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Foreign Policy in a Troubled World

GEOECONOMICS AND GLOBAL ISSUES  
PAPER 4 | JANUARY 2017

# China's Investment in Latin America

DAVID DOLLAR



Foreign Policy  
at BROOKINGS

## ABOUT THE ORDER FROM CHAOS PROJECT

In the two decades following the end of the Cold War, the world experienced an era characterized by declining war and rising prosperity. The absence of serious geopolitical competition created opportunities for increased interdependence and global cooperation. In recent years, however, several and possibly fundamental challenges to that new order have arisen—the collapse of order and the descent into violence in the Middle East; the Russian challenge to the European security order; and increasing geopolitical tensions in Asia being among the foremost of these. At this pivotal juncture, U.S. leadership is critical, and the task ahead is urgent and complex. The next U.S. president will need to adapt and protect the liberal international order as a means of continuing to provide stability and prosperity; develop a strategy that encourages cooperation not competition among willing powers; and, if necessary, contain or constrain actors seeking to undermine those goals.

In response to these changing global dynamics, the Foreign Policy Program at Brookings has established the Order from Chaos Project. With incisive analysis, new strategies, and innovative policies, the Foreign Policy Program and its scholars have embarked on a two-year project with three core purposes:

- To analyze the dynamics in the international system that are creating stresses, challenges, and a breakdown of order.
- To define U.S. interests in this new era and develop specific strategies for promoting a revitalized rules-based, liberal international order.
- To provide policy recommendations on how to develop the necessary tools of statecraft (military, economic, diplomatic, and social) and how to redesign the architecture of the international order.

The Order from Chaos Project strives to engage and influence the policy debate as the United States moves toward the 2016 election and as the next president takes office.

## ACKNOWLEDGEMENTS

An initial draft of this paper was presented at the Latin America Studies Association Meetings, New York, May 2016. For helpful comments on that draft I thank the panel discussants, Barbara Kotschwar and Margaret Myers, as well as my Brookings colleagues Ted Piccone and Harold Trinkunas. I thank Wei Wang for excellent research assistance.

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# China's Investment in Latin America

DAVID DOLLAR

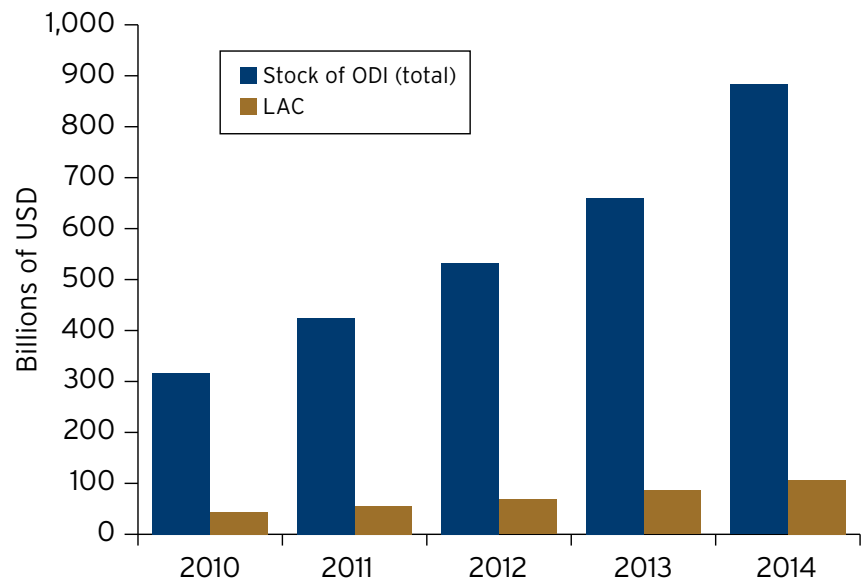
**F**or the five-year period between 2015 and 2019, China's President Xi Jinping set an ambitious goal of \$500 billion in trade with the Latin American and Caribbean region (LAC) and \$250 billion of direct investment. The pledge was made at the first ministerial meeting of the Forum of China and the Community of Latin American and Caribbean States, held in Beijing in January 2015. China has set some large investment targets in Southeast Asia and Africa that it has not always met, so it remains to be seen if this degree of integration can be achieved. But the investment numbers are certainly plausible, as China is likely to emerge in the next few years as the world's largest supplier of capital.

The outflow of capital from China takes two main forms. These are direct investment, which consists of greenfield investments plus mergers and acquisitions, and lending by China's policy banks, which are the Export-Import Bank of China (China EXIM Bank) and China Development Bank (CDB). China's Ministry of Commerce (MOFCOM) reports the allocation of China's overseas direct investment (ODI) among recipient countries. Specifically, MOFCOM reports the annual flow of ODI and the accumulating stock of China's outward investment. In recent years, China's ODI has amounted to somewhat more than \$100 billion per year, accelerating to above \$200 billion in 2014. The cumulative stock tripled between 2010 and the end of 2014, reaching nearly \$900 billion. Of this total, \$106 billion was direct investment to Latin American and Caribbean countries (Figure 1).

One problem with China's reporting of the ODI to individual economies is that about half of China's global ODI goes to Hong Kong. And within Latin

America and the Caribbean, large amounts of China's ODI go to the Virgin Islands and the Cayman Islands. These money centers are certainly not the ultimate destination for all of this investment. China should work to improve its statistics to reflect the ultimate destination of its overseas investments so that publics everywhere have more-accurate information. In general, direct investment is welcome, so it would be in China's interest to produce better data that more accurately reflects its growing role in global investment.

**Figure 1: The stock of China's ODI globally and in Latin America has expanded rapidly**



Source: Chinese Ministry of Commerce (2014).<sup>1</sup>

In addition to direct investment, China also provides significant overseas lending, primarily through China EXIM Bank and China Development Bank. This lending will show up as portfolio investment in the balance of payments. In recent years, each bank has been lending about \$100 billion overseas. Some of China's overseas investment takes place under the rubric of the "One Belt, One Road" initiative (OBOR). OBOR is Xi Jinping's vision for expanding infrastructure and other investment along the traditional Silk Road through Central Asia, as well as along the maritime route that goes south from China through Southeast Asia to South Asia and on to East Afri-

<sup>1</sup> Ministry of Commerce of China (MOFCOM), "Statistical Bulletin of China's Outward Foreign Direct Investment," 2014, <http://hzs.mofcom.gov.cn/article/date/201510/20151001130306.shtml>.

ca and Europe. However, the actual amounts involved in OBOR investment so far are small. Most of the countries in the list of the top 10 destinations for China's overseas direct investment are developed economies that are the traditional recipients of most foreign direct investment (FDI) globally. Taking out Hong Kong and other financial centers, the top three destinations for China's ODI are the United States, Australia, and the United Kingdom. Also in the top 10 are France, Canada, and Germany. Most FDI in the world goes to advanced industrial economies, and the same can be said for China's ODI. The only OBOR-involved countries among China's top 10 investment destinations are Russia, Indonesia, and Kazakhstan. No Latin American country is among the top ten destinations. Still, the \$106 billion that China has already invested in Latin America and the Caribbean is significant and the stock is certain to grow substantially in the next few years.

That a developing country is emerging as the world's largest investor is an interesting phenomenon that raises important questions. To what extent is Chinese investment similar to other foreign investment and to what extent, if any, is it challenging global norms and practices? In an earlier paper in Brookings's *Order from Chaos* series, I found that there are three ways in which Chinese investment differs from the existing norms and practices: (1) Chinese investment is relatively, though not absolutely, concentrated in poor-governance environments; (2) China in general does not subscribe to global standards of environmental and social safeguards; and (3) China itself remains relatively closed to foreign investment in many sectors, in contrast to its partners in both the developed and developing world.<sup>2</sup> The main objective of this paper is to examine China's investment in Latin America and to investigate whether these global patterns are also observed there. What are the implications for Latin America of Chinese investment deviating from global norms? As China's investment increases, will it become more typical, will it reshape global norms, or will it remain somewhat at odds with global practices?

### Chinese investment and governance

China has made headlines in Latin America through some large investments in countries that have poor governance, notably Venezuela and Ec-

<sup>2</sup> David Dollar, "China as a Global Investor," Brookings Institution, July 2016, <https://www.brookings.edu/wp-content/uploads/2016/07/China-as-a-Global-Investor-Asia-Working-Paper-4-2.pdf>.

**"No Latin American country is among [China's] top 10 [investment] destinations. Still, the \$106 billion that China has already invested in Latin America and the Caribbean is significant and the stock is certain to grow substantially in the next few years."**

uador. Yet the largest share of China's ODI has gone to Brazil, a country with relatively good governance in Latin America. This section examines the general relationship between ODI and governance, looking first at the global picture and then focusing on Latin America.

In an earlier paper I looked at how the allocation of ODI differs from total FDI globally.<sup>3</sup> The stock of FDI in the world is around \$20 trillion, and most of it has come from the Western industrial economies. Much FDI, in fact, is cross-investment among advanced economies. Of the 10 largest recipients of FDI, eight are advanced economies: the United States, the United Kingdom, France, Germany, Canada, Spain, the Netherlands, and Australia. The two emerging economies on the list are China (second, after the United States) and Brazil.<sup>4</sup>

The best predictor of how much FDI a country has received is market size as measured by total GDP. One of the main motivations of direct investment is to get close to markets in order to understand demand trends and to provide after-sales services. There is also a certain amount of FDI that seeks out natural resources. After controlling for market size and natural resource wealth, FDI is strongly attracted to better economic governance. The measure of economic governance that I use is the Rule of Law Index from the World Bank's Worldwide Governance Indicators, which "captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence."<sup>5</sup> Intuitively, the profitability of investment should be higher in an environment of better property rights and rule of law, and such environments should attract more investment, other things being equal. The data bear out this intuition: After controlling for market size and natural resource wealth, total FDI is highly correlated with rule of law.

<sup>3</sup> David Dollar, "United States-China Two-way Direct Investment: Opportunities and Challenges," Brookings Institution, January 2015, <http://www.brookings.edu/research/papers/2015/02/23-us-china-two-way-direct-investment-dollar>.

<sup>4</sup> The data on the stock of FDI in 2011 come from Lane and Milesi-Ferretti (2007, with online updates): Philip R. Lane and Gian Maria Milesi-Ferretti, "The external wealth of nations mark II: Revised and extended estimates of foreign assets and liabilities, 1970–2004," *Journal of International Economics* 73, no. 22 (November 2007): 223–250, doi: 10.1016/j.jinteco.2007.02.003.

<sup>5</sup> "Worldwide Governance Indicators," World Bank, 2016, <http://info.worldbank.org/governance/wgi/index.aspx#home>.

Globally, Chinese ODI is similar to overall FDI in that it is attracted to larger markets and to natural resource wealth. For ODI, the attraction to larger markets is a bit weaker than for FDI, and the attraction to natural resources a bit stronger; but basically, Chinese investment is similar to other investment. However, Chinese ODI differs in that it is uncorrelated with the index for property rights and the rule of law. It would be accurate to say that Chinese ODI appears indifferent to governance environment.

**Table 1: FDI and ODI shares in six major Latin American countries**

Country	Rule of Law Index	FDI share	ODI share
	2014	2011	2014
Chile	1.43	10.3	1.6
Brazil	-0.08	41.7	23.3
Mexico	-0.45	21.1	4.4
Argentina	-0.91	5.7	14.7
Ecuador	-1.05	1	7.8
Venezuela	-1.89	2.7	20.5

Source: Worldwide Governance Indicators;<sup>6</sup> MOFCOM Data; and Lane and Milesi-Ferretti (2007).

This aspect of Chinese investment is evident in Latin America. Leaving aside the money centers, the largest destination for Chinese investment is Brazil, which is among the better half of Latin American countries in terms of rule of law. But there is also significant investment in Argentina, Ecuador, and Venezuela, which rank poorly on the Rule of Law Index. Table 1 highlights six major Latin American countries. Chile is rated very highly with respect to rule of law.<sup>7</sup> Mexico, like Brazil, is above the median for Latin American countries. The table also shows each country's share of FDI in Latin America (in 2011) and each country's share of Chinese ODI (in 2014). The investment data are stocks. Chile, Brazil, and Mexico account for 73.1 percent of the FDI in Latin America. Argentina, Ecuador, and Venezuela account for only 9.4 percent. Of Chinese ODI, 29.3 percent

**“Chinese ODI appears indifferent to governance environment...This aspect of Chinese investment is evident in Latin America.”**

<sup>6</sup> “Worldwide Governance Indicators,” World Bank, 2014, <http://info.worldbank.org/governance/wgi/index.aspx#home>.

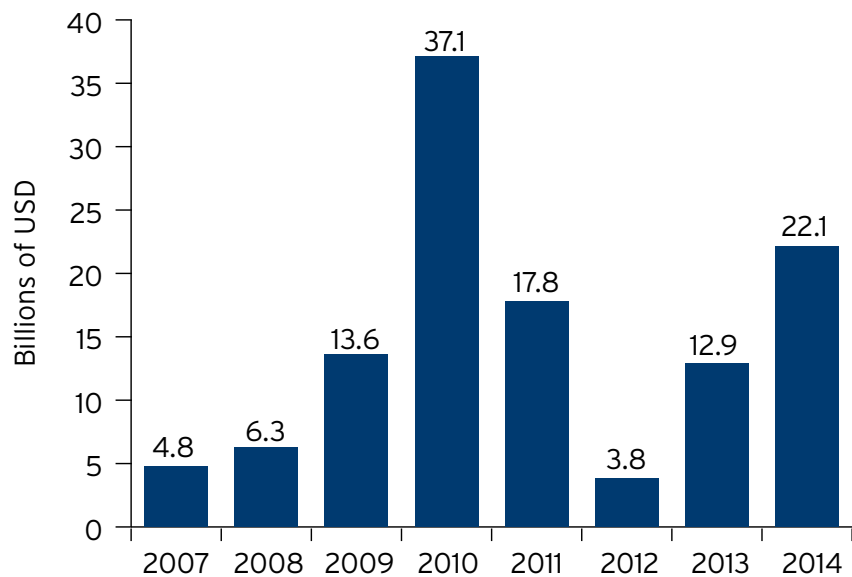
<sup>7</sup> By construction, the Rule of Law Index has a mean of zero globally, and a standard deviation of 1.0.



is in the better-governed group of countries, compared to 43 percent in the poorly governed group. Total FDI is strongly weighted towards the countries with better economic governance, whereas Chinese ODI is modestly biased towards the poor-governance group. But the Latin American result is similar to the global picture of China being indifferent to governance.

The pattern is similar for lending from China EXIM Bank and CDB. This lending is distinct from direct investment. It mostly goes to Latin American governments and parastatals, with a significant share financing infrastructure projects. Much of the remainder finances oil and gas and mining projects. The volume of lending has been rising over time, albeit with variability (Figure 2). The year 2010 was exceptional, with \$37.1 billion in lending to Latin American governments. In 2014 there was \$22.1 billion of lending from Chinese banks to Latin American governments, more than the combined loans from the two traditional multilateral lenders: the World Bank and the Inter-American Development Bank (IADB).<sup>8</sup>

**Figure 2: Chinese loans to Latin America and the Caribbean, 2007-2014**

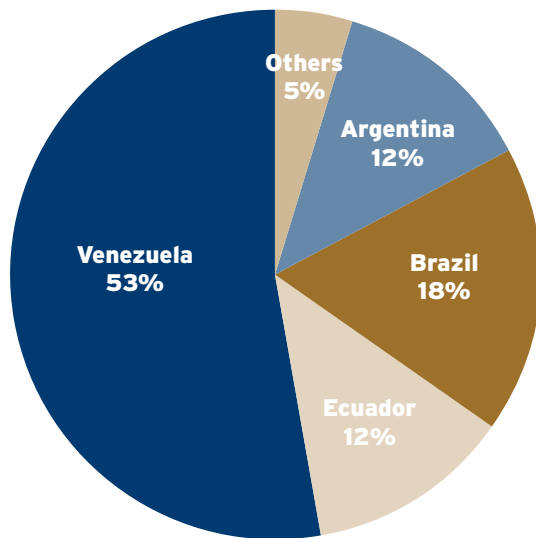


Source: Ray and Gallagher (2015).

<sup>8</sup> Rebecca Ray and Kevin Gallagher, "China-Latin America Economic Bulletin, 2015 Edition," Boston University, <https://www.bu.edu/pardeeschool/files/2015/02/Economic-Bulletin-2015.pdf>.

From 2007 until 2015, Venezuela was the largest borrower, with 53 percent of China's lending to LAC (Figure 3). Brazil was second with an 18-percent share. Argentina and Ecuador received 12 percent each. The rest of Latin America combined accounted for a meager 5 percent of lending.<sup>9</sup>

**Figure 3: Total loans from China to Latin American countries, 2007-2015**



Source: Gallagher and Myers (2014).

For both direct investment and bank lending, it does not appear to be the case that China is deliberately seeking out poor-governance environments. China is a major investor in the better-governed countries that are the largest recipients of FDI globally, including Brazil. But China does appear to be indifferent to governance environments to the extent that it is making major investments in weak-governance environments where other investors fear to tread. There are a number of plausible explanations for this pattern of investment. Many of the large investments from China are made by state enterprises. On the one hand, they do not face the same pressures as private firms to earn good returns on their investments. State enterprises are less productive and profitable than private ones within China, so it makes sense

<sup>9</sup> Kevin Gallagher and Margaret Myers, "China-Latin America Finance Database," Inter-American Dialogue, accessed March 23, 2015, [http://www.thedialogue.org/map\\_list](http://www.thedialogue.org/map_list).

that this would be the same abroad.<sup>10</sup> On the other hand, their investments in poor-governance environments are often part of state-to-state deals and they may feel insulated from the local economic environment.

It is also the case that China is a relative newcomer to the global investment scene, and Chinese firms may have underestimated the risks involved in some investments. Clearly some of China's natural resource investments in poor-governance environments are turning out badly. In the case of Venezuela, China has had to renegotiate loan terms in favor of Venezuela because the country was unable to service the original loan once the price of oil fell. As Venezuela's economic crisis has deepened in the wake of poor economic management, China has stopped making new loans to the country and direct investment has fallen to nearly zero.<sup>11</sup> The China Railway Engineering Company has halted construction on a bullet train that is now likely to never be completed.

China's investments in poor-governance environments raise a number of policy questions. First, is China getting the best return on its investments? Chinese state enterprises, by definition, are playing with the people's money. If they waste tens of billions of dollars on poor investments, that is a real loss for China. There is a macroeconomic reason why China is emerging as a major investor at this point in its development. Its own growth is slowing down as investment opportunities within the country are diminishing and as the rapid aging of its population has led to the labor force peaking in size and starting to decline. Earnings on overseas investments could help China finance its public pension system and the safety net more broadly. So it is in the Chinese people's interest to have sound management of overseas investments. China's leaders want the big state enterprises to evolve into global champions. Naturally, there is some learning involved and some initial losses may reflect that learning process. There is a risk, however, that state enterprises will not be sensitive enough to losses because they operate with soft budget constraints. Based on the domestic experience, the more of China's outward investment that comes through the private sector, the

<sup>10</sup> Chong-En Bai, Chang-Tai Hsieh, and Yingyi Qian, "The Return to Capital in China," *Brookings Papers on Economic Activity* 37, no. 2 (Fall 2006): 61-102, doi: 10.3386/w12755; and Nicholas R. Lardy, *Markets over Mao: The Rise of Private Business in China* (Washington: Peterson Institute for International Economics, 2014).

<sup>11</sup> Patrick Gillespie, "China is cutting off cash to Venezuela," CNN, September 30, 2016, <http://money.cnn.com/2016/09/30/news/economy/china-venezuela-finance>.

better. This is starting to happen with more private Chinese firms investing abroad, but still a large amount of ODI is state-directed.

From the point of view of the region, the key policy issue is whether China's state-to-state financing is sustaining poor governance in some countries. The projects in the worst governance environments may not be returning economic benefits, but China's money is going somewhere. In some countries Chinese funding is likely supporting corrupt political elites and helping them maintain their hold on power. In the case of Venezuela, for example, in the absence of Chinese finance the government would have had little choice but to turn to the IMF and other traditional sources of finance in exchange for policy reforms to stabilize the economy and restore growth. Ricardo Hausmann, an economist and the former planning minister of Venezuela, made this point in a 2015 op-ed for Project Syndicate:

Venezuela has tried to finance itself with the help of the China Development Bank, which does not impose the kind of conditionality that IMF bashers dislike. Instead, the CDB lends on secret terms, for uses that are undisclosed and corrupt, and with built-in privileges for Chinese companies in areas like telecommunications (Huawei), appliances (Haier), cars (Chery), and oil drilling (ICTV). The Chinese have not required that Venezuela do anything to increase the likelihood that it regains creditworthiness. They merely demand more oil as collateral. Whatever the IMF's faults, the CDB is a disgrace.<sup>12</sup>

As noted, though, China stopped making new loans to Venezuela as of fall 2016. Hence, it was not willing to underwrite a bad regime in perpetuity. Its activities sustained poor governance for a time, but eventually practical economic considerations won out. The humanitarian situation in Venezuela is tragic and hopefully there will be a global response that involves meeting basic needs but also requires the government to pursue needed economic reforms, including reining in runaway inflation, devaluing the currency, and creating a stable and predictable environment for private investment. An interesting question for the future will be whether China

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<sup>12</sup> Ricardo Hausmann, "Don't Fear the IMF," Project Syndicate, September 28, 2015, <https://www.project-syndicate.org/commentary/defending-the-international-monetary-fund-by-ricardo-hausmann-2015-09>.

**“The implementation of environmental and social regulations is often weak, especially in the countries with weak governance.”**

is able to work with the traditional lenders (the IMF, the Inter-American Development Bank, the United States) to design and implement a rescue package for Venezuela. China has already shown that it is not willing to finance poor economic management in perpetuity, so it is not farfetched to think that China could cooperate with the traditional institutions on a reform program. That is probably China's best hope to get some of its money back.

### **Environmental and social safeguards**

A second issue raised by China's emergence as a major global investor concerns environmental and social safeguards. China is a major funder of mining and infrastructure projects that typically carry significant environmental risks and involve the involuntary resettlement of large numbers of people. China so far has been reluctant to subscribe to any international standards for environmental and social safeguards. Its position is that it follows the laws and regulations of the host country. This is a reasonable point of view, consistent with China's general position that countries should not interfere in each other's internal affairs. The problem, however, is that the implementation of environmental and social regulations is often weak, especially in the countries with weak governance.

Private financial institutions from Western countries have generally subscribed to international environmental and social standards under the rubric of the Equator Principles (EP). The principles are “a risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in projects. It is primarily intended to provide a minimum standard for due diligence to support responsible risk decision-making. Currently, 83 Equator Principles Financial Institutions (EPFIs) in 36 countries have officially adopted the EP, covering over 70 percent of international Project Finance debt in emerging markets.”<sup>13</sup> Large Chinese banks such as China EXIM Bank and China Development Bank have not been willing to join. Only one small Chinese bank, Industrial Bank, has joined so far.

<sup>13</sup> “The Equator Principles III,” Equator Principles Association, 2013, <http://www.equator-principles.com/index.php/ep3>. For the list of current EPFIs, see <http://www.equator-principles.com/index.php/members-reporting>.

The multilateral development banks that fund infrastructure in the developing world have even more stringent standards. Led by the World Bank, these standards have been developed since the 1990s, primarily in response to pressure from civil society groups in wealthy countries. The safeguards are an area of tension between the rich countries that fund the multilateral banks and the developing countries that borrow from the banks. This tension is captured in a 2015 study by the Intergovernmental Group of Twenty-Four, which was established in 1971 to coordinate the positions of developing countries on monetary and development issues:

One aspect of the business practices of the World Bank and major RMDBs [regional multilateral development banks] that has a particularly strong impact on infrastructure investment is environmental and social safeguard policies. Safeguards comprise procedures and restrictions on different types of lending operations meant to “safeguard” the project from having negative impacts on the environment and social groups. Safeguards were first instituted at the World Bank in the 1990s, and the other major RMDBs followed suit in subsequent years. The World Bank’s safeguards are still considered the most comprehensive and rigorous, but the safeguards of the AsDB [Asian Development Bank], IADB, and AfDB [African Development Bank] have been gradually tightened over the years such that the differences between them are relatively small, particularly on the hot-button issues of environmental assessment and resettlement.

As a project undergoes the initial screening process, MDB [multilateral development bank] staff members determine whether it triggers any of the MDB’s applicable safeguards. Should that be the case, a separate series of special requirements must be followed before the loan can be approved and disbursed. The most frequently triggered safeguards in the case of the World Bank relate to environmental assessment and involuntary resettlement, and most frequently affect investment projects in the transportation, energy, and urban sectors. The required procedures are extraordinarily detailed and specific, and in many cases (notably, the World Bank’s IBRD [International Bank for Reconstruction and Development] and IDA [International Development Association]) extremely diffi-

cult for borrowers and even staff to fully understand. Requirements often include time-consuming, lengthy studies to be undertaken by third-party experts (usually at the government's cost), lengthy consultations with affected parties (sometimes including unelected non-governmental organizations), extensive mitigations measures, and lengthy mandatory prior public disclosure and comment periods during which time the project cannot move ahead. These requirements supersede whatever national laws may be in place in the borrowing country—a particularly troubling point of principle for many borrowing countries, beyond the practical impacts of safeguards.<sup>14</sup>

It is fair to say that these procedures developed by the World Bank are the gold standard of environmental and social safeguards in infrastructure projects. However, they have had a number of unintended consequences. It has become time-consuming and expensive to do infrastructure projects with the World Bank or the Inter-American Development Bank, and as a result, developing countries have turned to other sources of funding. Infrastructure was the original core business of the World Bank, accounting for 70 percent of lending in the 1950s and 1960s. That has steadily declined to about 30 percent in the 2000s. Looked at another way: All of the multilateral development banks together provided about \$50 billion of infrastructure financing in 2013, well under 1 percent of total infrastructure spending in developing countries. Hence, the multilateral banks have developed gold-plated standards, but they apply to only a tiny fraction of investment.

Given this situation, the emergence of China as a major funder of mining and infrastructure projects has been welcomed by most developing countries. As noted above, Chinese banks are financing more infrastructure in Latin America than the World Bank and the IADB combined. China is seen as more flexible and less bureaucratic. It completes infrastructure projects relatively quickly so that the benefits are realized sooner. However, China's approach of relying on a recipient country's own laws and regulations has its own risks. A study of the Chinese acquisition of the Hierro Mine in Peru

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<sup>14</sup> Chris Humphrey, "Infrastructure Finance in the Developing World: Challenges and Opportunities for Multilateral Development Banks in 21st Century Infrastructure Finance," Intergovernmental Group of Twenty-Four, June 2015, <http://g24.org/wp-content/uploads/2015/06/MARGGK-WP08.pdf>.

found poor environmental and labor standards.<sup>15</sup> But the study also found that similar mines owned by other countries or by locals had equal problems, so the Chinese-owned mines did not particularly stand out. Some of the infrastructure projects that China has proposed in Latin America, such as the Nicaragua Canal or the Brazil-to-Peru rail across the Amazon and the Andes, carry serious environmental and social risks. Such projects call for carefully balancing development needs with environmental risks.

The Working Group on Development and Environment in the Americas, a multi-university effort, carried out case studies for eight countries on the question of whether Chinese trade and investment had led to environmental degradation. On the one hand, they conclude that “Chinese trade and investment in Latin America since the turn of the 21st century was a major driver of environmental degradation in the region, and was also a source of social conflict.”<sup>16</sup> On the other hand, they find evidence of positive evolution: “Chinese investors show an ability to exceed local standards, but their performance varies widely across different regulatory regimes and between more experienced and newer firms. There is an important role for Latin American governments and civil society to raise the performance level across the board, through holding firms accountable and facilitating learning between firms.”<sup>17</sup>

An important recent development is that MOFCOM has issued guidelines on environmental and social policies for Chinese firms investing abroad.<sup>18</sup> The guidelines require Chinese companies operating overseas to conduct environmental impact assessments, develop mitigation measures, and work with local communities to identify potential negative impacts of investments. While implementation of the guidelines is left to individual investing countries, this is still an encouraging example of China evolving in the direction of global norms.

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<sup>15</sup> Amos Irwin and Kevin P. Gallagher, “Chinese Investment in Peru: A Comparative Analysis,” Working Group on Development and Environment in the Americas (Discussion Paper Number 34), December 2012, <https://ase.tufts.edu/gdae/Pubs/rp/DP34IrwinGallagherDec12.pdf>.

<sup>16</sup> Rebecca Ray, Kevin P. Gallagher, Andres Lopez, and Cynthia Sanborn, “China in Latin America: Lessons for South-South Cooperation and Sustainable Development,” Boston University, 2015, <http://www.bu.edu/pardeeschool/files/2014/12/Working-Group-Final-Report.pdf>.

<sup>17</sup> *Ibid.*, 3.

<sup>18</sup> Denise Leung and Yingzhen Zhao, “Environmental and Social Policies in Overseas Investments: Progress and Challenges for China,” World Resources Institute, April 2013, [http://www.wri.org/sites/default/files/pdf/environmental\\_and\\_social\\_policies\\_in\\_overseas\\_investments\\_china.pdf](http://www.wri.org/sites/default/files/pdf/environmental_and_social_policies_in_overseas_investments_china.pdf).



The issue of environmental and social safeguards was a key factor in the brouhaha around the founding of the Asian Infrastructure Investment Bank (AIIB). China proposed the new bank partly in response to its frustration with the slow pace of reform at existing institutions, including the IMF, World Bank, and IADB. The new bank is also a way for China to put its excess savings to use through a multilateral format, to complement (and perhaps provide some competition with) its bilateral efforts. The United States opposed the effort primarily due to concerns over governance, including the issue of environmental and social safeguards. Other major Western nations such as the United Kingdom, Germany, France, and Australia all chose to fight these battles from the inside. Brazil is also a founding member of AIIB.

AIIB has promulgated environmental and social policies which on paper are similar to the principles embodied in World Bank safeguards: environmental and social assessments to analyze risks; public disclosure of key information in a timely manner; consultation with affected parties; and decision-making that incorporates these risks. The AIIB approach, however, differs from that of the World Bank by avoiding detailed prescriptions for how to manage the process. My own experience in the World Bank was that the application of safeguards created two problems. First, the detailed regulations—literally hundreds of pages—inevitably made implementation slow and bureaucratic. Second, management tended to be very risk-averse, so the response to problems was often to conduct additional studies at extra expense. Developing countries have learned not to take complicated, risky projects to the existing banks, when in fact those are exactly the projects where the world would benefit the most from the assistance of multilateral institutions.

AIIB's website indicates that its environmental and social guidelines should be implemented "in proportion to the risk." AIIB's leadership hopes that the bank can meet international standards but be more timely and cost-effective. This is largely a matter of implementation and it will take time and experience on the ground to see if the effort is a success. AIIB joins the Andean Development Corporation (CAF) as a multilateral bank in which developing countries have the majority of the shareholding, so it follows that the preferences of the bank align more with those of developing countries. It is interesting that CAF relies on borrowing countries' own environ-

mental and social regulations in implementing projects. AIIB is evolving in the same direction. This could be a very positive innovation: Since most investment and growth now take place in developing countries, it would be more efficient if development bank activities reflected the preferences of those countries. If AIIB's activities can put pressure on the World Bank and the regional development banks to streamline their procedures and speed up their infrastructure projects, then this would be a positive change to the global system that emanated from China.

### Reciprocity

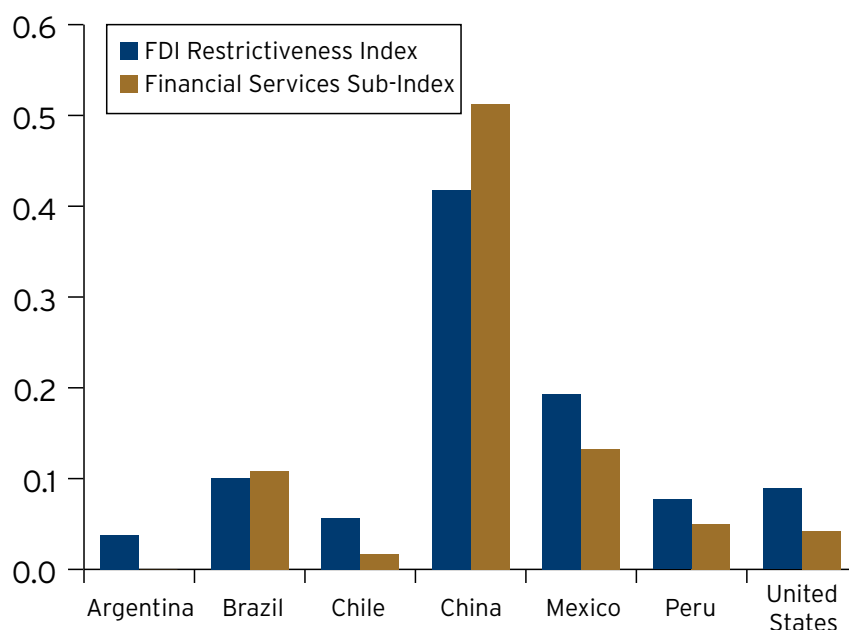
Most of the major investing countries in the world are developed economies. In addition to making direct investments elsewhere, they tend to be very open to inward investment. China is unusual in that it is a developing country that has emerged as a major investor. Brazil and India are also becoming important investors in their regions and globally. China itself is an important destination for foreign investment, and opening to the outside world has been an important part of its reform program since 1978. However, China's policy is to steer FDI to particular sectors. In general, it has welcomed FDI into most but not all of its manufacturing. However, other sectors of the economy are relatively closed to FDI, including mining, construction, and most modern services. It is not surprising that China is less open to FDI than developed economies such as the United States. But it is also the case that China is relatively closed among developing countries.

The OECD calculates an index of FDI restrictiveness for OECD countries and major emerging markets. The index is for overall FDI restrictiveness, and also for restrictiveness by sector. The measure covers various investment restrictions, the most important of which are equity caps, or how much of a domestic enterprise can be owned by a foreign investor. Figure 4 shows the restrictiveness index in 2014 for the whole economy and for financial services in China and the Latin American countries covered by the OECD index: Argentina, Brazil, Chile, Mexico, and Peru. The Latin American countries in general are very open to direct investment, similar to the United States, with overall restrictiveness around 0.1 (on a scale where "0" corresponds to fully open and "1" corresponds to fully closed). China is much more closed, with an index above 0.4. China's overall measure is an

**"Most of the major investing countries in the world are developed economies...China is unusual in that it is a developing country that has emerged as a major investor."**

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**Figure 4: FDI restrictiveness index, China and Latin American countries, 2014**



Source: OECD Data.<sup>19</sup>

average between a relatively open manufacturing sector and highly closed sectors such as mining, transport, financial services, and other services. China itself is closed in many of the sectors in which it is expanding abroad.

This lack of reciprocity creates problems for China’s partners. China has the second-largest market in the world. In these protected sectors, Chinese firms can grow unfettered by competition, and then use their domestic financial strength to develop overseas operations. In finance, for example, China’s four state-owned commercial banks operate in a domestic market in which foreign investors have been restricted to about 1 percent of the market. The four banks are now among the largest in the world and are expanding overseas. China’s monopoly credit card company, UnionPay, is similarly a world leader based on its protected domestic market. A similar strategy applies in mining and telecommunications.

<sup>19</sup> Blanca Kalinova, Angel Palerm, and Stephen Thomsen, “OECD’s FDI Restrictiveness Index: 2010 Update,” *OECD Working Papers on International Investment* (OECD Publishing, Paris), no. 2010/03, doi: 10.1787/5km91p02zj7g-en.

It is difficult for individual countries to take on this issue. Even the United States has limited leverage over China. It has tried for years, without success, to get China to open up more. Some Latin American countries bordering the Pacific (Chile, Peru, Mexico) were among the group of countries that negotiated the Trans-Pacific Partnership (TPP). If implemented, this would have created an open trade and investment regime for the Asia-Pacific. China was not one of the negotiating countries, but most of the countries involved hoped that China would eventually be attracted to join. That kind of large, regional agreement with strong standards would be the best option for encouraging China to behave in a more reciprocal manner in the area of investment. Because of political developments in the United States, however, it now seems that the TPP is dead. China is meanwhile pushing its own regional and bilateral trade initiatives. In general, these are low-standard agreements that involve minor amounts of additional trade liberalization in goods but do not take on issues such as investment openness, trade in services, or protection of intellectual property rights.

### **How is Chinese investment likely to evolve?**

To the extent that Chinese investment differs from global norms and practices, there are three possible paths forward: (1) Chinese investment could become more typical; (2) global practices could shift in the direction of China; or (3) China could remain at odds. This section speculates that in Latin America we are likely to see some combination of all three possible outcomes.

First, when it comes to investment in poor-governance environments, China is likely to evolve in the direction of current investment norms—that is, to favor better governance environments. Part of China's motivation for investing in countries such as Venezuela and Ecuador was to gain access to natural resources. In the 2000s, China's growth model was highly resource-intensive and global prices for most commodities were rising. That made it tempting to look for resources even in risky environments. That has all changed this decade, however. A lot of new supply has come online in sectors such as oil and gas, iron, and copper. Meanwhile, China's growth model is shifting away from resource-intensive investment towards more

reliance on consumption.<sup>20</sup> Consumption primarily consists of services, which are less resource-intensive. As a result of these shifts in supply and demand, commodity prices have come down, and China's import needs have diminished.

Also, as noted earlier, the investments in poor governance countries are not working out well. A study concludes that the relatively strong Chinese involvement in poor-governance states such as Venezuela represents "Beijing filling the 'void' left by a declining American presence in Washington's own 'backyard.'"<sup>21</sup> The fact that China has stopped funding Venezuela suggests, instead, that it has a more practical and economic attitude to these countries. As Chinese people demand a better return on state-backed investments abroad, it is likely that China will pull back on the resource investments in countries with poor governance. At the same time, many Chinese private firms are looking to invest abroad in a wide range of sectors, and those investments are heading to the United States, other advanced economies, and emerging markets with relatively good governance, as is the case with global investment in general. How much of a concern should this be for the United States? In a companion paper to this one, Harold Trinkunas finds that "the scope for Chinese leverage on Latin American governments is limited to a small set of countries."<sup>22</sup> Ted Piccone analogously concludes that "for now... China's rise has generally not impinged on core U.S. national security interests but requires careful monitoring."<sup>23</sup> My finding of rather indiscriminate investment by China across the continent is consistent with these more benign assessments of China's activity in Latin America and its potential to generate U.S.-China conflict.

Concerning environmental and social safeguards for infrastructure projects, China has identified an issue that resonates with other developing countries. The World Bank and other multilateral development banks have been imposing environmental and social standards that reflect the prefer-

<sup>20</sup> David Dollar, "Sino Shift," *Finance & Development* 51, no. 2 (June 2014), <http://www.imf.org/external/pubs/ft/fandd/2014/06/dollar.htm>.

<sup>21</sup> Francisco Urdinez, Fernando Mouron, Luis L. Schenoni, and Amâncio J. de Oliveira, "Chinese Economic Statecraft and U.S. Hegemony in Latin America: An Empirical Analysis, 2003-2014," *Latin American Politics and Society* 58, no. 4 (Winter 2016): 3-30, doi: 10.1111/laps.12000. 26.

<sup>22</sup> Harold Trinkunas, "Yuan Diplomacy? The Limits of China's Influence in Latin America" (paper presented at the Latin American Studies Association Meetings, New York, May 2016). 2.

<sup>23</sup> Ted Piccone, "China and Latin America: The Geopolitical Implications of Growing Economic and Trade Ties" (paper presented at the Latin American Studies Association Meetings, New York, May 2016). 17.

ences of rich-country electorates. Developing countries have been voting with their feet and have turned away from those banks as important sources of infrastructure financing. In general, they welcome Chinese financing of infrastructure. The response among developing countries to China's proposal for a new infrastructure bank, AIIB, was especially strong. Asian countries that are not particular friends of China, such as India, Indonesia, and Vietnam, were quick to sign up for the effort. AIIB's attempt to develop workable safeguards to address environmental and social risks without the long delays and high costs of practices at existing multilateral development banks is an important innovation. Latin American countries have indicated their preference by borrowing more from Chinese banks for infrastructure than from the World Bank and IADB. The Chinese-financed projects, however, do carry significant environmental and social risks and it will take strong oversight from Latin American governments and civil society to ensure that benefits exceed costs. Environmental and social safeguards are examples of areas where China may end up modifying global norms to make them align better with developing country preferences.

The third issue identified in this essay, reciprocity, should be an easy one for China to address. There is ample evidence that big state enterprises are less productive than private firms in China. Many of the sectors that remain closed in China are service sectors such as finance, telecommunications, transportation, and media—all of which are dominated by large state enterprises. With the shift in China's growth model, these service sectors have now become the fast-growing part of the economy, while industry is in relative decline.<sup>24</sup> It will be easier for China to maintain a healthy growth rate if it opens these sectors to international competition, in the same way that it opened manufacturing in an earlier era. And talk of opening these sectors can be found throughout party documents, such as the recent Third Plenum resolution. However, actual progress with opening up under the new leadership has been slow. It may be difficult for China to commit to any bold opening up in the next few years as it grapples with adjustment of its growth model and as it prepares for a political transition in 2017. It is likely that China will remain more closed to inward investment than its partners, which creates a dilemma for them. However, Latin American governments will probably continue to welcome Chinese investment despite the lack of reciprocity.

<sup>24</sup> Nicholas R. Lardy, "Skeptics of China's GDP Growth Have Not Made Their Case," *China Economic Watch* (blog), Petersen Institute for International Economics, August 14, 2015, <http://blogs.piie.com/china/?p=4469>.

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