**The Pathfinder Economic Alert**

# Maximizing the Benefits from Chinese Funding
# Lessons from Latin America

Sri Lanka has recently mobilized very substantial loans from China to fund large infrastructure projects (e.g. the Norochcholai power station and the Hambantota port). It would, therefore, be useful to understand better the manner in which the Chinese authorities administer their foreign loan programs.

## Increasing Influence of the Dragon

China has been playing an increasingly important role in the global and regional economies. It is the largest contributor to growth and its supply chains are playing an ever more important role in driving economic expansion in the Asian region. In addition, as the factory of the world China's voracious appetite for natural resources has boosted commodity prices. This has benefited countries ranging from Australia and Canada to developing nations in Africa and Latin America. More recently, China has also become a major lender. There is considerable debate about the nature of this lending and its quality. This article draws on research conducted by the Inter-American Dialogue on Chinese financing in Latin America to understand better the impact of this lending.

Chinese lending to Latin America has expanded rapidly, since 2008. Most of it has originated from the China Development Bank (CDB) and the China Export-Import Bank (Exim Bank). The Chinese banking system has long combined policy priorities/strategic interests and commercial criteria in its domestic operations. The Chinese banks' "Going-Global" policy has more recently brought the amalgamation of these twin objectives to the international arena.

This article will draw on the Inter-American Dialogue research to estimate the volume of Chinese loans to Latin America; examine the terms of its lending, compared particularly with the World Bank (WB), Inter-American Development Bank (IDB) and the US Ex-Im Bank; elaborate upon the special features of Chinese commodity – backed (particularly oil) loans; discuss the composition of Chinese finance; focus on the conditionality aspects of this lending compared to traditional donors; and explore the environmental guidelines supporting these loans.

## Funding Latin American Development

The Inter-American Dialogue research estimates that Chinese lending to Latin America amounted to $75 billion in 2005 – 2011 (there are data and methodological issues). The CDB was responsible for 82% of this; the Exim Bank 12%; and the Industrial and Commercial Bank of China 6%. The loans were extremely large and were focused on a few countries in the region. Venezuela, Brazil, Argentina and Ecuador received 91% of the loans and 2/3's of the lending were in the form of loans – for – oil. Though China has commenced lending to Latin American only recently, in 2010 it lent more than the WB, IDB and US Ex-Im Bank combined to the region. In that year, China lent $37 billion compared to the WB ($14 bn) and IDB ($12 bn). This transpired despite the fact that these banks had doubled their lending to the region since 2005. China's Ex-Im Bank out financed its US counterpart by $8.2 billion to $ 2.2 billion in that year.

The size of the Chinese loans was also remarkable: Venezuela ($20bn), Brazil and Argentina ($10 bn each). Following the conclusion of these enormous loans, Chinese lending to the region has plateaued out ($13bn in 2011). However, it still exceeded the commitments of the WB and IDB. It is noteworthy that the Chinese and Latin America's traditional lenders were directing their respective credit flows to different groups of countries. Venezuela and Ecuador accounted for 61% of Chinese financing which amounted to almost 10% of their GDP. These countries make up 8% of the population of the region and 7% of its GDP. As mentioned above, Argentina (trains) and Brazil (loans-for-oil) were recipients of other large loans. It should also be noted that Venezuela (political/nationalization) as well as Ecuador and Argentina (debt defaults) have had disrupted relations with international capital markets. Though Chinese lending is not cheap (see below), it is still less costly than the large risk premia that the international capital markets would demand from these economies. In effect, China has used its commodity-backed loans to reduce the risk attached to lending to these countries and thereby reduced its cost.

One may conclude that there is no significant overlap between China and the traditional lenders when it comes to beneficiary countries. As a result, one may argue that Chinese lending in Latin America is augmenting rather than substituting for the loans from traditional sources. There are also significant differences in the size distribution of the loans granted by the two parties. The overwhelming majority of Chinese financing packages to Latin America were $1 billion or greater; compared to 22% for the WB and 9% for the IDB.

## Are Chinese Loans Cheaper?

There has been a lively debate about the cost of Chinese loans. Some have argued that China has vigorously pursued its strategic interests by offering very cheap money to undercut traditional sources. Others have argued that Chinese money is hassle-free but more expensive. The Inter-American Dialogue research comes out somewhere in the middle. Chinese loans have broadened the financing options, particularly for countries that have high-risk premia attached to their borrowing. They also introduce healthy competition in a context where OECD rules can permit traditional donors to collude to the disadvantage of borrowers.

The evidence suggests that CDB interest rates are higher than the WB's IBRD lending; while the Chinese Exim Bank offers slightly lower rates than its International Financial Institution (IFI) and western bilateral counterparts. The latter is attributed to China channeling some of its development aid through its Exim Bank (OECD countries are prohibited from mixing export credits with development aid to prevent cut-throat competition among themselves). While these subsidies help, it is also a fact that Chinese companies are often simply more competitive. There are instances, however, where western companies have been preferred despite higher prices. For instance, Pakistan chose General Electric over Dongfeng trains despite the fact that the latter were "30%-50% cheaper due to quality differences"

**Commodity-Backed Loans**

$46 billion of China's $75 billion commitment to Latin American (2005-2011) has been in the form of loans-for-oil. Such credits combine loan and oil-sale agreements involving the state-owned banks and oil companies of the two countries involved. The Chinese banks grant large loans to an oil exporting country; that country, in turn, pledges to ship pre-agreed quantities of oil on a regular basis (sometimes daily) for the duration of the loan. The Chinese oil companies then buy the oil at spot-market prices prevailing on the day of the shipment and deposit their payment into an account of the exporting country held in the CDB. The CDB then withdraws a pre-agreed share (varies according to country) of the proceeds from this account as repayment of its loan. In the case of Ecuador, 21% of the oil revenue is used to pay back the CDB loan with the remainder reverting to the country.

Commodity-backed-loans are clearly a win-win arrangement. They fulfill China's strategic and commercial objectives. On the one hand, they build relationships with Latin America (and other commodity exporting countries) by enabling China to provide financing for these countries using an instrument that serves to reduce risk (i.e. this instrument has enabled China to give large loans to countries whose creditworthiness is poor by reducing the risk of borrower default). In the case of creditworthy countries, they also are able to obtain financing at costs well below the market rates, because of the risk-mitigating nature of the instrument. This helps China to be seen as a great power that assists developing countries. It also results in China establishing diverse, long - term commodity supply chains; promoting Chinese exports (out of the proceeds of the commodity exports); putting China's massive dollar reserves to productive use; and expanding the international use of the Yuan. The recipient countries are able secure large loans at very competitive cost.

It has been argued that China has turned to commodity-backed-loans as a second-best strategy. This line of argument contends that Chinese companies would prefer to own the assets rather than securing purchase-agreements. However, in practice, commodity-backed-loans have clearly proved to be win-win arrangements for both China and the natural resources suppliers.

**Composition of Chinese Loans: Learning from Japan.**

Chinese loans to Latin America are concentrated in sectors, which are different from the focus of support from traditional donors. China supports infrastructure and industrialization based on a different model of development. It supports growth rather

than social welfare. Traditional donors, on the other hand, believe that the growth agenda should be driven by the private sector and focus instead on interventions in the health, education and social services (eg the MDGs).

Chinese banks channel 87% of their lending in Latin America into energy, mining, infrastructure, transport and housing. The WB and IDB direct more than 1/3 of their loans to social development. These sectors are devoid of Chinese support. The Chinese are, in practice, replicating the Japanese banks' focus on infrastructure and transportation in China during the 1970s and 80s. In their view, this financing played a significant role in China's transformation process.

**Conditionality**

The Inter-American Dialogue research has found that while the WB attempts to shape projects and even the organizations receiving the loans; the Chinese give much greater freedom to the borrowers. However, Chinese lenders usually tie their advances to procurement of Chinese goods and services. The WB and IDB, on the other hand, are compelled to use competitive international bidding.

It has been argued that Chinese loans offer a new potentially liberating model of non-interventionist lending. This line of thinking contends that rather than forcing borrowers to comply with Western norms, Chinese partners treat them as equals and simply seek to do business with them.

However, the downside of Chinese lending is that the tied nature of the support and the lack of competitive bidding result in cost escalations which increase the burden of servicing the debt which ultimately falls on the people of the country. Borrowers need to balance the reform requirements (conditionality) of the traditional donors against the additional costs associated with the tied-loans from China. The speed and efficiency with which the Chinese system is able to respond is another plus factor that needs to be taken into account when assessing the relative merits of the two alternate approaches.

**Evolving Environmental Guidelines.**

It has been argued that the Chinese lenders have had a relatively cavalier approach to the environmental impact of the large-scale projects they financed. However, in the past five years, the Chinese authorities have sought to incorporate social and environmental guidelines into their banks' procedures to improve both domestic and international lending practices. In comparing these guidelines to those of the WB and IDB, the Inter-American Dialogue research finds that despite the significant progress made in recent years, China's guidelines do not match those of the IFIs as yet.

**Lessons for Recipients**

One may conclude that Chinese and traditional donors do not overlap significantly in Latin America because they give different size loans to different sectors in different countries. In addition, Chinese lending to the region seems to be yielding win-win outcomes to both the borrowers and creditors. However, the downside is that tied loans, combined with a lack of competitive bidding and transparency can lead to

significant cost escalations. It is important, therefore, for the authorities from borrowing countries to negotiate effectively and to ensure that their people are not burdened with the need to repay unnecessary costs. Furthermore, increased costs can also reduce the rate of return on projects thereby undermining the borrowing country's capacity to service these loans.

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