LATIN AMERICA/CHINA: Funding brings calculated risk

OxResearch Daily Brief Service. (May 04, 2015).

Oxford Analytica Global Strategic Analysis

Abstract

Chinese engagement in Latin America.

While Chinese investment in Latin America has grown rapidly over the past decade, most financial flows are sovereign loans, mainly to Argentina, Ecuador and Venezuela. Foreign direct investment (FDI), by contrast, remains comparatively small. In both cases, most financing has targeted natural resource sectors, raising concerns over excessive Chinese control. China's objectives are diverse, varying across sectors and countries, and increasingly attuned to local political dynamics, as well as the risks inherent in some of its regional deals.

Full Text

SUBJECT:Chinese engagement in Latin America.

SIGNIFICANCE:While Chinese investment in Latin America has grown rapidly over the past decade, most financial flows are sovereign loans, mainly to Argentina, Ecuador and Venezuela. Foreign direct investment (FDI), by contrast, remains comparatively small. In both cases, most financing has targeted natural resource sectors, raising concerns over excessive Chinese control. China's objectives are diverse, varying across sectors and countries, and increasingly attuned to local political dynamics, as well as the risks inherent in some of its regional deals.

ANALYSIS: Impacts.

Loans will continue to outstrip FDI in China's financing for the region.

Investor-unfriendly policies will increase some countries' dependence on Chinese finance.

However, Chinese lending will not be immune to financial and political risks.

Despite soaring trade, Chinese investment in Latin America remains modest. FDI inflows peaked in 2010 at an estimated 15 billion dollars and have since plateaued around 10 billion annually. However, FDI represents a small fraction of China's total financing for Latin America. Most has been through loans from the China Development Bank (CDB) and China Export-Import Bank, often repaid in oil at below-market prices or earmarked for projects employing Chinese firms and equipment. Argentina, Ecuador and Venezuela account for around 75% of this lending, with Venezuela alone receiving 47%. While not FDI, this financing reflects the broader patterns of Chinese investment.

Natural resources deals.

Since the early 2000s, Chinese state-owned enterprises (SOEs) have acquired ownership stakes in mining, agriculture and oil resources, accounting for over 90% of China's investment in Latin America (see LATIN AMERICA: China dependency will grow - August 1, 2014). The countries involved have diverse governance frameworks, ranging from state-dominated regimes to market-oriented ones. As a result, Chinese strategies vary, reflecting both Latin America's political diversity and the diversity of China's regional objectives:

Agriculture.

In agriculture, China's commercial activities are closely linked with an official policy of achieving state control of food supply from 'soil to shop'. However, acquisition of farmland by Chinese firms has had political blowback, especially in Argentina and Brazil where legislation was enacted (or, in Brazil, reinstated) limiting foreign land ownership.

China's strategy has recently shifted from land purchases to investing in large agricultural trading companies. COFCO, a major food sector SOE, spent 1.2 billion dollars to acquire 51% of NIDERA and 1.5 billion for a majority share of Hong-Kong based Noble Group in 2014. While not Latin American firms, both have significant presence in Argentina and Brazil. China has thus adapted its agricultural strategy following political setbacks.

Mining.

In mining, China's SOEs are also dominant and have invested in mineral assets, while also purchasing major quantities of metals through 'arms-length' trade in international commodities markets. Attempts to expand on-the-ground operations, eg through investments in steel mills in Brazil, have been mothballed due to falling demand there. In general, investment patterns will respond to price movements for these commodities.

Energy.

The energy sector presents the most diverse scenarios:

In Venezuela and Ecuador, major investments by Chinese SOEs have been buttressed by large loans from China's policy banks, often repaid in below-market price oil. These countries' energy sector policies have precluded most foreign private investment, making them increasingly dependent on Chinese financing. Its considerable bargaining power in such settings allows China to win projects through direct negotiations with governments, while leveraging its abundant financial resources to control growing amounts of oil production. In Ecuador, China controls an estimated 90% of oil produced, although most is sold on international markets (see ECUADOR: Yasuni deal shows oil under China's control - March 26, 2014). In 2013, less than 5% was consumed domestically by China.

However, controlling resource supplies is not China's only objective. Chinese firms also want to develop technical expertise in unconventional reserves, such as pre-salt oil in Brazil, Mexico's deep-water fields and Argentine shale resources. The participation of two Chinese energy companies, CNPC and CNOOC, in the winning consortium to develop the Libra pre-salt field in Brazil illustrates this strategy (see BRAZIL: Libra project puts pressure on Petrobras - November 27, 2013). Chinese firms are likely to be junior partners in consortium with Western majors whose technical and operational expertise China is keen to absorb.

Infrastructure, construction and public works .

A second category of Chinese investments consists of specific infrastructure projects such as dams, roads, railways or tourism centres. Their defining characteristic is one-off construction that generally requires contracting Chinese firms, purchasing Chinese equipment and sometimes hiring Chinese labour.

The use of temporary Chinese workforces has been especially prevalent in small Caribbean and Central American economies and has sparked political tension and even violence in some cases. Despite such flare-ups, China does not seem compelled to scale back these engagements. They remain largely confined to the smallest economies, where financing constraints are acute and power asymmetries most pronounced.

Manufacturing investments.

Private Chinese firms have established manufacturing facilities in the region, either to serve domestic markets or establish export platforms to hemispheric markets. These include automakers Chery and JAC; telecommunications firms Huawei and ZTE; and personal computer maker Lenovo.

These investments are pursued on market terms, and Chinese firms compete with other multinationals for market share. Latin American governments generally want more manufacturing FDI, so political tensions are less relevant. These investments should grow as China develops more sophisticated manufacturing firms with global ambitions, although short-term prospects will depend on regional economic cycles.

Risks and rewards.

China pursues increasingly diverse and politically attuned tactics to advance its regional objectives. Underwriting governments such as Argentina, Ecuador or Venezuela poses both financial and political risks:

On the financial side, lending to governments with large fiscal deficits, dwindling reserves and few sources of foreign exchange makes debt restructuring or even nonpayment a possibility that cannot be discounted.

Politically, severe polarisation and uncertainty mean that a new administration might seek to extricate itself from existing obligations to China.

Venezuela presents the greatest risk in both cases. The quantity at stake (an estimated 25 billion dollars) is consequential for China, and a political transition could generate major social, economic and policy upheaval. China's unwillingness to extend emergency financing during President Nicolas Maduro's January visit -- instead promising future loans probably tied to specific projects -- suggests China is wary of its Venezuelan exposure.

Still, to the extent Latin American countries continue to adhere to them, these arrangements serve China's interests, and will remain part of its regional strategy. China signed various agreements with the Argentine government in late 2014 for additional loans in exchange for exclusive access for the CDB and other SOEs to large infrastructure projects -- in essence doubling down on this type of engagement. China seems willing to bet that its geopolitical and financial clout will make any government think twice about reneging.

CONCLUSION: China will pursue its core strategic objectives in Latin America, including acquiring natural resources, while recalibrating its tactics to changing political and economic conditions. In countries excluded from international capital markets, Chinese financing will provide leverage to acquire oil on favourable terms and secure major contracts for its firms. Elsewhere, increasingly sophisticated Chinese companies will compete with other multinationals to develop unconventional energy resources, participate in manufacturing value chains and produce for the local market.

Details

Subject	Economic conditions; Industry; International relations; Agriculture; Debt; Energy policy; Financial institutions; Food processing industry; Foreign investment; Foreign policy; International trade; Gas industry; Infrastructure; Metal industry; Mining industry; Natural resources; Petroleum industry; Technology
Location	China, Latin America, Caribbean area, Argentina, Ecuador, Venezuela, Brazil, Central America
Classification	9173: Latin America 9179: Asia & the Pacific 1210: Politics & political behavior 1300: International trade & foreign investment
Identifier / keyword	China, Latin America, Caribbean area, Argentina, Ecuador, Venezuela, Brazil, Central America, Economic conditions, Industry, International relations, Agriculture, Debt, Energy policy, Financial institutions, Food processing industry, Foreign investment, Foreign policy, International trade, Gas industry, Infrastructure, Metal industry, Mining industry, Natural resources, Petroleum industry, Technology
Title	LATIN AMERICA/CHINA: Funding brings calculated risk

Publication title	OxResearch Daily Brief Service
Pages	n/a
Publication year	2015
Publication date	May 04, 2015
Year	2015
Publisher	Oxford Analytica Ltd
Place of publication	Oxford
Country of publication	United Kingdom
Publication subject	Business And Economics
Source type	Reports
Language of publication	English
Document type	News
ProQuest document ID	1678026260
Document URL	http://libproxy.nps.edu/login?url=http://search.proquest.com/docview/1678026260?accountid=12702
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Last updated	2015-05-29
Database	ProQuest Central