The Rise of Patient Capital: The Political Economy of Chinese Global Finance

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July 2018

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Abstract

As the United States has retreated from its lead role in globalization – first because of the 2008 financial crisis, and now under President Donald Trump's leadership – China has become a major global financial player. China, as the world's largest saver, has rapidly expanded its cross-border lending since the crisis, more than doubling its overseas banking presence. What are the implications? I contend that China's state-led capitalism is an important form of patient capital, characterized by a longer-term horizon. While technically classified as mobile capital, its higher risk tolerance and geopolitical shrewdness make state-owned capital less likely to swiftly exit debtor countries. Compared to traditional mobile capital, debtor governments thus gain more policy freedom, particularly during hard times when Western creditors might otherwise impose austerity and other onerous policy conditions. Employing an originally constructed dataset, the *China Global Financial Index*, I conduct an econometric test across 15 Latin American countries from 1990-2015. I find that left governments are more likely to borrow from China. However, notwithstanding this initial creditor choice, Chinese state-to-state lending then uniformly leads to higher budget deficits. It endows governments with more fiscal space to intervene in their economies by reducing their reliance on conditionality-linked Western financing. These results suggest that Chinese financing could be a development opportunity, but only if governments invest wisely. Otherwise, by lending without policy conditions, China may be encouraging developing country governments to spend without bounds, sowing the seeds for future debt problems.[1]

Word Count: 12,921 words.

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1   Introduction

With Western capital reeling from the global financial crisis, state-owned capital made historic inroads globally. China, as the world's largest saver, rapidly expanded its cross-border lending, more than doubling its overseas banking presence. Today, China's global lending continues to increase at a blistering US$100 billion pace annually, putting the country on the brink of becoming one of the top five countries for international bank lending.[2] In line with these trends, President Xi Jinping boldly promised to make China a "leading world power" by 2050 during the Communist Party's 19th National Congress this fall. "Blazing a new trail for other developing countries to achieve modernization," President Xi declared that China "offers a new option for other countries who want to speed up their development while preserving their independence."[3]

Is President Xi correct that China represents a development opportunity? How does China compare to other global creditors? Is China's state-led financing distinct from other forms of mobile capital, particularly the portfolio inflows that have dominated cross-border investment into developing countries in recent decades? From Argentina to Greece, such mobile capital has tended to constrain autonomy, often compelling governments to implement austerity across the globe. Might Chinese finance mitigate such globalization pressures, upending longstanding tensions between mobile capital and national autonomy?

In this article, I develop a theory about how Chinese bilateral financing – a new form of mobile capital – affects economic policymaking in developing countries. I claim that the structural shift in financing from traditional Western credit sources to Chinese bilateral financing has an accommodative effect on national budgetary policies. Developing countries rely heavily on external financing to fund their national budgets, which are critical to meeting such socioeconomic needs as infrastructure, education, and healthcare spending.

Historically, bond markets – the prevailing financing option at the turn of the 21st century – have often constrained government's ability to use the budget to respond to these social needs. Bond market investors operate under a short-term horizon that tends to scrutinize asset performance relative to quarterly and annual benchmarks.[4] The short-term financing window creates a mismatch for debtors' long-term development goals

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[2]China surpassed Switzerland as the 6th largest creditor in the international banking system in 2017, leaving only the United States, Japan, France, Germany, and the United Kingdom with a larger global banking presence (BIS Locational Banking Statistics 2017).

[3]Xinhuanet, October 18, 2017 (http://news.xinhuanet.com/english/2017-10/18/c_136688475.htm)

[4]Mosley 2003; Datz 2009.

because the capital exit threat can foment boom-bust cycles.[5] Capital can exit suddenly when sovereign assets underperform, creating destabilizing credit shocks that jeopardize sustainable growth.

I claim that the structure of Chinese mobile capital is different from capital-market investment. Based on extensive field research in China between 2015-2017, I characterize Chinese credit as patient capital[6] because of its long-term horizon and high risk tolerance. According to a key policy bank official who manages overseas lending, "Chinese investment is usually long-term investment; we don't expect to get repayment in 1-2 years; we are investing more in medium-to-long-term projects, which will only get returns in 10 years."[7] For example, with roots in China's domestic development, the China Development Bank now funnels $278 billion, or one-fifth of its total loans outstanding to such long-term international projects, which is about equivalent to Chile's GDP.[8]

Compared to bond market creditors, this long-term maturity structure tends to better align with debtors' long-term development goals.[9] Such bilateral lending is an important pillar of the East Asian model of foreign aid, which aims to promote infrastructure development and foreign direct investment as key drivers of longer-term growth.[10] It also allows countries to incrementally correct their policy errors without threatening destabilization.[11] Indeed, patient capital tends to incur uncertainty today in hopes of a more substantial return later, which is particularly appealing to those debtors who are frustrated by market volatility.[12]

Patient capital is also unique because it tends to endure emerging market business cycle risk. These investors typically view cyclical downturns as an opportunity to gain cheap assets and business opportunities. For example, in contrast to market capital's swift exit, Chinese capital has continued to flow into developing countries during periods of volatility – ranging from the global financial crisis, the 2014 commodity correction, and the Odebrecht corruption scandal. Of course, to some extent, such high risk tolerance is a product of implicit state insurance (Shi 2015) that may encourage Chinese creditors to more readily lend money to debtors. The centralized character of the lending also risks creating a moral hazard problem, as the perpetual

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[5]Frieden 2016.
[6]Kaplan 2016; Lin and Wang 2017.
[7]Author's interview, Beijing China, November 2017.
[8]China Development Bank's 2016 Annual Report.
[9]Kahler 1998.
[10]Stallings 2017.
[11]Kahler 1998.
[12]Armijo 1999; Calvo 1998.

promise of new funds might disrupt sound governance or delay natonal economic reform (Kaplan 2013).

Chinese creditors signal such risk tolerance through promises of non-intervention in sovereign affairs. In fact, China has avoided onerous policy conditions, or credit being contingent on a country's macroeconomic performance. Whereas market-based creditors often want short-term policy assurances to ensure higher near-term financial returns, Chinese patient capital seeks to promote long-term commercial opportunities by linking its investments to guaranteed contracts for its firms.

What are the policy ramifications of this shift from impatient to patient capital? I contend that patient capital allows developing country governments to pursue higher budget deficits by escaping the budget constraints traditionally imposed by global capital markets,[13] and international financial institutions.[14] In testing these theoretical expectations, I first examine governments' choice to borrow from China, before exploring how Chinese bilateral loans affect their fiscal policies.

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

In order to operationalize Chinese bilateral financing and examine its effect on the state, I employ a unique, 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, its 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, I find that left governments are more likely to seize China's state-to-state funding opportunity compared to their center and right counterparts who are more likely to book loans through private procurement in the marketplace. However, independent of this initial choice of creditors, Chinese state-to-state lending then uniformly leads to higher budget deficits at it accounts for a larger share of total external public financing (relative to other forms of

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[13]Mahon 1996; McNamara 1999; Mosley 2000; 2003; Wibbels 2006.
[14]Thacker 1999; Vreeland 2003; Nelson 2015; Chapman et al. 2017.

financing such as capital markets, multilateral loans, or commercial banking).

These findings offer important new insights for studies examining globalization and development. This scholarship has long debated the extent to which mobile capital constrains national fiscal policies,[15] often finding that interest group pressures, local state capacity, and institutional development can mitigate such globalization pressures.[16] I contend that disaggregating the structure of mobile capital can also shed light on the conditions enabling fiscal autonomy. I show that the emergence of Chinese mobile, but state-led capital, has endowed governments with greater fiscal space compared to market-centric governance.

This study also has significant implications for international political economy scholars examining trade and investment flows from rising powers, including such topics as the global emergence of national development banks,[17] the rise of China in the world economy,[18] debt and development in non-democracies,[19] and the prospects for China's currency, the renminbi, becoming a major global reserve currency.[20] 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 individual debtor countries.

These findings also contribute to our understanding of the sustainability of the emergence of the Latin American left.[21] During the early to mid-2000s, the commodity boom provided a funding source independent from global markets that helped the left increase budgetary spending[22] and veer from the centrism[23] previously defined by the neoliberal consensus.[24] 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.[25] I engage with this important issue, showing that the emergence of Chinese state-led financing has once again endowed governments with greater fiscal space.

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[15]Mahon 1996; McNamara 1999; Mosley 2000, 2003; Vreeland 2003; Wibbels 2006; Brooks, Cunha and Mosley 2014.

[16]Frieden 1991; Rudra 2002; 2008; Kurtz and Brooks 2008; Wibbels and Ahlquist, 2011; Carnes 2014; Bunte 2016;

[17]Sierra and Hochstetler 2017.

[18]Wise 2018; Gallagher 2016; Gallagher and Porzecanski 2010; Wise and Quiliconi 2007.

[19]Ballard-Rosa 2016; Ballard-Rosa, Mosley, and Wellhausen 2017.

[20]McDowell and Steinberg 2017; Liao and McDowell 2016; Steinberg 2014.

[21]Corrales 2009; Levitsky and Roberts 2011; Luna and Kaltwasser 2014

[22]Weyland 2009; Pinto 2010; Murillo, Oliveros, and Vaishnav 2011.

[23]Thacker 2000; Corrales 2000; Fairfield 2010; Baker and Greene 2011; Hellwig 2014.

[24]Murillo 2002.

[25]Tax reform has been a long-term option for expanding governments' revenue base, but the electoral calendar often impedes shorter-term reform efforts (Hallerberg and Scartascini 2017).

2 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.[26]

Over the last decade, Latin America has developed into the second largest destination for China's overseas investment, making the region a "natural extension" for China's flagship economic development program, the Belt and Road Initiative (BRI).[27] 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,[28] accounting for an average of $12.8 billion (about 5 percent of regional GDP) annually. 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 (almost 7 percent of regional GDP).

Given the considerable size of these commitments, it's important to examine how they affect national 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, a total of $15 billion (13 percent of regional GDP) annually was sourced from the private sector by Latin American governments.

2.1 Patient vs. Impatient Capital

Latin American countries have thus undergone an important shift in the structure of their external financing, where Chinese policy bank loans are increasingly accounting for a larger share of government borrowing. The region has made considerable progress in developing national sources of public finance

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[26]Myers and Wise 2017; Roett and Paz 2016; and Arnson, Heine and Zaino 2014.
[27]*Xinhua*, January 20, 2018.
[28]Gallagher 2016; Gallagher and Myers 2016.

by expanding tax bases and local capital markets, but is still highly dependent on external funding, and particularly global bond markets. In fact, more than three-quarters of the Latin American governments' debt to private creditors is financed by global capital markets.

What are the policy implications of this structural financing shift? Does it matter who is lending to Latin America? In this section, I hypothesize about Chinese creditors, developing country debtors, and how they interact to affect national fiscal policies. I claim that Chinese bilateral lending is distinct from bond market financing – Latin America's main external financing source the last few decades – because it is a form of patient capital. Patient capital is characterized by a long-term horizon and greater risk tolerance, meaning investors tend to stay with their investments through good times and bad in hopes of future profits.

Patient capital investors come in all shapes and sizes, ranging from individuals (i.e. parents invest in their children's education) and firms (i.e. venture capitalists invest in innovative ideas), to non-profit institutions (i.e. social entrepreneurs invest in societal value, or social returns) and countries (i.e. state banks investing in technology acquisition for promising firms). Financial systems based on such patient capital tend to yield dramatically different outcomes for financial stability,[29] and national economic policymaking.[30]

During the second half of the 20th century, such patient capital financial systems were a critical factor behind the high investment rates associated with the East Asian development model.[31] 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,[32] with development banks in particular investing with social purposes beyond short-term profit-maximization.[33]

Patient Capital: A Longer-term Horizon

Chinese state-owned capital represents the latest manifestation of patient capital in the global financial system. How does it compare to other types of lending today? It has some similarities to both bilateral and multilateral lending. First and foremost, its shares a long-term investor horizon with other bilateral lenders. For example, China's bilateral loans have an average maturity of 17 years, which is comparable to

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[29]Hardie and Maxfield 2013; Hardie, Howarth, Maxfield, and Verdun 2013.
[30]Kaplan 2013.
[31]Wade 2007.
[32]Kahler 1998; Maxfield 1998, Wade 1998.
[33]Wade 2007.

the 22-year average among other major bilateral lenders.[34]

In contrast to traditional Western bilateral overseas development aid (ODA) lending, however, Chinese development assistance is often bundled more broadly with policy bank loans and foreign direct investment (FDI). In many ways, its reminiscent of 'tied-aid' historically, where developed countries extended credit lines to developing countries through commercial bank loans,[35] bilateral development loans, and supplier credits from export-import banks in exchange for the purchase of goods and services from the creditor nation. However, policy bank loans are often part of a more expansive infrastructure-led package that seeks to boost FDI, economic growth, and development in overseas markets. By promoting the local presence of Chinese firms, policy banks aim to stimulate long-term development nationally, and greater integration globally.

The scale of infrastructure spending also differentiates Chinese creditors from other bilateral lenders, making it similar to multilateral development bank financing (e.g. World Bank). Why is China willing to engage in the infrastructure business? Economically, it serves as a convenient outlet for the country's construction overcapacity, with almost three-quarters of Chinese loans supporting investment in infrastructure and heavy industries, such as energy and mining.[36] Politically, Chinese finance reflects another long-term commitment, the nation's pledge to empower developing countries.

Although examining China's political motivations is beyond this paper's scope, its 2016 White Paper on Latin America and the Caribbean[37] talks of "win-win cooperation," "multi-polarization," and "enhancing the representation and voice of developing countries." Similarly, in President Xi Jinping's speech at the seventieth anniversary of the United Nations, he declared:

> "The movement toward a multi-polar world, and the rise of emerging markets and developing countries
>
> have become an irresistible trend of history."[38]

These overseas development priorities are reflected in the operations of China's policy banks, given that they are state-owned enterprises. They take their administrative cues from the Chinese government's

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[34]World Bank's International Debt Statistics.

[35]Frieden 1987.

[36]Gallagher 2016; Gallagher and Myers 2016.

[37]China's Policy Paper on Latin America and the Caribbean" (Ministry of Foreign Affairs of the People's Republic of China, November 24, 2016), http://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1418254.shtml.

[38]Xi Jinping, Xi Jinping zai Lianheguo Chengwei 70 Zhounian Xilie Fenghui Shang de Jianghua [Xi Jinping's Speech for the United Nations' 70th Anniversary Summit Meeting (Beijing: Renmin Chubanshe, 2015).

foreign economic strategy, blurring the lines between business and politics. Based on China's own successful development experience, policy banks help meet these national priorities by using China's comparative advantage in building infrastructure and production facilities to create "win-win" development opportunities in countries with large infrastructure deficits.[39]

Policy banks loans are particularly attractive for Latin American countries because their long-term maturity horizons afford governments more flexibility in financing infrastructure development. Historically, Latin America's national governments were the traditional financiers of public infrastructure, but during the last few decades, they often faced budget constraints that limited public works spending. With the few remaining funding possibilities being politically undesirable tax hikes or greater indebtedness, many national infrastructure needs went unfulfilled. Private financing of infrastructure projects has also been difficult because of creditor hesitancy to incur emerging market risk over the long-term, with more than four-fifths of bank lending in developing countries being shorter than five years.[40]

Patient Capital: A Higher Risk Tolerance

Compared to private investors, China's policy banks are more insulated from debtors' financial distress because they are backed by both China's implicit guarantee of their loan portfolios and its arsenal of foreign exchange reserves. This implicit government support not only offers a longer-term development horizon, but also increases the risk tolerance of Chinese creditors, another key feature of patient capital.

Chinese creditors are often willing to endure business cycle risk if they are able to help Chinese companies globalize their operations. China's "go global" strategy, first articulated by President Jiang Zemin in 1998, aims to promote the interests of the Chinese state globally by internationalizing Chinese investment and lending, and securing long-term access to energy and raw materials. Policy banks are a pivotal instrument in realizing these foreign policy goals. They catalyze finance in risky credit environments in order to bolster global trade and investment, and create opportunities for Chinese firms and goods internationally.

To improve their global competitiveness, Chinese firms are often hoping to gain cheap assets, build their market share, gain valuable overseas experience in marketing and distribution, and improve key logistical

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[39]Stallings 2017.
[40]World Bank's Global Financial Development Report 2015/16.

skills and local engineering capabilities. For example, the Chinese Development Bank (CDB) and the China Ex-Im Bank have committed more than $30 billion in Brazilian loans over the last three years, notwithstanding the country's historic recession. They helped stimulate over $21 billion in foreign direct investment into Brazil, primarily in the energy sector. Even beyond Brazil's borders, China has been able to leverage the crisis to collect cheap assets and market share in this sector. For example, in August 2017, a Chinese consortium led by China Three Gorges Corporation, agreed to purchase a $1.39 billion Peruvian hydroelectric plant from scandal-plagued, Brazilian builder Odebrecht.

This Chinese strategy of using policy bank loans to help spur trade and investment is particularly notable because of its growing share of Latin American external financing relative to private sector financing (see earlier discussion). I expect that such an increasing reliance on state-to-state financing has important implications for fiscal policy discretion because the majority of private sector debt has tended to derive from global bond markets. These market-based financing flows have their advantages, including favorable interest rates amid buoyant credit conditions.[41]

But, the short-term nature of this portfolio investment disproportionately places the burden of risk on debtor countries, which can be particularly arduous during credit downturns. Portfolio investors, many of whom compete in a competitive asset management industry that's known for its short-term performance benchmarks, tend to be restless financiers. Notwithstanding countries' long-term development goals, these investors often sell sovereign assets when they underperform their benchmark quarterly or annual returns. The consequent cross-border capital flight can leave a country cash-starved at is most pressing hour, forcing governments to raise interest rates and pursue austerity (i.e. budget discipline) in hopes of enticing some overseas capital to stay invested in the country. In its most extreme form, capital comes to a "sudden stop," creating a vicious cycle of capital outflows, credit shocks, and austerity that can hamper economic activity.

In summary, Chinese patient capital is more likely to persevere through boom and bust cycles, offering countries a development opportunity based on long-term infrastructure financing. However, like any form of credit, patient capital also has its costs. The government's implicit guarantee risks creating a moral hazard problem where financial overextension leads to misallocated investments and greater indebtedness.

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[41]Frieden 2016.

2.2   Who Borrows from Chinese Lenders?

In light of these tradeoffs, what actors are most likely to borrow from China? Beginning with the 1998 election of Hugo Chávez in Venezuela, a leftward shift took hold in Latin America, that was in part a response to disillusionment with neoliberal economic reforms as well as deep-seated structural problems of poverty, inequality, and crime.[42] 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."[43]

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 governments to be more socially responsive. Placating such demands often necessitates considerable new spending commitments. But, without sufficient budgetary resources, such programmatic aims can sharply diverge from policy outcomes. Hence, the appeal of a new financing source that extends the maturity horizon for governments borrowing.

Most Latin American governments today hope to address the above socioeconomic challenges, with conservative governments in Argentina, Brazil, and Chile supporting both important public works projects and social programs, such as conditional cash transfers.[44]

The most important partisan divide reflects the role of government, with centrist and right governments more likely to favor channels outside the public balance sheet to address infrastructure deficits and social inequalities. By comparison, despite the many variants of leftist ideology in Latin America,[45] they uniformly value the importance of national budgets in achieving their political agendas. Left governments need fiscal space, or the availability of resources, to supply more jobs, higher wages, and better public services.

I anticipate that left governments aim to access Chinese bank financing directly through state-to-state lending in order to increase their capacity to achieve their political agendas, 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.

Independent of this partisan choice of domestic financing channel (state-to-state vs. market), however, I anticipate that Chinese bilateral loans generally will lead to greater budget deficits because of their lack of

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[42]Mainwaring 2006; Corrales 2008; Roberts 2012.
[43]Levitsky and Roberts 2011.
[44]Luna and Kaltwasser 2014.
[45]Corrales 2009; Weyland, Madrid, and Hunter 2010; Levitsky and Roberts 2011.

policy conditionality. Without such scrutiny, governments from across the political spectrum are likely to be less fiscally disciplined. To further explore this theoretical prior, I will elaborate on the expected policy implications of tapping Chinese bilateral financing below.

2.3   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. This paper focuses on fiscal governance because a government's priorities are embedded in its national budget, just as a firm or household's preferences are conveyed through its balance sheet.

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 bond market investors, who were the dominant source of cross-border investment during the two decades preceding the global financial crisis, tend to scrutinize national budgets quite carefully. They often cast a wary eye toward large public sector deficits, concerned that public inefficiencies can slow growth. This skeptical view of the state promotes short lending maturities that frequently evaluate debtors' performance.

Financial industry pressures also contribute to the shorter lending horizon. Compared to state-owned creditors that mostly abide by administrative guidelines, these private financial investors are more oriented towards short-term benchmarks. They have to outperform short-term industry benchmarks to appease corporate board of directors that expect annual, if not quarterly profitability.[46]

In examining debtor's performance, bond investors thus place a high value in short-term conditionality targets in lieu of other economic policies with longer term implications.[47] In particular, bond market investors often compel fiscal austerity, seeing budget discipline as key to bolstering state finances, and hence the chances of debt repayment.[48] However, it gives debtor governments less budgetary room to maneuver because the failure to meet market metrics can spur capital outflows and credit shocks. In response to this

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[46]Mosley 2003; Datz 2009.
[47]Mosley 2000, 2003; Mosley, Wibbels, and Paniagua 2017.
[48]Thacker 1999; Vreeland 2003

capital exit threat, governments that rely on global bond markets tend to be more fiscally disciplined.[49]

Compared to mercurial nature of capital markets, China's policy banks are a more patient form of capital characterized by a longer-term horizon and greater risk tolerance. They do not impose stringent borrower conditionality. In general, Chinese authorities are considerably 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.[50]

This more optimistic view of the state is channeled through China's emphasis on policy sovereignty. Chinese officials operate under an official doctrine of nonintervention in domestic affairs, as stipulated in the country's Five Principles of Peaceful Coexistence.[51] 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. For example, Ecuadorean Vice Minister of Economic Policy Coordination, Gabriela Robalino, confirmed the lack of conditionality on Chinese policy bank loans from the debtor perspective.

> "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."[52]

If not through policy conditionality, how does China mitigate the potential for higher-than-expected credit risk? 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.

For debtor countries, the longer-term financing horizon may be conducive to promoting local development because it affords their governments more time to overcome policy missteps, political uncertainty, and economic volatility. At the same time, however, the steep cost of capital, extensive Chinese foreign content, and the lack of governance standards could create long-run costs for local firms, workers, and environment.

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[49]Kaplan 2013; Kaplan and Thomsson 2016.
[50]Naughton 2010.
[51]China's Initiation of the Five Principles of Peaceful Co-Existence, Ministry of Foreign Affairs, November 17, 2000.
[52]Author's interview, November 13, 2015, Quito, Ecuador.

Notwithstanding the question of longer-term development, I expect that the influx of Chinese patient capital yields greater policy divergence in Latin America. Without the threat of destabilizing capital outflows, national governments that borrow directly from China should have more fiscal space to intervene in their economies, yielding larger fiscal deficits.

3   Empirical Tests

To evaluate these theoretical priors systematically, I translate them into a testable hypothesis:

H_1: Left governments are more likely than right and centrist governments to tap Chinese bilateral financing to fund their budget expenditures.

H_2: An increase in Chinese bilateral lending as a share of total external public financing (relative to other forms of financing such as capital markets, multilateral loans, or commercial banking) will lead to a deterioration in fiscal balances, or higher budget deficits.

3.1   Data and Methods

I test these 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 now 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, relative to other forms of financing from capital markets, multilateral institutions, or commercial banks. On average, Chinese lending, which was virtually nonexistent prior to the 2008 financial crisis, has accounted 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.

I expect national governments to increase their deficit spending as Chinese policy bank financing accounts for a higher share of external financing. In testing this prior, I first employ a fixed effects model to address unit heterogeneity (Green, Kim, and Yoon 2001), given the expected country-specific differences in the time-series cross-sectional data (TSCS). The results of the Hausman test also favor a fixed effects over a random

effects specification, rejecting the null hypothesis ($\chi_1^2 = 32.9$). Finally, I also use fixed year-effects to control for common shocks to budget deficits.

In a preliminary series of regressions, I find that higher government budget deficits are positively associated with Chinese bilateral lending as a share of a nation's total external financing. In addition to this general effect, I find that partisanship is an important domestic channel for budgetary choices, with left governments more likely to use deficit spending when tapping Chinese finance compared to their center and right counterparts (see *Empirical Results* section).

However, other political factors may not be as observable, creating potential bias. For example, 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.

I thus attempt to correct for such endogeneity in the sovereign lending process by using a Heckman-type correction to control for treatment selection (Heckman 1988; Przeworksi and Vreeland 2000; Vreeland 2003; Chwieroth 2007). I calculate the inverse-mills ratio from the selection equation 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 bilateral lending on fiscal policy choices in the second stage of the model.

The findings of the second stage model are presented first using fixed effects and then later employing generalized methods of moments (GMM) estimators in the appendix. The empirical results are consistent across both estimation procedures, lending support to the primary hypothesis.

3.2 Data Description: Independent and Dependent Variables

This section evaluates the hypothesis using a panel of data covering 15 Latin American countries from 1990-2015. Employing the dataset, we can observe to what extent patient capital is associated with higher budget deficits. I focus on fiscal governance because of its importance in understanding governments' approach to development. Some governments are more likely to use the state to address infrastructure deficits and social inequalities, while others are more likely to favor channels outside the public balance sheet.

I thus 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.[53]

As outlined above, I expect that left partisans may be more likely to tap Chinese financing to attain greater fiscal policy discretion to implement their political agendas. However, the structure of sovereign financing (i.e. the extent to which a country is reliant on Chinese state-to-state lending) should have a accommodative effect on fiscal policy choices that is independent from the domestic political process.

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

To test these theoretical priors, I construct a variable, $Bilateral_{it}$, that measures the share of the total external debt stock derived from outstanding Chinese state-to-state loans, relative to other forms of financing such as capital markets, multilateral loans, or commercial banking. I expect that bilateral loans are more stable during distress, helping mitigate funding shocks (i.e. higher borrowing costs stemming from foreign investors' capital withdrawal during economic and financial downturns) that constrain government budgets. Patient capital should thus make it easier for countries to conduct countercyclical macro-economic policies.

I construct the Chinese bilateral loan data from a new, originally designed 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 project. In other words, when Chinese financing takes the form of state-to-state lending, the funds are more apt to directly enter government coffers, enabling incumbent politicians to increase their budgetary spending. By contrast, when loans are booked to a corporate entity in the marketplace (either a private firm or a separately managed state-owned enterprise) through government concessions, the central government does not benefit from the loan directly.[54] Consequently, they do not secure new budgetary financing, which creates considerable national variation in China's regional underwriting of public financing. I exploit this variation in sovereign financing type to test whether Chinese state-to-state financing enhances Latin America's fiscal policy autonomy and yields higher deficit spending.

I gathered this data using a variety of sources, including primary sources at Latin American finance

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[53]In robustness checks (models 5-6 in Table 3), I also employ general government balance as the main dependent variable.
[54]Similar to this study, 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).

and planning ministries during my field research,[55] and official websites of central banks and ministries of finance. I reinforce these individual efforts by also cross-checking them across other sources, including US SEC filings of foreign governments, investment bank reports, AidData, RED ALC-China, and the Inter-American Dialogue's China-Latin American Database.

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 the headline numbers are often discussed in the popular press, the data on the outstanding stock of loans is vital to accurately examining the impact of China's state-to-state lending on public finances.

In additional robustness checks, I also employ a measure of Japanese bilateral (*Japan Bilateral Loans*) and World Bank lending (*World Bank Loans*) constructed from external debt statistics by the BIS, IMF, OECD, and the World Bank that reflect commitments that are owed by a sovereign nation to foreigners, or non-residents. Given that China's lending shares some characteristics with other bilateral (e.g. long-term orientation) and multilateral (e.g. infrastructure orientation) lenders, examining such data will help us understand if these patterns might hold more generally for other sovereign creditors beyond China.

Finally, I also include a variable to account for a country's reliance on global bond financing (*Global Bonds*) that measures a government's total global bonds outstanding (or foreign currency bond debt held by foreign creditors) as a share of total external financing. I expect to observe a disciplining effect that runs counter to the accommodative effect of Chinese lending.

3.2.2   Partisanship

In order 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. It

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[55]I conducted field research in six different Latin American countries between 2013-2017, including the region's primary debtors to China (Argentina, Brazil, Ecuador, and Venezuela).

offers a measure that 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 from 0 to 3.[56] 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 that instead ranks ideological scores along a continuum. Based on Baker and Greene's (2011) measure of the ideological leanings of electorates since 1993,[57] I created a variable called $LeftIdeology_{it}$. Compared to the binary variable above, it preserves fine-grained distinctions among parties along the entire ideological spectrum. It will help examine how a more nuanced shift in government priorities affects fiscal policymaking both directly, and indirectly under Chinese financing.

3.2.3 Control Variables

I control for a variety of global economic, domestic, and institutional factors that may affect sovereign borrowing and national fiscal balances. I also use a slightly different set of controls for the Chinese lending and fiscal policy regressions, as I expect different factors to be important for different outcomes. In the two-stage model, it is also recommended to include at least one explanatory variable that influences selection but not the subsequent outcome.

I incorporate several key economic and political variables that may account for the choice to borrow from China, including indebtedness (*External Public Debt*), level of development (*Per Capita Income*), the structure of the domestic economy (*Index of Economic Freedom*), global interest rates (*U.S. Interest Rates*), and the political regime (*Regime Type*). I also employ the standard control variables (including a lagged

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[56]Parties defined as conservative, Christian democratic, or right-wing have a value of 1. Parties defined as centrist are a 2. Parties defined as communist, socialist, social democratic, or leftist have a value of 3. Otherwise, the variable is 0.

[57]Ideological scores, based on a combination of parties' ideologies and vote shares, are calculated on a 20-point scale, moving from extreme left (1) to extreme right (20).

dependent variable) for fiscal policy regressions used in the political budget cycles literature (Barberia and Avelino 2011). For further details, see the Supplementary Files.

3.3 Model Specification

To operationalize the hypothesis, I use the following specifications:

(1) $ChinaBilateral_{it} = \alpha + \beta_1 LeftPartisanship_{it} + \beta_2 X_{it} + \varepsilon_{it}$

(2) $Fisc_{it} = \alpha + \beta_1 ChinaBilateral_{it} + \beta_2 LeftPartisanship + \beta_3 X_{it} + \beta_4 X_{it-1} + \gamma_1 Fisc_{it-1} + \lambda_i + \eta_i + \varepsilon_i$

where $Fisc_{it}$ =fiscal balance; $ChinaBilateral_{it}$ = Chinese outstanding state-to-state loans / external public debt; and $LeftPartisanship$ = left governments. The index i =country; t =year; X_{it} = vector of control variables; X_{it-1} = lagged independent variables; $Fisc_{it-1}$ = fiscal balance (1-year lag); λ_i = inverse Mills ratio derived from first equation of Heckman-type correction model, and used in the second equation to control for treatment selection; η_i = dummy capturing unobserved country effects; ε_{it} = error term.

The first stage probit model explores the factors driving governments to borrow from China, 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.[58]

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.[59] 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 $ChineseBilateral_{it}$ (state-to-state financing) is the dependent variable, a positive coefficient for $LeftPartisanship_{it}$ would support the first hypothesis that left governments are more likely to seek out Chi-

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[58]Mankiw 2012.
[59]Keele and Kelly 2006 and De Boef and Keele 2008.

nese financing. When $Fisc_{it}$ is the dependent variable, I expect to observe an effect of $ChineseBilateral_{it}$ 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 a deterioration in fiscal balances (i.e. widens budget deficits, or narrows budget surpluses).

3.4 The Effect of Different Types of Sovereign Financing on Fiscal Balances

Do different forms of global credit have divergent effects on fiscal policy? Do Chinese creditors allow developing country governments to more readily expand fiscal policy? Are these policy effects any different from other bilateral and multilateral creditors which also have longer maturity structures? How does Chinese financing compare to bond market funding, which has been the major source of external financing during the turn of the 21st century? In contrast to patient capital's tendency to accommodate fiscal expansion, does bond market financing instead have the anticipated disciplining effect?

Table 1: The Effect of External Financing on Fiscal Latitude

|	(1) FE	(2) FE	(3) FE	(4) FE	(5) FE	(6) FE	(7) FE
Chinese StS / Debt	-0.030***	-0.021**					
	(0.009)	(0.008)					
Left Partisanship	0.592*	0.606*	0.583*	0.537*	-0.167	-0.288	-0.344
	(0.297)	(0.298)	(0.299)	(0.281)	(0.289)	(0.364)	(0.376)
StS Loans * Left Partisanship		-0.020**					
		(0.009)					
Chinese StS / GDP			-0.131***	-0.137***			
			(0.044)	(0.040)			
STS Loans * Left Partisanship				-0.167***			
				(0.051)			
Global Bonds					0.016***		
					(0.005)		
Japan Bilateral Loans						0.077	
						(0.140)	
World Bank Loans							0.013
							(0.034)
Global Growth	0.211**	0.213**	0.212**	0.265**	0.238***	0.147	0.159
	(0.086)	(0.087)	(0.085)	(0.093)	(0.066)	(0.104)	(0.107)
Output Gap (t-1)	0.028**	0.029**	0.027**	0.044***	0.013	-0.019	-0.019
	(0.012)	(0.011)	(0.012)	(0.014)	(0.021)	(0.022)	(0.023)
Global Commodity Index (t-1)	0.018**	0.018**	0.018**	0.014*	0.018*	0.021**	0.021**
	(0.007)	(0.007)	(0.007)	(0.007)	(0.010)	(0.009)	(0.009)
Inflation (log)	0.383***	0.378***	0.386***	0.465***	0.236**	0.054	0.065
	(0.109)	(0.108)	(0.111)	(0.127)	(0.099)	(0.102)	(0.098)
External Public Debt (t-1)	0.004***	0.004***	0.004***	0.005***	0.009***	0.004***	0.003***
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Per Capita Income (log)	-0.011	0.018	-0.027	-2.287*	-0.481	-0.282	-0.225
	(0.736)	(0.736)	(0.736)	(1.143)	(0.391)	(0.477)	(0.525)
Executive Constraints	0.137	0.153	0.111	-0.016	0.945	1.191	1.273
	(0.561)	(0.559)	(0.565)	(0.569)	(0.728)	(0.800)	(0.817)
Primary Fiscal Balance (t-1)	0.477***	0.477***	0.481***	0.488***	0.651***	0.729***	0.727***
	(0.075)	(0.075)	(0.076)	(0.077)	(0.056)	(0.035)	(0.038)
Observations	387	387	387	387	424	515	495

Standard errors in parentheses

Model 5 also holds when normalizing by GDP rather than external financing

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

In a series of fixed effects regression models,[60] I first examine how these different forms of global finance affect budget balances. I find that an increase in Chinese bilateral loans as a share of total external financing allows governments to pursues higher primary budget deficits (model 1 in Table 1). In other words, a 10 percentage point increase in Chinese bilateral lending as a share of external public debt is associated with government budget deficits rising by 0.30 percentage point of GDP.

Results for the control variables are also consistent with expectations. The coefficients for global growth and the output gap are positive and statistically significant, suggesting that improved budget balances tend to coincide with expanding global economic activity and above-trend national economic growth (model 1). Notably, the coefficient for left partisanship also has a statistically significant and positive relationship with fiscal balances. While left governments are typically expected to have a proclivity to spend, this finding supports the notion that they often adhere to a deficit-constraint in a capital-dependent region like Latin America where left governments must often signal their good governance to global creditors.

Figure 1: Marginal Effect of Partisanship
on Latin American Budget Balances
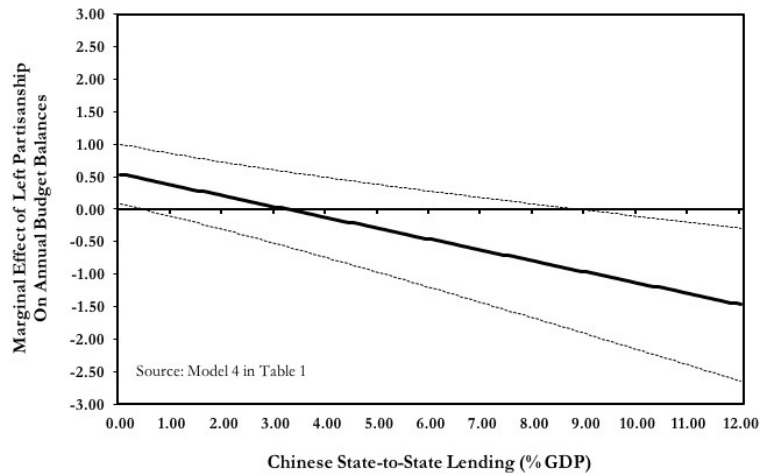
Are left governments then more likely than their centrist and right counterparts to use Chinese financing to bypass the market's historic emphasis on budget discipline? In the conditional regression models (see models 2-4), Chinese bilateral lending has a negative and statistically significant effect on budget deficits,

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[60]Fixed-year effects were tested and removed since their inclusion did not affect the main results.

once again lending support to our central hypothesis (see H_2). Note that these results for Chinese state-to-state lending hold when normalizing by both GDP and external financing, suggesting that the findings are driven by the structure of the debt, rather than the size of the external debt or the economy.

Figure 1 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. Fearing the threat of capital exit, left governments often adhere to market calls for budget discipline. They tend to increase budget deficits by about 0.6 percentage points of GDP. Notably, however, as Chinese bilateral financing accounts for a growing share of GDP, budget balances tend to deteriorate.

By contrast, global bond financing tends to have a disciplining effect on national budgetary policy (model 5). The coefficient on global bonds is positive and statistically significant, meaning that governments that borrow from global bond markets tend to have higher budget surpluses (or narrower budget deficits). In line with the political economy literature,[61] the heightened market scrutiny and risk of capital flight appears to increase government's fiscal rectitude.

Other forms of long-term bilateral and multilateral financing do not appear to have the same effect as Chinese lending. In fact, we are unable to reject the null hypothesis that Japanese bilateral loans and World Bank loans have no effect on fiscal policy (models 6 and 7 in Table 1). Despite their long-term maturity horizons, they do not appear to affect national policymaking, suggesting that Chinese lenders' risk-tolerance and lack of policy conditionality may make them unique creditors.

In summary, compared to traditional types of global financing, Chinese credit appears to have a distinct effect on national fiscal policies. Governments tend to increase their budget deficits as Chinese bilateral loans account for a larger share of outstanding external debt. This effect is also contingent on partisanship, with left governments more likely to enhance their budgetary discretion. However, to what extent are Chinese loans endogenous to domestic politics? Perhaps, left governments tend to borrow from China because they desire more fiscal space to redistribute income and spur employment. In the following section, 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.

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[61] Mosley 2003; Wibbels 2006; Kaplan 2013.

3.5 The Effect of Partisanship on Borrowing from China

Are left governments more likely to borrow from China? 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 (see models 1-2 in Table 2). Employing these coefficients to derive the predicted probability of borrowing from China,[62] I find that left partisanship makes a government about 10 percent more likely to secure Chinese loans compared to administrations from the right and center. These results lend support to the first hypothesis (H_1) that left governments are more likely to borrow from Chinese creditors.

Table 2: The Effect of Partisanship on Chinese Bank Lending

	(1) Probit	(2) Probit	(3) Probit	(4) Probit	(5) Probit	(6) Probit
Left Partisanship	0.924***	1.450***	1.688**			
	(0.261)	(0.447)	(0.678)			
Left Ideology				0.097***	0.141***	0.167**
				(0.024)	(0.038)	(0.066)
Global Growth	-0.163**	-0.021	-0.080	-0.146*	-0.037	-0.078
	(0.077)	(0.091)	(0.119)	(0.075)	(0.086)	(0.118)
Global Commodities Index	-0.000	0.044***	0.060***	-0.001	0.046***	0.063***
	(0.007)	(0.012)	(0.019)	(0.007)	(0.013)	(0.020)
Inflation (log)	0.593***	0.476*	0.423	0.423**	0.490*	0.545
	(0.188)	(0.277)	(0.386)	(0.196)	(0.263)	(0.385)
External Public Debt (t-1)	-0.073***	-0.064***	-0.144***	-0.077***	-0.096***	-0.183***
	(0.015)	(0.021)	(0.037)	(0.015)	(0.023)	(0.045)
Unemployment (t-1)	0.042	-0.015	-0.028	0.054	-0.040	-0.021
	(0.046)	(0.069)	(0.096)	(0.044)	(0.067)	(0.092)
Per Capita Income (log)	1.039***	1.710***	3.161***	0.964***	1.795***	3.024***
	(0.240)	(0.370)	(0.783)	(0.248)	(0.394)	(0.787)
Interest Rate (t-1)	-0.177***	-0.036	-0.097	-0.161***	-0.023	-0.091
	(0.033)	(0.044)	(0.063)	(0.034)	(0.045)	(0.065)
Regime Type	-0.286***	-0.548***	-0.494*	-0.244***	-0.425***	-0.175
	(0.057)	(0.134)	(0.287)	(0.075)	(0.125)	(0.265)
U.S. Interest Rates		-1.502***	-2.209***		-1.680***	-2.212***
		(0.280)	(0.581)		(0.323)	(0.617)
IMF Program		0.651	1.294**		0.837**	1.556***
		(0.422)	(0.530)		(0.394)	(0.602)
Inded of Economic Freedom			-0.141***			-0.158***
			(0.052)			(0.052)
China Trade			0.044			0.068
			(0.102)			(0.103)
UN Voting with China			7.449			5.341
			(5.272)			(5.687)
Observations	407	388	246	340	332	246

Standard errors in parentheses
Heckman first stage results for two-stage selection model.
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

The coefficients for control variables generally correspond to expectations. Higher commodity prices, higher levels of development, and lower indebtedness all make Latin American governments more likely to borrow from China. Notably, the coefficient for regime type is negative and statistically significant,

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[62]The changes in predicted probablities reflect a one-unit change (from 0 to 1) in the binary variable, *left partisanship*, and are calculated using Stata's margins command.

suggesting as governments become more autocratic, they are more likely to court Chinese creditors.

These results hold when controlling for several additional structural and institutional variables (models 2-3), including global interest rates (*U.S. Interest Rates*), whether a country has an IMF program (*IMF Program*), a nation's domestic economic structure (*Index of Economic Freedom*), and finally, the extent of a country's trade dependence (*China Trade*) and political alignment (*UN Voting with China*) with China.

While the main findings show that left partisanship is associated with an increased prevalence of Chinese loans, global financial conditions and domestic economic structures also play an important role. 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.

At the same time, the coefficient on the Index of Economic Freedom is also negative and statistically significant, meaning that Chinese state-to-state loans are more likely to be extended to mixed-market economies than liberal-market economies in Latin America. In further robustness checks, I also find that the coefficient for the interaction between left partisanship and the Index of Economic Freedom is negative ($\beta = -0.219$) and statistically significant ($p < 0.05$), suggesting that left governments from liberal-market economies may be more likely to solicit financing from sources other than China (e.g. private sector or capital markets). In other words, left governments hailing from market-centric Chile compared to those from state-centric Venezuela or Ecuador would be less likely to directly tap Chinese financing.

To what extent might we be able to pick up on such patterns with a more nuanced measure of left partisanship? In a final robustness check, 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 (see control discussion above). When using the more fine-grained ideological measure in the probit model, partisanship continues to have a positive and statistically significant effect at the 99 percent confidence interval (models 4-5 in Table 2). Additionally, including controls for a country's economic and political alignment with China does not yield any material changes (model 6).

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 1.2-1.4 percent more likely to secure Chinese loans. These results imply that an extreme

left government (ideology = 20) would be about about 6 to 7 percent more likely to borrow directly from China than a moderate left government (ideology =15). Those governments classified as extreme left, or left populists[63] 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.

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? Does the left tend to capitalize more strongly on the lack of conditionality associated with Chinese financing? Or alternatively, because of the absence of market scrutiny, does Chinese lending have a uniform easing effect on budget balances notwithstanding a government's partisan affiliation?

3.6   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 1-2 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).[64] 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 of a percentage point of GDP. They also hold when controlling for several additional institutional and economic variables, including the extent of executive constraints (*Executive Constraints*), whether a country has an IMF program (*IMF Program*), and global financing conditions (*U.S. Interest Rates*).

Beyond the initial selection effect in the first stage model, partisanship does not appear to have any direct effect on fiscal policymaking. In the second stage model, the coefficient on left partisanship is positive but statistically insignificant (models 1 and 2 in Table 3), meaning we cannot reject the null hypothesis that left partisanship does not affect budget deficits. Notably, when using Baker and Greene's (2011) more

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[63]Levitsky and Roberts 2011

[64]These results do not materially change when normalizing Chinese state-to-state lending by GDP rather than external debt.

fine-grained ideological measure (*Incumbent Ideology*), the primary findings about the accommodative effect of Chinese lending hold but partisanship remains statistically insignificant (see models 3 and 4).

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

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

	(1) FE	(2) FE	(3) FE	(4) FE	(5) FE	(6) FE
Chinese StS / Debt	-0.024***	-0.018*	-0.026***	-0.022**	-0.025***	-0.024***
	(0.008)	(0.009)	(0.008)	(0.009)	(0.006)	(0.007)
Left Partisanship	0.115	0.217				
	(0.235)	(0.242)				
Left Ideology			0.011	0.038	0.027	0.071
			(0.044)	(0.049)	(0.044)	(0.044)
Global Growth	0.321**	0.321***	0.336***	0.330***	0.305**	0.289**
	(0.128)	(0.106)	(0.105)	(0.107)	(0.106)	(0.109)
Output Gap	0.046	0.041	0.048	0.039	0.092**	0.075***
	(0.026)	(0.026)	(0.028)	(0.027)	(0.031)	(0.024)
Global Commodities Index	0.002	0.003	0.003	0.002	0.003	-0.000
	(0.006)	(0.007)	(0.007)	(0.007)	(0.006)	(0.006)
Inflation (log)	0.579*	0.751**	0.568**	0.691**	0.556*	0.723**
	(0.270)	(0.320)	(0.253)	(0.288)	(0.261)	(0.262)
External Public Debt (t-1)	0.002	-0.006	0.009	0.001	-0.006	-0.019
	(0.023)	(0.027)	(0.029)	(0.032)	(0.028)	(0.029)
Unemployment (t-1)	0.075*	0.084*	0.073*	0.083	0.043	0.049
	(0.036)	(0.043)	(0.040)	(0.047)	(0.043)	(0.046)
Per Capita Income (log)	-1.628**	-1.680	-1.433	-1.332	-0.802	-0.181
	(0.751)	(1.077)	(0.818)	(1.111)	(0.807)	(1.220)
Interest Rate (t-1)	-0.022	-0.049	-0.012	-0.034	-0.022	-0.056
	(0.058)	(0.069)	(0.061)	(0.069)	(0.064)	(0.064)
Exchange Rate Regime	0.315**	0.270	0.342*	0.302	0.220	0.153
	(0.143)	(0.157)	(0.168)	(0.186)	(0.164)	(0.170)
Chinese Loan Selection Instrument	-0.081	0.050	-0.154	-0.022	-0.019	0.181
	(0.325)	(0.370)	(0.383)	(0.409)	(0.390)	(0.370)
Executive Constraints		-0.394		-0.506		-0.925
		(0.436)		(0.489)		(0.646)
U.S. Interest Rates		-0.002		0.009		0.064
		(0.093)		(0.096)		(0.102)
IMF Program		-0.056		-0.009		0.063
		(0.140)		(0.157)		(0.191)
Primary Fiscal Balance (t-1)	0.525***	0.534***	0.518***	0.516***		
	(0.046)	(0.042)	(0.047)	(0.050)		
General Government Balance (t-1)					0.533***	0.500***
					(0.044)	(0.057)
Observations	314	295	315	296	315	296
R^2	0.59	0.57	0.59	0.57	0.52	0.52

Standard errors in parentheses
Heckman second stage results for two-stage selection model.
FE=Fixed effect models for 16 Latin American countries.
Robust standard errors.
Model 5-6 employ general government balance, rather than primary budget balance.
$^* p < 0.10, ^{**} p < 0.05, ^{***} p < 0.01$

For instance, Bolivia provides an example of a left government that did not borrow from China to get additional fiscal space. President Morales, who entered office as part of a popular indigenous movement seeking greater social rights, had used commodity windfalls to boost state redistribution and social spending.

During the 2008-2009 global commodity correction, however, falling hydrocarbon revenues (which account for almost half of total government revenues) depleted its fiscal resources.

With Chinese bilateral loans accounted for a modest 1 percent of external financing, the Bolivia government could not borrow to gain more fiscal flexibility. Instead, it had to cut expenditures to maintain a budget surplus of 1.4 percent of GDP in 2010.[65] Such austerity was aimed at placating its external creditors given that the IMF and private borrowers accounted for more than four-fifths of its external financing. The regression estimates above imply if the Bolivia government had 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.

Finally, a series of robustness checks do not yield any material changes in the results. 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. Employing the general government balance as the dependent variable does not yield any material changes in the direction or precision of the coefficients for Chinese state-to-state lending (model 5-6). These results also remain robust after a series of tests using the Arellano-Bond GMM first-difference estimator (Table A.3 in the appendix) to mitigate concerns about both bias resulting from the lagged dependent variable, and the possibility of reverse causality in the independent variables.

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[65]CEPALSTAT Database, 2017.

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:[66] 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 2).

Figure 2: Chinese Bilateral Credit and National Budgetary Stances (2004-2014)
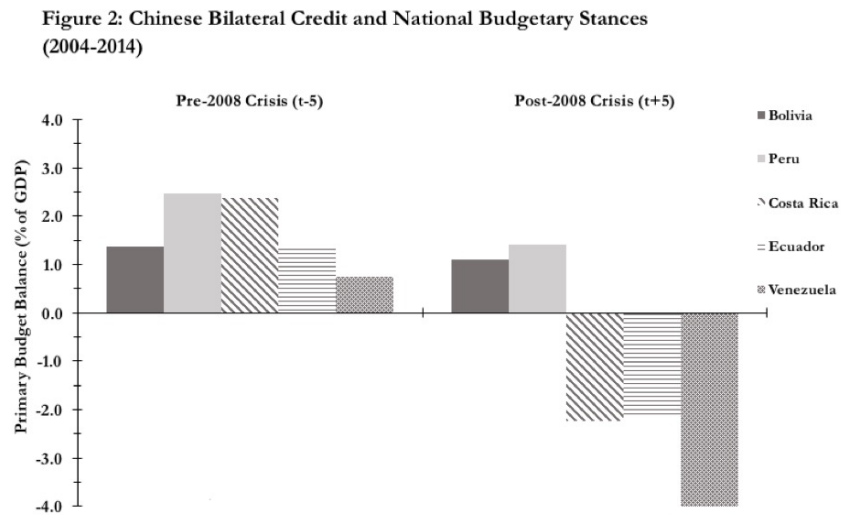
Before proceeding with the analysis, let us first examine a common alternative explanation for Latin America's fiscal deterioration following the global financial crisis: the commodity downturn. While the statistical findings above were robust to controls for commodity prices, I briefly elaborate on why the commodity downturn is not a sufficient explanation for deteriorating budget balances.

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[66]King et. al. 1994.

If it were a sufficient condition, we would expect that falling commodity revenues would have led to weakening of budget balances across all five Latin American countries. 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 2).

These patterns are particularly surprising because there does not appear to be any direct relationship between commodity volatility and 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 changes in fiscal policy, to what extent do 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[67] and a strong reliance on private sector external financing sources.[68] 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

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[67]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.

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

(see Figure 2), 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.[69] 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 influx of new Chinese financing helped fund rising government expenditures on social safety nets and public infrastructure that were intended to offset the downturn. Notably, new 2008 fiscal outlays on these expenditures 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

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[69]DeHart 2012.

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 2). 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,[70] 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. Our brief case discussion suggests that Chinese credit can independently affect government policy choices, notwithstanding their partisan affiliations. Not only was a centrist government in Costa Rica able to tap Chinese financing to help boost its budgetary flexibility, but a leftist government in Bolivia without much Chinese financing remained fiscally disciplined.

5   Conclusion

Has China's emergence as a global creditor changed international finance? Is China's governance approach different from more traditional global lenders? In this paper, I have examined how a reliance on Chinese financing can effect the economic policy choices of debtor governments. Compared to those debtors primarily 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 tend to emphasize the importance of policy conditionality, or prudent macroeconomic policies as a condition for new financing. Conditionality's cornerstone is a commitment to fiscal discipline. Such policy assurances help ensure high near-term financial returns by bolstering borrowers' finances and improving their debt repayment prospects. However, such short-term policy conditions also create a financing mismatch that hampers debtor countries'

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[70]Levitsky and Roberts 2011.

long-term development goals. This pattern is particular acute during economic downturns, when capital's exit threat often compels governments to implement austerity to mitigate financial volatility.

While Chinese creditors also are 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. China's patient capital also tends to align better with country's long-term development goals by allowing countries to incrementally correct their policy errors without threatening financial destabilization. Chinese state-to-state financing packages are clearly aimed at creating export markets and commercial opportunities for Chinese firms, but they also tend to promote infrastructure and foreign direct investment as key drivers of longer-term economic growth. In this regard, Chinese creditors are often willing to endure business cycle risk if they are able to help Chinese companies globalize their operations by gaining cheap assets, market share, or improving key logistical skills such as marketing, distribution, and local engineering capabilities.

Based on these differences in financing structures, I have developed and tested a theory that shows that deficit spending increases with Chinese patient capital. In other words, I expect that national governments that borrow from China will have more degrees of maneuverability compared to other financing sources such as global bond markets. In a cross-national test of of Latin America – a region, that on average, has experienced massive growth of Chinese financing since the global crisis – I find that higher government budget deficits are positively associated with Chinese bilateral lending as a 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's success in reaching its growth targets domestically during its miracle years reflected its ability to prosperously manage local investment projects. Can it also foster good governance internationally?

Rather than imposing policy conditions, China increasingly tempers its state-to-state credit risks by diversifying its investments to include market-based instruments. For example, in the wake of failed state-to-state investments in Sri Lanka, Indonesia, and Venezuela, China has created 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 partner-

ships (PPP) and varying its project financing partners to include Chinese commercial banks, multilateral institutions (e.g. World Bank, 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.

Moving beyond this setting, it would also be interesting to explore the effect of other forms of patient capital on global borrowers. Does the pattern of greater debtor latitude simply reflect China's uniqueness as a creditor, or might bilateral loans from other nations also expand debtors' room to maneuver? Do private entrepreneurs borrowing from venture capital also receive more flexibility? How about non-profit institutions investing in social returns? By examining such types of patient capital, it would help us to understand to what extent 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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