risk allocation" in their public works portfolios.[110]

In the world of finance, shifting from debt to equity financing is also a common way to mitigate credit exposure. The key question is whether China is moving forward quickly enough with these private-sector initiatives to avoid its mounting state-to-state problems. To some extent, China has been able to rely on multilateral institutions such as the IMF to resolve debt difficulties in nations across the globe, including Argentina, Ecuador, and Pakistan. Notably, China recently unveiled its own BRI debt sustainability framework in May 2019, which is voluntary for debtors. However, it is also conspicuously comparable to the IMF's own institutional approach[111], which regularly assesses sovereign debt based on borrowers' outstanding debt levels and their institutional capacity to absorb shocks.[112]

Moving forward, such policy initiatives suggest that China is likely to further experiment with both financing channels, state-to-state debt and market-oriented equity investments. Latin America's rich diversity of mixed-market economies – which have historically toggled between the market and the state – makes the region fertile ground for observing

[107] Author's interview with Fan Xiwen, Chief Operating Officer, China–Latin American Cooperation Fund, January 14, 2020, Beijing, China.
[108] See Figure 4.3.
[109] See Chapter 7.1.1.
[110] Author's interview, José Luis Morea, CEO of BICE, August 15, 2019.
[111] Morris and Plank 2019.
[112] These characteristics are measured across four-categories, *low risk*, *moderate risk*, *high risk*, and *in debt distress* (World Bank-IMF Debt Sustainability Framework, 2005).

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how Chinese policy banks behave internationally, particularly beyond East Asia.

While the state-to-state channel has excelled at promoting trade and investment ties internationally, this book's findings suggest that China may also mitigate its exposure to the region's indebtedness by channeling some of its patient capital directly toward project financing rather than state-to-state debt. By encouraging private-sector flows, Latin America's public procurement laws have also helped check the moral hazard problem that has plagued China's state-to-state deals.

In the coming years, developing countries' long-standing infrastructure needs (including hospital and clinics) are likely to be even more pronounced following the recent global coronavirus outbreak. In light of the economic disruptions created by the global pandemic to global trade, investment, and supply chains, some commentators have questioned the sustainability of globalization moving forward.[113] The crisis has also damaged China's soft power image globally because of its lack of transparency in warning the public about the coronavirus threat when it began in Wuhan Province in December 2019.

However, given the importance of the BRI initiative to both China's economic growth and President Xi's legacy, China is likely to continue to play a leading international role in the provision of infrastructure financing in a post-pandemic world. During July 2020, Foreign Minister Wang Li pledged China's ongoing cooperation with Latin America, particularly in the health care sector.[114] The country has also touted the advantages of its state-centric development model in marshaling public goods by providing desperately needed humanitarian assistance (i.e. protective surgical masks, testing kits, and ventilators) and new infrastructure (i.e. medical labs) to developed and developing countries across the globe. In Latin America, China donated $128 million in medical equipment between February and June 2020, sustained its regional trade ties after its economic recovery, and pledged $1 million to help finance the "public good" of a vaccine.[115]

With sovereign debt difficulties once again rearing their ugly head in several developing countries, China is left with a billion-dollar question.

[113] Farrell and Newman 2020.

[114] "China and Latin American and Caribbean Countries Hold Special Video Conference of Foreign Ministers on COVID-19," Ministry of Foreign Affairs, the People's Republic of China, July 23, 2020.

[115] Heine 2020; Sanborn 2020; Telias and Urdinez 2020.

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Should its policy banks further specialize in their comparative advantage of big-ticket state-to-state infrastructure deals, notwithstanding growing concerns about the extent to which its lack of transparency (i.e. fine print) contributes to this rising indebtedness. Or do China's state-backed bankers instead pivot toward market-oriented financing, and even market governance, to mitigate the politics of excess with the politics of austerity?

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