Investing In Bad Governance: China and Latin America

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Author: Dr. Fabiana Sofia Perera
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Dr. Fabiana Sofia Perera

Fabiana Sofia Perera is an Assistant Research Fellow at the William J. Perry Center for Hemispheric Defense Studies. Prior to joining the Perry Center, Fabiana was a Rosenthal Fellow at the Office of the Secretary of Defense, Under Secretary for Policy, Western Hemisphere Affairs. Fabiana has experience working in the public and private sectors. She worked as a research associate at Mitsubishi International Corporation focusing on Latin America and the energy and infrastructure sectors. She also has experience serving at the Department of Veterans Affairs and the US Agency for International Development (USAID).

Fabiana holds an MA in Latin American Studies from Georgetown University and earned a PhD in Political Science from The George Washington University. For her doctorate, Fabiana completed fieldwork in Venezuela and Ecuador. Fabiana has presented her research at the annual meetings of the American Political Science Association and the Latin American Studies Association. Her research and analysis have appeared in numerous publications including *The Washington Post*, *CNN.com*, and *War on the Rocks*. Her research and has been supported by numerous organizations including Columbia University's Women in Energy program and George Washington University's Center for International Business Education.

Investing In Bad Governance: China and Latin America

Dr. Fabiana Sofia Perera[1]

Though there have been many reports of the strengthening of commercial and financial relations between Latin America and China, comparatively few explore the conditions within the countries of Latin America that facilitated this engagement. The study proceeds as follows. The first section summarizes Chinese involvement in the region distinguishing between foreign direct investment (FDI) and official development assistance (ODA). The second section attempts to identify institutional determinants of this investment. Specifically, it differentiates between conditions that are seen as favorable to private Chinese investment and those that facilitate official Chinese development assistance. The third section outlines possible implications of Chinese involvement in Latin America.

Introduction

The Director-General of the Department of Latin American and Caribbean Affairs of the Foreign Ministry of the People's Republic of China (PRC), Mr. Zhao Bentang, said in a 2018 statement summarizing the relationship between his country and Latin America that "however wide the ocean we traverse might be, we navigate courageously taking advantage of favorable winds." The statement continues on to use nautical allegories to describe a relationship that is seen as ready to move full steam ahead.

For the five-year period between 2015 and 2019, China's President Xi Jinping had set ambitious goals for exchange with the Latin American and Caribbean region: $500 billion in trade and $250 billion in direct investment. Xi made the pledge in January 2015 at the first ministerial meeting of the Forum of China and the Community of Latin American and Caribbean States, which was held in Beijing. China appears well on its way to achieving this ambitious goal: trade between China in Latin America has more than doubled over the past decade (Sullivan & Lum, 2019; Gonzaléz, 2018). The list of investments by official Chinese institutions in the region grows every year. Indeed, two days after the statement summarized above Mr. Bentang announced that Latin America had become the second-largest destination for Chinese overseas investment, following Asia (Pingchao, 2018).

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[1] The author gratefully acknowledges research assistant Kevin Turcios, for his excellent research assistance.

Latin America that facilitated this engagement. Mr. Bentang is correct that China is "taking advantage of favorable winds," but what are these? What governance conditions attracted this investment?

The study proceeds as follows. The first section summarizes Chinese involvement in the region distinguishing between foreign direct investment (FDI) and official development assistance (ODA). The second section attempts to identify institutional determinants of this investment. Specifically, it differentiates between conditions that are seen as favorable to private Chinese investment and those that facilitate official Chinese development assistance. The third section outlines possible implications of Chinese involvement in Latin America.

Analyzing Chinese involvement as a commercial and development partner in Latin America is critical to understanding the full extent of Chinese influence in Latin America. Determining the institutional conditions that allowed for an extra-hemispheric actor such as China to decide to invest so heavily in the region allows the United States to better anticipate future investment and to prepare to compete more effectively to remain the partner of choice across key commercial and financial sectors.

Chinese Involvement in the Region

The ties between China and Latin America are old but, until the last two decades, were shallow. The distance between Latin America and China, among other factors, made deeper ties difficult. In 1960, President Osvaldo Dorticos Torrado of Cuba became the first Latin American head of state to pay an official visit to Beijing; the majority of countries in the region did not recognize China until 1972, after President Nixon visited the country. A (declining) number of countries still do not recognize China, choosing to recognize Taiwan instead.[2] In addition to the political distance, the physical distance between China and the western hemisphere has been difficult to overcome in practice. Indeed, the first non-stop commercial flight between the western hemisphere and China took off from Detroit in 1996. Outside of the United States, there were no direct flights between the western hemisphere and Asia until 2016.[3]

Latin America's lack of interest in China as a partner was mirrored on the other side of the Pacific. During its first fifty years, the People's Republic of China (PRC) took little notice of the western hemisphere. However, since the mid-1990s, in Latin America as in the rest of the world, China was exercising a brand of non-interventionist foreign policy described as "peaceful rise" or "peaceful development." The doctrine emphasizes soft power and asserts that China's first commitment is to its own people and domestic affairs and not to intervention in international affairs. There are three core principles of this concept, as articulated by Zheng Bijan, former chairman of the China Reform Forum. First, China must advance reforms centering on the production of a socialist market economy and a socialist democracy. Second, China must ensure cultural support for its peaceful rise. Third, China must balance the interests of different domestic sectors to create a social environment for China's peaceful rise (Glaser & Medeiros, 2007). In short, to secure China's peaceful rise, the country needed to create domestic political, economic, and cultural conditions that would allow for the country to become a

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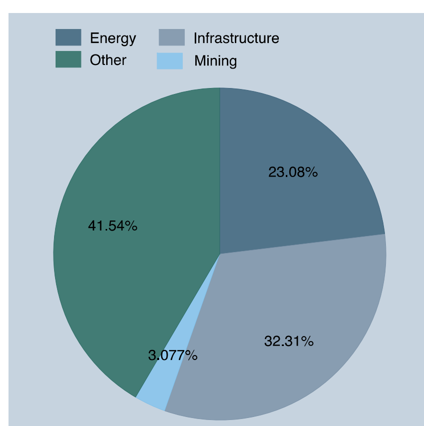
[2] Belize, Guatemala, Haiti, Honduras, Nicaragua, Paraguay, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines still don't recognize the PRC and instead maintain relations with Taiwan.
[3] The first flight between Latin America and Asia is an All Nippon Air route connecting Mexico City to Tokyo.

world power. In addition, it was necessary to create external markets for Chinese goods and services as well as a cultural understanding abroad that would support Chinese ambitions. It is here that Latin America had a role to play.

In 1992, China ventured into Latin America with the acquisition of Hierro Peru by Shougang, a state-owned enterprise (Ellis, 2014). At the time, it was reported as "the largest single foreign investment by the Chinese Government outside Asia and the northern Pacific" (Nash, 1992). For almost two decades, the purchase was China's largest outlay of foreign direct investment in Latin America. This type of investment in Latin America is seen as an opportunity for China to expand the market for its goods and services, create employment opportunities for Chinese workers, and expand Chinese cultural influence (Gallagher, 2016; González, 2018; Peters & Armony, 2017).

Since then, China has continued to engage in the hemisphere, as it does elsewhere, through a combination of official development assistance and foreign direct investment. Official development assistance (ODA) comprises all funds transferred from the Chinese government to the host country government. Foreign direct investment (FDI) comprises all funds transferred from Chinese firms to host country firms. A second dimension of FDI, outward FDI, which captures all funds going from a country into China is not analyzed here.

Figure 1: Chinese FDI into Latin America by sector (1996-2017) in millions of US$



Source: Inter-American Development Bank.

ODA is financial aid from one government to another that promotes and specifically targets the welfare of the recipient country. The capital is provided by an official government agency and is concessional in form. Typically a loan is considered ODA if the terms include a 20% grant element. Chinese official development assistance is distinctive from ODA provided by other countries in a number of ways. First, Chinese ODA privileges energy over other sectors (Figure 1). Second, it is often accompanied by other forms of engagement, including foreign direct investment by private Chinese firms, diplomatic exchanges, etc. Third, Chinese ODA does not at first glance appear to consider the credit-worthiness of the recipient country as a determinant factor in issuing loans (Brautigam, 2009).

FDI is investment by an entity (often a private entity) in one country in assets located in another country. FDI typically involves an equity position. Chinese FDI, i.e., money flowing to the country from

Chinese firms, is also distinctive from FDI provided by other countries. In other environments, the strongest predictor of how much FDI a country receives is market size such that a larger GDP correlates with greater inward FDI (Bénassy-Quéré, Coupet & Mayer, 2007). Natural resources and good economic governance are likewise strong predictors of inward FDI such that greater stocks of natural resources will attract greater FDI and likewise, better economic governance will attract high FDI.

Research on Chinese FDI and ODA is hindered by problems with data availability. Data on Chinese development assistance are especially challenging to collect. China, unlike members of the Organization for Economic Cooperation and Development (OECD) and most other countries, considers foreign aid a "state secret," so the total amount of aid to any country of region remains unconfirmed (Vieiro, 2012) as does the extent of their development programs. By some estimates in recent years China has offered more assistance to the developing world than the World Bank, which loans about $100 billion per year. However, unlike in the case of traditional major donor countries, in the Chinese context, "aid" tends to blur the traditional line between development loans and foreign investment.

Data on Chinese inward FDI into Latin America also present challenges. In this case, official FDI figures are compiled by the Ministry of Commerce. The Chinese Ministry of Commerce does follow international guidelines in its methodology such that aggregate figures by year are considered accurate. Disaggregated data by destination, however, are distorted by the fact that most Chinese companies route their foreign investments through the Special Administrative Regions of Hong Kong and Macau, Taiwan Province of China, among others. According to official Ministry statistics, 79% of outward Chinese FDI is registered as going to Hong Kong (SAR), Cayman Islands, or the British Virgin Islands (CEPAL, 2011). Data on FDI are available through the Monitor of Chinese OFDI in LAC. The database was compiled and maintained by the Red Académica de América Latina y el Caribe sobre China (Red ALC-CHINA), a project housed in the Universidad Nacional Autónoma de México (UNAM). The database was developed by aggregating transactions at the company level and covers the period between 2000 and 2017.

Available data show that there is wide variation in the level of commitment and destination of foreign direct investment and official development assistance from China into Latin America (Table 1). While a number of explanations have been advanced that focus on China's motives to pursue these investments, less is known about the domestic conditions in the region that facilitated these activities. Moreover, while motives are nearly impossible to ascertain, it is possible to observe both the activity of investing itself, and the domestic conditions of the recipient countries. Looking for a relationship between these two might provide a more promising path to try to understand Chinese investment in the region and might yield insights that can be applied to understand Chinese investment in other parts of the world as well.

Table 1: Chinese investment in Latin America (in millions of US$)

	ODA	FDI
Argentina	**$18,176**	**$11,870**
Bolivia	**$3,462**	**$496**
Brazil	**$42,106**	**$48,025**
Ecuador	**$17,420**	**$3,052**
Mexico	**$1,000**	**$6,012**
Peru	**$478**	**$18,252**
Venezuela	**$67,200**	**$41,800**

Sources: Inter-American Dialogue, RED-Alc[4]

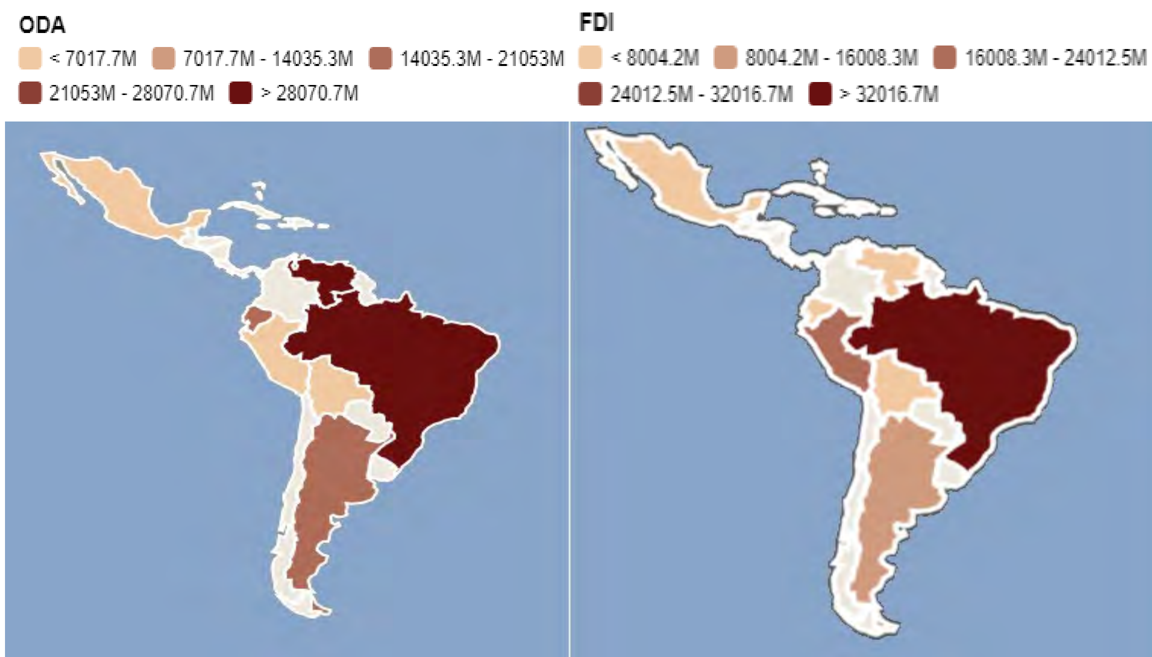


Figure 2 Chinese official development assistance to Latin America (1998-2017)

Figure 3: Chinese foreign direct investment into Latin America (1998-2017)

[4] Data used from 1998-2017

Institutional Determinants of Investment

Chinese investment abroad of the types described has been argued to lack transparency, accountability and to not be market-oriented (CIPE, 2018). That is, "bad governance" appears to attract "no strings attached" investments. This connection appears intuitive and is well-documented anecdotally. In other contexts, quality of governance has been related to good economic outcomes including economic growth (North, 1993) and wealth (Kaufmann, Kraay & Zoido-Lobatón, 1999). Good governance has also been related to foreign direct investment and official development assistance. Specifically, better governance has been linked to higher FDI (Roberts, 2006; Jensen, 2008; Busse & Hefeker, 2007; Garland & Biglaiser, 2009; Bissoon, 2011).

Governance is the traditions and institutions by which authority in a country is exercised (Kaufmann, Kraay & Mastruzzi, 2011). It is a government's ability to make and enforce rules as well as to deliver services. In this sense, governance is separate from regime type: democracies can experience bad governance just as autocracies can experience good governance. The quality of governance relates to whether the government in power can deliver on the goals it set for itself, not a measure of the quality or worthiness of those goals (Fukuyama, 2013).

The World Bank considers six dimensions of good governance: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. Though all of these directly contribute to good governance as described above, three might be considered most relevant to attracting foreign capital: corruption, political stability, and rule of law.

Control of corruption captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption (i.e., state capture). Political stability measures perceptions of the likelihood of protests, terrorism, civil war, and interstate war, all of which are related to political instability. Finally, rule of law captures perceptions of the extent to which citizens have confidence in and abide by the rules of society and, in particular, the quality of contract enforcement, property rights, the police, and the courts.

Lower levels of corruption are related to greater FDI inflows either because investors are attracted to countries with lower levels of corruption (Gatti, 2004; Lambsdorff, 1999; Mauro, 1995; Smarzynska & Wei, 2000) or because FDI lowers corruption in the country (Gerring and Thacker, 2005; Sandholtz & Koetzle, 2000). There is no significant relationship between corruption and Chinese FDI into Latin America, meaning that the influx of capital from Chinese firms into the region is likely agnostic to corruption and attracted by other factors (see Table 2).

Political stability has been shown to be related to greater inward FDI (Lucas, 1990; Kim, 2010). Chinese FDI into Latin America appears to follow this same pattern: greater political stability is positively and significantly correlated with greater FDI inflows. This is consistent with evidence which has shown that there is no negative relationship between political risk and Chinese FDI (Buckley et al., 2010).

Lastly, there is a positive and significant correlation between Chinese FDI and rule of law. This relationship is as expected given that FDI is attracted to stronger contract enforcement (Kolstad & Wiig, 2012; Mengistu & Bishnu, 2011). The small but positive relationship between these dimensions of good

governance and Chinese FDI into Latin America can perhaps be attributed to the accountability that is associated with this type of investment. Unlike investments channeled as ODA, which are secret, investment by firms is often publicized and returns scrutinized.

Table 2: Chinese FDI and governance in Latin America

Indicator	FDI
Control of Corruption	**0.2175**
Political stability	**0.2694***
Rule of law	**0.3433***

In contrast to FDI, Chinese ODA appears to be agnostic to all three indicators of good governance. Neither levels of corruption, political stability, nor rule of law appear to be significant predictors of Chinese ODA. In other contexts, corruption has been shown to have no negative relationship to ODA from western countries, though there are differences between countries (Alesina & Weder, 2002). In general, western donors and multilateral institutions do appear to reward good governance in their distribution of ODA (Zanger, 2000). At the very least, the rhetoric of traditional donor countries includes references to good governance as a condition for receiving aid (Neumayer, 2005). In contrast, Chinese ODA includes no such rhetorical commitments and in practice, its distribution appears unrelated to good governance.

Table 3: Chinese ODA and governance in Latin America

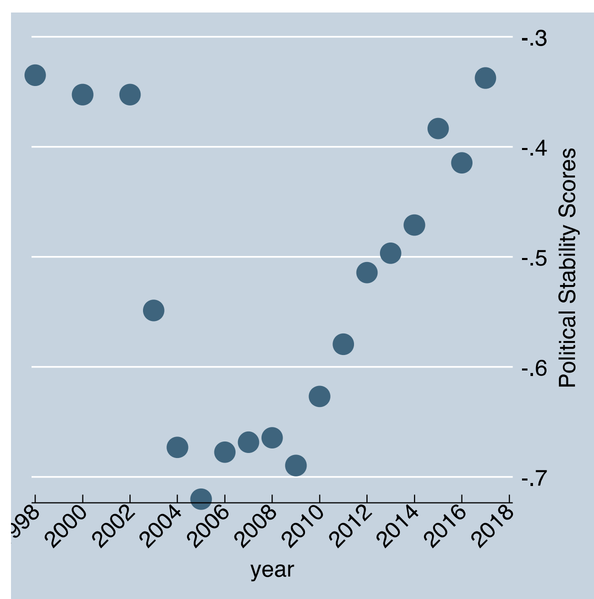
Indicator	ODA
Control of Corruption	**-0.0696**
Political stability	**-0.0271**
Rule of law	**0.1089**

Unfortunately the amount of data available do not allow for further statistical analysis to establish causality. To try to understand the direction of the relationship, it is useful to analyze changes in the good governance indicators for countries in which China has invested and compare those to changes in good governance indicators for the region as a whole. If the relationship is causal in one direction–Chinese investment drives poorer governance—we should see that countries where China has invested experience declines in their good governance indicators. If the relationship is causal in the other direction–Chinese investment is driven by poorer governance—we should see no changes in good governance indicators for the countries in which China has invested relative to changes in the region as a whole.

In the case of political stability scores, we see that countries where China has invested do not experience a decline in political stability. Moreover, the mean of the political stability scores of

countries with no Chinese investment is significantly different from countries with Chinese investment. Though not conclusive, the evidence does suggest that Chinese FDI into Latin America might not have an effect on perceptions of political stability.

Figure 4: Political stability scores of countries with Chinese investment



Corruption scores also exhibit an interesting pattern. While it does initially appear that Chinese ODA is attracted to countries with higher levels of corruption relative to countries without Chinese ODA and relative to countries that attract Chinese FDI, the evidence is inconclusive because the region as a whole experienced declines in perceptions of corruption over the period being analyzed. This again is consistent with existing research on the relationship between FDI and corruption, as described in the previous section. The negative (but weak) relationship between ODA and corruption cannot initially be explained by existing research or in the analysis presented here, but does deserve further research, particularly in light of the finding that capital that is attracted to this type of environment tends to exacerbate bad governance (CIPE, 2017).

Finally, with regards to rule of law, there appears to be a decline in the indicator for countries that receive Chinese investment relative to those that do not. Interestingly, however, the initial scores for countries that received Chinese FDI are higher than those for countries that did not, corroborating the earlier suggestion that Chinese FDI does appear to be responsive to certain elements of good governance.

Figure 5: Rule of law scores of countries with Chinese investment

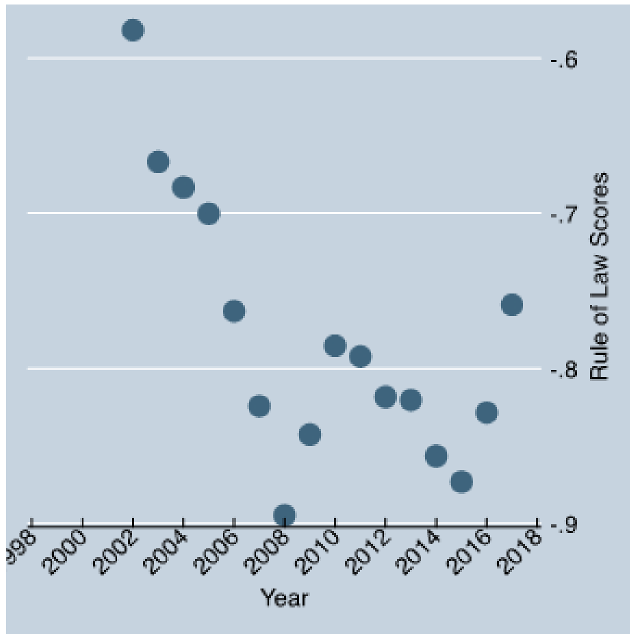
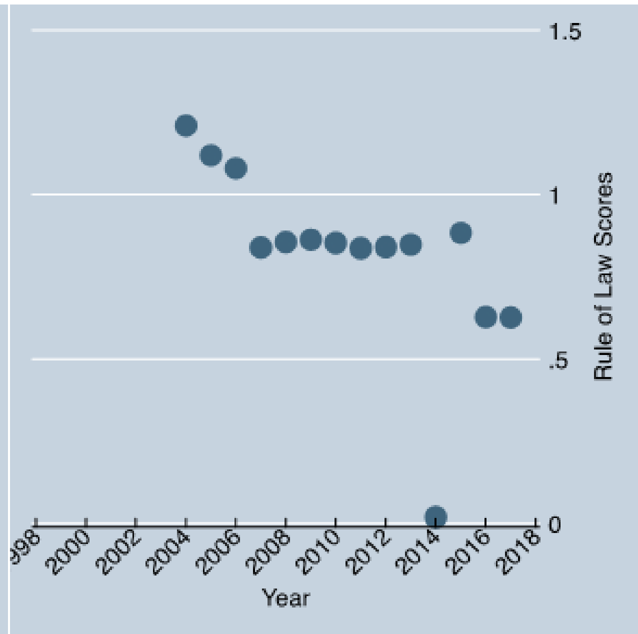


Figure 6: Rule of law scores of countries without Chinese investment



The analysis suggested here posits that there is much to be gained in examining the domestic conditions of countries that attract Chinese FDI and ODA. The analysis presented here has argued that Chinese FDI into Latin America is similar to FDI from other countries in that it is attracted to good governance, whereas Chinese ODA into Latin America is different from ODA from Western donor countries in that it is at best indifferent to good governance.

Possible Implications

Chinese investment in Latin America has important implications for US-Latin America relations. US-Latin America relations have been characterized by being the strength of linkage between the countries and US leverage on most countries in the region. Linkage refers to the density of ties and cross-border flows between two countries. Leverage refers to a government's vulnerability to external pressure (Levitsky & Way, 2006). In expanding its investments in the region through both FDI and ODA, China is increasing its linkage and leverage to Latin America and the region it shares with the United States. As this relationship grows, it reduces the leverage the United States has in the region and possibly affects linkage.

Chinese investment in the region has so far mostly been studied as a whole or analyzed by two distinct communities–those of aid and international finance—with relatively little interaction among them. This analysis has attempted to aggregate both types of Chinese investment and to look for determinants of the inflow of each type of money into the region. The analysis suggests that capital entering the region as FDI largely behaves the way FDI from other countries does: i.e., it is attracted to good governance environments, whereas capital entering the region as ODA is agnostic to good governance. This is different from ODA from western donor countries which attempt to privilege good governance in their distribution of aid.

Maintaining strong ties to Latin America is important for the security of the hemisphere. Increased investment by China in the region relatively weakens ties between the United States and its partner nations in Latin America. The challenge is that the United States is not able to compete with no-strings-attached offers of development assistance. A possible way forward for the United States to counter increasing ties to China in the region would be to continue to work to strengthen good governance in the region. This might accomplish two goals. First, it would potentially make more countries eligible for certain kinds of assistance from Western donor countries. Second, governance improvements might make it less likely that the country would seek Chinese investment, though this relationship is unclear and deserves further explanation.

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