# The Rise of China's Patient Capital: A Tectonic Shift in Global Finance in Developing Countries?

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**Abstract**

This article develops a theory about how China's emergence as a global creditor affects national policymaking. The international and comparative political economy literature has long-debated the extent to which international capital mobility constrains national autonomy, but has mainly focused on private capital flows. Incorporating China's state-led capitalism into this political economy framework, I expect that Chinese credit enhances national governments' room to maneuver. It is a distinct form of patient capital, characterized by a long-term horizon and a lack of policy conditionality, that endows governments with more fiscal space to intervene in their economies. Employing an originally-constructed dataset, the *China Global Financial Index*, cross-national tests (spanning 15 Latin American countries from 1990-2015) find that left governments tend to borrow directly from China when they can dilute market-oriented investment laws. However, independent of this partisan choice, Chinese state-to-state lending reduces reliance on conditionality-linked Western financing, leading to higher budget deficits.[1]

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# Introduction

Financial integration has posed a catch-22 for national governments. They tap international markets to increase their spending possibilities, only to subject their budget decisions to financial market scrutiny. During the last three decades, international and comparative political economy scholars have consequently examined the question of how nations can maintain policy autonomy in an era of global capital mobility. Scholars find that the threat of capital exit compels governments toward 'market-friendly' policies.[2] Some thinkers expect a 'race to the bottom' where states have little power to resist investor interests, while other scholars are more optimistic about states' capacity to mitigate market pressures.[3] Yet comparatively little attention has been paid to how the rise of state-led capital over the last decade affects these patterns.

With Western capital reeling during the global financial crisis, China – as the world's largest saver – more than doubled its overseas banking presence from 2006 to 2009. Today, China's lending increases at a blistering US$200 million pace annually, putting the country on the brink of becoming one of the world's top five bank lenders (Figure 1).[4] Given the scale of these financial flows, how might the rise of China's state-led capitalism affect the relationship between financial globalization and state capacity? Are Chinese state lenders any different from Western investors, and if so, what are the implications for national governments?

***Figure 1***

This article develops a theory about how Chinese state-led overseas investment affects national-level policymaking. In a world characterized by global capital mobility, the political economy scholarship has long anticipated that governments will face a trade-off between national macroeconomic policy autonomy and exchange rate stability, known as the Mundell-Fleming trilemma.[5] However, a key assumption of this seminal literature was that capital was private, and hence it would exit countries when faced with financial instability and currency depreciation that erodes profits. During hard economic times, capital's exit threat

[2]Helleiner 1995; Helleiner 1996; Mahon 1996; Rodrik 1997; Garrett 1998; Armijo 1999; McNamara 1999; Mosley 2000; Mosley 2003; Brooks 2004; Wibbels 2006; Kaplan 2013; Brooks, Cunha, Mosley 2015; Kaplan and Thomsson 2017.
[3]Frieden 1991; Rudra 2008; Kurtz and Brooks 2008; Wibbels and Ahlquist, 2011; Carnes 2014.
[4]China surpassed Switzerland to become the 6th largest international banking creditor in 2017 (BIS 2018).
[5]Frieden 1991; Helleiner 1996; McNamara 1998; Broz and Frieden 2001.

would compel governments to keep interest rates in line with global levels,[6] and constrain fiscal expansion to entice inflation-wary bondholders to remain vested in the economy.

However, I contend that China's emergence as a global creditor has changed the basis of the trilemma by eliminating capital's exit threat and allowing for greater policy maneuverability. China's overseas investments have mainly been characterized by state-backed capital given the country's capital controls on private investment. The Chinese government heavily restricts the ability of its residents to invest in financial assets overseas, meaning there are minimal short-run financial connections between China and the rest of the world. Its contribution to the international financial architecture thus includes long-run development finance, banking, and foreign direct investment,[7] but not global bond financing.

Given the lack of short-term financing, I assert that China's mobile capital is a distinct type of patient capital. Not only does it exhibit the long-term lending horizon that's typical for patient capital,[8] but it also features a distinct approach to managing credit risk compared to Western creditors. Whereas Chinese patient capital seeks to promote long-term commercial opportunities, market-based creditors prefer short-term policy assurances that boost near-term financial returns. Other Western financial institutions, such as the World Bank and Inter-American Development Bank may share a long-term project financing window. However, these creditors often place a big emphasis on policy conditionality, or debt sustainability metrics evaluating a nation's macroeconomic environment (i.e. the budget framework and governance quality).

By comparison, Chinese investors view such institutional metrics as political, instead operating according to long-term administrative guidelines. In structuring its loan contracts, China employs a form of 'commercial conditionality' to mitigate its credit risk. Chinese policy banks tie their investments to commercial conditions (i.e. Chinese machinery content or commodity guarantees) embedded in loan contracts.

By delinking overseas lending from short-term policy performance (i.e. budget discipline), China's patient capital not only features long-term maturity structures, but also greater risk-tolerance. Rather than exiting when governments miss short-term economic benchmarks, these investors typically view cyclical downturns as an opportunity to gain cheap assets and business opportunities. For example, Chinese capital has continued

[6] According to interest rate parity, higher interest rates are necessary to offset an expected currency depreciation.
[7] Stallings 2017.
[8] Kahler 1998; Wade 1998.

to flow into developing countries during periods of volatility – ranging from the global financial crisis, the 2014 commodity correction, and Brazil's Odebrecht corruption scandal (see Figure 2). These insights are based on extensive field research in China between 2015-2017, including meetings with executives from policy banks, sovereign investment funds, government ministries, and top public think tanks.

***Figure 2***

This article argues that China's patient capital allows developing country governments to pursue higher budget deficits by escaping the budget constraints traditionally imposed by global capital markets,[9] and international financial institutions.[10] As China's patient capital accounts for a larger share of a nation's external debt outstanding, governments should gain greater fiscal space than when relying upon conditionality-linked market and multilateral funding sources. However, such fiscal policy discretion may sow the seeds for future debt problems. National governments can interpret the lack of policy conditionality as a tacit acceptance of an expanding state, which may create a moral hazard problem by encouraging boundless spending.[11]

In many ways, debtor countries are exposed to the same risks that China's local governments face domestically. China used a sustained expansion of local government debt to invest in heavy industry and infrastructure. The reward was lofty economic growth, but it came at the cost of bad loans, which may account for as much as one-quarter of total loans today.

If not policy conditionality, what provides the budget constraint on national governments borrowing directly from China? I expect fiscal outcomes to be conditioned by a country's structure of investment governance (state-to-state vs. market-based). When Chinese financing takes the form of state-to-state lending, the funds directly enter government coffers, enabling incumbent politicians to increase their spending on their political agendas. By contrast, when these loans are instead booked to a corporate entity (either a private firm or a separately managed state-owned enterprise) through government concessions, the central government does not benefit from the loan directly, keeping its spending in check.[12]

I investigate these priors in Latin America, a region that is ideally suited for this analysis because of

[9] Mahon 1996; McNamara 1999; Mosley 2000; 2003; Wibbels 2006.
[10] Thacker 1999; Vreeland 2003; Nelson 2015.
[11] Moral hazard is when an institution fails to bear the full consequences of its actions, or change its behavior.
[12] According to the IMF's *Government Statistics Manual*, state-owned enterprises are not included in public debt calculations when they are a market producer, or a producer that sells its goods for economically significant prices.

its considerable variation in exposure to Chinese bilateral financing – about three-fifths of its governments had loans outstanding to China over the last decade. Latin America is also a region marked by the world's highest income inequality and largest infrastructure deficits, which raises the political appeal of increasing fiscal space to address these challenges – particularly amongst leftist government that have traditionally viewed the public balance sheet as a tool to address these problems.

I first examine governments' choice to borrow directly from China, before exploring how Chinese bilateral loans affect their fiscal policies. The choice to solicit state-to-state financing from China reflects Latin America's domestic governance structure. When China emerged as a Latin American creditor following the 2008 global financial crisis, much of the region was constrained from borrowing directly from China. During this time, many countries had market-oriented investment laws, which were initially adopted after the 1980's debt crisis in hopes of attracting global capital. Viewing that the lack of public sector constraint catalyzed this crisis, these laws aimed to 'tie-the-hands' of governments with private procurement provisions.

I expect that left governments, hoping to gain fiscal space to achieve their redistributive goals, should be more likely to court Chinese state-to-state investment compared to their right and center counterparts. When left governments are able to dilute market-oriented provisions (i.e. procurement and investment laws), they gain direct access to Chinese financing. When they are unable to change procurement and investment laws, left governments should be more constrained, instead having to solicit the majority of their Chinese financing through the private sector, or alternative funding sources (e.g. global capital markets). While Latin American history brimming with powerful chief executives, these laws can be fairly resilient either because of their constitutional origins, or a strong national business constituency favoring private procurement.

In order to operationalize Chinese bilateral financing and examine its effect on the state, I employ a novel dataset, dubbed the *China Global Financial Index*. The index characterizes Chinese policy loans by their financing channel (state-to-state vs. market-based) for each national level investment project. To my knowledge, it's the first of its kind to classify policy bank loans by their investment channel.

Employing cross-national data from 15 Latin American countries from 1990-2015,[13] I find that left governments are more likely to borrow directly from China compared to their center and right counterparts who

[13]The analysis omits the Caribbean (i.e. Cuba, the Dominican Republic, and Jamaica).

tend to book loans through private procurement in the marketplace. However, independent of this initial partisan choice of creditors, Chinese state-to-state lending then uniformly leads to higher budget deficits as it accounts for a larger share of total external public debt (relative to other debt financing components from capital markets, multilateral institutions, or commercial banks).

This study makes several contributions. First, it brings new and original data to bear on the classic question of states' room to maneuver under financial globalization,[14] a question that is increasingly pertinent given the rise of state-led finance over the last decade. Second, employing a mixed method approach, the article sheds light on the behavior of state-led financing, particularly how its lack of policy conditionality affects national-level governance decisions. Finally, it makes several important theoretical contributions by disaggregating the structure of global finance. The globalization scholarship suggests that local state capacity and institutional development can mitigate 'race to the bottom' pressures,[15] but this study finds that the type of international investment (state vs. market) can also influence the extent of policy discretion.

This investigation also has significant implications for international political economy scholars examining the growing economic influence of rising powers, including the global emergence of national development banks,[16] China's challenge to the U.S. in the world economy,[17] debt and development in non-democracies,[18] and the prospects for the Chinese renminbi becoming a major global reserve currency.[19] These studies break new scholarly ground, exploring how the transfer of wealth from developed to developing countries is affecting the global architecture. My argument complements this literature by offering a systematic examination of how China's approach to global finance affects the policy choices of developing country governments.

These findings also contribute to our understanding of democracy and development,[20] particularly the relationship between financial crises and partisanship[21] and the sustainability of the Latin American left.[22] During the early to mid-2000s, the commodity boom provided a funding source independent from global

[14]Mosley 2000, 2003; Wibbels 2006; Brooks, Cunha and Mosley 2015
[15]Frieden 1991; Rudra 2008; Kurtz and Brooks 2008; Wibbels and Ahlquist, 2011; Carnes 2014.
[16]Sierra and Hochstetler 2017; Griffith-Jones and Ocampo 2019.
[17]Wise 2018; Gallagher 2016; Gallagher and Porzecanski 2010; Wise and Quiliconi 2007.
[18]Ballard-Rosa 2016; Ballard-Rosa, Mosley, and Wellhausen 2017.
[19]Helleiner and Kirchner 2014; Steinberg 2014; McDowell and Steinberg 2017.
[20]Stallings and Kaufman 1990.
[21]Broz 2013.
[22]Corrales 2009; Levitsky and Roberts 2011; Luna and Kaltwasser 2014

markets that helped the left increase budgetary spending[23] and veer from the centrism[24] previously defined by the neoliberal consensus.[25] However, in the wake of the global financial crisis and ensuing commodity correction, many governments lost revenues from their coffers, and thus their budgetary maneuverability.[26] I engage with this important issue, showing that the emergence of Chinese state-led financing endows governments with greater fiscal space.

## Theoretical Framework

The rise of Chinese capital globally coincided with a watershed moment in the history of international markets – the 2008 global financial crisis. After the crisis curtailed U.S. demand, China began investing overseas to create new trade opportunities. China's 2001 WTO entry had long-ago catalyzed its Latin American trade, but the rising power had hoped that regional investment in infrastructure, construction, and heavy extraction industries could meet two important strategic national goals simultaneously: improving its access to raw materials and energy supplies, while securing new export markets to replace those lost to the U.S. recession. Today, China has become the top trade partner for Brazil, Chile, and Peru, and a key capital provider to many Latin American nations that are eager to address longstanding infrastructure deficits.[27]

Over the last decade, Latin America has developed into the second largest destination for China's overseas investment, serving as a "natural extension" for China's flagship investment program, the Belt and Road Initiative (BRI).[28] Chinese policy banks (i.e. Chinese Development Bank, China Export-Import Bank), charged by the government to finance infrastructure and trade, have provided more than $140 billion in Latin American loan commitments,[29] accounting for an average of $12.8 billion annually (or 5.4 percent of total regional FDI). Over the next decade, China has also pledged to invest an additional $250 billion, which if realized, would push this annual figure above $20 billion (or 8.5 percent of total regional FDI).

Given the considerable size of these commitments, it's important to examine how they affect national

[23] Murillo, Oliveros, and Vaishnav 2011.
[24] Baker 2008; Baker and Greene 2011; Hellwig 2014.
[25] Murillo 2002, 2009; Roberts 2002; Baker 2008.
[26] Some countries pursued tax reforms to raise revenue, but were often impeded by elections (Hallerberg and Scartascini 2017).
[27] Myers and Wise 2017; Arnson, Heine and Zaino 2014.
[28] *Xinhua*, January 20, 2018.
[29] Gallagher 2016; Gallagher and Myers 2019.

economies, particularly in comparison to private sector flows, which were the dominant source of cross-border investment throughout the previous two decades. For example, between 1995 and 2005, Latin American governments sourced a total of $15 billion (about 6 percent of total regional FDI) annually from the private sector. When combined with multilateral development bank financing, these conditionality-linked funds accounted for three-quarters of Latin America's external financing.

## Capital Mobility: Patient vs. Impatient Capital

Today, however, Chinese policy bank loans are increasingly accounting for a larger share of government's external borrowing, marking an important shift in external financing structures. Regional governments have made considerable progress in reducing their reliance on external financing by expanding national tax bases and local capital markets, but external financing remains a major funding source for national budgets.

What are the policy implications of this structural financing shift? In this section, I first outline how the rise of Chinese patient capital has changed the traditional relationship between global capital mobility and national-level policymaking, before hypothesizing about the effect of Chinese credit on developing country debtors and their approach to national fiscal policies (see $H_1$ and $H_2$ below).

### A Shifting 21st Century Trilemma?

A high degree of financial integration during the turn of the 21st century had presented national governments with a stark choice known as the Mundell-Fleming Trilemma. In a world of high capital mobility, governments had to opt for either exchange rate stability or macroeconomic policy autonomy.[30] Global capital was highly mobile during the 1990s and 2000s, meaning it could readily exit countries when economic, financial, or currency volatility threatened to squeeze its profit margins. National governments could choose to reduce the chance of such volatility by fixing their exchange rate, but in turn, they had to sacrifice their capacity to conduct an independent monetary policy. Alternatively, governments could instead float their currencies and aim to mitigate external shocks with independent monetary policy. But economic policy was never truly independent in a world of global capital mobility. Capital's exit threat could be triggered

[30]See Helleiner 1996, McNamara 1998, and Broz and Frieden 2001.

by investors' concerns about budget deficits and inflation,[31] incentivizing national governments to cultivate global capital inflows with higher interest rates and fiscal austerity.

Importantly, these seminal principles about the effects of capital mobility in the political economy literature had assumed that global financial integration was defined by private capital flows. However, with China's emergence as a global creditor, international capital mobility has been increasingly characterized by state-led capitalism. What are the implications of the 21st century emergence of state-capitalism globally?

Chinese state-owned capital represents the latest manifestation of patient capital in the global financial system. During the second half of the 20th century, patient capital financial systems[32] were a critical factor behind the high investment rates associated with the East Asian development model. In contrast to Western governance systems' emphasis on short-term and arms-length relations to appease corporate boards of directors, these systems featured long-term relationships between financiers, companies, and the state,[33] with development banks in particular investing with social purposes beyond short-term profit-maximization.

At the heart of China's 21st century state-capitalism are the country's policy banks, which often headline a broad-infrastructure led investment package. They catalyze finance in risky credit environments, with the goal of bolstering global trade and investment, and creating opportunities for Chinese firms internationally. To improve their global competitiveness, Chinese firms often hope to gain cheap assets, build their market share, gain valuable overseas experience in marketing and distribution, and improve key logistical skills and local engineering capabilities. This financing also reflects other key state priorities outlined in China's 'go global' strategy, including securing long-term access to energy and raw material markets, and more generally, exporting domestic investment overcapacity and promoting renminbi internationalization.

Given the strong role of the state in economic planning, Chinese policy banks tend to adhere to administrative guidelines that reflect these long-term priorities. For example, China's State-owned Assets Supervision and Administration Commission (SASAC) considers "respect for the laws and policies of the country being invested in and respect for local customs" as primary principles in its foreign investment guidelines. Policy banks thus pursue commercially viable and profitable projects, but they also incorporate

[31] Helleiner 1996; McNamara 1998; Mosley 2000; 2003.
[32] Hardie and Maxfield 2013; Hardie, Howarth, Maxfield, and Verdun 2013.
[33] Kahler 1998; Maxfield 1998; Wade 1998; Rosenbluth and Schaap 2003.

these state objectives, blurring the lines between business and politics.[34]

Beyond its long-term horizon, China's patient capital is unique because of its tendency to manage credit risk with commercial rather than policy conditions. Chinese creditors do not impose fiscal austerity, or stringent borrower conditionality that links lending to macroeconomic policy performance. In general, they are more accepting of a large public sector balance sheet. Rather than believing that a large state yields inefficiency, state-led investment is often viewed as necessary to catalyze economic activity.[35]

Economic officials from Latin America's largest debtors to China tend to confirm this lack policy of conditionality. For example, Ecuadorean Vice Minister of Economic Policy Coordination, Gabriela Robalino, who negotiated Chinese bilateral loans during the Rafael Correa administration, told me in our 2015 interview.

"It's not conditional. In fact, there are many more degrees of freedom because we have never consulted the Chinese on our economic policy decisions. There has not been a single condition."[36]

In lieu of policy conditionality, China's state banks tend to secure their loans with commodity guarantees, or supplier contracts that helped foster new markets for Chinese firms and machinery.[37] They are able to use such 'commercial conditionality' to mitigate credit risk in part because of the government's implicit guarantee of their lending portfolios. The implicit subsidy helps insulate their debtors' financial distress, allowing policy banks to endure business cycle risk to meet China's long-term strategic priorities.

In summary, I expect that China's long-term horizon and lack of policy conditionality reduce the threat of capital exit, endowing national governments with greater budgetary room to maneuver. To better understand when governments seek out this policy discretion, let us examine the role of government partisanship and national investment architecture in choosing whether or not to borrow from China directly.[38]

## Who Borrows from Chinese Lenders?

In many ways, the Latin American left found a natural financial partner in China. Beginning with the 1998 election of Hugo Chávez in Venezuela, a leftward shift took hold in Latin America, that was in part a

[34]Flores-Macías and Kreps 2013.
[35]Naughton 2010; Ferchen 2013.
[36]Author's interview, November 13, 2015, Quito, Ecuador.
[37]Kaplan 2016.
[38]Domestic interest groups generally offer a complementary explanation for governments' borrowing decisions (Bunte 2019). Given the state-to-state nature, lack of transparency, and high primary sector concentration of Chinese loans, however, this analysis concentrates on the supply-side channel.

response to disillusionment with neoliberal economic reforms as well as deep-seated structural problems of poverty, inequality, and crime.[39] Compared with many of their predecessors focus on economic growth and stability, the left's central programmatic aim has been to "reduce social and economic inequalities."[40]

Such ambitions often carry a high price tag; however, because Latin America is now a largely democratized region, with a rising middle class that expects greater social responsiveness. Placating such demands often necessitates new spending commitments, and thus new financing sources.

The need for enhanced capacity was particularly acute in the wake of the global financial crisis, but many Latin American governments were prohibited from directly borrowing from China. The region's domestic institutional architecture was a product of the 1980's debt crisis, which aimed to constrain public sector expansion by tying governments' budgetary hands. By encouraging state efficiency through private procurement, national policymakers also hoped to attract foreign investment.

However, these institutions also reflected some of the deepest partisan economic divides regionally. By the 2000s, most Latin American governments had agreed on the importance of using public works projects and social programs to ensure their responsiveness.[41] The bigger question involved the role of government in addressing these infrastructure deficits and social inequalities. Taking their cue from market governance models, most centrist and right governments favored small-government solutions outside the public balance sheet. By comparison, despite the many variants of leftist ideology in Latin America,[42] the left uniformly valued the importance of using national budgets to offer better public services.

Hence, the appeal of Chinese financing, which de-emphasized short-term budget discipline. But, was greater fiscal space worth the potential cost of China's commercial conditions undercutting the welfare of national firms and labor? For the left, the macro and microeconomic were not mutually exclusive. After gaining fiscal freedom from the loan contract, they sought to bilaterally negotiate the commercial contract with China to protect local industry and employment. For example, during the negotiations for China's $2.1 billion Belgrano cargo railway investment, former Argentine Secretary for International Economic Relations, Cecelia Nahon, emphasized that China had accepted their demands that "all the construction work would

[39] Mainwaring 2006; Corrales 2009; Roberts 2012.
[40] Levitsky and Roberts 2011.
[41] Luna and Kaltwasser 2014.
[42] Corrales 2009; Levitsky and Roberts 2011.

be done in Argentina, by Argentine workers, and with Argentine materials."[43]

To get direct access to Chinese bilateral financing, left governments had to dilute national investment and procurement laws. For example, Argentina's public works law necessitates public bidding for major infrastructure projects, yet the 2014 Bilateral Agreement on Economic Cooperation and Investment between China and Argentina allows Chinese corporations to forego public bidding for infrastructure projects if Chinese banks are offering project finance. Similarly, in 2008, the Rafael Correa administration amended the Ecuadorean Constitution to allow the state to have a greater role in planning the economy. According to Ecuador's 2009 Organic Law of Public Enterprises, domestic state-owned enterprises follow a special procurement regime with limited oversight, giving them the ability to award infrastructure contracts to foreign state-owned companies in a non-competitive bidding process.

However, these procurement laws tend to be more resilient when they have strong constitutional underpinnings and the support of a robust private sector. For example, Brazil's 1993 Procurement Law is constitutionally enshrined, and cannot be overturned without a three-fifths Congressional supermajority. Investment laws are also more robust when the business community actively participates in private procurement. Mexico and Brazil have witnessed a whopping 300 and 900 procurement projects since 1990, at a price tag of $78 and $338 billion respectively, making these laws less likely to be upended than in Ecuador, which has seen only 27 private procurement projects (at a mere $4 billion) since 1990.

In summary, I expect that left governments are more likely to access Chinese bank financing directly through state-to-state lending, while centrist and right governments are more likely to book these loans to a corporate entity (either a private firm or a separately managed state-owned enterprise) through government concessions.[44] However, the extent of the left's ability to tap direct Chinese financing is conditioned by a country's investment structure. When left governments are able to circumvent or curtail market-oriented investment laws, they gain direct access to Chinese financing. When they are unable to change investment or procurement laws, left governments should be more constrained, instead having to solicit the majority of their financing from sources other than China (e.g. the private sector or capital markets). Facing such

[43] Author's interview, August 3rd, 2018.

[44] The foreign aid literature has also found that policy discretion is conditional on whether funds are allocated through the government or non-state actors (Dietrich, 2013; Winters, 2010).

constraints, the left might prioritize social spending and public investment, but pursues these goals within a balanced-budget framework to appease investors and the business community (see Figure 3 below).

$H_1$: Left governments are more likely than right and centrist governments to tap Chinese bilateral financing to fund their budget expenditures. When left governments are unable to dilute national investment or procurement laws, however, they are more likely to channel Chinese financing outside of the public balance sheet.

## What are the Policy Consequence of the Shift to Patient Capital?

I hypothesized above that left governments are more likely to borrow from China, hoping to use increased state capacity to meet their programmatic goals. In this section, independent of the initial process of securing Chinese loans, I discuss the expected effect of Chinese state-to-state lending on fiscal policy.

I anticipate that national fiscal policy choices reflect the structure of global finance, with Chinese and Western lending practices yielding different policy outcomes across debtor countries. Western creditors, who were the principal source of cross-border investment (e.g. global bond markets and multilateral investment banks) during the two decades preceding the global financial crisis, tend to scrutinize national budgets quite carefully. They cast a wary eye toward large government deficits, concerned that public inefficiencies slow growth, and hence, extend short-lending maturities to frequently evaluate debtors' performance.

In competition for this capital, debtor governments will often pursue fiscal austerity[45] in hopes of both receiving governance endorsements from international financial institutions[46] and enticing overseas capital to stay vested in the country. Financial industry pressures reinforce the emphasis on these near-term policy metrics, given their need to outperform short-term industry benchmarks and appease board of directors.[47]

By comparison, China's policy banks do not impose macroeconomic conditionality, preferring to instead craft a microeconomic solution to ensure debt repayment. Government lending is secured either through commodity-backed loans, which are collateralized by future commodity deliveries, or by guaranteed contracts with Chinese state-owned enterprises. By reducing their exposure to default risk with commercial ties rather than policy conditions, these banks can simultaneously promote the interests of the Chinese state globally.

***Figure 3***

[45] Kaplan 2013; Kaplan and Thomsson 2017.
[46] Thacker 1999; Vreeland 2003
[47] Mosley 2003; Datz 2009.

Without such conditionality, national governments that borrow directly from China should have more fiscal space to intervene in their economies, yielding larger fiscal deficits. However, a single policy bank loan does not immediately translate into such budgetary flexibility. Rather, as national governments borrow more from China as a share of their total external financing, they are more likely to to incur deficits as they become less reliant on conditionality-linked Western financing. By contrast, when Chinese loans are instead booked to a corporate entity (either a private firm or a separately managed state-owned enterprise) through government concessions, the central government does not benefit from the loan directly, and hence does not gain additional fiscal space (see Figure 3 above).

$H_2$: An increase in Chinese bilateral lending as a share of total external public debt (relative to other debt financing components such as capital markets, multilateral loans, or commercial banking) will lead to greater fiscal space, as exhibited by higher budget deficits.

# Empirical Tests

Employing a data panel covering 15 countries from 1990-2015, I test the above hypotheses in Latin America, a region where policy banks have steadily increased their financing since the onset of the 2008 global financial crisis. About three-fifths of Latin American countries have tapped Chinese policy bank financing, making it a fitting environment to examine how Chinese finance affects fiscal governance. These governments have also become increasingly reliant on Chinese policy bank financing. On average, Chinese lending, which was virtually nonexistent before the 2008 crisis, now accounts for one-fifth of the region's total external funding. Notably, for some nations, Chinese policy bank financing has reached as high as two-thirds of their government's total external financing.

## Data and Methods

Recall the implications of this structural shift in external financing. Without policy conditionality, national governments should have more room to maneuver when borrowing from China, allowing for greater deficit financing. Figure 4 provides some initial support for these theoretical priors. It illustrates the accommodative effect of China's patient capital (measured by Chinese bilateral loans outstanding as a share of GDP) on government budget balances between 1990 and 2015. When Chinese state-to-state credit

accounts for a low share of public external financing, we observe that governments are fiscally disciplined, on average, overseeing primary budget surpluses. However, as the share of Chinese credit to total public external financing grows over time, Latin American governments tend to increase their budget deficits.

***Figure 4***

Are these budget deficits a product of Chinese financing or left governance? Latin America is a region marked by the world's highest income inequality and large infrastructure deficits, which raises the political appeal of increasing fiscal space to address these challenges – particularly among leftist governments that have traditionally viewed the public balance sheet as a tool to address these problems. Left governments may be more likely to borrow from Chinese creditors because it allows them more latitude with their budgetary choices. In other words, their political base may view deficit spending as a tool to either spur jobs and wage growth, or redistribute income, which then influences why they select Chinese financing.

**Methodology**

I attempt to correct for such endogeneity in the sovereign lending process by using a Heckman-type correction to control for treatment selection.[48] The empirical analysis proceeds in two stages. In the first-stage probit model, I test for both supply and demand side determinants of Chinese loans to Latin American governments. I employ a binary dependent variable to observe if in a given year, the government has a Chinese bilateral loan outstanding as a share of its external debt stock. I then calculate the inverse-mills ratio from the selection equation in the first-stage model to use as a switching value to control for the nonrandom selection of Chinese bilateral lending in the outcome equation. I can thus test for the independent effect of Chinese lending on fiscal policy choices in the second-stage regression model, where Chinese state-to-state lending as a share of outstanding external debt is the dependent variable.

**Data Description: First-Stage Model, Supply and Demand Determinants of Chinese Loans**

In the first-stage model, I incorporate two main demand-side factors explaining borrowers' choice to tap Chinese loans, domestic partisanship and investment structure. I also include several supply-side variables

[48] Heckman 1988; Vreeland 2003; Chwieroth 2007.

that account for China's choice to invest in Latin America, such as indebtedness (*External Public Debt*), level of development (*Per Capita Income*), global interest rates (*U.S. Interest Rates*), sovereign borrowing costs (*EMBI Country Risk*), political regime (*Regime Type*), and the extent of a country's trade (*China Trade*) and political alignment (*U.N. Voting with China*) with China.

Although the Heckman model is identified when the same independent variables appear in both the selection and outcome equations, it is generally recommended to include at least one extra explanatory variable that influences selection but not the subsequent outcome of interest. I use both a country's trade and U.N. voting alignment with China based on the following logic. Global ties with China may affect a country's borrowing decisions, but not its fiscal policy choices, which more typically reflect broad-based domestic economic conditions rather than global politics or trade.

**Partisanship**

To test both the direct effect of left partisanship on fiscal policy choices, and the indirect effect operating through Chinese bilateral loans, I employ the World Bank's Database of Political Institutions. This measure helps account for partisan behavior in Latin America's complex political spectrum, where political parties have either shifted their ideological priorities or diluted their partisan brands over time. It codes party orientation with respect to economic policy along a right-left spectrum.[49] Employing this coding, I design the binary variable, $LeftPartisanship_{it}$, to test if left-leaning politicians (compared to centrist and right-leaning politicians) are more likely to pursue higher budget deficits when tapping Chinese bilateral loans.

$$LeftPartisanship_{it} = \left\{ \begin{array}{c} \text{1 if government is classified as left leaning.} \\ \\ \text{0 otherwise.} \end{array} \right\}$$

In additional robustness checks, I employ a different measure of left partisanship, $LeftIdeology_{it}$, that instead ranks scores along Baker and Greene's (2011) 20-point left-right ideological continuum, helping preserve fine-grained distinctions among parties. We can then examine how a more nuanced shift in government priorities affects fiscal policymaking both directly, and indirectly under Chinese financing.

[49] Conservative or right-wing parties are a 1, centrists parties are a 2, and social democratic or leftist parties are a 3.

**Investment Structure**

I also control for a nation's domestic investment structure, based on the assumption that left governments are most likely to tap Chinese financing when they can dilute national procurement and investment laws. I employ two different measures of investment structure, *Procurement Regulations* and *Investment Regulations*. The variable, *Procurement Regulations*, is derived from the World Bank's Private Participation in Infrastructure Database, which ranks national regulatory frameworks according to "internationally recognized good practices." For robustness checks, I also include the variable, *Investment Regulations*, which is calculated from the World Bank's Regulatory Quality Index, which captures governments' ability to formulate "sound regulations" that "promote private sector development."

**Data Description: Second-Stage Model, The Effect of Chinese Bilateral Loans on Fiscal Policy**

In the second-stage model, I construct a variable, $ChinaStS/Debt_{it}$, that measures the share of the total external debt stock derived from outstanding Chinese state-to-state loans (see below), relative to a country's other external financing sources, including capital markets, commercial bank loans, and multilateral lending. I expect bilateral loans are more stable during distress, given their lack of short-term policy benchmarks constraining government budgets, facilitating countercyclical macro-economic policies.

I employ the primary fiscal balance as a percentage of GDP (*Fiscal balance*) as the dependent variable. I use the primary fiscal balance (net of interest payments on public debt) rather than the general government balance (inclusive of interest payments) because it is the more appropriate measure of the government's fiscal policy stance, particularly in highly indebted countries where interest payments are predetermined by the size of previous deficits. I also use the standard control variables, including a lagged dependent variable, for fiscal policy regressions used in the political budget cycles literature.[50] In further robustness checks (models 4-5 in Tables 2, and Tables A.3 and A.4 in the Appendix), I also employ general government balance as the main dependent variable to account for the effect of interest payments on a government's fiscal space.

Given the expected country-specific differences in the time-series cross-sectional (TSCS) data, I present the findings of the second stage of the model with fixed effects estimators to address unit heterogeneity.[51]

[50] Barberia and Avelino 2011.
[51] Green et. al., 2001.

To mitigate concerns about potential bias resulting from the lagged dependent variable, the second-stage findings are also presented using both a fixed effects estimator that excludes the lagged dependent variable, and a generalized methods of moments (GMM) estimator (see Tables A.3 and A.4 in the Appendix).

**Chinese State-to-State Lending (Patient Capital)**

I construct the Chinese bilateral loan data from a new, original dataset called the *Chinese Global Finance Index*, which characterizes the financing channel (state-to-state vs. market-based) for Chinese policy bank loans by national investment projects. I gathered this data from primary sources at Latin American finance and planning ministries during field research,[52] and official central bank and finance ministry websites. I reinforced these efforts by also cross-checking them across other sources, including Gallagher and Myers 2019; U.S. SEC filings of foreign governments, investment bank reports, AidData, and RED ALC-China.

While the aforementioned sources contain basic descriptive project characteristics (i.e. main investors, primary contractors, type of project, and expected tenure), this dataset is the first one of its kind to code each individual loan's financing channel (i.e. state-to-state vs. market based). The dataset is also unique in that its calculations are based on the amount actually disbursed to countries, and not on initial project announcements. Finally, this new dataset also adjusts the outstanding stock of Chinese loans to account for debtor repayment and creditor roll-overs (to avoid double-counting of debt obligations). While headline Chinese loan numbers are often discussed in the popular press, accurate data on the outstanding stock of loans is vital to examining the impact of China's state-to-state lending on public finances.

## Model Specification

To operationalize the hypotheses, I use the following specifications:

$$ChinaStS/Debt_{it} = \alpha + \beta_1 Left_{it} + \beta_2 Investreg_{it} + \beta_3 Left_{it} * Investreg_{it} + \beta_4 X_{it} + \varepsilon_{it}$$

$$Fiscal_{it} = \alpha + \beta_1 ChinaStS/Debt_{it} + \beta_2 Left_{it} + \beta_3 X_{it} + \beta_4 X_{it-1} + \gamma_1 Fiscal_{it-1} + \lambda_i + \eta_i + \varepsilon_i$$

where $Fisc_{it}$ =fiscal balance; $ChinaStS/Debt_{it}$ = Chinese outstanding state-to-state loans / external public debt; $Left_{it}$ = left governments; and $Investreg_{it}$=domestic investment regulations. The index

[52]These countries included the four primary debtors to China (Argentina, Brazil, Ecuador, and Venezuela).

$i$ =country; $t$ =year; $X_{it}$ = vector of control variables; $X_{it-1}$ = lagged independent variables; $Fisc_{it-1}$ = fiscal balance (1-year lag); $\lambda_i$ = inverse Mills ratio derived from first equation of Heckman-type correction model, and used in the second equation to control for treatment selection; $\eta_i$ = dummy capturing unobserved country effects; $\varepsilon_{it}$ = error term.

The first stage probit model explores the factors driving governments to borrow from China (including partisanship, national indebtness, global credit conditions, and geopolitics), while the second stage independently examines how such lending affects fiscal policymaking using a dynamic model specification with lags of both the dependent and independent variables. The lagged dependent variable helps account for the influence of past economic performance on present conditions, specifically potential long fiscal policy lags. While fiscal policy may rapidly affect the economy through automatic stabilizers (i.e government spending increases because of recession-driven government benefits like unemployment insurance), its effect can also be slow because of implementation delays due to the political process.[53]

Lagged independent variables were also used, based on the assumption that many of the economic variables included in the model do not have an instantaneous effect on the outcome variable, and may be distributed across more than one time period.[54] However, I did include contemporaneous values for those international economic variables – including global growth and commodities – that are primarily expected to affect fiscal outcomes within the current year because of high global interdependence.

When $ChineseStS/Debt_{it}$ (state-to-state financing) is the dependent variable, a positive coefficient for $Left_{it}$ would support the first hypothesis that left governments are more likely to seek out Chinese financing. At the same time, a negative coefficient for $Left_i * Investreg_{it}$ suggests that when left incumbents operate in a market-oriented investment structure, they are less likely to directly tap Chinese financing, instead channeling outside the public balance sheet. When $Fiscal_{it}$is the dependent variable, I expect to observe an effect of $ChineseStS/Debt_{it}$ on fiscal policy that is independent of the government's initial choice of financing. A negative coefficient would provide support for the hypothesis that state-to-state financing leads to greater fiscal space (i.e. widens budget deficits, or narrows budget surpluses).

[53] Mankiw 2012.
[54] Keele and Kelly 2006; De Boef and Keele 2008.

## The Effect of Partisanship on Borrowing from China

Are left governments more likely than their centrist and right counterparts to use Chinese financing to bypass their budgetary constraints? To begin, let us examine a series of straightforward regression models. In Table 1, the coefficient for Chinese state-to-state lending has a negative and statistically significant relationship with budget deficits, lending support to the hypothesis that Chinese bilateral financing enhances fiscal discretion. Note that these results for Chinese state-to-state lending hold when normalizing by both external financing (models 1 and 2) and GDP (models 3 and 4), suggesting that the findings are driven by the structure of the debt, rather than the size of the external debt or the economy.

In contrast to Chinese capital's tendency to promote fiscal flexibility, the theoretical priors suggest that Western financing sources should instead be associated with fiscal consolidation. As expected, the coefficients for multilateral loans, normalized by both GDP and external debt, have a positive and statistically significant effect on budget balances (models 5-6). Notwithstanding their long-term financing window, multilateral banks (i.e. the World Bank and Inter-American Development Bank) are associated with fiscal discipline. It's also useful to compare Chinese capital with global bond financing, given it's historic importance as a Latin American funding source (though China's capital controls prevent it from having comparable short-term financial connections). Notably, the coefficient for global bonds is also positive and statistically significant, suggesting that capital market financing also tends to coincide with budget discipline (model 7).

***Table 1 here***

To what extent is the variation in fiscal outcomes conditioned by government partisanship? Figure 5 shows the marginal effect of these conditional models. When countries have little or no exposure to Chinese state-to-state financing, left partisanship has a positive and statistically significant effect on budget balances. Facing the budget constraints traditionally imposed by their global creditors (i.e. global markets and international financial institutions), left governments tend to adhere to budget discipline, on average, registering budgetary surpluses of 0.6 percentage points of GDP. Notably, however, as Chinese bilateral financing accounts for a growing share of GDP, budget balances tend to deteriorate over time.

***See Figure 5***

But, to what extent are Chinese loans endogenous to domestic politics? Perhaps, left governments borrow from China because they desire more fiscal space to redistribute income and spur employment. I address such potential endogeneity in sovereign borrowing by first controlling for treatment selection, and then estimating the independent effect of Chinese financing on fiscal policy choices in the model's second stage.

***Table 2 here***

The first series of probit models display the effects of the independent variables on national government's choice to tap Chinese bilateral loans. The coefficient on left partisanship is positive and statistically significant at the 99 percent confidence interval (models 1-4 in Table 2). Employing these coefficients to derive the predicted probability of borrowing from China,[55] I find that left partisanship makes a government as much as 40 percent more likely to secure Chinese loans compared to right and centrist administrations.

In the conditional regression models (models 3-4 in Table 2), domestic investment structure has a statistically significant and mitigating effect on the choice to borrow from China, providing further support to the first hypothesis. Left governments are most likely to tap Chinese financing when they have weaker procurement regulations. When they have robust procurement laws and rely on private sector financing, they are less likely to dilute these market-oriented legal provisions to enable state-to-state infrastructure lending. In other words, left governments hailing from countries with a sound procurement framework like Chile are less likely to directly tap Chinese financing than those countries like Ecuador or Venezuela with a lower quality procurement framework.

In further robustness checks, I replace the variable for *Procurement Regulations*, with *Investment Regulations* to observe how a country's broader investment framework affects borrowing from China. The coefficient on the interaction term (*Investment Regulations*Left*) remains negative, but gains in magnitude. This relationship shows that the left's tendency to borrow directly from China is tempered by market-oriented investment frameworks (see model 5 in Table 2).

Beyond these demand-side factors, several supply-side variable also account for China's choice to invest in Latin America. The coefficient for regime type is negative and statistically significant, suggesting Chinese

[55]The changes in predicted probabilities reflect a one-unit change (from 0 to 1) in the binary variable, *left partisanship*.

creditors are more likely to court autocratic governments. Political alignment with China also appears to play a role, given the positive relationship between Chinese lending and a nation's U.N. voting record.

Global financial conditions also influence Chinese creditors' choices. For example, the coefficient on U.S. interest rates is negative and statistically significant, suggesting that rising global interest rates are likely to make it more difficult for Latin American governments to borrow from China. Chinese creditors can be cautious at times, as they are more likely to lend to Latin American governments with a higher level of development, lower indebtedness, and higher prices for their commodities (see models 1-5). That said, the positive coefficient on emerging market country risk suggests that China does exhibit some relative risk tolerance; it's willing to lend to emerging market countries notwithstanding higher risk premiums.

Returning to our demand-side analysis, to what extent might the partisan findings hold when using a more nuanced measure of left partisanship? In a series of robustness checks, I alter the measure of partisanship to account for more gradual shifts in ideological leanings across a continuum by employing Employing Baker and Greene's (2011) proxy for incumbent ideology. When using the more fine-grained ideological measure (*Left Ideology*) in the probit model, partisanship continues to have a positive and statistically significant effect at the 99 percent confidence interval (models 6-7 in Table 2).

Employing these coefficients to derive the predicted probability of borrowing from China, I find that as governments become one unit more leftist across the ideological spectrum (on a scale ranging from 1 to 20), they become 1.1-1.2 percent more likely to secure Chinese loans. These results imply that an extreme left government (ideology = 20) would be about about 5.5 to 6.0 percent more likely to borrow directly from China than a moderate left government (ideology =15). Those governments classified as extreme left, or left populists[56] with more concentrated state power such as Ecuador and Venezuela, are thus more likely to solicit China for direct state-to-state loans than the center-left from Chile or Peru.

In theory, the populist right might also want to expand its fiscal space to meet expensive spending promises, but historic right-wing populists in Latin America have not coincided with contemporary period of Chinese financing. The recent presidential victory of Jair Bolsonaro in Brazil provides an exception. However, during the 2018 campaign, Bolsonaro was circumspect about deepening Chinese economic ties

[56]Levitsky and Roberts 2011

with Brazil, saying "the Chinese are not buying in Brazil. They are buying Brazil."[57]

In summary, the first-stage of the selection model shows that left partisanship often conditions the choice of Latin American governments to borrow directly from China, lending support to the first hypothesis ($H_1$). Independent of the choice of creditors, however, what is the effect of Chinese bilateral lending on a governments' fiscal policies?

## The Effect of Chinese Bilateral Lending on Fiscal Policy

The model's second stage shows that Chinese bilateral financing, independently of the initial process of securing the loans, tends to increase government budget deficits. In models 1-5 in Table 3, the coefficients on Chinese state-to-state lending (*Chinese StS / Debt*) are negative and statistically significant, lending support to the second hypothesis ($H_2$). These findings imply that for each 10 percentage point increase in Chinese loans as a share of external financing, the budget deficit expands by about one-quarter to one-half of a percentage point of GDP. Notably, the selection instrument for Chinese loans is statistically insignificant, indicating that non-random selection does not introduce bias.

Beyond the initial selection effect in the first stage model, partisanship does not appear to have any direct effect on fiscal policymaking, even when conditioning for investment regulations (model 2 in Table 3). In the second stage model, the coefficients on left partisanship is positive but statistically insignificant (models 1-2), meaning we cannot reject the null hypothesis that left partisanship does not affect budget deficits. Notably, when using Baker and Greene's (2011) more fine-grained ideological measure (*Incumbent Ideology*), the primary findings about the accommodative effect of Chinese lending hold but partisanship remains statistically insignificant (see model 3).

Left governments may be more apt to borrow from China than other right or centrist governments. However, once governments secure financing, Chinese loans have a uniform accommodative effect on budget policy that is not sensitive to a government's partisan affiliation. Holding all else equal, we should then observe that left governments without access to Chinese financing are more fiscally disciplined, while right or centrist governments with access to Chinese financing are more fiscally accommodative. In the following

[57] *Reuters*, October 25, 2018.

*Discussion* section, we'll turn to two comparative cases, Bolivia and Costa Rica, that illustrate this variation.

***Table 3 here***

For instance, Bolivia provides an example of a left government that did not borrow from China to get additional fiscal space. In the wake of the global financial crisis, Chinese bilateral loans had accounted for a modest 2 percent of external financing. By comparison, the IMF and private borrowers accounted for more than four-fifths of Bolivia's external financing. To placate these creditors, President Evo Morales had to pursue austerity, cutting expenditures to maintain a budget surplus of 1.4 percent of GDP in 2010.[58] The regression estimates above imply if the Bolivia government had instead increased its Chinese loans outstanding to Ecuador's 2010 level (about one-third of its external financing), the additional bilateral borrowing could have allowed for about 1 percentage point of GDP in new fiscal stimulus.

By comparison, despite being governed by the centrist National Liberation Party (PLN), the Costa Rican government had been financing about one-tenth of its external debt with Chinese loans during 2010. Borrowing from Chinese creditors who had little preoccupation with national budget policies, allowed the government to pursue countercyclical spending at at time when market capital was typically exiting developing countries in the wake of the global financial crisis.

In a series of robustness, I employ an alternative measure of the dependent variable: the general government balance (inclusive of interest payments), rather than the primary fiscal balance (net of interest payments on the debt) to examine how additional interest payments may affect a country's fiscal space. It does not yield any material changes in the direction or precision of the coefficients for Chinese state-to-state lending (models 4-5 in Table 3, and models 4-5 in Tables A.3-A.4 in the Appendix).

Might low indebtedness instead be the main driver of greater policy maneuverability? As discussed earlier, I have included a control for external indebtedness in the regression analysis. However, to ensure that countries with more sustainable debt levels are not driving the results, I re-estimated the main independent variable – Chinese state-to-state lending – to further establish the results are driven by the structure of the debt, and not the overall size of the debt. In these models, I normalize Chinese bilateral loans by GDP

[58] CEPALSTAT 2018.

instead of total external financing needs, confirming that Chinese bilateral loans have a liberating effect on budgetary accounts (models 6-7 in Table 3, and A.3-A.4 in the Appendix).

These results also remain robust after a series of tests designed to mitigate concerns about potential bias resulting from the lagged dependent variables. I first re-estimate the fixed effects models excluding the lagged dependent variables. I also employ the Arellano-Bond GMM first-difference estimator to both reduce possible Nickell bias, and the possibility of reverse causality in the independent variables (see Table A.3-A.4).

## Discussion

To further examine the extent to which Chinese credit affects budgetary balances, I briefly explore some of the dataset's cases in more detail below. If the relationship between Chinese credit and deficit spending is not contingent on partisanship, we should observe, all else equal, that centrist governments that borrow from China are more likely to increase their budget deficits. By the same logic, leftist governments that do not tap Chinese bilateral loans should be more likely to pursue budget discipline.

Let us momentarily journey to five Latin American countries: Bolivia, Costa Rica, Ecuador, Peru, and Venezuela. They are high middle income countries that are located in a similar geographic region (within 20 degrees of latitude from one another), yet maximize the variation in the main independent variables of interest:[59] Chinese indebtedness. I examine their relationship to budgetary stances in the five years before and after the 2008 global financial crisis, when China emerged as a major regional creditor (see Figure 6).

***Figure 6***

Before proceeding with the analysis, let us first examine a common alternative explanation for Latin America's fiscal deterioration following the global financial crisis: the commodity downturn. While the statistical findings above were robust to controls for commodity prices, I briefly elaborate on why the commodity downturn is not a sufficient explanation for the region's higher budget deficits.

If it were a sufficient condition, we would expect that falling commodity revenues would have led to weakening of budget balances in those countries with a high dependence on natural resources for fiscal

[59] King et. al. 1994.

revenues. In other words, we should observe budget deficits in Bolivia, Ecuador, Peru, and Venezuela, while Costa Rica low dependence on natural resource revenue should make it an outlier case of budgetary rectitude. However, in the five years following the crisis, Bolivia and Peru maintained consistent budget surpluses that averaged more than 1 percent of GDP. By comparison, Costa Rica, Ecuador, and Venezuela's budgetary accounts moved into the red post-crisis, with sustained deficits throughout the period (Figure 6).

These patterns suggest that commodity volatility may not be the most important driver of fiscal performance. For example, Bolivia should have been one of the countries that was most susceptible to a revenue shock, given that its pre-crisis, non-tax commodity revenues averaged 11 percent of GDP compared to a regional average of 3.9 percent of GDP. Yet, its government maintained a post-crisis primary budget surplus. At the same time, Costa Rica should have been fairly insulated from post-crisis commodity volatility, with pre-crisis non-tax revenues averaging a paltry 0.25 percent of GDP. Yet, it's government saw its budgetary accounts swing from surplus to heavy deficit.

If commodity volatility does not sufficiently explain fiscal policy changes, to what extent might Chinese bilateral loans account for the divergence in fiscal performance? In line with my earlier statistical findings, I expect that when governments gain access to sizable amounts of Chinese loans, governments should increase budget deficits, notwithstanding their partisan affiliation.

For example, in Costa Rica, Óscar Arias' centrist government tapped Chinese loans to expand its fiscal space during the global financial crisis. Without such financing, Costa Rica would have had considerably more difficulty covering its countercyclical spending, as well as its own post-crisis state bank recapitilization.

To contemplate this counterfactual constraint, we can compare Costa Rica to Peru, which shared several important characteristics with Costa Rica at the time of the crisis, including a centrist government[60] and a strong reliance on private sector external financing sources.[61] However, its government did not receive Chinese credit, leaving them with less fiscal space. The Alan Garcia administration increased its public investment to mitigate the effects of the global crisis and falling mineral prices. However, in contrast to Costa Rica, the Peruvian government maintained primary budget surpluses through the post-crisis period

[60]Despite being viewed as a radical leftist during his first presidency, Alan Garcia was more moderate during his second presidency (2006-2011), classified as a centrist politician by Baker and Greene's (2011)'s incumbent ideology measure.

[61]Nearly one-half of Peru's external funding came from the private sector during the prelude to the global financial crisis.

(see Figure 6), in part to sustain its strong external credit position.

Costa Rica had first turned to China in 2008 to help navigate its economic distress. China opened the spigots of its global financing to Costa Rica, after the Arias' government had officially established relations with the People's Republic of China (PRC). Notwithstanding its historical recognition of Taiwan, President Arias considered his diplomatic about-face a 'natural evolution' in light of the important economic development opportunities offered by China. In return, the Costa Rican government immediately received its choice of public financing projects (a $100 million soccer stadium), and $300 million of Costa Rican bond purchases. The bond financing alone amounted to 1 percent of the country's GDP.

Historically, Costa Rica had raised almost two-thirds of its external financing from private sector creditors, but was having a difficult time issuing bonds amid the 2008 global credit crunch. Western investors had been retreating from Costa Rica amid the crisis, propelling the country's foreign bond prices to historical lows and raising the government's funding costs. Facing financial turmoil, sharp currency depreciation, and capital outflows, economic officials fretted that the global downturn could destabilize Costa Rica, particularly its U.S. dependent, high-tech manufacturing sector.

In contrast to such volatility, China's patient capital provided Costa Rica with more budgetary room to maneuver. The countercyclical influx of new Chinese financing helped fund government spending on social safety nets and public infrastructure that were intended to offset the downturn. Notably, new 2008 expenditure outlays were just over 1 percent of GDP, equivalent to China's total bond purchases.

By comparison, what happens when left governments do not tap Chinese financing? Are they more disciplined fiscally? Until recently, Bolivia had not been a major debtor to China. In the five years following the global financial crisis, Chinese bilateral loans accounted for less than one percentage point of GDP. By comparison, this tally was dwarfed by China's biggest debtors; Ecuador and Venezuela's debt to China averaged 4.5 and 11.7 percent of GDP respectively over the same period. While the presidents governing all three countries (Hugo Chavez, Rafael Correa, and Evo Morales) were part of the same leftist tide that swept through Latin America in the mid 2000s, they parted ways fiscally with the rise of Chinese credit.

Whereas Bolivia remained fiscally frugal, Ecuador and Venezuela oversaw some of the region's largest post-crisis deficits. They escaped fiscal austerity in part because of Chinese unconditional loans. Ecuador

and Venezuela moved from lofty budget surpluses of 1.4 and 1.0 percent of GDP in the five years before the crisis to sizable deficits averaging -2.1 and -4.1 percent of GDP in the five years after the crisis.

By contrast, without Chinese unconditional financing, Bolivia's fiscal accounts barely budged, averaging 1.3 and 1.1 percent of GDP in the five years before and after the crisis (see Figure 6). The sustained fiscal rectitude is surprising given the political success President Evo Morales earned by condemning neoliberalism. Moreover, Morales' party, Movimiento al Socialismo (MAS), has a substantial left-of-center support base,[62] incentivizing using fiscal policy for greater redistribution. However, its reliance on austerity-linked external credit limited the government's fiscal space, particularly during periods of commodity volatility.

In summary, the relationship between Chinese credit and deficit spending does not appear to be contingent on partisanship. Not only did a centrist Costan Rican government tap Chinese financing to boost its budgetary flexibility, but a leftist Bolivian government without Chinese credit remained fiscally disciplined.

## Conclusion

Has China's emergence as a international creditor changed global governance? In this paper, I have examined how a reliance on China's state-led financing can affect the economic policy choices of developing countries. Compared to those debtors relying upon Western market financing, governments that primarily borrow from China tend to be more insulated from the scrutiny of global financial markets and international financial institutions. Why?

In evaluating sovereign credit, both global markets and Western governance institutions emphasize the importance of policy conditionality, or prudent macroeconomic policies (i.e. fiscal discipline) as a condition for new financing. Such policy assurances help ensure high near-term financial returns by bolstering borrowers' debt repayment prospects. However, such short-term policy conditions also create a financing mismatch where non-compliance catalyzes capital exit during economic downturns .

While Chinese creditors are also concerned with debt repayment, I contend that they offer a more patient form of capital. By emphasizing non-intervention in sovereign affairs, the lack of conditionality extends the financing horizon beyond short-term policy targets. Based on these priors, I have developed and tested a

[62] Levitsky and Roberts 2011.

theory that expects governments that borrow from China to have more degrees of maneuverability compared to other multilateral and market financing sources. In a cross-national test of Latin America – a region, that on average, has experienced massive growth of Chinese financing since the global crisis – I find that budget deficits grow as Chinese bilateral lending accounts for a larger share of a nation's external financing.

This comparative creditor framework offers several future research opportunities. If China remains committed to its non-intervention principle, how does it mitigate its credit risk without such policy conditionality? China tends to underwrite credit risk with commercial conditions embedded in its loan contracts. While the crux of this study has examined tradeoffs reflecting the lack of policy conditionality, it would be a fruitful research endeavor to assess the cost and benefits of these commercial conditions, and the extent to which China can foster good governance without policy conditionality. For example, these loan provisions, which typically involve some type of combination of Chinese foreign content and commodity guarantees, are designed to improve the competitiveness of Chinese firms globally. However, they may also impose some costs on Latin American countries. Preferential treatment for Chinese capital inputs and machinery may undermine Latin America's industrial competitiveness. At the same time, commodity guarantees embedded in loans-for-oil agreements risk eroding commodity proceeds that could otherwise be channeled toward domestic spending or reinvestment in state energy firms. Perhaps, most importantly, China's tendency to focus on commercial rather than policy terms may encourage governments to spend beyond their means, sowing the seeds for future debt problems. For example, former President Rafael Correa said he preferred Chinese loans because "there is no limit for indebtedness with China."[63]

In addition to these commercial conditions, China has also sought to temper its state-to-state credit risks by diversifying its investments to include market-based instruments, and thus rebranding its development image.[64] For instance, in the wake of failed state-to-state investments in Sri Lanka, Indonesia, and Venezuela, China has created state-backed private equity funds (e.g., China-LAC Cooperation Fund, China-Latin America Infrastructure Fund) that are directly investing in corporate entities in manufacturing, energy, logistics and technology. It's also participating in public private partnerships (PPP) and varying its project financing partners to include Chinese commercial banks, multilateral institutions (e.g. World Bank,

[63]Ecuador Recibirá Créditos de China, *Ecuador Inmediato*, February 2, 2012.
[64]Dietrich, Mahmud, and Winters 2018.

Inter-American Development Bank) and local development banks.

To quantify to what extent China's overseas financing strategy now includes such market-based mechanisms, I plan to expand my *China Global Financial Index*, which codes Chinese investment projects by their financing channel (state vs. market), to include other developing region's projects from China's flagship external investment initiative, *Belt and Road Initiative* (BRI). I expect that China is incrementally experimenting with market-based solutions, much as it did during its domestic development. Such findings would suggest that its approach to global economic affairs is more pragmatic than ideological. China's state-led financing may endow countries with more near-term policy discretion, but it does not necessarily challenge the role of market governance as a development strategy more broadly.

Moving beyond this setting, it would also be interesting to explore the effect of other forms of patient capital on global borrowers. While this article emphasizes a sovereign form of patient capital, it may also take the form of individuals (i.e. parents investing in education), firms (i.e. venture capitalists investing in innovation), or non-profit institutions (i.e. entrepreneurs investing in social returns). Do these creditors also grant their debtors more flexibility? By examining such types of patient capital, it would help us understand if a longer investment horizon is a sufficient condition for enhancing borrower autonomy.

These examples suggest that the notion of patient capital can be fruitfully extended in many ways. The globalization scholarship has long debated the extent to which mobile capital constrains national autonomy, often finding that local state capacity and institutional development can mitigate such globalization pressures. The above research agenda suggests that disaggregating the structure of mobile capital can also shed light on the conditions enabling greater sovereign autonomy. When creditors afford their debtors such policy autonomy, it creates a development opportunity by allowing nations to target longer-term societal welfare. However, it also transfers the burden of demonstrating creditworthiness squarely on the borrower. And with greater power, comes greater responsibility. If national governments do not invest the proceeds prudently, they risk squandering their sovereignty gains with mounting indebtedness.

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Table 1: The Effect of Chinese Bilateral Lending on Fiscal Latitude

| | (1) FE | (2) FE | (3) FE | (4) FE | (5) FE | (6) FE | (7) FE |
|---|---|---|---|---|---|---|---|
| Chinese StS / Debt | -0.029*** | -0.022** | | | | | |
| | (0.010) | (0.009) | | | | | |
| Left Partisanship | 0.583* | 0.593* | 0.566* | 0.515* | -0.272 | -0.365 | -0.163 |
| | (0.307) | (0.309) | (0.309) | (0.286) | (0.364) | (0.362) | (0.290) |
| StS Loans * Left Partisanship | | -0.015* | | | | | |
| | | (0.008) | | | | | |
| Chinese StS / GDP | | | -0.138** | -0.153*** | | | |
| | | | (0.055) | (0.046) | | | |
| STS Loans * Left Partisanship | | | | -0.131** | | | |
| | | | | (0.047) | | | |
| Multilateral Loans / GDP | | | | | 0.019** | | |
| | | | | | (0.008) | | |
| Multilateral Loans / Debt | | | | | | 0.030* | |
| | | | | | | (0.017) | |
| Global Bonds | | | | | | | 0.016*** |
| | | | | | | | (0.005) |
| Global Growth | 0.211** | 0.212** | 0.210** | 0.264** | 0.156 | 0.179** | 0.244*** |
| | (0.084) | (0.085) | (0.083) | (0.092) | (0.097) | (0.069) | (0.065) |
| Output Gap (t-1) | 0.029** | 0.030** | 0.029** | 0.046*** | -0.023 | -0.034 | 0.008 |
| | (0.012) | (0.012) | (0.013) | (0.015) | (0.025) | (0.036) | (0.019) |
| Global Commodity Index (t-1) | 0.018** | 0.018** | 0.018** | 0.014* | 0.019** | 0.017** | 0.017* |
| | (0.007) | (0.007) | (0.007) | (0.007) | (0.008) | (0.008) | (0.009) |
| Inflation (log) | 0.361** | 0.358** | 0.362** | 0.447*** | 0.162** | 0.165** | 0.293** |
| | (0.131) | (0.130) | (0.133) | (0.144) | (0.070) | (0.077) | (0.128) |
| External Public Debt (t-1) | 0.004*** | 0.004*** | 0.004*** | 0.005*** | 0.002 | 0.007*** | 0.009*** |
| | (0.001) | (0.001) | (0.001) | (0.001) | (0.001) | (0.001) | (0.001) |
| Exchange Rate Regime | 0.095 | 0.087 | 0.096 | 0.086 | -0.105 | -0.065 | -0.132 |
| | (0.115) | (0.115) | (0.111) | (0.122) | (0.216) | (0.176) | (0.174) |
| Executive Constraints | 0.169 | 0.174 | 0.148 | 0.021 | 1.079 | 0.699 | 0.944 |
| | (0.560) | (0.560) | (0.565) | (0.566) | (0.815) | (0.718) | (0.744) |
| Primary Fiscal Balance (t-1) | 0.483*** | 0.482*** | 0.484*** | 0.492*** | 0.729*** | 0.600*** | 0.650*** |
| | (0.076) | (0.076) | (0.077) | (0.077) | (0.038) | (0.094) | (0.055) |
| Observations | 387 | 387 | 387 | 387 | 515 | 537 | 424 |
| $R^2$ | 0.47 | 0.48 | 0.47 | 0.49 | 0.56 | 0.57 | 0.51 |

Standard errors in parentheses

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Table 2: The Effect of Partisanship on Chinese Bank Lending

| | (1) Probit | (2) Probit | (3) Probit | (4) Probit | (5) Probit | (6) Probit | (7) Probit |
|---|---|---|---|---|---|---|---|
| Left Partisanship | 0.924*** | 1.364*** | 6.841*** | 5.754*** | 7.714*** | | |
| | (0.261) | (0.403) | (1.834) | (1.957) | (2.851) | | |
| Procurement Regulations | | | -0.000 | 0.012 | | | |
| | | | (0.017) | (0.019) | | | |
| Procurement*Left | | | -0.085*** | -0.072*** | | | |
| | | | (0.025) | (0.028) | | | |
| Investment Regulations | | | | | 0.034 | | |
| | | | | | (0.035) | | |
| Investment Regulations*Left | | | | | -0.129** | | |
| | | | | | (0.053) | | |
| Left Ideology | | | | | | 0.097*** | 0.189*** |
| | | | | | | (0.024) | (0.069) |
| Global Growth | -0.163** | -0.311** | -0.009 | 0.004 | -0.048 | -0.146* | -0.038 |
| | (0.077) | (0.138) | (0.107) | (0.113) | (0.125) | (0.075) | (0.120) |
| Global Commodities Index | -0.000 | 0.009 | 0.062*** | 0.063*** | 0.061*** | -0.001 | 0.068*** |
| | (0.007) | (0.011) | (0.017) | (0.018) | (0.018) | (0.007) | (0.021) |
| Inflation (log) | 0.593*** | -0.017 | 0.548* | 0.466 | 0.712 | 0.423** | 0.509 |
| | (0.188) | (0.206) | (0.299) | (0.376) | (0.540) | (0.196) | (0.394) |
| External Public Debt (t-1) | -0.073*** | -0.142*** | -0.111*** | -0.105*** | -0.106*** | -0.077*** | -0.201*** |
| | (0.015) | (0.035) | (0.028) | (0.033) | (0.034) | (0.015) | (0.049) |
| Unemployment (t-1) | 0.042 | 0.103* | 0.015 | 0.022 | 0.086 | 0.054 | -0.005 |
| | (0.046) | (0.059) | (0.076) | (0.080) | (0.118) | (0.044) | (0.098) |
| Per Capita Income (log) | 1.039*** | 3.193*** | 3.223*** | 2.990*** | 3.657*** | 0.964*** | 3.153*** |
| | (0.240) | (0.951) | (0.651) | (0.793) | (1.069) | (0.248) | (0.823) |
| Interest Rate (t-1) | -0.177*** | | -0.001 | 0.000 | -0.064 | -0.161*** | -0.077 |
| | (0.033) | | (0.004) | (0.005) | (0.074) | (0.034) | (0.066) |
| EMBI Country Risk | | 0.004*** | | | | | |
| | | (0.001) | | | | | |
| Regime Type | -0.286*** | -0.370*** | -0.577*** | -0.568*** | -0.250 | -0.244*** | -0.067 |
| | (0.057) | (0.127) | (0.166) | (0.182) | (0.319) | (0.075) | (0.276) |
| U.S. Interest Rates | | | -2.083*** | -2.622*** | -2.785*** | | -2.381*** |
| | | | (0.427) | (0.635) | (0.711) | | (0.664) |
| IMF Program | | | 1.589*** | 1.557** | 0.876 | | 1.461** |
| | | | (0.555) | (0.614) | (0.563) | | (0.613) |
| UN Voting with China | | | | 11.003* | 17.740** | | 5.836 |
| | | | | (6.279) | (8.566) | | (5.791) |
| China Trade | | | | -0.040 | -0.021 | | 0.092 |
| | | | | (0.096) | (0.104) | | (0.108) |
| Observations | 407 | 167 | 321 | 294 | 250 | 340 | 235 |

Standard errors in parentheses

Heckman first stage results for two-stage selection model.

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Table 3: The Effect of Chinese Bilateral Lending on Fiscal Policy Choices

| | (1) FE | (2) FE | (3) FE | (4) FE(GG) | (5) FE(GG) | (6) FE | (7) FE |
|---|---|---|---|---|---|---|---|
| Chinese StS / Debt | -0.024*** | -0.034** | -0.040*** | -0.038*** | -0.026*** | | |
| | (0.007) | (0.012) | (0.010) | (0.012) | (0.007) | | |
| Chinese StS / GDP | | | | | | -0.144** | -0.121*** |
| | | | | | | (0.059) | (0.038) |
| Left Partisanship | 0.145 | 0.769 | | 1.228 | | 0.541 | |
| | (0.238) | (1.107) | | (1.363) | | (1.266) | |
| Investment Regulations | | -0.016 | | -0.023 | | -0.020 | |
| | | (0.014) | | (0.017) | | (0.016) | |
| Investment Regulations*Left | | -0.009 | | -0.016 | | -0.006 | |
| | | (0.017) | | (0.019) | | (0.019) | |
| Left Ideology | | | -0.012 | | 0.075 | | 0.036 |
| | | | (0.064) | | (0.044) | | (0.049) |
| Global Growth | 0.318** | 0.381** | 0.372*** | 0.319*** | 0.285** | 0.380** | 0.330*** |
| | (0.125) | (0.126) | (0.102) | (0.104) | (0.107) | (0.127) | (0.105) |
| Output Gap | 0.047* | 0.034 | 0.065** | 0.069* | 0.076*** | 0.025 | 0.040 |
| | (0.026) | (0.032) | (0.030) | (0.034) | (0.024) | (0.035) | (0.027) |
| Global Commodities Index | 0.002 | -0.002 | 0.003 | -0.001 | -0.000 | -0.003 | 0.002 |
| | (0.006) | (0.008) | (0.006) | (0.008) | (0.006) | (0.008) | (0.007) |
| Inflation (log) | 0.598** | 0.581** | 0.576** | 0.641* | 0.736** | 0.631** | 0.693** |
| | (0.266) | (0.249) | (0.262) | (0.309) | (0.258) | (0.277) | (0.285) |
| External Public Debt (t-1) | 0.000 | 0.005 | 0.043 | -0.002 | -0.021 | 0.007 | 0.002 |
| | (0.023) | (0.014) | (0.032) | (0.019) | (0.029) | (0.014) | (0.032) |
| Unemployment (t-1) | 0.076* | 0.122** | 0.083* | 0.098* | 0.049 | 0.134** | 0.082 |
| | (0.036) | (0.047) | (0.042) | (0.049) | (0.045) | (0.053) | (0.047) |
| Per Capita Income (log) | -1.586* | -1.240 | -2.012* | 0.785 | -0.169 | -0.615 | -1.370 |
| | (0.746) | (1.545) | (0.971) | (1.929) | (1.230) | (2.094) | (1.136) |
| Interest Rate (t-1) | -0.027 | -0.034 | 0.028 | -0.039 | -0.060 | -0.036 | -0.031 |
| | (0.057) | (0.029) | (0.067) | (0.038) | (0.063) | (0.034) | (0.068) |
| Exchange Rate Regime | 0.316** | 0.489** | 0.458** | 0.307* | 0.153 | 0.449** | 0.309 |
| | (0.146) | (0.160) | (0.189) | (0.168) | (0.175) | (0.157) | (0.186) |
| Chinese Loan Selection Instrument | -0.056 | -0.059 | -0.518 | -0.012 | 0.208 | -0.058 | -0.041 |
| | (0.317) | (0.175) | (0.431) | (0.232) | (0.364) | (0.193) | (0.405) |
| Executive Constraints | | | | -0.426 | -0.884 | -0.068 | -0.497 |
| | | | | (0.810) | (0.631) | (0.549) | (0.485) |
| U.S. Interest Rates | | | | 0.141 | 0.060 | 0.056 | 0.003 |
| | | | | (0.125) | (0.104) | (0.133) | (0.097) |
| IMF Program | | | | 0.134 | 0.050 | 0.018 | -0.014 |
| | | | | (0.319) | (0.185) | (0.237) | (0.157) |
| Primary Fiscal Balance (t-1) | 0.527*** | 0.509*** | | | | 0.512*** | 0.516*** |
| | (0.045) | (0.070) | | | | (0.068) | (0.049) |
| General Government Balance (t-1) | | | 0.439*** | 0.472*** | 0.500*** | | |
| | | | (0.060) | (0.078) | (0.056) | | |
| Observations | 314 | 248 | 315 | 240 | 296 | 240 | 296 |
| $R^2$ | 0.59 | 0.61 | 0.53 | 0.56 | 0.52 | 0.61 | 0.57 |

Standard errors in parentheses

Heckman second stage results for two-stage selection model for Models 3, 5, and 7 from Table 2.

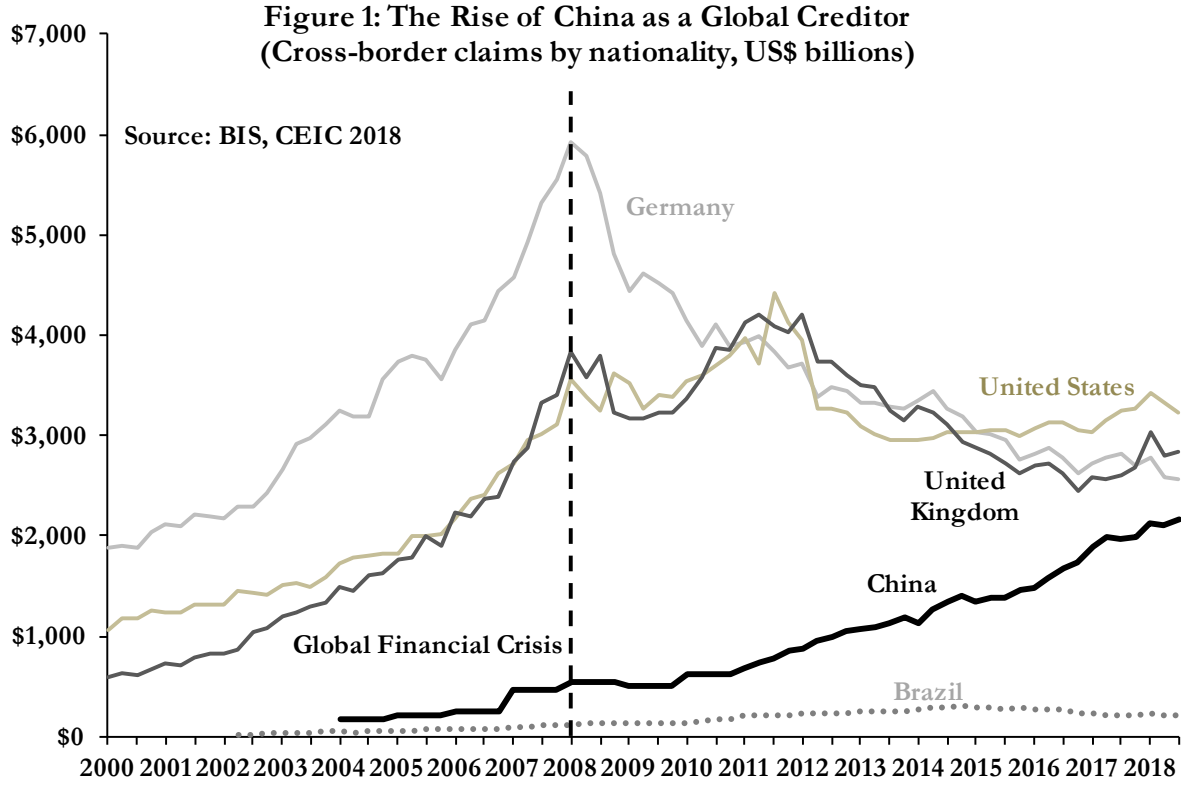
FE=Fixed effect models, 16 Latin American countries.

Robust standard errors.

Model 4-5 employ general government balance. Model 6-7 normalized by GDP.

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

**Figure 1: The Rise of China as a Global Creditor**
**(Cross-border claims by nationality, US$ billions)**




Note: Chinese banking statistics are sourced from CEIC's balance of payments data and BIS locational banking statistics.

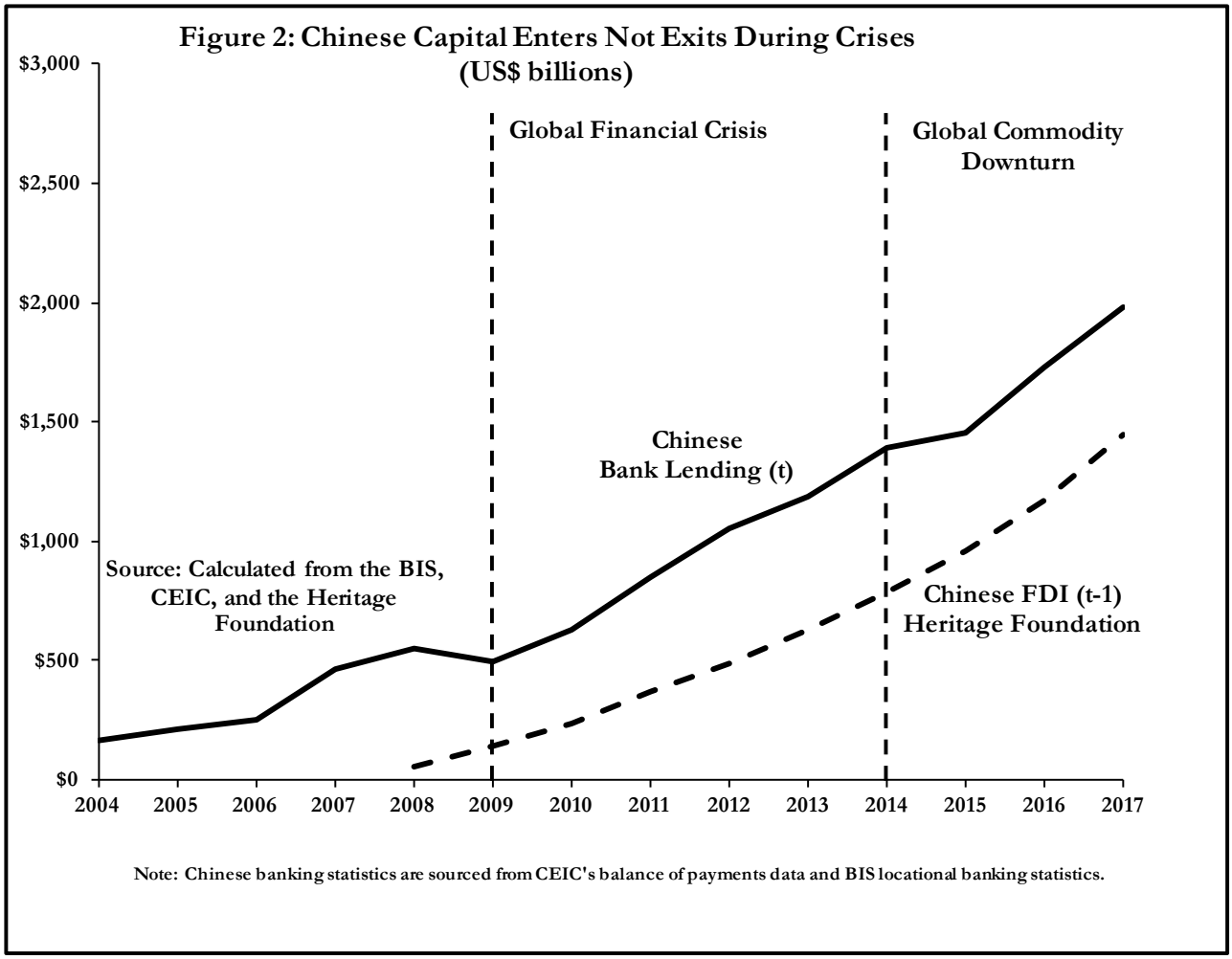
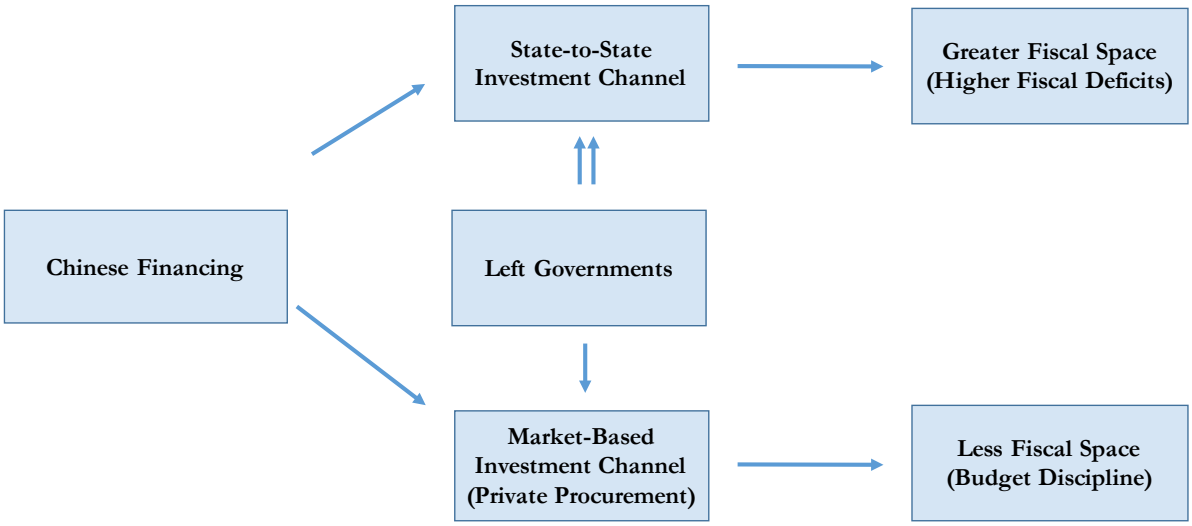


**Figure 3: Chinese Investment Channel, State-to-State vs. Market Based**



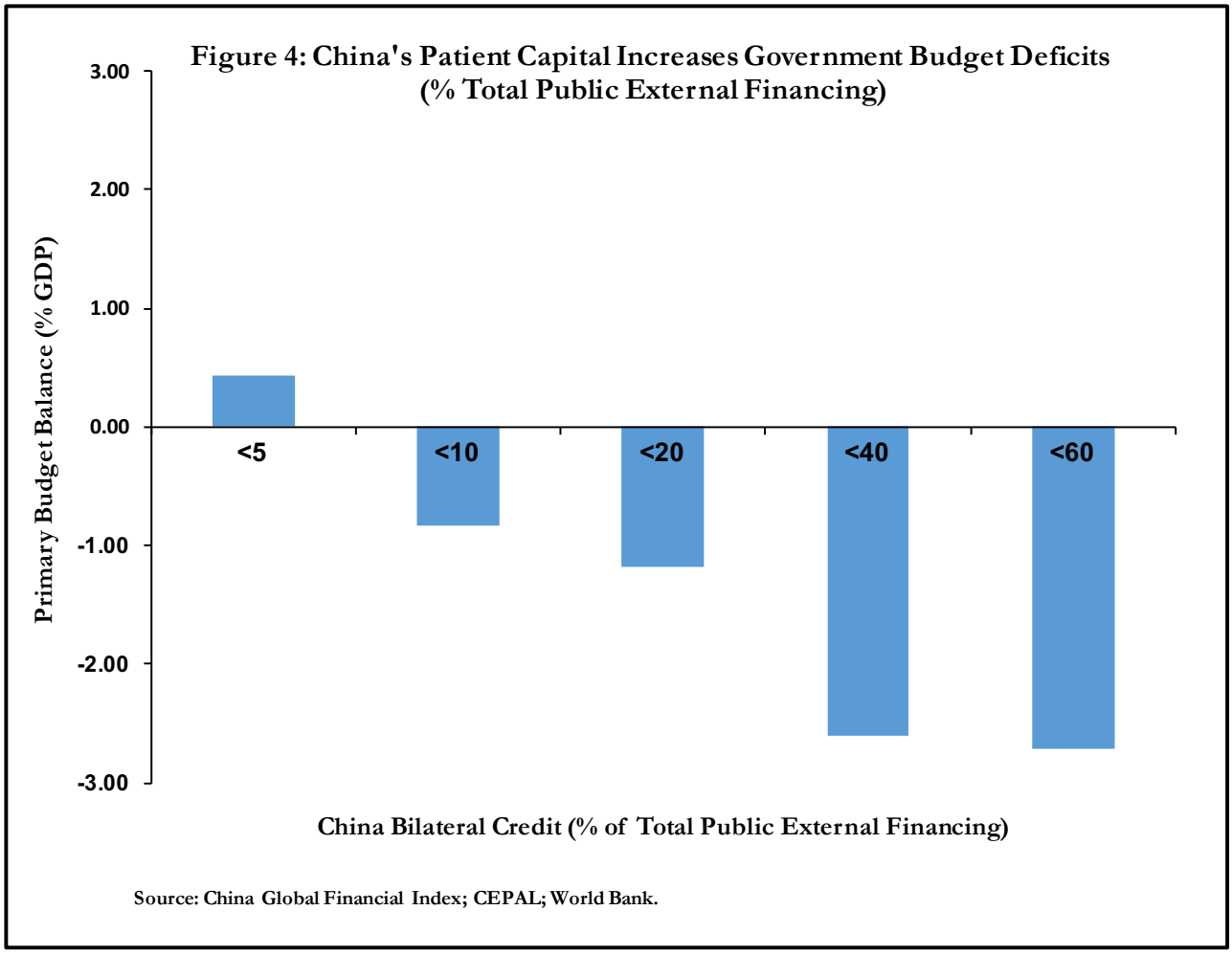


**Figure 5: Marginal Effect of Partisanship on Latin American Budget Balances**

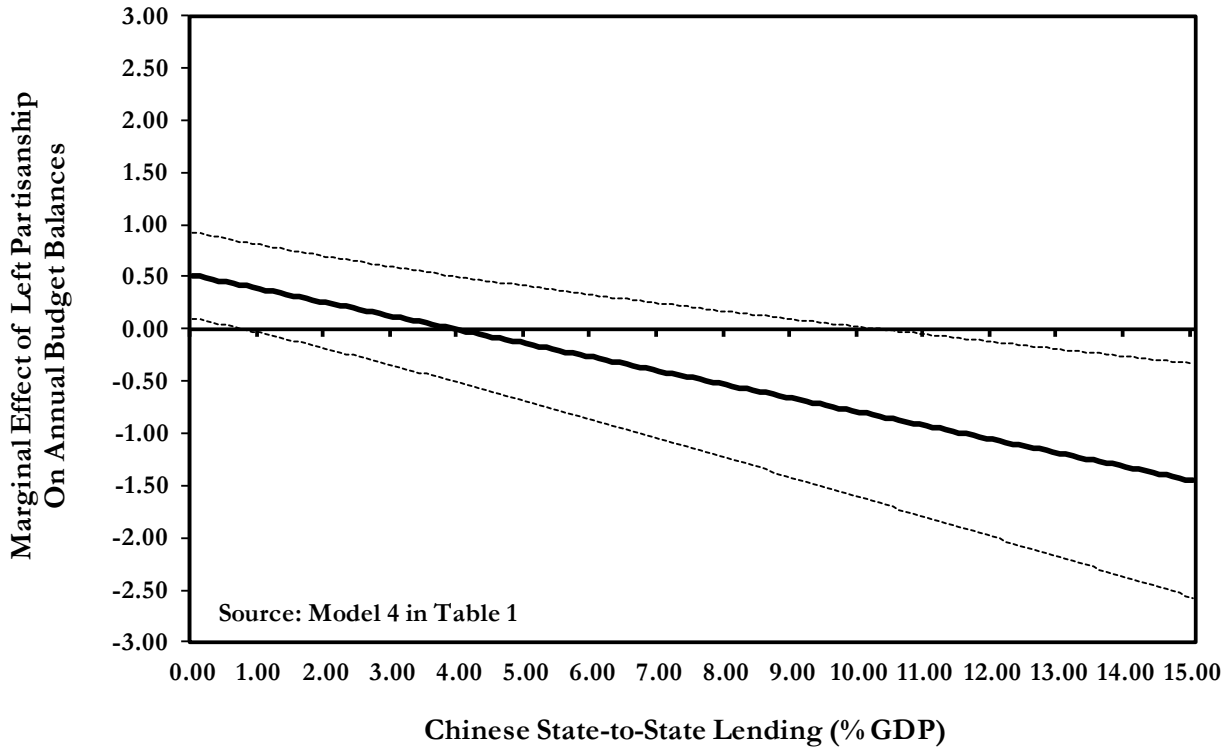


**Figure 6: Chinese Bilateral Credit and National Budgetary Stances (2004-2014)**