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China’s Unlikely Partnership with Venezuela

Why does China continue to invest heavily in unstable and cash-strapped Venezuela? The answer, according to Margaret Myers, lies in Beijing’s well-documented determination to enhance its energy security, particularly in the wake of so many financial and political troubles.

By Margaret Myers for ISN

Chinese President Xi Jinping’s recent visits to Brazil, Argentina, Venezuela, and Cuba resulted – as they tend to do – in a series of impressive bilateral agreements. Brazil signed finance deals for its railways and also agreed to sell sixty Embraer aircraft to China. In Argentina, where China maintains substantial energy-related interests, President Christina Fernandez de Kirchner secured a $4.7 billion loan for the construction of two hydroelectric dams and $2.1 billion for a railway to transport grains to the country’s ports. Cuba boasted 29 bilateral agreements, ranging from a credit line to modernize the port of Santiago de Cuba to the development of golf courses on the island.

Perhaps the most notable outcome of Xi’s bilateral visits, however, was his country’s continued commitment to Venezuela. Even amidst violent demonstrations, product shortages, and crushing inflation, China offered Venezuela $4 billion in oil-backed financing, adding to the $50 billion that Beijing has promised the South American nation since 2005. By means of a Joint Financing Fund and other financing arrangements, China's banks have issued more loans to Venezuela than any other country in the region. In 2013 alone, Caracas received over $10 billion in Chinese investment.

The Venezuelan President Nicolás Maduro and Xi also inked a series of smaller agreements for cooperation in a range of economic sectors. The leaders talked about establishing a special economic zone and, in a largely symbolic gesture, upgraded Venezuela’s bilateral status from “strategic partnership" to “comprehensive strategic partnership.”

Why Venezuela?

China’s perceived love affair with Venezuela has left many scratching their heads, especially as other firms plot their exit strategies. For instance, Russian firms Lukoil and Surgutneftegas sold their shares in Junín 6 oil field in 2013. Malaysia’s Petronas also pulled out of Carabobo-1 project last year. ExxonMobil and ConocoPhillips left Venezuela after being stripped of their leading role in joint ventures in the Orinoco region. They continue to seek compensation in arbitration proceedings.

Chinese investors are well aware of the risks of engagement in Venezuela. They have carefully observed nationalization efforts, protectionist policies, and tax regulations across Latin America. In this respect, the China National Petroleum Company (CNPC) released a report in 2012 on the

implications of a Venezuelan tax plan for the Chinese petroleum industry. It concluded that the tax burden for China's large-scale oil projects could be as high as eighty percent of total profit and pegged the policy as a deterrent to future investment.

China has also encountered its fair share of challenges in the South American nation. The Washington Post reported in 2012 that Chinese officials were increasingly frustrated with delays and a lack of preferential access in the Orinoco. Output has also been a problem. State-owned Petróleos de Venezuela S.A. (PdVSA) has consistently fallen short in the production of the 800,000 barrels per day (bpd) it promised to China. According to Bloomberg, output at the new Orinoco fields was supposed to reach 195,000 barrels a day by the end of last year. Instead, production is closer to a 6,000 barrel-a-day "trickle" that's costing PdVSA an estimated $19 million per day in lost revenue.

Calculating the Risks

There is broad support in China, therefore, for a more cautious approach to Venezuela and other "populist" countries across Latin America. Although it identifies considerable opportunity for partnership with Venezuela, a 2012 China Development Bank study on risk in Latin America also cautions against the South American country's excessive reliance on oil and tradition of military intervention. Some Chinese scholars even suggest that Beijing should become more selective in overseas projects by giving greater consideration to such factors as the climate for foreign direct investment (FDI) in the recipient country.

China is also looking to move from a system of state bank preferential financing for state-owned enterprises (SOEs) towards a more sophisticated policy scheme. This approach to investment is already evident elsewhere in the region. In Argentina and Brazil, for example, Chinese firms are more readily engaging in mergers and acquisitions (M&A) in order to take advantage of the networks and expertise that the acquired firms have to offer. In addition Chinese businesses are increasingly becoming members of investment consortia and continue to integrate into established resource supply chains. These approaches are less evident in Venezuela, however, where SOEs and state financing continue to dominate the landscape.

There are also indications of a progressive loss of confidence in Venezuela's leaders and their aptitude for fiscal reform. After perceived misuse of Chinese funds in the past few years, Beijing is keeping an increasingly close eye on Venezuelan spending. In 2011, it reportedly dispatched inspectors to Venezuelan ministries and national facilities to study the use of Chinese funds.

Why stay?

Why, then, does China continue to offer billions in financial support to Venezuela? The answer can be attributed in no small part to China's complex plans for energy security, which have involved a retrogressive, government-level focus on supply risk and diversification. The government's interest in diversifying supply was especially evident in the aftermath of the global financial crisis and in response to the political turmoil that has engulfed parts of the Middle East and North Africa since early 2011. Accordingly, China's oil diplomacy in Venezuela - as well as in other seemingly risky nations - is thought to be part of Beijing's efforts to reduce supply uncertainty.

To the extent that there is money to be made, China's state-owned firms have also been attracted to the prospect of quick deal-making in cash-strapped Venezuela. And from a lending perspective, there is a sense that Chinese banks have reduced risk by means of commodity-backed loans, dollar and Renminbi-based transactions, special account arrangements, and joint lending ventures (the Joint Financing Fund, for example).

It would seem, then, that despite obvious challenges, China's oil-based commitments to Venezuela will remain intact for the time being, including involvement in the development of the Junín 1, 4, 8, 10, and Boyacá 3 blocks of the Orinoco Belt. For Chinese investors (and some of their international counterparts – Chevron, for example), the potential benefit of continued operation in Venezuela still outweighs the risk. Moreover, China's foreign policy apparatus is looking to forge stronger and longer-term friendships throughout Latin America. Close relations with Venezuela are one part of this equation.

This is good news for Maduro. An end to Chinese financing could be very costly for his cash-strapped government, although funds distributed thus far have done little to strengthen the country's economy – Venezuela's debt burden has increased along with Chinese engagement. Even so, China's loans have helped to prop up Venezuela's current regime and appease certain sections of the population. A China-Venezuela cooperation project will soon produce 13,000 units of residential houses for low-income Venezuelans, for example.

Stability a Priority

Continued Chinese lending may very well be intended to prevent Venezuela's collapse in the short-term, albeit with the expectation of an eventual peaceful transition to a more reliable government. A worst-case scenario for China is extensive unrest in Venezuela, which would lead, presumably, to further delays in oil production and an even greater decline in economic stability. China is by no means devoted to *chavismo,* but instead to protecting its extensive investments in Venezuela's oil sector. Toward this end, Chinese officials were rumored to have met with opposition candidate Henrique Capriles before the 2012 presidential elections.

Chinese officials will also keep a closer eye on Maduro's accounting, a move consistent with its sharpening approach to investment throughout the region. The new agreement to establish a China Development Bank office in Caracas can easily be interpreted as an attempt to more closely monitor Venezuelan expenditures. Additional presence might also provide the China Development Bank, Venezuela's largest foreign lender, with a greater degree of influence in the event of a political transition.

Venezuela's prospects are undoubtedly a hot topic of discussion within China's foreign affairs apparatus, the country's SOEs, and among experts at state-affiliated think tanks. China nevertheless appears committed to its now "comprehensive strategic partnership" with Venezuela, even as some in Beijing advise caution, and even as patience with Maduro wanes. Whether Beijing's approach to Venezuela is indeed misguided remains to be seen. A foot in the door, in this case, may be worth two safely planted in Beijing.

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Margaret Myers is director of the **China and Latin America** program at the Inter-American Dialogue. She received a BA in Foreign Affairs from the University of Virginia and conducted her graduate work at The George Washington University, Zhejiang University of Technology, and the Johns Hopkins University/Nanjing University Center for Chinese-American Studies.

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