



Chinese President Xi Jinping, right, shakes hands with Venezuela's President Nicolás Maduro, Sept. 22, 2013. © Lintao Zhang / AP Photo

China-Venezuela Economic Relations: Hedging Venezuelan Bets with Chinese Characteristics¹

Stephen B. Kaplan and Michael Penfold



Tens of thousands of Venezuelans raised their hands toward the sky on January 23, 2019, to offer solidarity to legislative leader, Juan Guaidó, who declared himself interim president of Venezuela during a rally demanding President Nicolás Maduro's resignation. Refusing to recognize the legitimacy of Maduro's May 2018 re-election, Guaidó cited his constitutional duty as the head of the National Assembly to fill the presidential vacancy until new elections were called. Hand in hand with Guaidó, the United States unequivocally supported his declaration, recognizing him as Venezuela's head of state. Backed by Argentina, Brazil, Canada, Chile, Colombia, Israel, and Peru, President Trump said he would "use the full weight of United States economic and diplomatic power to press for the restoration of Venezuelan democracy." More recently, Spain, the United Kingdom, France, and Germany also recognized Guaidó as interim president after Maduro failed to call new elections. The United States also backed its position with some economic muscle, imposing sanctions on Venezuela's state-owned oil company, *Petróleos de Venezuela, S.A. (PdVSA)*, saying that all PdVSA assets, including its oil sale proceeds, will be frozen in U.S. jurisdictions.

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But, what about those countries that have not aligned with the United States, particularly those powers, such as China and Russia, with a major financial interest in Venezuela? China and Russia are Venezuela's two main bilateral creditors, accounting for one-quarter of the nation's foreign debt. The 2018 U.S. National Defense Strategy cites the reemergence of

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long-term strategic competition with both China and Russia, labeling them "revisionist powers" that threaten to "undermine the international order."²

However, to what extent do China and Russia share such geopolitical ends in the Western Hemisphere? To date, the two countries have offered distinct political reactions to the crisis. Russia's foreign ministry warned the United States against meddling in Venezuela, saying "the cynical, overt interference in the internal affairs of a sovereign state continues. It must stop."³ Russia's foreign policy response fell along enduring Cold War frontiers, similar ideologically to Cuba's, whose foreign ministry expressed "its unwavering solidarity" with the Maduro government.⁴

China has also supported Venezuela, with its foreign ministry saying it will respect Venezuela's efforts "to uphold national sovereignty, independence and stability."⁵ However, China has also been more pragmatic and subdued than Russia, calling on "all parties to remain rational and keep calm, and reach a political settlement through peaceful dialogue."⁶ What explains China's more reticent reaction to the crisis?

China is Venezuela's largest bilateral lender, but has been unwinding its financial ties with Venezuela since President Maduro succeeded Hugo Chávez in 2013. Adorned in its state-to-state 'sisterhood' rhetoric, Beijing continues to offer diplomatic support for the regime. However, given its longstanding concerns about Venezuela's economic mismanagement, China

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2 U.S. Department of Defense, "Summary of the 2018 National Defense Strategy of the United States of America: Sharpening the American Military's Competitive Edge," 2, <https://dod.defense.gov/Portals/1/Documents/pubs/2018-National-Defense-Strategy-Summary.pdf>.

3 Paul Day, "European powers poised to recognise Venezuela's Guaido," *Reuters*, January 26, 2019, <https://uk.reuters.com/article/uk-venezuela-politics-germany/european-powers-poised-to-recognise-venezuelas-guaido-idUKKCN1PKOD0>.

4 "Revolutionary Government Declaration: Aggression against Venezuela must cease," *Granma*, January 24, 2019, <http://en.granma.cu/cuba/2019-01-24/revolutionary-government-declaration-aggression-against-venezuela-must-cess>.

5 Shi Jiangtao, "Wary China offers support to embattled Venezuelan President Nicolas Maduro," *South China Morning Post*, February 7, 2019, <https://www.scmp.com/news/china/diplomacy/article/2183519/wary-china-offers-support-embattled-venezuelan-president>.

6 Ibid.

has steadily dissolved its Venezuelan financial links over the last half-decade. At its peak, between 2010 and 2013 Venezuela accounted for an average of 64 percent of China's new approved lines of credit to Latin America. By contrast, between 2014 and 2017 Venezuela represented only 18 percent of China's total new lines of credit to the region (see Table 1 on page 13). In other words, China has been lending defensively,⁷ or offering Venezuela limited new funds to keep the country afloat so that it can repay its debts.

Much popular attention has focused on the question of whether 'debt trap' diplomacy is a tool of China's global economic power. Most recently, Vice President Mike Pence remarked that "China uses so-called 'debt diplomacy' to expand its influence,"⁸ offering unsustainable infrastructure loans that mire borrowers in a growing debt burden until they must repay China with key strategic assets. Pence explicitly censured China's loans to Venezuela, saying they "saddle" the Venezuelan people in debt, even as their "democracy vanishes."⁹

In the case of Venezuela, however, China was ensnared by a *creditor* trap in Venezuela, much more than Venezuela was caught in a debt trap by China. In light of China's foreign policy doctrine of non-intervention in sovereign affairs,¹⁰ Chinese loans to Latin American governments often are accompanied by fewer policy conditions and lack the traditional Western emphasis on budget rectitude. China has thus been willing to make what are in essence risky bets. But, how does China ensure debt repayment, if it deliberately avoids imposing onerous borrowing conditions like austerity?

In Venezuela, China policy banks secured their lending with loan-for-oil-deals, wagering that the country's oil production capacity was a sufficient guarantee for debt repayment. China also hoped to gain a foothold in the Latin American energy sector by offering Venezuela cheap loans, development financing, and the autonomy to massively expand its state balance sheet. Notably, during the early years of its Venezuelan economic courtship, China's financing yielded a few, project-level commercial successes in the mining and energy sectors, and some lower-profile manufacturing investment by Huawei Technologies and Chery Automobile.

Importantly, the structure of these loan-for-oil deals involved two separate contracts: a financial agreement in which Chinese policy banks lend Latin American governments money, and

7 Stephen B. Kaplan, *Globalization and Austerity Politics in Latin America* (Cambridge, United Kingdom: Cambridge University Press, 2013).

8 Michael Pence, "Remarks by Vice President Pence on the Administration's Policy Toward China," *The White House*, October 4, 2018, <https://www.whitehouse.gov/briefings-statements/remarks-vice-president-pence-administrations-policy-toward-china/>.

9 Ibid.

10 "China's Initiation of the Five Principles of Peaceful Co-Existence," Ministry of Foreign Affairs, November 17, 2000.



PDV gas station in Caracas, Venezuela; PDV is a subsidiary of PDVSA. © testing/ Shutterstock.com

a commercial agreement in which Chinese importers purchase oil from PdVSA, Venezuela's state oil company. The commercial agreement secures the loans, as PdVSA uses its daily oil proceeds from its China sales to steadily repay the loans to Chinese policy banks over time until maturity. In other words, the policy bank loan to the national government is collateralized by the daily inflow of oil income from the country's state oil company.

However, the success of China's efforts to hedge its Venezuelan risk with oil collateral was contingent on PdVSA's ability to sustain its oil production. Without steady or increasing oil production, PdVSA was in a financial Catch-22. Complying with the terms of these oil-for-loan deals meant funneling an increasing share of its export proceeds to China, rather than reinvesting in the company's operations. Ironically, as PdVSA struggled to finance its operations, the state oil company jeopardized its production, and ultimately, its ability to repay the government's loan-for-oil debts.

Perhaps most importantly, China's commodity guarantees were unable to check the Venezuelan government's moral hazard problem¹¹ under President Maduro's leadership. By the beginning of Maduro's 2013 term, China had extended more than \$40 billion to Venezuela through its loans-for-oil facilities (and other bilateral credits), and about \$30 billion of that amount was still outstanding. Given ongoing uncertainty about President Maduro's economic management credentials, however, China's policy banks relented from deepening their financial relationship with new state-to-state loan facilities. Instead, they renewed \$9 billion of previous loan tranches to help Maduro navigate the commodity correction during 2014–15.

Maduro gladly borrowed from China, using the state oil company future oil sales as collateral, but he did not heed the advice of his own cabinet about the importance of reforming economically. He instead doubled down on public spending by leveraging the health of Venezue-

11 Moral hazard occurs when an institution does not bear the full consequences of its actions, and does not change its behavior. For a discussion of moral hazard in the Latin American context, see Stephen B. Kaplan, *Globalization and Austerity Politics in Latin America*.

la's prized asset, PdVSA. With PdVSA already struggling from commodity volatility after the financial crisis and a loss of managerial expertise earlier in the decade, transferring proceeds from the state oil company to repay the central government's debts stunted its reinvestment and profitability, and eventually its operational capacity. As the central government's spending expanded without bounds, Maduro was increasingly killing the preverbal goose that had long laid Venezuela's golden egg.

China's commodity guarantees could not insulate its investments from Venezuela's long history of oil boom and busts. Despite their rosy state-to-state rhetoric, the two countries began moving in different directions. After internalizing the extent of Venezuela's governance problems, Chinese policy banks reduced their credit risk exposure. By contrast, Venezuelan government deepened its governability crisis by refusing to change its economic model, leading the country into the worst economic depression and migration crisis in Latin America's modern history. With the collapse of Venezuela's oil industry, the Maduro government increasingly had difficulty getting new credit from anywhere, let alone China.

By 2016, China's defensive lending had entered a new stage, as it extended some temporary debt relief to Venezuela, negotiating a two-year moratorium on the country's bilateral loans. To the extent that China lent Venezuelan new money, such as a reported \$5 billion loan during the summer of 2018, it has been linked to directly financing joint ventures in the oil industry to help boost production, and hence, recover China's outstanding oil collateral under its loan-for-oil deals.

China's primary strategy regarding Venezuela thus appears to be protecting its considerable financial commitments, which means hedging both financially and politically. In recent years, Beijing has reinforced its longstanding willingness to deal with governments from across the political spectrum in Latin America.¹² Chinese leaders courted Venezuela's opposition leaders during both the 2012 presidential and the 2015 parliamentary elections, suggesting that China may be more willing to negotiate with Juan Guaidó and Venezuela's opposition than other financial backers, such as Russia.

12 Jorge Domínguez, "China's Relations with Latin America: Shared Gains, Asymmetric Hopes," *China Working Paper* (Washington D.C.: Inter-American Dialogue, 2006), <http://archive.thedialogue.org/page.cfm?pageID=32&pubID=321>; David Shambaugh, "China's Quiet Diplomacy: The International Department of the Chinese Communist Party," *China: An International Journal* 5, no. 1 (2007): 26–54.

13 Former Australian Prime Minister Kevin Rudd, quoted in Tobin Harshaw, "Emperor Xi's China Is Done Biding Its Time," *Bloomberg Opinion*, March 3, 2018, <https://www.bloomberg.com/opinion/articles/2018-03-03/emperor-xi-s-china-is-done-biding-its-time>.

China's Commercial Relations in Latin America

To provide background to these creditor-debtor relations, let us turn the clock back to the mid-2000s, when China made its initial investment foray into Latin America under the umbrella of its 'go global' strategy. During this time, China's leadership, under the stewardship of Hu Jintao, had embraced Deng Xiaoping's circumspect view of international relations: "hide

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your strength, bide your time, never take the lead."¹³ In first expanding its Latin American investment, China had emphasized its 'peaceful rise' in the hemisphere by prioritizing its bilateral relationship with the United States, and carefully avoiding any direct geopolitical challenges. For example, during a 2011 state visit to the United States, President Hu emphasized that "we do not engage in arms races or pose a military threat to any country; China will never seek hegemony or pursue an expansionist policy."¹⁴

China's accompanied this peaceful rise theme with its 'go global' strategy. First articulated by President Jiang Zemin in 1998, the 'go global' strategy has aimed 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. China's policy banks are a key instrument in achieving these foreign policy goals. Charged by the government to finance infrastructure and trade, policy bank loans often headline broad infrastructure-led investment packages. 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.¹⁵

Building on these foreign policy foundations, President Xi Jinping more recently incorporated these policy tools under the banner of the Belt and Road Initiative (BRI). Initially crafted to invest more than \$1 trillion (9 percent of China's GDP) in infrastructure across more than 60 neighboring Asian, European, and African countries, China recently invited Latin American countries to join this initiative. After its policy banks (i.e. Chinese Development Bank, China Export-Import Bank) had invested more than \$140 billion in Latin American loan commitments over the last decade (which amounts to \$12.8 billion annually, or 5.4 percent of total foreign direct investment

14 Shaun Tandon, "Unbowed China Leader Warns U.S.," *The Sydney Morning Herald*, January 21, 2011, <https://www.smh.com.au/world/unbowed-china-leader-warns-us-20110121-19y97.html>.

15 Barbara Stallings and Eun Mee Kim, *Promoting Development: The Political Economy of East Asian Foreign Aid* (New York: Palgrave MacMillan, 2017).

into the region), China has now pledged to invest an additional \$250 billion, which if realized, would push this annual figure above \$20 billion (or 8.5 percent of total regional FDI).

Taking a page from China's domestic playbook where infrastructure spending and trade promotion helped spur growth during its miracle years, many Chinese leaders today see infrastructure investment as a catalyst for overseas development. For example, in a 2017 interview, a sovereign risk director from one of China's policy banks underscored the benefits of financing infrastructure investments internationally.

*"One of the deciding factors between a developed and a developing country is the level of infrastructure; the world needs a new way of infrastructure building; the developing world has a most urgent need, and for the rest time in history, China is willingly supporting these activities because China now is a capital exporting country."*¹⁶

Cloaked within these development objectives is China's commercial goal of promoting its firms internationally. China hopes to catalyze finance in risky credit environments to bolster global trade and investment, creating opportunities for Chinese firms and goods globally. 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 skills and local engineering capabilities.

Several other commercial factors have also helped catalyze China's outward investment. Faced with rising wages and inflation domestically, China today is finding it more difficult to move incrementally in its global economic relations. Capital is flowing abroad for both sanctioned and unsanctioned reasons. They include exporting domestic overcapacity in such sectors as infrastructure, construction, steel, and energy, acquiring foreign technology under "Made in China 2025," but also unplanned private sector capital flight. China's investment overseas also reflects its loss of comparative advantage in labor-intensive manufacturing. Its outward foreign direct investment (FDI) is in part meant to keep a foothold in this sector, which has become a crucial part of its global win-win development strategy.

In this regard, China's 2016 white paper on Latin America and the Caribbean¹⁷ lists manufacturing among its six priority cooperation areas.¹⁸ Compared to Africa, however, Latin

16 Stephen Kaplan interview, Beijing, China, November 16, 2017. See Stephen B. Kaplan, *The Rise of Patient Capital: The Political Economy of Chinese Finance in the Western Hemisphere* (Cambridge, U.K.: Cambridge University Press, forthcoming). A related working paper is available at SSRN: <https://ssrn.com/abstract=3108215>.

17 "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.

18 The other focal areas are energy and resources, infrastructure construction, agriculture, scientific and technological innovation, and information technology.

American labor costs are relatively high, helping explain why to date only one-tenth of China's regional FDI has been oriented toward manufacturing. The White Paper expects this trend to change, suggesting that China will foster "industrial cooperation in such fields as automobiles, new energy equipment, motorcycles and chemical industry, which will cover the whole industrial chain."¹⁹

China's strategic interest in Venezuela has been primarily commercial, but also accommodative of President Hugo Chávez's political goal of economic diversification from the United States (see below). Commercially, China's policy bank lending to Venezuela helps defray operational costs, encouraging companies to position themselves in global energy and commodity markets that are vital to meeting the demands of China's rising middle class. Since the first Venezuelan loan deals were negotiated in 2007, the China Development Bank (CDB) and the China Export-Import Bank have mainly supported investment in the energy and mining sectors, including power stations, oil refineries, and pipelines. They have helped some of China's largest state-run enterprises develop a local presence in Venezuela, including the China National Petroleum Company (CNPC), the China Petroleum and Chemical Company (Sinopec), and the Sinohydro Group.

However, the initial discretionary nature of these policy bank loans also meant that Venezuela used the proceeds for infrastructure projects in a variety of other economic sectors, including agricultural, transport, and real estate. Although it receives less attention because of its lower headline numbers compared to China's billion-dollar energy agreements, Venezuela has also quietly attracted \$800 million (or about two-fifths of its total Chinese FDI)²⁰ in manufacturing investment in the automotive and consumer electronics industry by private firms like Huawei Technologies and Chery Automobile. Notably, three-quarters of this investment took place during the Chávez regime when economic conditions were more favorable.

China's investment thus tended to reflect its stated foreign policy economic objectives for Latin America, funneling finance and investment resources into energy, infrastructure, and manufacturing.²¹ But, do China's creditors and investors behave any differently compared to the West?

19 See note 14.

20 Calculated by George Washington University student researcher, Sebastian Maag Pardo. Sourced from Rolando Avendano, Ángel Melguizo, and Sean Miner, *Chinese FDI in Latin America: New Trends with Global Implications*, The Atlantic Council and OECD Development Centre, June 2017, <http://publications.atlanticcouncil.org/china-fdi-latin-america/>.

21 For further discussion of these regional patterns, see Kevin Gallagher, *The China Triangle: Latin America's China Boom and the Fate of the Washington Consensus* (New York: Oxford University Press, 2016); and Margaret Myers and Carol Wise, eds., *The Political Economy of China-Latin American Relations in the New Millennium* (New York: Routledge Press, 2017).



Chinese President Xi Jinping on a state visit to Venezuela to meet former Venezuelan President Hugo Chávez in 2009. © Harold Escalona /Shutterstock.com

Latin American Risk Management: China vs. the West

Chinese policy banks historically approached sovereign risk evaluation with a different set of metrics compared to Western capital. In structuring their loan contracts, China has avoided policy conditionality, or credit being contingent on a country's macroeconomic performance. Chinese bankers operate under an official doctrine of non-intervention in domestic affairs, as stipulated in the country's Five Principles of Peaceful Coexistence.²² 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.²³

Whereas Western creditors often place a big emphasis on the macroeconomic and institutional environment (i.e. the budget framework, the extent of indebtedness, rule of law, transparency, governance quality), Chinese investors have tended to view such institutional metrics as political. Rather than imposing such policy conditions, China tends to underwrite credit risk with commercial conditions embedded in its loan contracts.²⁴ Chinese scholars, officials, and practitioners all tend to emphasize this distinctly commercial, non-Western approach. For example, Chinese scholars have illustrated this point in the Chinese Academy of Social Sciences (CASS)'s *Journal of Latin American Studies*, the government think tank's premier regional studies publication.

"The primary reason that the World Bank and other developmental financial institutions overlook Venezuela and other such countries is that they are so-called 'high-risk nations.' This type of judgment is based upon a political perspective and not an economic perspec-

22 See note 7.

23 Stephen B. Kaplan, "Banking Unconditionally: The Political Economy of Chinese Finance in Latin America," *Review of International Political Economy* 23, no. 4 (2016): 23.

24 Kaplan, "Banking Unconditionally."

tive. In reality, Venezuela is South America's largest oil exporter and maintains a relatively strong ability to repay debts."²⁵

The Latin American Institute of the China Social Science Academy (CSSA), which publishes the *Yellow Book of Latin America and the Caribbean* that details China's foreign affairs strategy for Latin America, concurs with CASS's assessment of the oil industry.

*"Latin America is the realistic choice of Chinese resources diversification. In the recent years in Latin America, mineral resource reserves have constantly escalated, the large size oil fields have been discovered, which offers good condition for China resources diversification strategy."*²⁶

Finally, Chinese investors responsible for external investment decisions also share these viewpoints about Latin American risk. For example, a former executive member of the loan approval committee of one of China's major policy banks sees their role as creating credit space and spurring economic activity in risky operational environments.

*"A lot of people say Venezuela is so risky, you shouldn't give more loans to this country! Some critics even say Exim Bank and China Development Bank should stop giving money to Venezuela. But, for these two banks, we are OK. We have different metrics than you. We think Venezuela is OK... ICBC or China Construction Bank—they may say that Venezuela is too risky, but Exim Bank or CDB say OK, because these banks have different tastes for risks, and they also have different skills towards risk management. Exim Bank and CDB, they are so good at playing in developing countries, especially Africa and Latin America. These two banks set very strong guarantees. They set up different risk management structures."*²⁷

Compared to market-based creditors who often want short-term policy assurances to ensure higher near-term financial returns, Chinese creditors seek to promote long-term commercial opportunities by tying their investments to guaranteed contracts for its state-owned firms, Chinese content requirements to stimulate machinery exports, or commodity guarantees.²⁸

In Venezuela, China's policy banks have tended to use commodity guarantees that secure their loans with oil. While these financial vehicles are popularly understood as exchanging loans for

25 Ming Liu and Fajun Wang, "Zhongguo aai Lading Meizhou de daikuan [China's Loans in Latin America]," *Lading Meizhou Yanjiu [Journal of Latin American Studies]* 34, no. 4 (August 2012): 14–19.

26 Wu Baiyi, *Yellow Book of Latin America and the Caribbean—Annual Report on Latin America and the Caribbean, 2015-2016* (China: Social Science Academic Press, June 2016).

27 Stephen Kaplan interview, Beijing, China, November 16, 2017. See Kaplan, *The Rise of Patient Capital*.

28 Kaplan, "Banking Unconditionally."

oil, they are a bit more complicated in their execution. They are based on two different transactions. Chinese policy banks lend Latin American governments money, while Chinese importers simultaneously establish a daily purchasing agreement with PdVSA. The state oil company then uses the cash it earns from its daily sales to Chinese importers to incrementally repay the policy bank loans over time until maturity. PdVSA's daily inflow of income from Chinese oil purchases thus serves as collateral for policy bank loans to the national government.

These types of loans deliver policy flexibility, but at the potential cost of long-run commercial competitiveness. For example, former Venezuelan President Hugo Chávez lauded the lack of conditionality, saying, "it differs from other multilateral loans because it comes with no strings attached, unlike the scrutiny of international finances."²⁹ However, both types of financing come at a price. The commodity guarantees embedded in loans-for-oil agreements risk eroding commodity proceeds that could otherwise be channeled toward domestic spending or reinvestment in state energy firms.

How China's Sovereign Risk Assessment Changed in Venezuela

This growing opportunity cost of borrowing from China has encapsulated the China-Venezuela lending relationship since oil production began to falter in 2013–14. Mired in its historically devastating crisis, Venezuela has struggled to repay its outstanding Chinese debts because of its dwindling state oil production. China has consequently questioned whether their commercial approach to lending is sufficient, while increasingly incorporating a more traditional macroeconomic approach to sovereign risk. For example, China reportedly conditioned its recent \$5 billion in joint-venture financing on the government's currency devaluation³⁰—a far cry from non-intervention in Venezuelan affairs. What has prompted China's about-face as a creditor?

Given the importance that China places on state-to-state relations, its shifting creditor position reflects politics as much as economics. China views its state-to-state cooperation as

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29 Ibid.

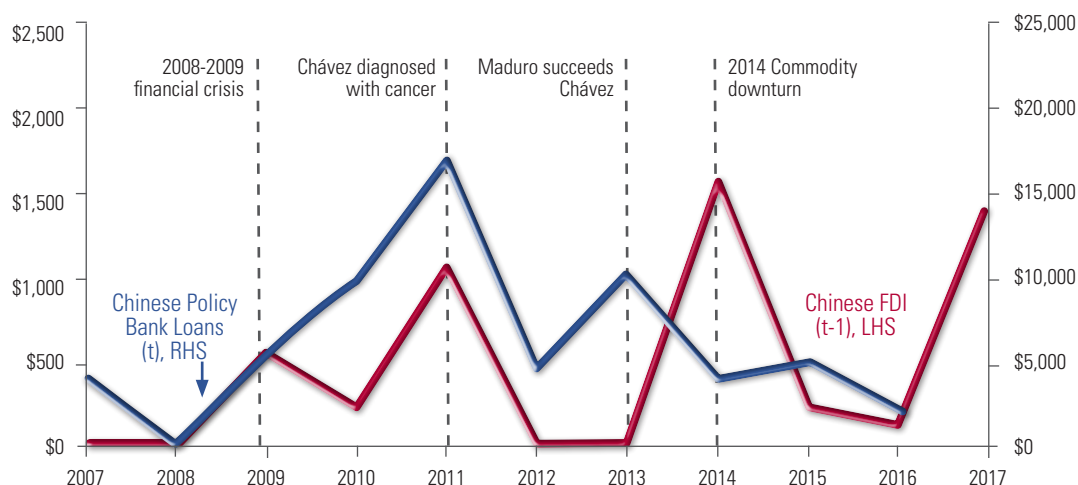
30 Corina Pons and Christian Shepherd, "Venezuela's Maduro travels to China in search of fresh funds," *Reuters*, September 12, 2018, <https://www.reuters.com/article/us-venezuela-china/venezuelas-maduro-travels-to-china-in-search-of-fresh-funds-idUSKCN1LS2UL>; "Zhongguo xiang Weineiruilu tigong ju-e yuanzhu" [China provides large sum of loan to Venezuela], Ministry of Commerce of the People's Republic of China, July 4, 2018.

the diplomatic entryway into new creditor-debtor relations, but the administrative channel is also a lifeline for resolving investor disruptions and commercial disputes. From a political perspective, China has a long-history of cross-ideological relationships in Latin America,³¹ but little tolerance for political instability. For instance, Argentina’s regime stability has allowed China to forge business deals across the political aisle with both President Mauricio Macri, a center-right president, and Cristina Fernández de Kirchner, a leftist former president. It also has not shied away from doing business in Brazil after the presidential victory of far-right candidate, Jair Bolsonaro. According to a Chinese Foreign Ministry Spokesperson, Lu Kang,

“China congratulates Brazil on a smooth presidential election and congratulates Mr. Bolsonaro for his election...China has always aimed to develop the China-Brazil relationship from a strategic and long-term perspective. We are willing to maintain and further develop our current partnership with Brazil in order to better serve the people of our countries, as well as striving to maintain regional peace and stability for the world.”³²

China was more circumspect regarding Venezuela’s political transition. For more than a decade, China had extended new financial commitments to Venezuela, even during periods of volatility such as the global financial crisis and the 2014 commodity downturn. However, the

Figure 1: China’s Finance and Investment into Venezuela (US\$ millions, New Financing)



Note: Policy bank loans include financial commitments that are rolled-over in any given year (see *Total Bilateral Financing* from Table 1). Sources: Calculated from Torino Capital data; China-Latin American Finance Database (Inter-American Dialogue), CEIC data, MOFCOMM, SEC, China Global Investment Tracker, AID data, and the Atlantic Council.

31 Domínguez, “China’s Relations with Latin America”; Shambaugh, “China’s Quiet Diplomacy.”

32 Lu Kang, “2018 nian 10 yue 29 ri waijiaobu fayanren Lu Kang zhuchi lixing jizhehui” [2018.10.29 Foreign Ministry Spokesperson Lu Kang hosts daily press conference], *Embassy of the People’s Republic of China in Brazil*, October 29, 2018.

Table 1: China's Lines of Credits to Venezuela

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total
Original Tranches (A, B, C, Great Fund) (Billions USD)	4.0	0.0	4.0	8.9	11.4	0.0	5.0	0.0	0.0	0.0	0.0	33.3
Renewed Tranches (A, B, C, Great Fund) (Billions USD)	0.0	0.0	0.0	0.0	4.0	4.0	0.0	4.0	5.0	0.0	0.0	17.0
Total Central Government Financing	4.0	0.0	4.0	8.9	15.4	4.0	5.0	4.0	5.0	0.0	0.0	50.3
Direct Joint-Venture Financing	0.0	0.0	0.0	0.0	0.0	0.0	4.0	0.0	0.0	2.2	0.0	6.2
Other Bilateral Credits	0.0	0.0	1.5	1.1	1.5	0.5	1.1	0.0	0.0	0.0	0.0	5.7
Total Bilateral Financing	8.0	0.0	9.5	18.8	32.3	8.5	15.1	8.0	10.0	2.2	0.0	62.1
Amount (% of Total for LatAm)	83.3%	0.0%	35.0%	41.1%	87.5%	64.3%	72.1%	40.0%	20.3%	10.4%	0.0%	41.4%
No. of Loans	1	0	3	2	3	2	4	1	1	1	0	17

Sources: Calculated from data supplied by Francisco Rodriguez, Torino Capital; Venezuela's Official Gazettes; and the Inter-American Dialogue's China-Latin America Database.

scale of its new financial commitments eased over time, particularly since former President Hugo Chávez was first diagnosed with life-threatening cancer in 2011 and was then succeeded by Nicolás Maduro in 2013 (see Figure 1). Chinese FDI and trade finance continued with news of a successful transition. However, public bankers have been more skeptical of Maduro's ability to manage the economy and repay Venezuela's debts, particularly as Venezuela's cash crunch stymied repayments on both its 'loan-for-oil' deals, and the financing of its \$7.5 billion high-speed railway project.

Policy banks have not lent the central government any new funds directly since 2015, instead channeling funding toward joint ventures (see Table 1). Policy banks have also conditioned such new funding on 'monitoring' of oil production and economic reforms. Beyond these financial institutions, state-owned insurance firms, such as Sinosure, have increasingly adopted macroeconomic risk metrics that are similar to Western investment banks and multilateral institutions in their project evaluations.

In summary, Chinese lenders have become more circumspect about their Venezuelan lending, which reflects their learning curve as a creditor. After mispricing Venezuelan investment risk, China appears to be placing a growing emphasis on macroeconomic assessment relative to commercial project evaluation. Notably, the bulk of China's Venezuelan lending occurred during the leadership of President Hu Jintao, who publicly prioritized China's global commerce above its geopolitics. Between 2010 and 2013, Venezuela accounted on average for about 64 percent of China's new approved lines of credits to Latin America. By contrast, between 2014 and 2017, Venezuela represented only 18 percent of China's total new lines of credits to the region (See Table 1). In recent years, China's current president, Xi Jinping, has taken a more assertive foreign policy posture internationally. However, Xi's shift in diplomatic tone has aligned with a period where China has been unwinding its financial commitments to Venezuela, a pattern that contradicts the premise of the debt escalation associated with debt-trap diplomacy.



View of Caracas from the top of Ávila National Park. © Alexander Chaikin/ Shutterstock.com

The Limits of Venezuela's Chinese Courtship

Sitting atop the Caracas congestion is Venezuela's treasured Ávila National Park, the verdant central coast mountain range that is full of fauna. According to local lore, a flower-picker named Pacheco, who hailed from the nearby mountain town of Galipán, once travelled the long-winding road to Plaza Bolívar in Caracas to sell his flower harvest annually. His arrival tended to coincide with winter, spawning the provincial expression, "*Llegó Pacheco*," or "Pacheco has arrived," meaning bleaker, dreary days of Venezuelan hardship were approaching. Nine-thousand miles across the globe where winters are much colder, China has its own historical wisdom for surviving the seasonal chill, one that is rooted in nutrition. To reduce illness, the age-old proverb favors eating 'carrots in winter, and ginger in summer,' to boost immunity.

In the current era of globalization, China has cultivated its roots in Venezuela, growing its financial and commercial ties over the last decade. When Venezuela's economy first arrived at its long, arduous winter following the global financial crisis, China offered carrots to boost Venezuela's health, strengthening state-to-state ties to sustain its economic vitality. Venezuelan leaders considered China to be a key foreign policy ally, helping the country finance the expansion of the Venezuelan state and diversify its economic relations from the West.

As the Venezuelan winter turned darker amid the country's historic crisis, China balked at being Venezuela's lender of last resort. Despite Venezuela's desire to further deepen its state-to-state relationship during its crisis, China increasingly reduced its financial commitments against the backdrop of President Maduro's economic mismanagement, the state oil company's collapse, and the consequent political instability. However, they avoided completely cutting financial ties to Venezuela.

The tendency of Chinese policy banks to mitigate credit risk with commercial rather than macroeconomic conditions had left them exposed to Venezuela's governance failures. Without policy conditionality on the loans, President Maduro could spend without bounds even after the commodity bust. Given that Chinese loans were instead tied to oil production, Chinese

bankers were compelled to lend defensively in hopes of boosting Venezuelan oil output and recovering their oil collateral. The following sections of this report explore China-Venezuela ties in further detail, first examining Venezuela's foreign policy objectives toward China and then assessing the risks that prompted China to partially recoil to from the relationship.

Venezuela's Foreign Policy Objectives Toward China

Following Hugo Chávez's successful 1998 presidential bid in Venezuela, he entered office as a neoliberal critic, but also as the head of a country with a long history of economic alignment with the United States, the global exporter of market capitalism. How could Chávez craft the policy space to pursue heterodox governing solutions if he was constrained by the financial and trade architecture established by the United States?

Chávez's foreign policy had two principal goals. First, Chávez hoped to leverage oil revenues to counterbalance U.S. influence in Latin America. Second, the Venezuelan president aimed to build international support from non-Western state actors.

Early on in his tenure, Chávez identified China's emergence on the global economic stage as a potential opportunity to help Venezuela gain autonomy from the United States. In a conference at the University of Beijing, during his first official visit to China, Chávez publicly declared:

"We have already begun to pursue a world policy aimed at restoring our autonomy, our independence from any other world power, and in that sense, we are very much like China."³³

By the time Hugo Chávez passed away in 2013, the first objective had been undercut by the 2008 global financial crisis. Providing subsidies to other allies internationally through such programs as PetroCaribe, a Venezuela-Caribbean alliance, was hampered by the post-crisis oil volatility. At the same time, Venezuela's economic implosion mitigated the ideological appeal of *chavismo* as a political option for the Latin American left. Collapsing oil production, mounting foreign debt, the expropriation of private sector assets, and distortion-

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33 Authors' translation of quote from the Agencia Venezolana de Noticias (1999), "Primer viaje de Chávez a China empezó a levantar la verdad de Venezuela en el mundo," Embajada de la República Bolivariana de Venezuela en la República Popular China [The Venezuelan Embassy in Beijing, China], October 12, 2014, http://china.embajada.gob.ve/index.php?option=com_content&view=article&id=1389:primer-viaje-de-chavez-a-china-empezo-a-levantar-la-verdad-de-venezuela-en-el-mundo&catid=3:noticias-de-venezuela-en-el-mundo&Itemid=17&lang=es.

ary exchange rate and price controls hamstrung economic activity. Finally, the ebbing of Latin America's so-called "pink tide," with a shift away from left-leaning governments in Argentina, Brazil, Peru, and Chile, further eroded the appeal of leftist regional messaging.

Although Chávez failed to counterbalance U.S. influence in the region, the Bolivarian Revolution did secure its other foreign policy objective: obtaining support from non-Western global powers that might prove more sympathetic to Venezuela's socialist project. On this front, Hugo Chávez succeeded in building strong state-to-state ties with Cuba, China, and Russia.

Although Chávez failed to counterbalance U.S. influence in the region, the Bolivarian Revolution did secure its other foreign policy objective: obtaining support from non-Western global powers that might prove more sympathetic to Venezuela's socialist project.

During the last two decades, each of these countries has played a pivotal but very different role for Venezuela's foreign policy. India and Turkey have also increased their Venezuelan presence recently, but to a lesser extent than the three nations mentioned above. India has mainly deepened ties commercial ties with Venezuela since 2013, becoming the third largest purchaser of Venezuelan oil. By comparison, Turkey has been more comfortable stepping into the geopolitical limelight as a key provider of humanitarian aid to the Venezuelan government.

In the geopolitical realm, not only has Cuba been an ideological partner of *chavismo*; the island has also helped the Venezuelan regime develop key intelligence capacities for repressing dissent, particularly within the armed forces.

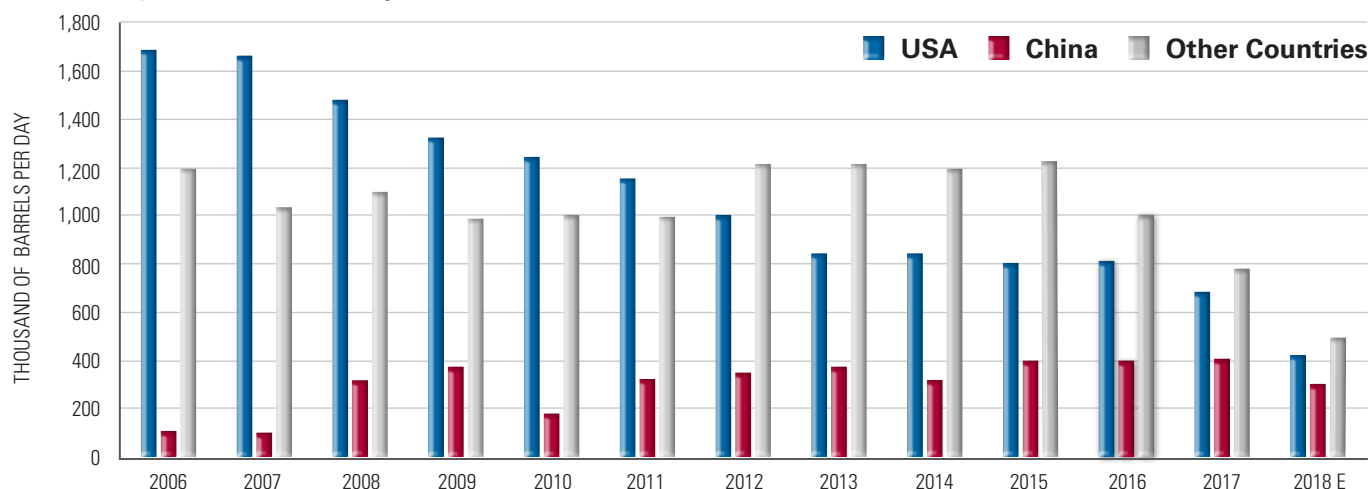
These intelligence capabilities have become instrumental to regime survival, as the Bolivarian Revolution has become more authoritarian in recent years. In turn, Russia has evolved into Venezuela's most important security ally.³⁴ Leveraging this alliance, Venezuela has circumvented U.S. sanctions to purchase military equipment. Russia's state-owned enterprises have also emerged as key investors in the gas and oil sectors, with Rosneft and Gazprom providing valued short-term financing to Venezuela's crumbling oil-state giant, PdVSA.

In the case of China, Venezuela's foreign policy has consisted of a complex juxtaposition of geopolitical, commercial, and financial considerations.³⁵ First, recall that President Hugo

34 "Venezuela: Internal Turmoil and Global Stakes," phone briefing sponsored by the Woodrow Wilson International Center for Scholars, Washington D.C., February 1, 2019, <https://www.wilsoncenter.org/event/venezuela-internal-turmoil-and-global-stakes>.

35 Javier Corrales, "China and Venezuela's Search for Oil Markets," in Alex Fernández Jilberto and Barbaras Hogenboom, eds., *Latin America Facing China: South-South Relations beyond the Washington Consensus* (Amsterdam: CEDLA, 2010). See also Rita Giacalone and Jose Briceño Ruiz, "The Chinese–Venezuelan Oil Agreements: Material and Nonmaterial Goals," *Latin American Policy* 4, no. 1(2014): 76–92.

Figure 2: Venezuela's Oil Exports



Source: Calculated from PDVSA, EIA, ITC - TradeMap.

Chávez prioritized diversification from its economic reliance on the United States. Given China's abundant capital and its foreign policy goal of securing oil access, it represented the most expedient commercial route for diversifying oil markets.

Early in his tenure, President Chávez formalized this bilateral relationship with Chinese President Jiang Zemin through the creation of the High-Level China-Venezuela Commission. In a 2001 White Paper, the two governments established the framework for energy cooperation for the next decade,³⁶ helping reduce the barriers to entry in Venezuela's oil sector for China's state-owned oil companies, CNPC, Sinopec, and the China National Offshore Oil Corporation (CNOOC). In line with Venezuela's strategic objective of oil independence from the United States, Chávez oversaw a three-fold increase in its oil exports to China, from less than 90,000 barrels per day in 2005 to more than 344,000 barrels per day in 2014 (see Figure 2).

In addition to these geopolitical goals, the Venezuelan government also sought foreign financing to both expand the size of the state in strategic sectors and fund public infrastructure and social investment projects. Multilateral institutions such as the World Bank and the Inter-American Development Bank (IADB) were unwilling to finance a development plan that they deemed to be fiscally and technically unsustainable. In fact, the World Bank stopped financing new projects in the country and the IADB reduced its credit portfolio in Venezuela compared to other Latin American countries. In line with these assessments, the World Bank moved its regional office from Caracas to Bogotá in 2001, leaving just a representative office; the IADB reduced its Venezuelan staff. Without much of a multilateral presence in Venezuela, Chávez increasingly courted Chinese financing to expand his development plan and social reforms, known as "Socialism of the XXI Century."

36 Ana Carolina Cardona Romero, "China en Venezuela: los préstamos por petróleo," *Informe de la Asociación Ambiente y Sociedad*, February 8, 2017, <https://www.ambienteysociedad.org.co/es/china-en-venezuela-los-prestamos-por-petroleo-2/>.

Chinese financing helped endow Chávez with the capacity to expand the Venezuelan state's economic reach, beyond the resource-abundant oil and mining sectors. In 2007, China and Venezuela created a development fund, dubbed the China-Venezuela Joint Fund (FCCV), that would be managed by their national development banks. The FCCV was jointly capitalized with \$4 billion from the China Development Bank (CDB), and \$2 billion from Venezuela's Development Fund (FONDEN).

Rather than conditioning lending on macroeconomic targets, China instead employed commercial means to mitigate credit risk. In Venezuela's case, this meant using commodity guar-

antees to collateralize its policy bank loans. Each time China injected fresh funds into the FCCV, PdVSA would sign a simultaneous contract to sell oil through an international subsidiary of CNPC. For example, China's first \$4 billion FCCV tranche was collateralized by 100,000 barrels per day in oil sales, which the Venezuelan government would then use to repay Chinese policy banks during the three-year loan maturity. As the China Development Bank extended new loans to Venezuela or rolled-over existing three-year tranches (see Table 1), PdVSA would commit to sending new oil shipments to China. By the end of 2016, Venezuela's oil shipments to China had surpassed 400,000 barrels per day (or almost one-fifth of total exports), helping the Venezuelan government's goal of oil diversification.

Ironically, if the lack of conditionality was not sufficient, these loan agreements further fueled state spending through accounting schemes which obfuscated the government's debt

obligations. In structuring these deals, Chávez and Maduro had both agreed to register these loans as sovereign debt for the central government, which enabled the government to use the loans discretionally.³⁷ PdVSA would repay the central government's outstanding loans to China with oil sales, yet these debt-servicing expenditures were not included in the national budget, opening fiscal space for other types of spending. In other words, the government could finance additional public expenditures by leveraging the balance sheet of PdVSA.

By 2013, China had provided the Venezuelan government with more than \$30 billion in oil-backed loans (see Table 1), which enabled sectoral investments on state priorities beyond the

China helped finance sugar refineries, cellphone assembly, electricity generation, cattle ranches, egg farms, transportation systems, and massive housing projects. Several of these projects were never completed, and if built, failed to be commercially viable, including controversial investments in a home appliance factory and high-speed railway.

37 BANDES, the central government's main development bank, was the financial vehicle selected by the Chávez government to control these operations.



China National Offshore Oil Corporation (CNOOC Group) headquarters in Beijing, China. © testing / Shutterstock.com

most economically-important oil and mining industries, including infrastructure, construction, agriculture, telecommunications, housing, and forestry. For example, China helped finance sugar refineries, cellphone assembly, electricity generation, cattle ranches, egg farms, transportation systems, and massive housing projects.³⁸ Several of these projects were never completed, and if built, failed to be commercially viable, including controversial investments in a home appliance factory and high-speed railway.

Although the Chinese financial relationship was embedded in oil, it also empowered the Venezuelan state. For Chávez, China's "no strings-attached" loans helped facilitate the expansion of the state into non-oil sectors that had been previously the purview of the private sector.³⁹ During the decade-long commodity boom (from 2004–14), the size of the Venezuelan state expanded to more than 40 percent of GDP.⁴⁰ Notably, however, more than two-thirds of this public balance sheet expansion occurred during the boom's final few years just as Chinese lending to Venezuela reached its peak (see Table 1).

While China extolled the merits of non-intervention and ideological flexibility in its commercial dealings, its lack of conditionality implicitly gave creditor consent to Chávez's nationalization spree that would have been far more challenging under the stewardship of Western multilateral creditors.⁴¹ After his successful 2006 re-election, Chávez began to march the country more swiftly along the path of his "Socialism for the XXI Century." He first leveraged an oil windfall to help propel an initial series of oil and gas nationalizations between 2004 and 2006, before later launching a second wave in early 2007. The second wave included both nationalizations

38 Erica Downs, "Inside China, Inc.: China Development Bank's cross-border energy deals," *John L. Thornton China Center Monograph* no. 3. (Washington, D.C.: The Brookings Institution, 2011), <https://www.brookings.edu/research/inside-china-inc-china-development-banks-cross-border-energy-deals/>.

39 Kevin Gallagher, Amos Irwin, and Katherine Koleski, "The New Banks in Town: Chinese Finance in Latin America," *the Inter-American Dialogue*, February 15, 2012, <https://www.thedialogue.org/analysis/the-new-banks-in-town-chinese-finance-in-latin-america/>.

40 CEPALSTAT 2018 database.

41 Kaplan, *The Rise of Patient Capital*.

and expropriations in the mining, electricity, financial, telecommunications, agriculture, and industrial sectors. Simultaneously, China's investments in hundreds of projects helped expand the presence of the Venezuelan state in the non-oil economy, through deals with Venezuela's state-owned enterprises that operated outside of the energy or mining sectors.

Chronicle of a Crisis Foretold: How China Mispriced Venezuelan Credit Risk

In the classic novel by Gabriel García Márquez, *Chronicle of a Death Foretold*, two brothers from a small Colombian town plan to murder fellow townsman, Santiago Nasar, for deflowering their sister, Angela Vicario, prior to her wedding night. As news spreads from the butcher's shop to the milk market, the entire village soon learns of the Vicario brothers' plans, yet few town folks attempt to stop Nasar's foreseen murder. Neighboring Venezuela's story over the last decade has been a calculable descent into a historic crisis, yet few Chinese economic spectators have attempted to change the country's course. Akin to the Colombian villagers' lack of intervention in Nasar's butchery, China failed to stop Venezuela's slow economic death. Of the slew of reasons offered for the town's negligence in warning Nasar, perhaps the most common theme was a diffusion of responsibility. Colombian townsfolk failed to intervene in part because they assumed that other villagers will act. Similarly, because China conducts its foreign affairs through the prism of non-intervention, the Chinese government places faith in its state-to-state relations, leaving the burden of local governance with the Venezuelan authorities.

For this reason, the passing of the Bolivarian baton from Chávez to Maduro was a key inflection point for China's public bankers. High oil prices and Chávez's more pragmatic governing had buttressed their favorable risk assessment of Venezuela's ability to repay its debt. For example, in the fallout of the global financial crisis in 2010, Chávez didn't hesitate to devalue the currency despite the risk it posed to his popular support base. The devaluation placated creditors by preserving the government's fiscal stability and facilitating debt repayment. It lined government coffers with new cash by yielding more local bolivars from its dollar-based oil revenues. But it also essentially levied an inflation tax on the poor, by raising the import prices of goods such as food and electronic goods.

However, with Chávez's death in 2013, Maduro had to assure Chinese creditors of his governance capabilities. Their lending might lack policy conditions, but their faith in the state-to-state relationship was instrumental to sustaining an open financing spigot (Figure 1). Unfortunately for Maduro, Chávez's demise had coincided with the end of the largest oil windfall in Venezuela's modern history as well as the beginning of the most dramatic economic depression in Latin America's recent past.

By the end of 2018, Venezuela's economy was in a death spiral. Venezuela had lost more than half of its GDP, and was struggling with an annual hyperinflation⁴² that according to the IMF had reached over 1 million percent. If that were not a sufficient nail in Venezuela's economic coffin, the country had no access to financial capital markets, the economy was subject to international sanctions, and the Central Bank had less than US\$1 billion in liquid international reserves to cover basic imports.

After succeeding Chávez in 2013, Maduro was unable to stop the economy's bleeding. Rather than addressing Venezuela's severe macroeconomic imbalances, Maduro doubled-down on public spending, with the government's fiscal deficit reaching double-digit levels as a share of GDP.⁴³ He also unsuccessfully attempted to solve the country's woes with expensive fuel subsidies, costly nationalizations, exchange rate and price controls, and strengthening the military's role in the management of state-owned enterprises.

At the same time, Maduro was unable to turn the tide in Venezuela's oil industry, with oil production collapsing from 2.4 million barrels per day when he took office in 2013 to less than 1.2 million by the end of 2018. The historic collapse reflects a variety of factors, including the 2014 oil price crash, stunted investment, waning technology acquisition, a loss of public managerial expertise, massive corruption, and the government's longstanding practice of redirecting oil revenue toward social spending. Dependent on oil for 95 percent of its foreign exchange earnings, the economy receded along with the oil wells. Maduro could not even turn to global capital markets, Venezuela's historic fail-safe financier, to help revive the oil industry after the United States sanctioned any new financing to PdVSA in 2017.

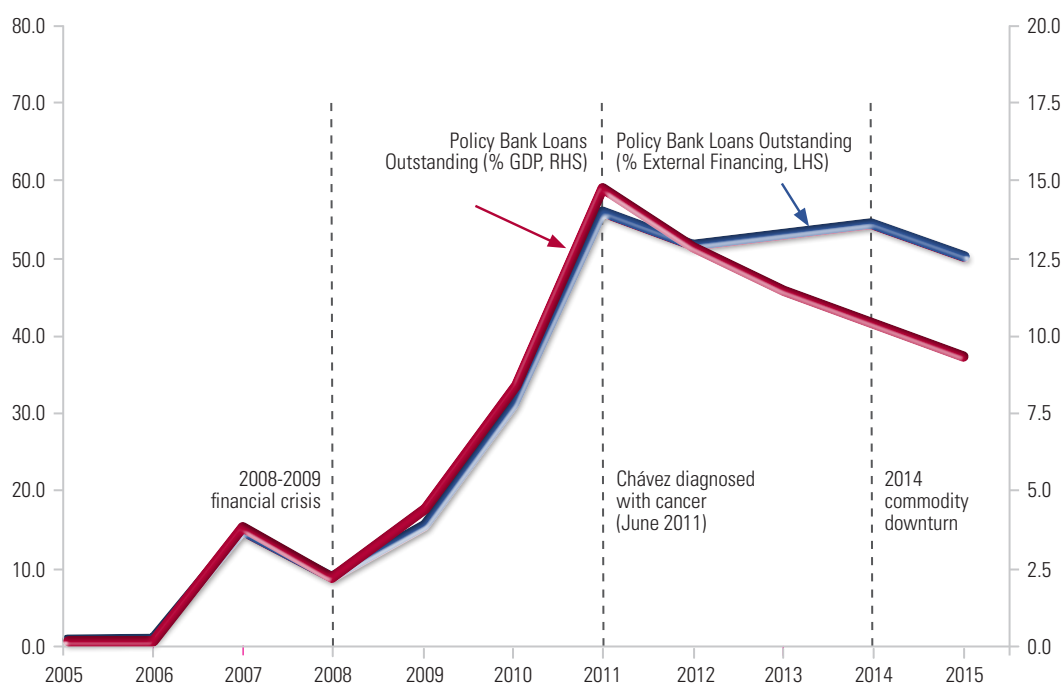
Why did China not cut its credit lines or craft a clear exit strategy from Venezuela, particularly once the economy soured under Maduro? As discussed earlier, China sustained state-to-state relations, but deleveraged from its peak financial commitments to Venezuela when first confronted with Chávez's illness (see Figure 1 and 3). However, China was willing to renew some commitments under President Maduro in hopes of recovering its initial investments. In other words, China's creditors lent defensively to secure Venezuela's oil collateral. It was reluctant to be a sole

...the passing of the Bolivarian baton from Chávez to Maduro was a key inflection point for China's public bankers.

42 Stephen B. Kaplan, "Will Sunday's Elections Bring Economic Reform and Relief to Venezuela?" *The Washington Post*, May 17, 2018, https://www.washingtonpost.com/news/monkey-cage/wp/2018/05/17/will-sundays-elections-bring-economic-relief-and-reform-to-venezuela/?utm_term=.2507dfbd98bc.

43 Venezuela's Central Bank has not officially published key economic indicators since 2014. The best estimates have been calculated by Francisco Rodríguez, *Red Book* 2018, Torino Capital, New York. See also Economic Intelligence Unit's 2018 *Country Data*.

Figure 3: Venezuela's Outstanding Debt to China (2005-2015)



Note: Outstanding debt calculations only include central government financing from Table 1, adjusted annually for roll-over of tranches (A, B, C, and Great Fund), and debt repayment.

Sources: Kaplan 2016; 2019; China-Latin American Finance Database (Inter-American Dialogue), CEIC data, SEC, AID data.

lender of last resort, but willing to maintain some financial linkages in hopes of expanding its long-term commercial presence in the oil sector.⁴⁴ For example, notwithstanding the commodity downturn, China renewed \$9 billion of financing to the crisis-ridden country between 2014 and 2015 (see Table 1). With this refinancing, Venezuela's total outstanding debt remained high at about \$25 billion, accounting for approximately one-half of Venezuela's external debt, or about 10 percent of GDP (see Figure 3). Notably, this calculation of outstanding debt is well below some widely cited—but inflated—estimates because it adjusts the outstanding loan amount for both financing renewals and debt repayment.

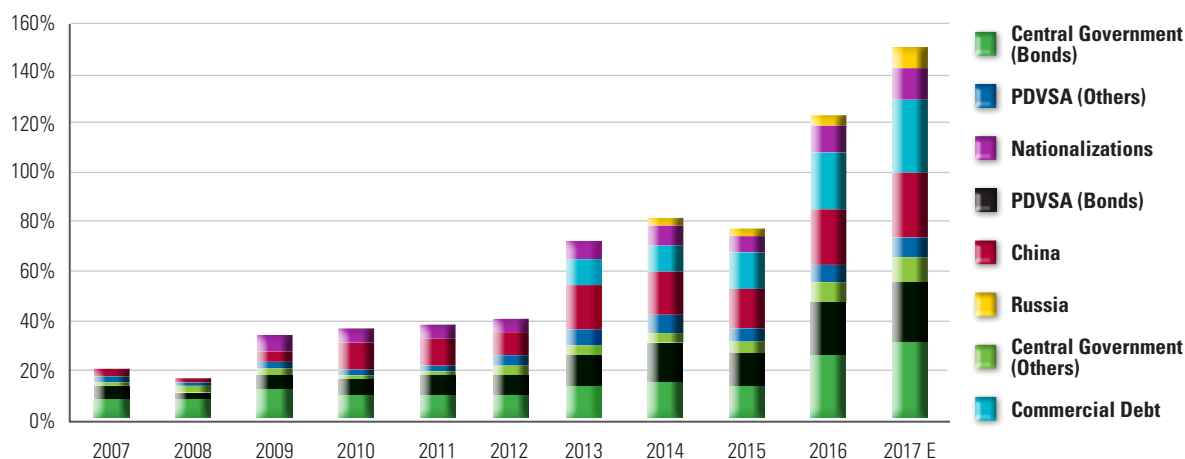
China's lack of conditionality and willingness to refinance during downturns helped advance its soft-power diplomacy of South-South cooperation and developing country empowerment. For example, President Xi frequently emphasized these values within his foreign economic policy.

"We uphold fairness and justice and advance the democratization of international relations. In many major international and local issues, we share a common voice with emerging markets and developing countries."⁴⁵

44 Stephen B. Kaplan, "China Investing Seriously in Latin America: Should You Worry?" *Washington Post*, January 24, 2018, https://www.washingtonpost.com/news/monkey-cage/wp/2018/01/24/china-is-investing-seriously-in-lat-in-america-should-you-worry/?utm_term=.5150ec8a2396; Kaplan, *The Rise of Patient Capital*.

45 Xi Jinping, "Gongjian huoban guanxi gongchuang meihao weilai" [Building Common Partnership, Creating a Beautiful Common Future], Renmin Ribao, July 10, 2015, 3rd edition.

Figure 4: Composition of Venezuela's Foreign Debt (% GDP)



Source: Calculated from Table 1, Figure 1, BCV, ONCP, IMF.

“China’s development, within world development, is also for the common development of each country in the world, adds more energy, and brings about more opportunities.”⁴⁶

However, this approach to finance in developing countries also placed the burden of governance on local governments. An emphasis on policy autonomy could be a positive development for South-South cooperation, if Latin American governments use this money to promote sustainable growth and address longstanding socioeconomic inequalities. But the Venezuelan government’s failure to reach such lofty goals left China exposed to considerable macroeconomic risk as a creditor, with little recourse aside from approving a 2016 debt moratorium.

PdVSA’s Collapse and Venezuela’s Debt Hangover

China’s growing reluctance to provide Venezuela with new financing reflected the collapse of Venezuela’s oil sector and national credit quality. Ironically, China attempted to leverage its lack of policy conditionality to entice, diplomatically and developmentally, a region with a longstanding frustration with austerity.⁴⁷ By lending without policy conditions, however, China became exposed to Maduro’s mismanagement of the oil sector and the economy more broadly. China’s commercial approach to mitigating sovereign risk with oil collateral could not sufficiently protect its creditor interests in Venezuela. China had to lend defensively, providing new funds to Venezuela in hopes of securing debt repayment, despite the country’s growing economic dysfunction.

Mired in a vicious cycle of collapsing oil production, feeble investment, and a crashing economy, Venezuela’s foreign debt became unsustainable following the commodity downturn. The foreign debt to GDP ratio had increased from a mere 21 percent in 2007 to more than

46 Xi Jinping, “Gongchang kaifang baorong gongjin heping fazhan” [Mutually Advocate Openness and Inclusiveness, Mutually Advance Peaceful Development], Renmin Ribao, October 23, 2015, 2nd edition.

47 Kaplan, *Globalization and Austerity Politics*.

145 percent by 2018 (Figure 4).⁴⁸ In addition to borrowing from China, the Maduro government also raised money from global capital markets and new bilateral creditors. For instance, global bondholders steadily financed more than half of Venezuela's external debt over the

Fearing creditor litigation and overseas asset seizures, including key refineries owned by CITGO in the United States, Venezuela requested a debt moratorium with China so that it could repay its international bondholders. China relented, offering an interest-only grace period on Venezuela's debt repayment...

last decade. In May 2017, Goldman Sachs bought PdVSA bonds, drawing the rebuke of then-National Assembly president Julio Borges, for its decision to "aid and abet Venezuela's dictatorial regime."⁴⁹ Russia also entered the financial scene during this time, providing more than US\$6 billion in new funds through its state-owned oil enterprise, Rosneft, to Venezuela's state oil company between 2016 and 2017. In exchange, PdVSA accepted to provide 49.9 percent of CITGO's total shares as its U.S. collateral to Rosneft in order to guarantee any future payments.

Theoretically, the influx of new funds should have provided Venezuela with some relief, but it also created a financial quandary. Under the structure of these loan-for-oil deals, Chinese policy banks lend Latin American governments money, but there is a separate commercial agreement in

which Venezuela sells its oil to Chinese importers. PdVSA then takes these export proceeds and puts them in an account with the policy banks, to repay the loans. Hence, a certain amount of PdVSA sales are pre-committed to China for debt repayment.

In other words, these loans were collateralized by PdVSA's daily income, yet as mentioned earlier, the liability was registered as sovereign debt for the central government. The Venezuelan government's debt repayments to China were paid with income from PdVSA's export sales to China, meaning that the Venezuelan government could leverage PdVSA's balance sheet to boost its public expenditures. The viability of these oil-for-loan deals was then contingent on PdVSA's current cash flow, and ultimately the state oil company's ability to sustain consistent oil production and future export sales.

However, the once world-class state oil company was teetering on the edge of insolvency, struggling to finance its basic operations and service its own foreign debt obligations. Under these conditions, complying with the terms of these oil-for-loan deals meant funneling an increasing share of its export proceeds to China, rather than reinvesting in the company's

48 Francisco Rodríguez, "Ecuador and Venezuela this Week: Uncharted Terrain," *Torino Economics*, December 17, 2018.

49 "Goldman Sachs is Criticized for Buying Venezuelan Bonds," *The Economist*, June 1, 2017, <https://www.economist.com/finance-and-economics/2017/06/01/goldman-sachs-is-criticised-for-buying-venezuelan-bonds>.

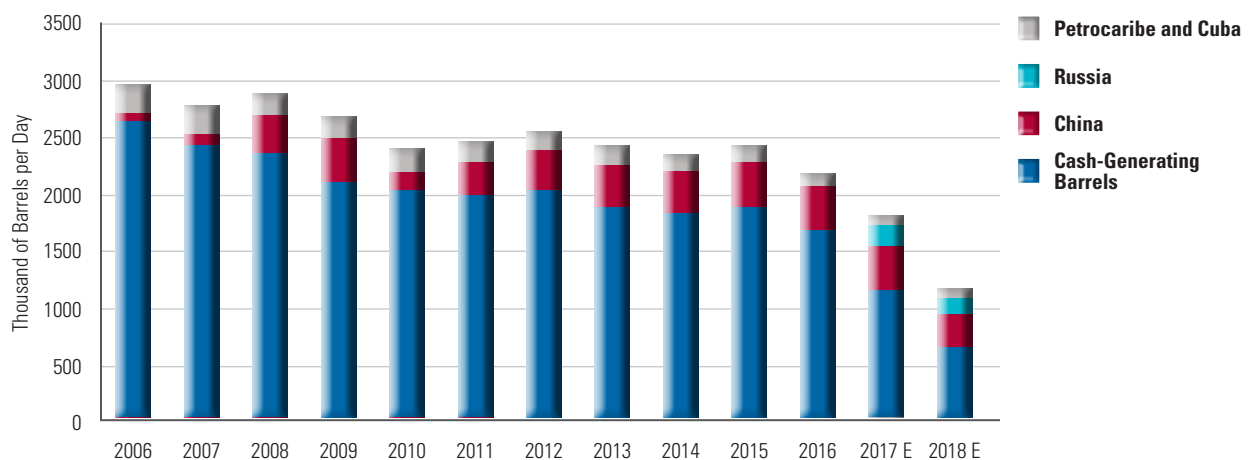
operations. Export sales to China have represented a growing share of PdVSA's dwindling exported oil sales, rising from a 3 percent share in 2006 to an 18 percent in 2016 (see Figure 5).

Venezuelan debt payments to Russia, related to the aforementioned \$6 billion, further squeezed the state oil company's export margins. Of PdVSA's total export sales, only the proceeds from the United States and India were not fully earmarked for debt repayment, and hence, generated a positive cash flow. Saddled with this export-linked debt servicing, PdVSA increasingly struggled to invest in its operations, and boost oil production. For example, in 2006, PdVSA exported over 2.5 million barrels per day that supported its cash flow.

However, by 2013, oil production plummeted below the critical 2 million barrel-per-day threshold, PdVSA increasingly encountered debt repayment difficulties. Fearing creditor litigation and overseas asset seizures, including key refineries owned by CITGO in the United States, Venezuela requested a debt moratorium with China so that it could repay its international bondholders. China relented, offering an interest-only grace period on Venezuela's debt repayment, in part because PdVSA was already in arrears with its export-linked debt repayments (which had declined by 48,000 barrels per day in 2016).

The 2017 financial sanctions imposed by the United States further strained PdVSA's balance sheet, which limited Venezuela's ability to issue, refinance, or restructure its foreign debt. Without the policy space that would come from a restructuring, PdVSA was left with a stark choice that pitted debt repayment against investment in oil production. The state oil company chose debt repayment, sacrificing its ability to stabilize production. By 2018, it had about 600,000 cash-generating barrels—a mere one-quarter of its 2006 income—that it could invest back into the operations of the state oil company (see Figure 5).

Figure 5: Composition of Exported Barrels



Source: Calculated from PDVSA, EIA, OPEC, ITC.



The President of the People's Republic of China, Xi Jinping, arrives in Caracas, Venezuela, on an official visit. © Harold Escalona/ Shutterstock.com

China Lends Defensively to Protect its Commercial Interests

In the early days of the China-Venezuelan economic courtship, Chinese bilateral financing had offered Venezuela a development opportunity. However, the broad-based development focus beyond the oil sector left Chinese creditors exposed to the health of the entire Venezuelan economy. They hoped to avoid the failings of other historic creditors in Latin America by circumventing policy conditionality with commercial conditions. As discussed earlier, Chinese policy banks thought securing their policy loans with oil collateral could sufficiently mitigate credit risk. However, this time was not any different, and growing debt obligations once again hampered investment and productivity, albeit on the balance sheet of the state oil company rather than the central government.

Not only did China underestimate Venezuela's ability to sustain oil production, and hence, economic activity, but also its ability to successfully manage several commercial projects that were spread across broad sectors of the economy. Similar to any investment portfolio, China's investments in Venezuela's commercial landscape are populated with both successes and failures. According to one Chinese policy bank official responsible for risk assessment, some projects will "generate high profits, other less than zero."⁵⁰ Chinese firms successfully invested in a number of projects in the energy, mining, manufacturing, and electronics sector in Venezuela, but the price tag of some of the largest failures, such as a Haier home appliance factory and a China Railway Engineering high-speed railway across Venezuela's plans, captured local headlines. While China has invested in more than 50 combined foreign direct investment (FDI) and construction projects in Venezuela,⁵¹ these two failed projects alone

50 "Banking Unconditionally: China's Investment and Influence in Latin America," George Washington University, Institute for International Economic Policy, 2015, <http://www.internationaleconpolicy.com/international-finance/banking-unconditionally-chinas-investment-and-influence-in-latin-america/>.

51 See footnote 17.

accounted for 12 percent of the total size of inward FDI, and one-third of total Chinese construction contracts respectively.

If Venezuela's economic and resource management were not sufficiently suspect, these commercial failures prompted China to balk at its lending relationship, particularly as arrears accrued on the \$7.5 billion high-speed cargo railway investment. When Chinese project managers finally left in 2015, railroad factories along the construction corridor were ransacked for their power generators, computers, metal siding, and copper wiring.⁵² Venezuela's opposition leaders have lamented these bad investments. For example, former Caracas mayor Antonio Ledezma denounced Maduro's botched governance of these two projects, saying:

*"We ran a debt with China to build a railroad from Valencia and Caracas, and that was never concluded... We have a large debt to China (and Russia) for public works that were contracted, and never built, and with China because we give them more oil in exchange for televisions, etc. That's unheard of!"*⁵³

China's emphasis on local governance had also left it exposed to President Maduro's economic mismanagement. Maduro had delayed reforms in the oil sector and foreign exchange market that were aimed at economic stabilization. For instance, the Venezuelan president dismissed internal pressures from his own economic cabinet about eliminating foreign exchange controls that were seen as intensifying the oil sector's operational problems. In late 2014, Vice-President Rafael Ramírez, who was also the head of PdVSA, unsuccessfully advocated for such reforms before eventually leaving his government post. In the face of a sharp decline in global oil prices that was the spark for Venezuela's economic woes, Ramírez proposed to remove some of the economy's worst distortions, including exchange rate and price controls.⁵⁴ He also wanted to cut gasoline subsidies and instead help the most vulnerable sectors with targeted cash transfers.⁵⁵

Without reform, China was walking a delicate financial tightrope in Venezuela. If Chinese policy banks had cut their financing to Venezuela out of concern that the country's historic crisis

52 "Chinese bullet train project in Venezuela stalls as alliance derails," *The Japan Times*, May 15, 2016, <https://www.japantimes.co.jp/news/2016/05/15/business/chinese-bullet-train-project-in-venezuela-stalls-as-alliance-derails/#.XF26zGd8BaQ>.

53 "Plea for Action: A Conversation with Venezuelan Opposition Leader Antonio Ledezma," *American Enterprise Institute*, November 29th, 2017, <http://www.aei.org/multimedia/plea-for-action-a-conversation-with-venezuelan-opposition-leader-antonio-ledezma/>.

54 Ramírez's program did not include reversing nationalizations or increasing foreign investment in the oil sector.

55 Juan Carlos Zapata, "Cuándo comenzó la pelea entre el Zar de PDVSA y Nicolás Maduro" [When the fight between Zar of PdVSA and Nicolás Maduro began], *Al Navío*, December 12, 2017, <https://alnavio.com/noticia/12245/firmas/cuando-comenzo-la-pelea-entre-el-zar-de-pdvsa-y-nicolas-maduro.html>.

would jeopardize its debt servicing capacity, a likely default would have impeded the flow of Venezuela's oil shipments to the Middle Kingdom. Chinese policy banks were thus willing to renew tranches under the original joint development financing scheme (FCCV) to foster debt repayment,⁵⁶ but did not offer Venezuela any new funding facilities.

President Xi Jinping's July 2014 visit during his Latin American tour had marked the beginning of China's defensive lending phase in Venezuela. Xi's visit was a symbolic gesture about Venezuela's importance as a long-term political and economic partner, even after Chávez's 2013 death. However, China's policy banks refrained from deepening their financial relationship

China's reluctance to extend new credit lines to Venezuela may have also reflected its concerns about political stability in the post-Chávez era.

amid ongoing uncertainty about President Maduro's economic management credentials. Shortly after his visit, the China Export-Import Bank and China Development Bank replenished tranche A and B respectively (totaling \$9 billion) of the China-Venezuela Joint Fund (FCCV). This financing was vital in helping Venezuela cover its financing shortfalls and avoid a balance of payments crisis. From 2014–15, Chinese funds provided nearly one-third of Venezuela's total financing needs, often directly padding its international reserves.⁵⁷ Beyond these credit renewals, however, China's policy banks

did not offer any new loan-for-oil deals because they first wanted to recover their oil collateral on previous bilateral debts before extending any new funds.

China's Financiers Also Tread Cautiously Because of Political Instability

China's reluctance to extend new credit lines to Venezuela may have also reflected its concerns about political stability in the post-Chávez era. In December 2015, the Venezuelan opposition won a two-thirds supermajority in the National Assembly and immediately initiated a recall referendum. Faced with the threat of democratic removal from the presidency, Maduro used his political control of the judiciary to block the referendum. The Supreme Court then stripped the National Assembly of its constitutional powers. This governability crisis catalyzed four months of massive street protests, which were violently repressed by the armed forces. To further undermine the opposition, Maduro illegally held elections in July 2017 for a National Constituent Assembly to bypass the National Assembly. In response, the following month, the United States imposed financial and capital market sanctions on Venezuela, while twelve

56 Stephen B. Kaplan, "Why Is China Investing \$250 Billion in Latin America?" *Washington Post*, February 4, 2015, https://www.washingtonpost.com/news/monkey-cage/wp/2015/02/04/why-china-is-investing-250-billion-in-latin-america/?noredirect=on&utm_term=.e0ba4fc40ecd. See also Kaplan, *The Rise of Patient Capital*.

57 Alejandro Grisanti, "Counting on Oil Prices and China," *Barclays Emerging Markets Research*, June 22, 2015.

other hemispheric countries refused to recognize the Constituent Assembly and formulated the Lima Group to “condemn the breakdown of democratic order in Venezuela.”⁵⁸

The dismantling of the National Assembly also cast a cloud over Venezuela’s debt servicing capacity. Without formal approval from the National Assembly, new debt incurred by the Maduro government could be legally questioned or repudiated following a potential opposition-led transition. In fact, the National Assembly formally conveyed to Venezuela’s creditors that any new debt would be considered illegal without its legislative approval, sending letters to international banks (i.e. Goldman Sachs, JP Morgan, and Nomura),⁵⁹ multilateral institutions (i.e. the CAF Development Bank of Latin America),⁶⁰ and Chinese creditors.

A cautionary missive was also delivered to China’s Embassy in Caracas, underscoring the legal perils of extending new credit without the National Assembly’s consent.⁶¹

To hedge this growing political risk, Beijing courted Venezuela’s opposition leaders and reinforced its longstanding willingness to deal with governments from across the political spectrum.⁶² For example, during the 2012 presidential election campaign, Chinese leaders had met informally with opposition candidate Henrique Capriles. In its latest political overture to Venezuela’s opposition, Beijing extended invitations to key opposition leaders to visit China, including Julio Borges, who was going to be the parliament’s president in 2017.⁶³ The opposition’s message resonated with Chinese officials, who appeared sensitive to the legality

To hedge this growing political risk, Beijing courted Venezuela’s opposition leaders and reinforced its longstanding willingness to deal with governments from across the political spectrum.

58 “Lima Group Statement on the Takeover of the Legislative Powers of the Venezuelan National Assembly,” August 18, 2017, <https://www.gob.mx/sre/en/prensa/lima-group-statement-on-the-takeover-of-the-legislative-powers-of-the-venezuelan-national-assembly>. The Lima Group, established in August 2017, is comprised of Argentina, Brazil, Canada, Chile, Colombia, Costa Rica, Guatemala, Honduras, Mexico, Panama, Paraguay, and Peru.

59 “Julio Borges envió carta a director de Goldman Sach” [Julio Borges sent a letter to the director of Goldman Sachs], *El Nacional*, May 29, 2017, http://www.el-nacional.com/noticias/oposicion/julio-borges-envio-carta-director-goldman-sach_184976.

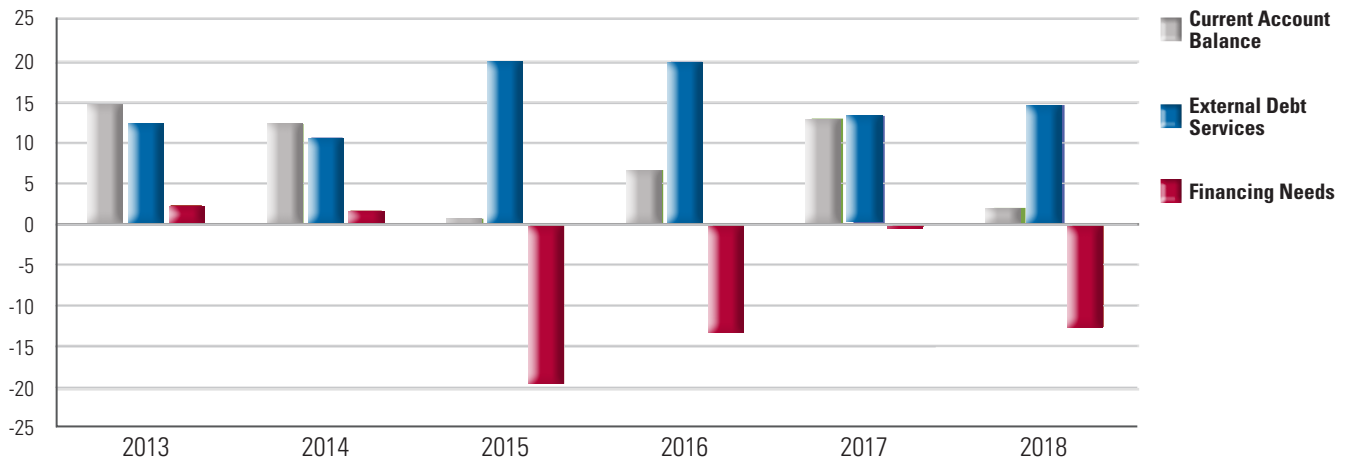
60 “Guerra: Préstamo solicitado por el BCV a la CAF sería ilegal” [War: Loan solicited by BCV from CAF would be illegal], *El Nacional*, March 27, 2017, http://www.el-nacional.com/noticias/asamblea-nacional/guerra-prestamo-solicitado-por-bcv-caf-seria-ilegal_87469.

61 Michael Penfold interview with Deputy Rafael Guzmán, Head of the Finance Committee, National Assembly, Caracas, November 20, 2018.

62 Domínguez. “China’s Relations with Latin America;” Shambaugh, “China’s Quiet Diplomacy.”

63 La invitación de China a Julio Borges debe tener nervioso al gobierno” [China’s invitation to Julio Borges should make the government nervous], *KonZapata*, June 29, 2016, <https://konzapata.com/2016/06/la-invitecion-de-china-a-julio-borges-debe-tener-nervioso-al-gobierno>.

Figure 6: External Account (\$USD Billions)



Source: Calculated from BCV, ITC – TradeMap, IMF, Own Estimations.

question surrounding any new debt issues. In private conversations with the Maduro government, Chinese officials had ostensibly linked Venezuela’s access to new credit lines to formal approvals from the National Assembly.⁶⁴

Defensive Lending and the Debt Moratorium

Notwithstanding China’s efforts to lend defensively, Venezuela’s foreign debt was too large for China alone to make much of a dent by 2016. Venezuela’s current account was earning too little in income to cover the country’s debt service, meaning its external financing needs averaged more than \$15 billion between 2015 and 2016 (see Figure 6).

To address these severe balance of payment problems, Maduro balked at economic reform, instead opting to cut imports to avoid further aggravating Venezuela’s indebtedness difficulties. Venezuela’s imports plummeted to US\$13 billion by the end of 2017, a mere one-fourth of its 2013 total of US\$54 billion. But exports also continued to fall due to lackluster oil production, eroding Venezuela’s current account surplus to virtually nil by 2018. Without new financing, repaying its debt became an uphill battle for Venezuela. Multilateral institutions and capital markets were reluctant to be Venezuela’s lender of last resort. At the same time, China and Russia had little appetite for this risk, particularly given Venezuela’s depleted oil production.

It was in this broader context that China’s defensive lending had initially entered a new stage in 2016. At that time, China’s policy banks had cut their discretionary loans and increasingly linked any new financing to boosting oil production, so that Venezuela could repay its debt under loans-for-oil deals. For example, the China Development Bank’s loan to Venezuela that

64 Michael Penfold interview with Deputy Rafael Guzmán. See also: Holman Rodríguez, “China y Rusia estarían perdiendo la paciencia por deuda de Venezuela” [China and Russia are losing patience with Venezuela’s debt], *Panas en Colombia*, November 12, 2017, <https://www.eltiempo.com/mundo/venezuela/china-y-rusia-estarian-perdiendo-la-paciencia-con-venezuela-por-deuda-149796>.

year was broadly geared toward improving oil production through upgrading and reform (see Table 1).⁶⁵ However, the spigot for new financing beyond the oil sector had run dry. As part of its defensive lending strategy, China shifted to temporary debt relief rather than refinancing. At Venezuela's request, China negotiated a two-year moratorium on the South American country's state-to-state debt. China reportedly loosened the terms on Venezuela's outstanding loans. In the financial contract, China allowed the country to pay interest only and defer its principal payments. In the commercial contract based on the underlying collateral, China lowered minimum oil shipment quantities and extended repayment deadlines.

The moratorium served a few strategic interests for China. First, it helped improve PdVSA's cash flow without the need to extend significant fresh funds to Venezuela. In other words, China could mitigate its financial risk while still forging a long-term commercial presence in the oil sector. Second, it allowed Chinese creditors to walk a political middle ground in Venezuela. They extended a grace period to endow the Venezuelan government with more financial flexibility, but the lack of new financing also signaled good will toward the Venezuelan opposition. China would not provide fresh financing without the approval of the National Assembly. In the event of political turnover, such good will would help smooth a pathway for China's sustained commercial relations in Venezuela. Recently, China doubled down on this financial strategy. In late 2018, after Maduro's second official visit to Beijing, according to several unofficial sources, the moratorium was extended for an unknown period of time amid Venezuela's deepening and historic crisis.⁶⁶

As part of its defensive lending strategy, China shifted to temporary debt relief rather than refinancing.

The debt moratorium also likely reflected China's need to manage the soft power optics of its South-to-South cooperation and developing country empowerment. Failed investments would undermine those optics, as would a complete cessation of lending, particularly as regional leaders focused more attention on the Venezuelan crisis. Historically, Latin American governments have been reluctant to criticize one another's internal situations, but major economic powers like Argentina and Brazil had become more critical of Maduro's autocratic turn, as illustrated by Mercosur's eventual condemnation of the Constituent Assembly in 2017. More recently, five members of the Lima Group (Argentina, Colombia, Chile, Paraguay, and Peru) requested that the International Criminal Court (ICC) launch a preliminary investi-

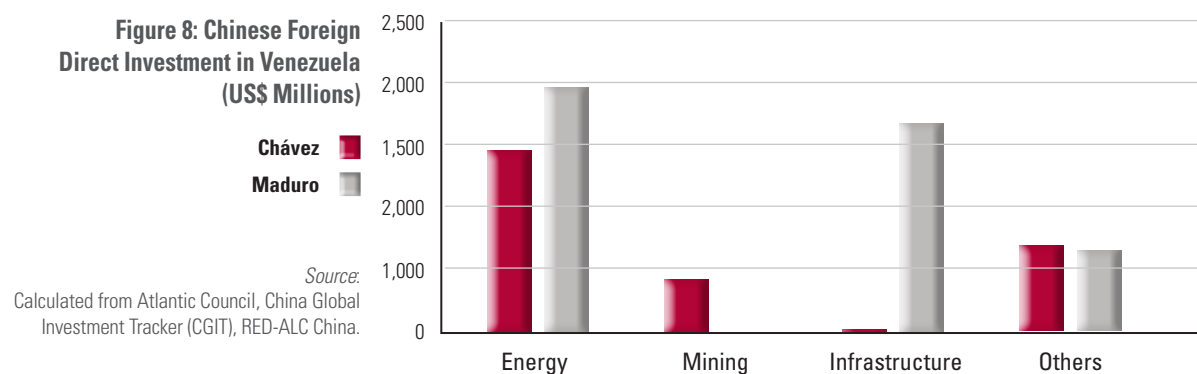
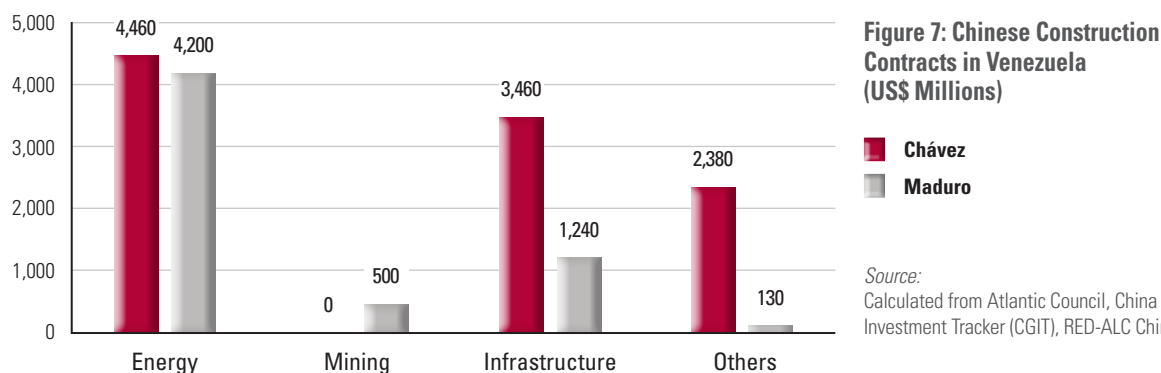
65 Kaplan, "Banking Unconditionally."

66 This information is based on interviews with several high-level Venezuelan economists who follow the relationship with China and have access to key actors managing the relationship. It is unclear if the extension was for six months or more than a year.

gation of the Venezuelan government for crimes against humanity.⁶⁷ Against this contentious backdrop, a debt moratorium not only allowed China to occupy the sidelines domestically in Venezuela, but also regionally in Latin America.

Hedging Mispriced Risk Administratively and Commercially

The fact that China has been unwinding its financial ties in Venezuela since 2014 suggests that Venezuela’s economic woes are not a product of debt-trap diplomacy, nor does China’s behavior represent an intentional effort to bankrupt Venezuela to seize the country’s assets. Venezuela’s outstanding debt to China has retreated from its 2010–11 highs (see Figure 3). By contrast, Venezuela’s overall foreign debt has expanded since 2011 (see Figure 4), in large part due to the collapse in GDP, but also to the government’s and PdVSA’s ongoing willingness to finance a fiscally unsustainable public balance sheet expansion with global bond issuance.



67 Francisco Rodríguez, “Ecuador and Venezuela this Week: Letter from Beijing,” *Torino Economics*, September 24, 2018.



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Beyond reducing its financial ties with Venezuela, China also increasingly employed administrative and commercial measures to help hedge its sovereign risk. Initially, China's policy banks had extended loans-for-oil in Venezuela, leaving the central government considerable discretion in the design of its development projects. Recall that projects had targeted a wide range of economic sectors, from agriculture and manufacturing to transportation and real estate. Following the Maduro transition, however, China became more selective in its investments, favoring more projects in the strategically important oil and energy infrastructure sectors where it hoped to maintain a long-term commercial presence. Under Maduro, China was significantly more reluctant to invest in other areas. Figures 7 and 8 show how China's inward investment became increasingly concentrated in oil and energy infrastructure.

To further hedge its commercial risk, China also tied new lending directly to boosting oil production in Venezuela. Whereas in the past Venezuela had greater discretion in using China's bilateral financing, China increasingly was using joint venture financing arrangements. Under these arrangements, China would lend directly to the China-Venezuelan joint venture firm, using the joint venture's production to eventually repay the loan (see Table 1). While Maduro reportedly secured a new loan from China that was as large as US\$5 billion in the summer of 2018, the Chinese Ministry of Commerce stated it would be used to improve the country's oil production,⁶⁸ implying that any new bilateral loan was likely to follow the joint venture financing model rather than direct state-to-state lending under the Chinese-Venezuelan cooperation fund.

China's headline oil investment in Venezuela—Sinovensa—is its joint venture with PdVSA in the heavy Orinoco oil belt, home to the world's largest petroleum reserves. China has also invested in smaller greenfield projects, such as Petrozumano, that have yielded a considerably smaller oil output than Sinovensa. The Sinovensa project, which had recently been

68 "Zhongguo xiang Weineiruila tigong ju-e yuanzhu" [China provides large sum of loan to Venezuela], *Ministry of Commerce of the People's Republic of China*, July 4, 2018.

operating below its 100,000 barrels per day oil output, has been directly linked to China's new financing.⁶⁹

Shortly after Maduro's 2018 visit, China's state oil company, CNPC, announced that it had increased its stake in Sinovensa to 49.9 percent. Against the backdrop of China's ongoing efforts to recover its oil payment arrears from Venezuela, the equity stake likely made China a more willing investor, albeit with some controversy. Venezuela's Hydrocarbons Law caps foreign ownership participation at less than 50 percent, meaning that a change above that amount would have likely required approval from the disbanded National Assembly.⁷⁰ China has previously been careful not to roil the Venezuelan opposition, but the equity transfer may invite some long-run legal challenges.

Beyond the Sinovensa joint venture, China is also exploring the possibility of exchanging existing debt-for-equity participation elsewhere in the oil sector. The refining industry, which was operating at less than 30 percent of its capacity due to lack of investment and maintenance, has been a key target. In 2017, local oil unions reported that Chinese and Russian officers conducted a two-month due diligence assessment of the large refinery complex in Paraguaná.⁷¹ In the service sector, China links its lending to the use of Chinese drilling equipment and to contracts for Chinese logistics firms, but may want to foster a longer-term presence. In the mining sector, the Venezuelan government outsourced the operational management of its most important state-owned producer of iron ore to a Chinese firm.

Complementing these commercial activities, China has also employed administrative measures to help mitigate its sovereign risk. For example, in August 2015, President Maduro made his first state visit to China. One of Maduro's most important objectives was to solicit further financing. While China was willing to renew tranche B of the China-Venezuela Joint Fund (FCCV), it also began to offer cooperation assistance to Venezuelan authorities. Following that official visit, a commission of Chinese economic experts was sent in 2016 to meet with the Minister of Planning and the Central Bank in Venezuela in order to discuss the current macro-economic imbalances in the country and exchange views on how to address these problems.⁷²

69 Stephen Kaplan interview with Francisco Monaldi, founding director of the Center for Energy and the Environment at IESA in Venezuela, December 12, 2018.

70 Ibid.

71 Ahiana Figueroa, "Chinos y rusos llevan dos meses metidos en refinerías venezolanas" [Chinese and Russians have spent two months in Venezuelan refineries], *El Estímulo*, June 11, 2017, <http://elestimulo.com/elinteres/chinos-y-rusos-llevan-dos-meses-metidos-en-refinerias-venezolanas/>.

72 "Maduro se reúne con delegación china para consolidar alianzas estratégicas" [Maduro meets with Chinese delegation to consolidate strategic relations], *Nicolás Maduro*, August 6, 2015, <http://www.nicolasmaduro.org.ve/presidente/maduro-se-reune-con-delegacion-china-para-consolidar-alianzas-estrategicas/#.XBP8kC2ZOu4>.

Chinese officials thus began to walk a delicate tightrope between adhering to their foreign policy framework of non-intervention and inching toward greater “collaboration in the formulation of policies,”⁷³ including advising the Venezuelan government on the need to reform the economy.⁷⁴

While the China-Venezuela relationship has primarily been characterized by economic cooperation assistance over the last few years, the Chinese have also deepened political cooperation.

Under the leadership of the Chinese telecommunications company ZTE, the Chinese helped the Maduro regime design a sophisticated electronic card for its citizens. In hopes of building political loyalty for the May 2018 elections, the government openly used the card to offer cash transfers and heavily-subsidized public services to the Venezuelan population in exchange for votes and refraining from protesting. Following the 2018 elections, China affirmed its state-to-state cooperation with Venezuela, with the Chinese Ambassador Li Baorong saying that China is willing to “deepen pragmatic cooperation, and push the comprehensive strategic partnership to a higher level.”⁷⁵

Despite such rosy state-to-state rhetoric, however, Chinese officials have also cautioned investors about Venezuelan risk. In the Chinese Ministry of Commerce’s recent report, entitled *Foreign Investment Directory—Venezuela*, Ji Xianzheng, the Chinese Economic and Business Counselor to Venezuela, issued the following warning for companies seeking out business in Venezuela,

“Venezuela has been regarded as a high-risk market. Apart from political instability and high social risks, Venezuela also has a tight control on foreign exchange... Additionally, strong unions, labor complications, and security threats all pose significant risks and costs for doing business in Venezuela. If Chinese companies wish to enter the Venezuelan market,

Moving forward, China is likely to sustain its current approach to Venezuelan risk, deepening state-to-state relations, while increasingly targeting its financial assistance toward boosting oil production, recovering oil collateral, and growing its long-term commercial presence in the Venezuelan energy sector.

73 Stephen Kaplan interview with Chinese policy bank officials, November 2017, Beijing, China. See also: Kaplan, *The Rise of Patient Capital*. A related working paper is available at SSRN: <https://ssrn.com/abstract=3108215>.

74 “Venezuela plantea programa de recuperación económica ante comisión nacional de desarrollo de China” [Venezuela presents economic recuperation plan before National Commission of Chinese Development], Ministerio del Poder Popular para la Comunicación e Información, Bolivarian Government of Venezuela, August 28, 2018, <http://vtv.mippci.gob.ve/venezuela-plantea-programa-de-recuperacion-economica-ante-comision-nacional-de-desarrollo-de-china/>.

75 “Zhu Weineiruila dashi Li Baorong baihui Wei fu zongtong Ai Sami” [Chinese Ambassador to Venezuela Li Baorong Meets with Vice President of Venezuela Aisammi, Embassy of the People’s Republic of China, Venezuela], May 30, 2018.



President of Venezuelan National Assembly Juan Guaidó talks to the people during a rally on January 23rd 2019. © Ruben Alfonso Shutterstock.com

they need to have a deep understanding of the Venezuelan political scene, macroeconomic trend, industry insights and the potential risks involved. Do not enter blindly.”⁷⁶

Moving forward, China is likely to sustain its current approach to Venezuelan risk, deepening state-to-state relations, while increasingly targeting its financial assistance toward boosting oil production, recovering oil collateral, and growing its long-term commercial presence in the Venezuelan energy sector.

Conclusion

On the eve of the global financial crisis, President Chávez and President Hu laid the foundations of the China-Venezuela state-to-state relationship when they crafted the China-Venezuela Joint Fund (FCCV). The timing was good for both governments. For Venezuela, President Chávez was able to court a creditor to help expand the Venezuelan state, particularly his development plan and social reforms under the banner of “Socialism of the XXI Century.” For China, Venezuela’s abundant natural resources and energy supplies could help China secure long-term access to these vital national assets.

The relationship worked even during hard times, given President Chávez’s willingness pragmatically to manage the economy when necessary. In contrast, Maduro was more ideological than Chávez, refusing to reform the Venezuelan economy when it buckled under the weight of the global commodity correction in 2014.

Maduro wanted an ideological partner in China, but China was first and foremost a commercial partner. While China’s foreign policy emphasized ‘non-intervention’ in sovereign affairs, it also placed the onus of economic decision on local governance choices. From China’s perspective, even if its policy banks have been willing financiers of Venezuela, the Bolivarian

⁷⁶ “Duiwai touzi hezuo guobie zhinan, Weineiruila” [Foreign Investment Directory-- Venezuela], *Chinese Ministry of Commerce*, 2017.

nation carries the burden of engineering its own economic crisis. For this reason, China has been steadily unwinding its financial ties over the last half-decade.

In U.S. policymaking circles in recent years, many practitioners have viewed China as more culpable, suggesting that China's foreign economic policy reflects the pernicious pattern of debt-trap diplomacy.⁷⁷ According to this perspective, China's financial sirens helped to shipwreck the Venezuelan economy. In other words, China, who emerged as a major Latin American financier for energy, mining, and infrastructure projects, used its financial might to entice Venezuela to accumulate large and costly loans. In exchange for these financial offerings, China increased its economic and political leverage by trapping the oil-rich nation in an unsustainable debt spiral.

However, in many ways, China was entangled in a creditor trap more than Venezuela was captured in a debt trap. China's tendency to bank unconditionally has a diplomatic appeal throughout Latin America, but left Chinese creditors exposed to moral hazard risk in the case of Venezuela.⁷⁸ Pursuing unconditional lending meant that China's policy banks had eventually to lend defensively to help overcome the errors of Chávez's and Maduro's governance deficit. They provided debt relief to a political regime that was gravely mismanaging the economy in hopes of eventual debt repayment.

Basically, China's lack of policy conditionality had meant a tacit acceptance of Venezuela's massive balance sheet expansion during China's decade-long presence from 2004 to 2014. Rather than imposing policy conditionality on debtor governments, China's public bankers attempted to secure their Venezuelan loans commercially with commodity guarantees. China's policy banks thus based their overseas lending to Venezuela on a non-Western interpretation of sovereign risk, which emphasized the expansion of credit in developing countries to create commercial opportunities.

However, as Venezuela experienced an unprecedented institutional and economic collapse, China became a reluctant, defensive lender.⁷⁹ China had paid a high cost for its creditor learning curve in Venezuela as the country fell into arrears on both its oil collateral and its financing of its transport infrastructure. To mitigate their high exposure during the Maduro years, China's policy banks thus steadily tempered new state-to-state lending. However, they also had to incur a series of costs to facilitate debt repayment, including providing temporary debt relief,

77 See, for example: Moisés Rendon and Sarah Baumunk, "When Investment Hurts: Chinese Influence in Venezuela," Center for Strategic and International Studies, April 3, 2018, <https://www.csis.org/analysis/when-investment-hurts-chinese-influence-venezuela>.

78 Kaplan, "Banking Unconditionally."

79 Kaplan, *The Rise of Patient Capital*.



restructuring the terms of the country's outstanding loans, reducing required oil shipments, and relaxing repayment deadlines. In response to these costs, policy banks have increasingly reoriented their hemispheric strategy toward equity rather than debt financing, and also encouraged its firms to progressively focalize their Venezuela investment in the energy sector.

In the meantime, China continues to deepen its diplomatic ties with Venezuelan actors across the political spectrum, with the aim of fostering its long-term commercial interests beyond the current crisis. For example, it has signaled its willingness to work with Venezuela's opposition on multiple occasions, prompting National Assembly leader, Juan Guaidó, to recently court China, saying that its "support will be very important in boosting our country's economy and future development."⁸⁰

Notwithstanding China's political hedge in Venezuela, has China's soft-power rhetoric paid dividends in the country, or has its reputation suffered from its creditor woes? China's political influence in Venezuela has suffered a marked deterioration. A mere third of the Venezuelan population deemed China "untrustworthy" in 2012, but more than half the population mistrusted China by 2016 (Figure 9). We expect China to further contain the political fallout by trading carefully in Venezuela, particularly during the current crisis. Recently, President Xi reiterated China's reluctance to pursue global hegemony, saying that China would not develop "at the expense of other countries' interests."⁸¹

Indeed, why would China intentionally invite debt problems in the developing world when the appeal of China's South-South cooperation is its development rhetoric? Why would Beijing allow for such a debt spiral in Venezuela, its flagship state-to-state lending case in Latin America, after investing billions in its soft power image?⁸² We think the answer is that it was unintentional—a product of China mispricing Venezuelan risk as a creditor.

Ultimately, China's creditor mishaps create an opportunity for the United States, which has seen its image improve in Venezuela over the last half-decade (see Figure 10). By contrast, China has not gotten much political leverage from its investments in Venezuela, which, at their peak, accounted for three-quarters of China's Latin American portfolio. To the extent that the U.S. government remains concerned about China's ability to gain hemispheric influence through its economic ties, it should strive to compete economically with China. The

80 Stuart Lau, "Self-declared leader of Venezuela Juan Guaidó extends olive branch to China," *South China Morning Post*, February 2, 2019, <https://www.scmp.com/news/china/diplomacy/article/2184773/exclusive-self-declared-leader-venezuela-juan-guaido-extends>.

81 "China 'Will Never Seek Hegemony' President Xi Jinping Says," *Time*, December 18, 2018, <https://www.youtube.com/watch?v=GZMafmCqsNI/>.

82 David Shambaugh, *China Goes Global: The Partial Power* (Oxford, UK: Oxford University Press, 2013).

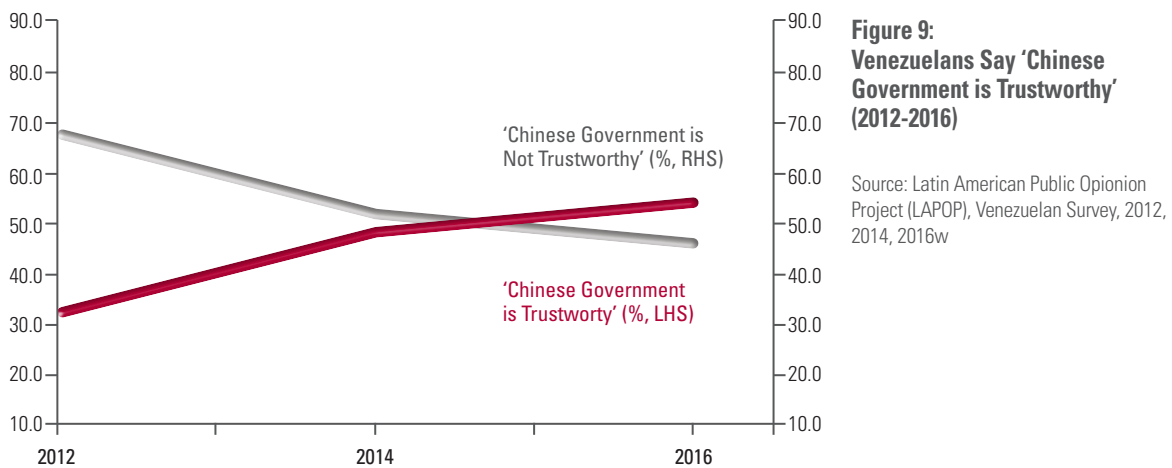


Figure 9:
Venezuelans Say 'Chinese Government is Trustworthy' (2012-2016)

Source: Latin American Public Opinion Project (LAPOP), Venezuelan Survey, 2012, 2014, 2016w

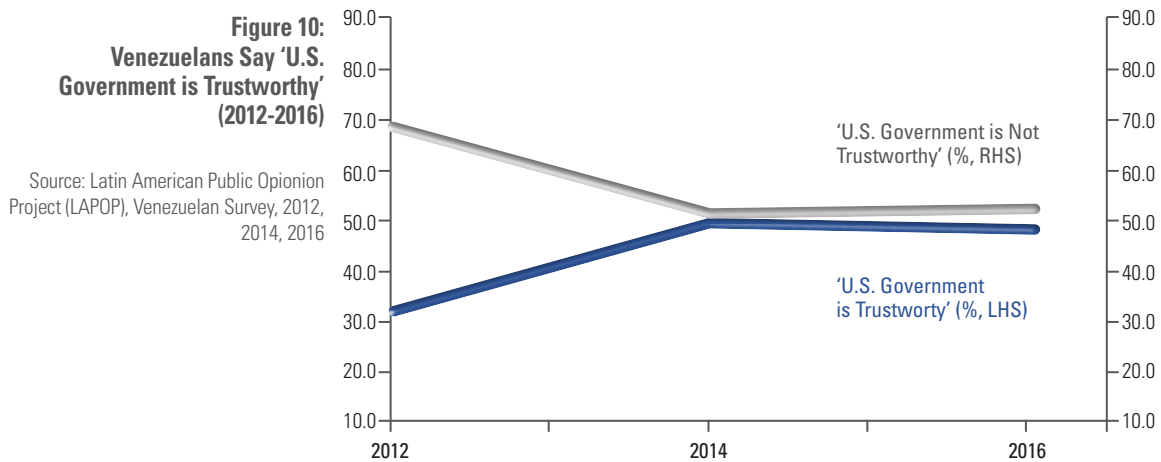


Figure 10:
Venezuelans Say 'U.S. Government is Trustworthy' (2012-2016)

Source: Latin American Public Opinion Project (LAPOP), Venezuelan Survey, 2012, 2014, 2016

state-to-state model is floundering in Venezuela, creating a window of opportunity for alternative development ideas. While Venezuela's political crisis limits near-term opportunities, the United States could bolster its regional capital by articulating a strategic vision for helping improve Latin American development. The BUILD Act, a bipartisan bill which created a new U.S. development agency this past summer,⁸³ is a step in the right direction. By leveraging private investment, the new development agency aims to support developing countries transition toward market economies, using loans, loan guarantees, equity capital, insurance, and technical assistance. The United States will gain little regional capital through its ongoing critiques of China's 'predatory economics' given that much of the region still views China as offering a development opportunity. However, presenting the region with a competing development vision could help restore U.S. economic and political leadership.

83 The Better Utilization of Investment Leading to Development (BUILD) Act created a US\$60 billion agency, known as the U.S. International Development Finance Corporation (USIDFC), which in part is designed to better compete with China internationally.

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