China to Finance Infrastructure in Latin America

Francisco Javier Valderrey*, Miguel Ángel Montoya**

Abstract - In this article we present an overview of Chinese investment in Latin America and a succinct analysis of the financial challenges and repercussions of infrastructure investment in the region.

Introduction

In a world of shrinking opportunities investors face a pressing need to look for new alternatives. Latin America is eye catching, due to the lack of adequate infrastructure to sustain population growth, the rise of middle classes and the betterment of economic conditions, if considered in the long run. Infrastructure is widely recognized as necessary to carry the region into the developed world and opens enticing possibilities to local and international business people and enterprises. Nevertheless, infrastructure presents a gloomy panorama in Latin America, with profound differences on a per country basis, although some nations look attractive to international investors. Traditional problems of infrastructure investment, mainly commitment of massive resources, long term planning and capital allocation, or the need for a clear regulatory framework, acquire a multiplier effect in Latin America. During many decades the difficult role of providing for those services has been considered a state responsibility. Without a sizable input from the private sector[1], governments have been unable to reach the yearly 5% of GDP of infrastructure investment, which many experts consider the threshold to reach development, when sustained over a long period of time.

On the positive side, the inclusion of some countries in global value chains and participation in free trade areas have fostered the construction of highways, sea ports, airports, railways and other elements to carry out the necessary logistics for international trade. Although advances in transportation may be more evident, numerous projects have successfully provided clean water, sewage or electricity to communities, thus fulfilling some of the Millennium Development Goals. The growth in telecommunications is noticeable and the energy sector has been the driver of foreign direct investment (FDI) in major projects. In spite of those improvements, infrastructure investment in Latin America repeatedly falls below expectations. Therefore, it is evident the need for a game changer, which may have already arrived.

A unique investor profile

Latin American economies were subordinated to European countries during early stages, although for more than a century the area has fallen under the umbrella of the United States. The presence of American investment is overwhelming, except for a handful of nations that ideologically oppose its dominance. Recently, though, China is rivalling the US in several industries and markets. The Asian country is getting closer to Latin America due to geopolitical reasons, market expansion, as well as for the need to secure agricultural commodities and raw materials for its industry.

At first, the relationship between China and Latin America was fundamentally based on trade. China exported low added value manufacturing products in exchange for commodities, leaving a rampant trade deficit on the reverse side, with negligible FDI involved. Recently, the situation started to change; a review of FDI inflows from China to Latin America between 2010 and 2013 reveals a dramatic increase in the Chinese direct presence in Brazil, Argentina and Peru, through investment in infrastructure, energy related and turnkey projects. Aggregate investment in the region reached US$ 42,716 million between those three years, as opposed to US$ 7,342 million during the entire preceding decade[2]. The year 2010, in fact, witnessed an inflow of US$ 13 billion into the region, especially

*Francisco Javier Valderrey (francisco.valderrey@itesm.mx) is Research Professor at Tecnologico de Monterrey, Leon Campus, Mexico.

**Miguel Àngel Montoya (mmontoya@itesm.mx) is Research and Postgraduate Studies Director at the EGADE Business School, Guadalajara, Tecnologico de Monterrey, Mexico.

1 Serebrisky et al. propose different solutions for the chronic problem of underinvestment in infrastructure in Latin America and they make a major point at “treating infrastructure as an asset class in its own right, rather than a sub-class derived from real estate”. (Serebrisky, Suárez-Alemán, Margot and Ramirez, 2015, p. 22).

2 Enrique Dussel Peters points at the fact that Chinese investment policy has evolved into regional agreements, although with focus on five key countries: Argentina, Brazil, Cuba, Mexico and Venezuela. (Dussel, 2015, p. 4).

through mergers and some large acquisitions in the oil industry. As pointed by the Economic Commission for Latin America and the Caribbean (ECLAC), investments included operations in different sectors, which caught "the attention of governments and civil society", with unintended consequences in strategic sectors[3].

The composition of Chinese outward direct investment is rapidly evolving and so are the main actors involved. Initially, State-Owned Enterprises (SOEs) were the investors, as part of the internationalization process of China. Large, but rather unknown companies in the West, selected projects of strategic importance for their government, with international policy prevailing over business decisions. Then, a new breed of enterprises of different sizes took the lead[4], with near 25% of total non financial FDI. In both cases, the so called "quasi-governmental organizations" or institutions devoted to the promotion of exports and investments, such as China Development Bank, Export and Import Bank of China, among others, paved the road for the success abroad of both SOEs and privately owned enterprises[5]. The new China-CELAC Forum is expected to provide further support to Chinese companies by promoting the removal of barriers to doing business. A major turning point is the shift in the composition of China`s FDI in the region, from merger and acquisitions into greenfield projects; the numbers are astonishing, with approximately US$ 10 billion in 2014 in greenfield FDI, following a US$ 46 billion figure in 2013, including the colossal project for the construction of the Nicaragua Canal[6]. Last year`s numbers show a reversal of this trend, but the fact of the matter is that China is displaying the capabilities needed to pursue investment projects of greater size and different shape.

The size of Chinese FDI in Latin America is growing rapidly. There are severe limitations to obtain statistics on incoming FDI into the region, but the figure nears the US$ 99 billion in 2014, although those numbers may change according to different sources. There are also changes in the making that will have an impact. In fact, different internal events in China have reshaped the relationship between this country and Latin America. Some of the factors, such as the so called "soft landing" of the economy, are beyond the government`s control; others are consequences of the restructuring of the national economy in an effort to become service oriented, while others are part of new international policy. The GDP growth has been reduced significantly, with new targets within a range nearing 6.5% of annual growth and unprecedented latitude for deviations. Although such rate of growth is only achieved by few countries in the world, the impact from the economic slowdown has been great in domestic production. The effect has been also noticeable for commodities export oriented economies in Latin America. Demand for agricultural products, minerals and raw materials has not changed much in quantity, but the less favourable terms of trade have a great impact in those countries. Additionally, the overcapacity for construction materials and engineering services has forced China to extend infrastructure projects overseas.

Financing infrastructure investments

The new China is gearing towards domestic consumption, but in the process requires downloading the idle capacity for infrastructure development in other markets. As part of the One Belt One Road (OBOR) and the First 21st Century Maritime Silk Road initiatives, the nation is bidding and financing infrastructure projects in a myriad of countries in Asia, Africa and now also in Europe. The call for globalization of Chinese enterprises, the "Going Out" strategy, has also strengthened the incentive for companies of all sizes to go international. Latin America is probably a temporary exception, although President Xi Jinping has already pledged US$ 250 billion for direct investment in the region, with US$ 20 billion committed to infrastructure.

China is, relatively speaking, a new banker in Latin America, but it is already filling up the void left by international and multilateral lenders. Infrastructure investment in Latin America is carried out by Chinese enterprises and entities in many different forms, although they "fall into three categories: a) FDI in infrastructure, b) engineering and construction contracts, and c) loans provided to countries, with loan financing as the most significant form" out of the three[7]. Foreign infrastructure investment comes mainly through direct acquisitions, while engineering and construction contracts are not so straightforward. Finally, loans to countries are widely used, but on a case by case basis and subordinated to geopolitical strategy.

3 By the end of 2011, Latin America accounted for 13% of the stock of China`s outward direct investment (ECLAC, 2013, p. 7).

4 Chinese investment is extending to private companies, which are offering diversity and technological content. (Niu, 2015, 43).

5 Another quasi governmental organization, China Council for the Promotion of International Trade (CCPIT), plays a fundamental role by maintaining a strong relationship with all the parties involved. CCPIT is at the middle ground of the "top-down" action from the government and the "bottom-up" action from enterprises. (Yang, Z., 2015, in Peters, E. D. and Armony, A. C., p. 74).

6 With the Nicaragua Canal, the distribution of sectoral greenfield FDI changed drastically and construction dwarfed activities, with 63% of the aggregate. (Ray and Gallagher, 2015, p. 12).

7 Bettina Gransow explains in full detail each category, with detailed data and figures of loans committed to countries and companies. (Gransow, B., 2015, in Peters, E. D. and Armony, A. C., p. 94).

Many experts anticipate a reduction in sovereign lending, counting on the new strategies that encourage enterprises to invest overseas. Their estimate is probably right in the long run, but for the moment there is room for surprises. In fact, by 2015 sovereign lending was increasing to US$ 29 billion, "nearly twice as much as the combined of all the Western multilateral development banks, including The World Bank, The Inter-American Development Bank and The Latin-American Development Bank"[8]. Sovereign loans have served different sectorial needs, although in the last year, oil and gas and infrastructure have prevailed.

A report from the Inter-American Dialogue offers information in full detail about lending practices from Chinese financial institutions. Although it was published in 2012, provides the following lessons: a) generally, those loans are offered under China`s terms; b) often they are backed by commodities; c) typically, they are not tied to specific policy actions, although they come with some strings attached; d) it is customary to demand some reciprocity or a buy-back scheme of some goods or services[9] and, e) recently, loans include social and environmental guidelines[10]. The advice given at that particular time is still valid today, perhaps with the exception of the large greenfield projects, such as the Nicaragua Canal or the Twin Ocean Railway Route, connecting the Atlantic shores of Brazil with the Pacific Ocean. Those are far more complex scenarios, as seen in the project for construction of a high speed train connecting Mexico City and Queretaro, which was cancelled after the bid was won by a Chinese company. Additionally, there must be a better mutual understanding and good will, before undertaken similar large scale projects[11].

There is a factor whose consequences are hard to predict: China`s efforts to place the Renminbi (Chinese Yuan), among the basket of strong currencies. The interest on the internationalization of the yuan ranges from national pride to practical reasons. The country has a strong desire to reach a position in the international financial arena more consistent with the status of global super power in the making. Furthermore, the national bank will gladly shift the immense amount of accumulated dollar reserves to other currencies and even issue yuan denominated bonds in international markets. At present, China is a large holder of US Treasure securities, competing with Japan for the top place, with well over one trillion dollars in bonds, notes and bills; this gives much power over the United States, but at the expense of high exposure and currency dependency.

Finally, there are other factors with full potential to impact the availability of financial resources from China. Firstly, the country has already committed more than a trillion dollars to OBOR. This is Xi Jinping's preferred plan and if his prestige happens to be at risk, all the necessary resources will be shifted to the project. Secondly, China is facing increasing tensions in the South China Sea. Although a military conflict is not part of the foreseeable future, the pressure may result into a military build-up, draining available resources. Thirdly, there are some domestic issues, such as regional income redistribution, compensation to workers losing jobs by the millions in the restructuring process of obsolete SOEs, or shifting patterns of rural and urban migration. Any of those factors may result in deviation of resources that could otherwise go to Latin America.

Final remarks

The presence of China in Latin America is growing solidly, with no indications for a slowdown. Granted, turmoil and the expected resurgence of some markets will shift the preference from country to country. The region desperately needs new business partners that may provide infrastructure investment and a wide range of financial tools to sustain it.

In 2014 China became also a net foreign investor, after years of being one of the leading recipients of FDI. The country is an international lender and perhaps the only one nowadays with the resources, the planning capabilities and momentum to carry out massive projects. Yet, those considerations are at the mercy of geopolitical strategies and the avid promotion of the renminbi as a strong international currency. There is one more caveat: presumably, Latin American governments will find increasingly hard to reach their traditional lender of last resort. For many years China has being handing out easy money for infrastructure projects to countries on the brink of collapse. Governments in precarious economic conditions gladly accepted loans with minor political and commercial strings attached, or backed by their own commodities, but such assistance will be limited in the future. In fact, many of the newcomers are private enterprises, with the same interest on making money as their local counterparts. Those companies will use hard bargaining as soon as they feel prepared to compete in global markets.

---

8 Rebecca Ray and al. also argue that "China has emerged as an important source of counter cyclical finance during times of regional economic contraction" in Latin America. (Ray, Gallagher, Sarmiento, 2016, p. 4).

9 According to the report, "China has used its loans-for-oil and purchase requirements to reduce the cost of lending to otherwise non-creditworthy borrowers". (Gallagher, Koleski, 2012, p. 9).

10 The report by Ray and al. emphasizes the importance of community engagement, (Ray, R., Gallagher, K., Lopez, A., Sanborn, C. 2015, p. 15)

11 Ferchen anticipates a bumpy road for Chinese investment in Latin America (Ferchen, 2015, p. 1).

References

1. Dussel, E. 2015. China's Evolving Role in Latin America Can It Be a Win-Win? The Atlantic Council's Adrienne Arsht Latin America Center.
2. Dussel, E., Armony, A. 2015. Beyond Raw Materials Who are the Actors in the Latin America and Caribbean-China Relationship? Red Academica de America Latina y el Caribe sobre China University of Pittsburgh Center of Latin American Studies.
3. ECLAC. 2013. Chinese foreign direct investment in Latin America and the Caribbean China-Latin America cross-council taskforce. Economic Commission for Latin America and the Caribbean (ECLAC).
4. Ferchen, M. 2015. Chinese Infrastructure Initiatives in Latin America: A Bumpy Road Ahead. Carnegie-Tsinghua Center for Global Policy. <http://carnegietsinghua.org/2015/06/26/chinese-infrastructure- initiatives-in- latin-america- bumpy-road-ahead/ie6c>
5. Gallagher, K, Irwin, A, Koleski, K. 2012. The New Banks in Town: Chinese Finance in Latin America. Inter-American Dialogue.
6. Niu, H. 2015. A New Era of China-Latin America Relations. Inter-American Development Bank.
7. Ray, R., Gallagher, K. 2015. China-Latin America Economic Bulletin 2015 Edition. Boston University Global Economic Governance Initiative.
8. Ray, R., Gallagher, K., Lopez, A., Sanborn, C. 2015. China in Latin America: Lessons for South-South Cooperation and Sustainable Development. Boston University Global Economic Governance Initiative.
9. Ray, R., Gallagher, K., Sarmiento, R. 2016. China-Latin America Economic Bulletin 2016 Edition. Boston University Global Economic Governance Initiative.
10. Serebrisky, T., Suárez-Alemán, A., Margot, D. and Ramirez, M.C., 2015. Financing Infrastructure in Latin America and the Caribbean: How, How Much and by Whom? Inter-American Development Bank.