Lending money: Latin America and China's New Engagement

By **Lilliana Avendaño**

Introduction

Recent research highlights that much of Chinese foreign direct investment (FDI) is located in developing countries (UNCTAD, 2006, Morck, Yeung & Zhao, 2008; Gugler & Boie, 2008). At the same time, reports from the Chinese Ministry of Commerce (MOFCOM, 2010) point to sub-Saharan-Africa and Latin America as important destinations for FDI. In addition, other research suggests that there are two fundamental reasons that explain Chinese FDI in both regions: a) the need for oil and raw materials and b) the need for international allies (Chambers, 2006; Lafargue, 2006; Van de Looy, 2006; Hsiang, 2009; Regalado 2009).

However, Sino-African relations have historically been deeper than Sino-Latin American relations. For example, in the 1950s and 1960s China provided assistance to some African countries in the field of agriculture, forestry, food processing, textiles and other light industries, supply and distribution of water and in electric power generation. They also collaborated in the construction of the TaZaRa Railway. In the early 1970s they provided military assistance to several countries in the region who fought for independence, but as the decade progressed, the ideological approach led to a more pragmatic strategy focused on the economic interests of the

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country (He, 2006). Instead, the Chinese assistance in Latin America was almost non-existent and the ideological support ended when, in the mid-1960s, relations with Cuba deteriorated since the Caribbean country decided to support the Soviet Union in its struggle to secure global hegemony (Li, 1991).

Sino-Latin American relations mostly remained trade based; while Sino-African relations, for their part, include trade, investment and very deep political relations. In addition, China has made more investments in sub-Saharan Africa than in Latin America, creating the Forum on China–Africa Cooperation (FOCAC) and the China-Africa Development Fund (CADFund) to finance various projects. None of these or similar efforts were made in Latin America.

The ties between the People´s Republic of China (PRC) and Latin America and the Caribbean (LAC) started in the early 1960s after the establishment of diplomatic relations with Cuba. Other LAC countries joined the initiative but later Chinese diplomatic offices in countries like Panama, Ecuador, Brazil, Mexico and Argentina were closed and their representatives expelled due to the PRC´s support to the Cuban revolution. However, the improvement in Sino-US relations in the 1970s contributed to the reestablishment of diplomatic relations between China and LAC countries. Since then, relations between them have been characterised mainly by the export of raw materials and food to China and by the imports of textiles, light industrial products and handcrafts in limited quantities from China (Li, 1991). During the following decades, the exchanges remained in the commercial sector with a balance less and less favourable for LAC[ii].

At the beginning of the 1990s Chinese companies began to invest in the LAC. Starting the new century there was a rapprochement between China and Latin America. Regalado (2009) argues that the inclusion of the PRC into the World Trade Organization (WTO) joined with the maturity of their relationship reached in the 21st century allowed significant rapprochement between the two sides. This approach was more relevant to commerce than mere FDI since, during the decade, more than 95 per cent of Chinese FDI flows to LAC were invested in the Cayman Islands and the Virgin Islands tax havens. In other words, it cannot be said that China's entry to the WTO boosted trade in LAC but not FDI as in other regions of the world. Also, during those years, the PRC funded several countries in Asia and Africa through concessional loans, many of which were oil-related. However, the PRC did not boost lending in LAC, despite the fact that it is a rich in oil resources region, the same as Africa.

In 2008, the PRC introduced its first policy paper on Latin America and the Caribbean[iii], in order to formalise the terms of agreements and reach more collaborative agreements with the countries of the area in commercial aspects, investment, finance, agriculture, industry, natural resources and energy. This is a very significant event since Sino-Latin American relations in general, as previously mentioned, have been cordial but not exceptionally deep, based primarily on trade.

A major change in Sino-Latin American relations occurred with the beginning of the financial crisis in 2008. From that moment, the PRC became an important source of funding for Latin-American countries, directing 87 per cent of its loans into the energy, mining, infrastructure, transportation, and housing sectors. Export-Import Bank of China and China Development Bank are the main Chinese lenders in LAC becoming an alternative source of funding, especially for those countries trying to gain access to international financing. In the light of the above, the aim of this work is to analyse the scope, circumstances and characteristics of Chinese funding in LAC.

This paper is organised as follows. Section one outlines the economic relations between China and Latin America. Section two describes China's financial institutions involved in international lending. Section three analyses the scope and characteristics of China´s loans in LAC. Finally, section four presents the conclusions.

1. A brief history of China-LAC economic relations

As mentioned in the introduction, Sino-Latin American relations began early in the

1960s followed by a break mainly due to ideological issues and then a commercial rather than political approach during the 1970s.

After the 1978 economic reform it was clear that the PRC wanted to increase its foreign trade. In fact, their foreign policy was focused on ensuring access to scarce natural resources in the country, to allow the transfer of technology to China and to increase export opportunities for Chinese companies. In addition, the PRC government legalised the emission of FDI through its Fifteen Measures of Economic Reform in 1979. This period of Sino-Latin relations was characterised by the commodity and natural resources trades. Consequently, Chinese enterprises in the region were mainly trading companies. At that time, both China and LAC, showed willingness to diversify their commercial and political relations. Thus, a favourable environment was created to promote Sino-Latin relations.

In the early 1990s, not only trading companies were active in the LAC region, but manufacturing companies were established as well. This was largely because Chinese enterprises discovered that they could transfer low-tech manufacturing and produce goods at a lower cost and dominate the market.

The interest of the companies was mainly market-seeking, but they were also looking for strategic locations, not only for trade and investment purposes, but also to export to third countries (triangulation). This was with two major objectives in mind: a) to elude import tax payment on markets organised in blocs, b) to try to eliminate restrictions imposed by those governments opposed to products "made in China" and to limit the effects of their protectionist instincts. Those investments were located mainly in Brazil, Argentina and Colombia. The first two could allow trade in the MERCOSUR area whereas the last one could open the door to Mexico directly, and eventually to the whole NAFTA area.

With China´s entrance into the WTO in 2001, Chinese trade and FDI expanded all over the world, with Latin America being no exception. Many Chinese companies located in LAC. There were investments in the automotive sectors, machinery and equipment, electronics, information technology (IT), transport and finance. In other words, Chinese investment in LAC began upgrading the value chain during the decade.

Nevertheless, the most important investments in the region were oriented towards two principal locations: the Cayman Islands and the Virgin Islands, tax havens where Chinese capital could be returned to China ("round tripping") or be invested in any other country in the world. In other words, most Chinese capital was sent abroad just to have it return as foreign investment in order to enjoy special lower taxes and benefits from the Chinese government.

Between 2003 and 2007 Chinese FDI flows into the Cayman Islands and the Virgin Islands represented more than 90 per cent of the total of Chinese FDI flows into LAC. This suggests that Chinese FDI in Latin America is in fact relatively small compared to Chinese investments in Asia and Africa.

The PRC issued its first policy paper on Latin America and the Caribbean in November 2008. The paper stresses the importance of the relationship between the PRC and LAC, considering it as "strategic" and focusing on diplomacy, bilateral trade and economic relations. As a result, loans to some countries in LAC between 2008 and 2012 amounted to US$ 85.559 billion, while in previous years these loans did not exceed one billion. In fact, Chinese loans to LAC are larger and growing faster in the recent years than those from the international financial institutions (Gallagher, Irwin & Koleski. 2013).

2. Chinese financial institutions involvement in international lending

China Development Bank (CDB) and Export-Import Bank of China (Exim Bank) are the two primary agencies carrying out China's international lending. Both of them were founded during the 1994 financial reform and are called "policy banks" meaning "tools of the government to support policy objectives". The "Going Out" policy promoted by the Chinese government has been supported by these two banks financing the overseas activities of Chinese state-owned enterprises (SOEs), mainly helping SOEs to acquire oil and other natural re-sources (Gallagher *et al*, 2013). At the same time, *The Guidelines on Risk Management of Loans Extended by Commercial Banks for Mergers and Acquisitions* and the *Notice on Certain Issues Relating to Foreign Exchange Administration on Offshore Lending by Domestic Enterprises*, reinforce this effort as we will see later.

Previous to 1994, the so-called "big four" banks (Bank of China, China Construction Bank, Agricultural Bank of China, and Industrial and Commercial Bank of China) were designed to provide policy loans. With the arrival of the two new banks in 1994, the "big four" were discharged of that activity and were able to deliver commercial loans.

Gradually, the Policy banks have experienced major changes owing to market economy expansion; their role has gained importance and their business has become progressively market-based. For example, CDB used to be focused on infrastructure, construction and other industrial sectors. However, at present it is trying to increase its share in the commercial banking business. CDB underwent commercialisation on 2008 into a joint stock banking institution under the ownership of the Ministry of Finance and Central Huijin Investment Corporation. In 2010, it enhanced its corporate governance mechanisms by developing a complete risk management system for its mid-to-long term loan business; consequently, it could grow into a banking group engaging in direct investments, securities business, leasing services, local branching activities and overseas operations. CDB has been mainly involved in overseas lending and has stressed grassroots financing and international co-operation (KPMG Advisory, 2011).

CDB has created two international representative offices in Egypt and Russia. Through the China-Africa Development Fund (CADFund) it has established offices in Africa. However, those offices are insufficient due to the large number of CDB´s investments in more than 90 countries. As a result, some CDB's domestic branch offices, for example Henan and Chongqing, are responsible for overseas bank operations. In order to gather country-specific information, estab-

Table 1: Chinese Loans-for-Oil in Latin America

YEAR	BORROWING COUNTRY	BORROWER	LENDER	AMOUNT (US$ MILLION)	PURPOSE
2008	Venezuela	BANDES and PDVSA	CDB	4000	Funding infrastructure, other projects
2009	Brazil	Petrobras	CDB	10 000	Pre-salt oil technology
2009	Ecuador	Petroecuador	PetroChina	1000	Advance payment for Petroecuador oil
2009	Venezuela	BANDES and PDVSA	CDB	4000	Infrastructure, including satellite
2010	Ecuador	Petroecuador	CDB	1000	80 per cent discretionary, 20 per cent oil-related
2010	Venezuela	BANDES and PDVSA	CDB	20 000	Funding infrastructure
2011	Ecuador	Government	CDB	2000	70 per cent discretionary, 30 per cent oil-related
2011	Venezuela	PDVSA	CDB	4000	Infrastructure
2011	Venezuela	PDVSA	ICBC	4000	Housing

Source: Gallagher et al (2013).

lish relationships with local officials and businesses, and provide logistical support to visiting CDB officials, the domestic offices send work teams to several countries (BankTrack, 2012).

The Exim Bank is also interested in undergoing commercialisation but it has not formally undertaken to do so. Nevertheless, it has begun to expand the scope of its operations, supporting the "Going Out" policy, covering over 100 countries worldwide, opening three overseas branches by 2010 and lending more than US$ 190 billion. Until now, China Exim Bank has been financed through Ministry of Finance bonds and its main activities are focused on improving foreign trade and economic co-operation (KPMG Advisory, 2011).

There are three regulatory bodies for banks in China: Ministry of Finance (MOF), China Banking Regulatory Commission (CBRC) and State Administration of Foreign Exchange (SAFE).

MOF was created in 1949 and is in charge of the macro-economic management of the state's budget, financial and tax policy, revenues from taxes, treasury bonds, and hard currency reserves. MOF supervises the issuance of T-bonds in addition to the negotiation of loans provided by foreign governments and is responsible for the non-governmental auditing sector. Additionally, it has a major function in the reform of the financial management systems of SOEs and other public institutions, including monitoring budgetary and construction fund spending at local levels.

CBRC is a State Council Directly Administered Office; it was founded in March 2003 to supervise the banking sector. CBRC is mainly composed of bank supervision departments that formerly reported to the People's Bank of China (PBOC). Some elements of the former Central Finance Work Committee are now part of CBRC.

One main responsibility of the CBRC is the application of supervision requirements to push the big four banks to achieve a quality level that allows more uniform enforcement of capital adequacy ratios and other regulatory requirements. CBRC controls risk mitigation policies to bring down the non-performing loan ratio of China's big four state banks. In addition, it works to fortify credit-risk management and internal audit controls within the banking sector. The commission's formation further represents an attempt to raise the efficiency and transparency of China's banking sector through the separation of banking supervision from the central bank and is an important stage in the reform of China's state banking industry (US-China Business Council, 2013).

In December, 2008, CBRC launched the, *Guidelines on Risk Management of Loans Extended by Commercial Banks for Mergers and Acquisitions,* that allowed the Chinese banks to provide loans for mergers and acquisitions (M&A) purposes, reducing qualification requirements for offshore lending, expanding the sources of funds for lending, and shortening verification and remittance procedures for lending. The guidelines authorise loans to purchase existing equity interests, subscriptions for new capital, mergers, asset acquisitions, debt restructuring and other similar transactions, excluding the purchase of non-controlling minority stakes. The guidelines were launched owing to the State Council's desire to increase bank support for M&A transactions as part of an effort to fight the global financial crisis (Benesch, Friedlander, Coplan & Aronoff LLP, 2010).

SAFE was established in 1979 under the Bank of China but was moved in 1982 to PBOC, which functioned as an independent organisation, prior to the 1998 government restructuring. It is responsible for administering the use and flow of foreign exchange, making foreign exchange policy recommendations to the PBOC and overseeing the transfer of foreign exchange out of and into China under the capital account of the balance of payments (Wenbin & Wilkes, 2006; US-China Business Council, 2013).

In June 2009, SAFE launched the *Notice on Certain Issues Relating to Foreign Exchange Administration on Offshore Lending by Domestic Enterprises*. The Notice simplifies the process for financing Chinese companies' overseas operations by reducing qualification stipulations for offshore lending, enlarging the sources of funds for lending, and shortening verification and remittance procedures for lending. The notice also permits Chinese enterprises to use their own foreign currency holdings as well as government foreign exchange reserves to make loans to their overseas subsidiaries. The global financial crisis has made it more difficult for foreign subsidiaries of Chinese enterprises to obtain funding abroad. The purpose of the notice is to avoid this situation and facilitate Chinese companies to invest abroad (Benesch, Friedlander, Coplan & Aronoff LLP, 2010).

3. Scope and characteristics of China´s loans in LAC

Prior to 2008, Chinese loans to Latin America were uncommon, not exceeding US$1 billion, according to Gallagher *et al* (2013). However, since 2008, several factors contributed to increase the number of loans from the PRC in LAC.

First, the PRC needs natural resources to feed its rapidly expanding economy, but it does not have sufficient oil, natural gas, aluminium, copper, or iron ore to satisfy its energy and manufacturing needs. Second, the 2008 financial crisis provided an opportunity to lend money to a number of countries as well as to some enterprises in LAC region where traditional lenders, like the Inter-American Development Bank (IDB), are having hard times. Third, the contraction of credit markets caused main oil and natural gas producers in the world to look for alternative sources of funding to support investment programs, refinance short-term debts, and sustain social spending. China is a new and growing source of finance for LAC (Table 1), especially for small nations that are usually overlooked by international financial institutions (IFIs) and countries suffering to gain access to international capital markets (Gallagher *et al*, 2013; Downs, 2011).

According to Li (1991), between 1978 and 1990 there were some agreements on an reciprocal credit line between the Bank of China and its counterparts in LAC, but the credit lines were rarely used because of high fees and little understanding between businessmen on both sides. Nevertheless, in the 2000’s some LAC

Table 2 Bank Loans to Latin America by Sector, 2005–2011 (US$ million)

SECTOR	TOTAL	WORLD BANK	IDB	CHINESE
Health	17 926	8463	9463	—
Education	7008	4389	2619	—
Water, Environment	16144	7061	9084	—
Public Administration	19105	11 013	8092	—
Finance, Trade	18328	7170	9858	1300
Housing, Infrastructure	38 098	—	4397	33 701
Transportation	27 693	7192	8821	11 680
Energy, Mining	30 061	2565	7576	19 920
Other	10 651	378	2028	8614
TOTAL	185 383	48 231	61 937	75 215

Source: Gallagher et al, 2013

countries that were sanctioned or/and isolated by the United States, such as Venezuela and Argentina, received loans from the PRC in exchange for oil (Li, 2007). Chinese loans were increasing gradually especially in some countries so that between 2008 and 2011, Venezuela, Argentina, Ecuador and Brazil received 91 per cent of Chinese lending (Gallagher *et al*, 2013).

Given that in 2009 upstream capital cost decreased about 12 per cent and upstream spending was 15 per cent lower (as a result of the financial crisis) it was cheaper for Chinese national oil companies (NOC´s) to invest in upstream activities. Additionally, at the end of 2010, the NOC´s also had a competitive advantage due to the possibility to use part of the PRC's US$ 2.45 trillion reserves. Furthermore, the recent appreciation of China's currency has made buying overseas assets cheaper for the NOC´s (Jian and Sinton, 2011).

CDB and China Exim Bank play a major role in providing funding for oil and gas arrangements. For example, in 2009, CDB had provided no less than US$ 44 billion in loans to resource rich countries. In September 2010, CBD made strategic alliances with China National Petroleum Corporation (CNPC) and China Petroleum & Chemical Corporation (Sinopec). As a result, CDB approved US$ 30 billion loans to CNPC at low rates over the next five years to finance CNPC's overseas expansion. Simultaneously, China Exim Bank gave concessional loans to Ecuador and Bolivia (Jian and Sinton, 2011; Gallagher *et al*, 2012). In sum, the financial crisis and the huge China's reserves made it possible to provide long-term loans to resource rich countries. At the same time, some LAC countries were the indirect beneficiaries of these loans.

According to Dyer et al. (2011) CDB and China Exim Bank gave loans of at least US$ 110bn to developing countries between 2009 and 2010. Jian and Sinton (2011) report of US$ 77 billion in loans delivered by CDB for long term oil and gas supply signed during the same period, 48 per cent of which went to some LAC countries. Gallagher et al. (2013) reveal that, between 2008 and 2012, Chinese banks approximately delivered in LAC US$ 85.559 billion loans, 70 per cent of which were oil-related loans. In other words, most of China´s loans in recent years have been delivered in LAC.

Some projects supported by Chinese banks in LAC are related to the purchase or construction of home gas lines, oil drilling rigs, transportation, infrastructure, telecommunications infrastructure and equipment, roads, mining and steel mill equipment. A salient feature of these loans is that they are often tied to the purchase of Chinese goods or investment from Chinese firms. Therefore, the banks make sure that any machinery or equipment needed for the financed project is bought in China, that is, the money will stay in China (Downs, 2011; BankTrack, 2012; Gallagher *et al*, 2013).

Chinese banks are lending more money in LAC than The World Bank and Inter-American Development Bank. However, Chinese and Western banks do not overlap considerably in LAC because they provide different size loans to different sectors in different countries (Table 2).

Chinese bank, for example finance countries like Ecuador and Venezuela that have difficulty finding international sources of funding. In addition, Chinese lenders usually finance infrastructure, energy, mining, housing, and transportation; in contrast, Western banks support a range of governmental, social, and environmental projects.

One possible cause is that while the Western banks take into account Millennium Development Goals[iv], Chinese banks copy the aid scheme used by the Japanese in the 1970s (Gallagher *et al*, 2013). Chinese financing philosophy differs greatly from Western countries. The Chinese government believes in mutual benefit and equilibrium; in being partners instead of donors in financing areas neglected by western financial institutions, as for example infrastructure and housing; in respect for sovereignty with no conditions involved; promotes self-reliance, not dependency, technology transfer through technical assistance and quick results (Brautigam, 2011a).

The roots of this philosophy came partially from the Chinese premier Zhou Enlai who, in 1964, spelled out some of the principles previously enounced. At the same time, the PRC government learned from Deng Xiaoping's initiative to ask Japan for a long-term contract to speed up the exploration of coal and petroleum "on the condition of equality and mutual benefit, and in accordance with accepted practices of international trade such as deferred and instalment payments [...] where they will supply complete sets of modern equipment required by us, and we will pay for them with the coal and oil we produce" (Brautigam, 2011b:4-5).

Accordingly, Chinese funding seeks to improve the borrower´s economic conditions using commodities to secure commercial loans. In this way a country can finance a project and pay for it with its own commodity production.

Instead, funding from Western institutions has its origins in charitable aid from the colonial era which promotes education and health and, currently, also supports care of the environment (Brautigam, 2009).

Conclusions

The global financial crisis provided Chinese banks with an opportunity to undergone a remarkable expansion in LAC. China Exim Bank and CDB have become central actors in the acquisition of oil-related assets and the creation of strategic alliances with resource rich countries. Considering the circumstances, we can say that China Exim Bank and CDB´s loans allowed the reaching of three main objectives: to increase financial gains, expanding at the same time their portfolio of cross-border deals; to support the PRC's "going out" strategy; obtaining recognition inside and outside China and to encourage China's national oil companies to build their international upstream portfolio.

For LAC countries, Chinese loans have become an alternative source of funding, especially when the IFIs require excessive conditions. Simultaneously, LAC countries received development loans, which was very important during the worst phase of the financial crisis. Nevertheless, China's growing influence in LAC raises some questions considering its role in the region's political and economic development. The United States perceived that China´s presence in LAC has negative implications for its own economic and political hegemony.

Some argue that Chinese loans are empowering anti-American regimes. In contrast, other claims that Chinese growing presence in LAC just transfer external power from one economic power to another. Despite the criticisms, the presence of the PRC in the region is lower than in sub-Saharan-Africa and Asia, in terms of oil investments and loans, so that the implications of their presence in LAC are still unclear. In other words: so far, China is good news for Latin America.

End notes

[ii]In the decade of 2000, the trade between China and Latin America showed a deficit most of the years. Currently the structure of LAC´s imports from China is composed of medium and high technological manufactures. Chinese imports from LAC are concentrated in natural resources and products processed from those (Rosales and Kuwayama, 2012, SELA, 2012).

[iii]Two years earlier, in 2006, China had already launched the China's African Policy White Paper.

[iv]Eradicate extreme poverty and hunger; achieve universal primary education, promote gender equality and empower women; reduce child mortality; improve maternal health; combat HIV/AIDS, malaria and other diseases; ensure environmental sustainability; create a global partnership for development with targets for aid; trade and debt relief.

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