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CHINA'S FINANCING IN LATIN AMERICA AND THE CARIBBEAN

Edited by
Enrique Dussel Peters

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Enrique Dussel Peters	<i>Coordinador</i>
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Socorro García	<i>Diseño y formación de interiores</i>

D.R. ©2019, Universidad Nacional Autónoma de México,
Facultad de Economía
Ciudad Universitaria, 04510, México, D.F.

Primera edición: octubre 2019

ISBN: 978-607-8066-46-9

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Impreso y hecho en México/Printed and made in Mexico

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CHINESE FINANCING IN LATIN AMERICA AND THE CARIBBEAN (2000-2018)

THE CASE OF CENTRAL AMERICA AND PANAMA

*Luis Vargas Montoya, Marlen Rodríguez Morales
and Rafael Arias Ramírez*

Introduction

The present chapter seeks to analyze the diplomatic and economic relations between the People's Republic of China (PRC) and countries of Central America. Even though there is not a clear strategy, on behalf of this region, as to how to manage new relationships with China, the emergence of the Asian giant in international politics and international markets has compelled Central American countries to establish or consider establishing bilateral relations with this emerging power (Dussel Peters 2018).

The first country in the region to do so was Costa Rica in 2007, followed by Panama in 2017, and most recently El Salvador in 2018. Other Central American countries such as Guatemala, Honduras and Nicaragua have not yet established formal diplomatic relations, but they have influential private actors that have intensified pressure to begin relations with China (Dussel Peters 2018). The backdrop of geopolitical tensions and strategic competition between the United States and China has a lot to do with the differences among Central American countries regarding their relationship with China (IIS 2018).

In terms of trade, direct investment and financing policies, China has had an increasing interest in strengthening economic

relations with Latin America, not only because of the region's importance as a supplier of raw materials and primary goods, but also with the perspective of investing in and financing infrastructure projects and others in economic sectors in which the region has potential. In the case of Central America, Chinese interests have been associated to locational advantages that the region has to facilitate the logistics of Chinese trade and commerce in the Western Hemisphere, which are also connected to the possibilities for developing special economic zones and investing in projects to improve competitive positions in global chains (Urcuyo 2014). On the other hand, for Central American countries, China represents an immense market that offers opportunities for economic growth and to diversify trade partners, both in terms of exports and imports (INCAE 2014). This is particularly important for Central America, given the high dependence on the US market and vulnerability to US trade policies (Dussel Peters 2018).

China is particularly interested in Central America because of the region's locational advantages for the development of logistics for global trade. Investment in infrastructure has been the focus point for China's direct investments in Central America, specifically projects that could facilitate transportation through the Pacific Basin and the Panama Canal to reduce transactions costs and increase economies of scale. Likewise, financing projects related to the energy sector has been of interest for China; this is the case of the hydroelectric project Patuca III in Honduras (Urcuyo 2014). The following pages offer a more in-depth overview of these aspects of the political and economic relations between Central America and China.

The Relationship Between Central America and China

Diplomatic Relations

The rise of China as an economic power has been accompanied by a strong foreign policy that seeks to ensure Chinese interests worldwide. Establishing diplomatic and commercial relationships

with countries of strategic interest has been an important part of Chinese foreign policy. Countries with abundant natural resources and potential for vigorous development of the renewable energy sector have been important in sustaining China's economic growth (Arnson and Davidow 2011). Furthermore, Central America's geographic position has been of great interest given that it can facilitate trade routes and economic positioning for Chinese investments.

Aside from economic interests, a more historical and political goal has also been pursued by China in the region. The Chinese "one China principle" has also motivated the establishment of diplomatic relations with the region (Arnson and Davidow 2011). In this regard, ceasing diplomatic relations with Taiwan and establishing them with China has been an ongoing dilemma for Central American countries. Another factor that influences Central American countries in their management of Chinese presence in the region is the "sharpening rivalry between China and the US" (IIS 2018). Even though China could become an important alternative and market, the United States is still the most important economic partner and political actor in the region (Dussel Peters 2018).

It is commonplace to consider that China's economic expansion will also lead to a larger political role in the region. The possibility of Central America, and countries from the rest of Latin America, backing Chinese foreign policy has recently been a cause of concern for the United States government. This is specifically true with the Chinese Belt and Road Initiative which for now does not directly contemplate Latin America and the Caribbean as part of the plan, but the different investments in infrastructure in the region can raise questions as to how the initiative will evolve (IIS 2018).

Commercial Relations

In recent years, commercial relations between Central America and China have grown significantly, this has especially been the case for imports from China. Since 2012 China has become the third largest commercial partner for the region, only behind the United

States and the Central American Common Market, comprised of Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua (Dussel Peters 2018). In terms of Central American exports to China, these are a lot smaller in volume than the region's imports from China. The only country that has been able to penetrate the Chinese market in a significant manner has been Costa Rica, which has accounted for over 50% of Central American exports to China (INCAE 2014).

An important technological gap, reflected by the trade deficit, characterizes economic relations between Central America and China. Costa Rica has been an exception given foreign direct investments, such as Intel, with technological spillovers and linkages with other economic activities in the service sector. As for the rest of the Central American countries, technological exports of middle or high value account for less than 1% of the total exports from the region (Dussel Peters 2018).

Chinese Investments and Financing in the Region

Some have argued that China's main interest in the region has to do with investments given the geographic characteristics of Central America and the logistical advantages it offers in terms of trade (Urcuyo 2014). In this regard, Central American countries also see this as a great advantage to establishing diplomatic relations with China, given the interest the Asian giant has in investing in sectors such as energy, transportation, technology and manufacturing (PROESA 2018; El Capital 2018).

Costa Rica, being the first country in Central America to establish both diplomatic relations and a free trade agreement with China, sought to deepen Chinese investment in transportation, energy, infrastructure and telecommunication through a pact signed in 2018 (Revista Summa 2018). This pact seeks to increase Chinese investment in the country which has decreased considerably since 2014.

In Panama, investments have been estimated to reach \$2,585 million dollars in infrastructure related to ports and transportation (Ávila 2018). China has invested in a cruise ship terminal, a convention center and a new bridge for the Panamá Canal. Chinese companies such as Huawei have also made considerable investments in the Colón Free Zone. Investments are expected to continue given the geostrategic position of Panama and the Panama Canal, which has intensified the already existent rivalry between China and the United States, given the historical importance of the Panama Canal for the United States.

An important consequence of the diplomatic relations between Panama and China has been the increasing uncertainty related to the completion of a canal project in Nicaragua which has sought to rival the Panama Canal. This initiative was led by the HK Nicaragua Canal Development Investment and Chinese billionaire Wang Jing. Given an important loss of capital by the investment group, and Panama's introduction as a player in Central American relations with China, there is anxiety surrounding the funding and Chinese interest in the project (South China Morning Post 2018).

As for El Salvador, the third and most recent country to establish diplomatic relations with China, an unclear stance on behalf of the country's recently elected president Nayib Bukele, has produced doubts about the future of these relations (Diálogo Chino 2019). Possible investments have continued to be explored by both countries. For instance, during June of 2019 a group of Chinese investors visited El Salvador seeking investment opportunities with the institution in charge of promoting exports and foreign direct investments (Pastrán 2019). As for Guatemala, there has been little investment in comparison with the rest of the region, but there are also private efforts to attract Chinese investment to this country.

In Honduras, financing has been channeled into the energy sector; the Chinese company Sinohydro recently completed the Patuca III project which is the second largest hydroelectric dam in the country. The Patuca III was financed by a Chinese state-owned commercial bank, even though there were no formal diplomatic relations between these two countries.

This interest in the region seems to be articulated to the Chinese Belt and Road Initiative (BRI) which seeks to improve connectivity between Asia, Europe, Africa and the Middle East through financing projects and investments in infrastructure and the promotion of regional cooperation (Maliszewska and van der Mensbrugghe 2019). Even though Latin American countries, and specifically those in Central America, have not been formally contemplated in the BRI, it seems that investments and financing in the region seek to achieve goals that are consistent with the BRI strategy. In fact, China has been promoting the BRI with various countries, that have emitted statements and memorandums of understanding that support the initiative. This has made the scope of the initiative unclear as investments in the region seem to be articulated to this globalized strategy when Latin American countries have begun to formally and openly support the BRI¹ (IISS 2018).

Chinese Financing in Central America

One thing is clear, Chinese financing in Central America has been lower compared to that received by the rest of LAC; the latter have a greater number of transactions with Chinese financiers and over a longer period as empirical evidence and existing data show (Gallagher and Myers 2019). It has been documented that over the last decade China's financing has been concentrated in a small number of Latin American countries (Myers and Gallagher 2019).

We believe that one of the underlying reasons for the smaller presence of Chinese funding in Central America is that until 2007 none of these countries had diplomatic relations with China, which is a key factor for consolidating economic relations. Likewise, a historical diplomatic relationship with Taiwan has been a barrier for Central American countries to consolidate their relationship

1 Costa Rica and Panama have emitted memorandums of understanding in 2018 and 2017, respectively.

with China. Central America and the Caribbean have been the epicenter of the diplomatic competition between China and Taiwan, because this region concentrates almost all the countries that recognize Taiwan as an independent republic (Esteban 2018).

However, China's interest in the region has been growing derived from its shifting, yet complementary, intention to move from investing and financing in natural resources and raw materials to other sectors such as infrastructure, renewable energy, tourism and, in more general terms, special economic zones, for which Central America and Panama offer locational advantages (Myers and Gallagher 2019).

According to existing data, there are only two cases of Chinese financing in Central America. The first case is the hydroelectric project "Patuca III" in Honduras. The second is the rebuilding of a national road that connects the metropolitan area of Costa Rica with the main port on the Caribbean side of the country (Ruta 32).

With respect to the Patuca project, in September 2010 a Memorandum of Understanding (MOU) was signed between the Government of Honduras and the company Sinohydro, a Chinese government Engineering and Construction Company. In December 2010, Sinohydro presented the technical and economic proposal for the project, with an estimated investment of \$300 million dollars required to begin construction, which generated optimistic expectations. In May 2011, the President of Honduras, Porfirio Lobo Sosa, placed the first stone on the site of the camp as a sign to start the construction of the Hydroelectric Project.

The project took off with a total investment of \$350 million dollars, \$300 million of which was a loan from the Industrial and Commercial Bank of China (ICBC), a state-owned bank. The remaining \$50 million was provided by the government of Honduras. The term of the loan from ICBC was for 15 years with a grace period of five years and an interest rate of 4.5% (Dinero Hn 2018).

After delays for various reasons, in September 2015 construction was restarted and continued without problems (El Heraldo 2014). According to experts and reports, by the end of 2018 the project was 96% completed and its full operation expected during

the first semester of 2019 (Dinero Hn 2018; Frijins 2016). Despite several delays, as a result of difficulties to start operations, along with climatic and contractual factors, the authorities of the National Enterprise of Energy and Electricity (ENEE) assured the beginning of Patuca III's operations by the end of 2019 (Pastrán 2019). There is no certainty about the final cost of the project, because of the delays and overvaluation of costs and services. However, according to government reports, the project will conclude with an excess of \$181.5 million dollars over the budgeted amount, bringing the total cost to \$531.5 million (Construcción Pan-Americana 2019).

The other case of Chinese financing in the region was approved in 2015 in Costa Rica, as can be seen in the China-Latin America Finance Database (Gallagher and Myers 2019). A first phase of this funding started with the signing of a Framework Agreement, in which China offered to grant a Preferential Credit Line to Costa Rica. This agreement was established by the Costa Rican Ministry of Finance and the Export-Import Bank of China (China Ex-Im Bank). The China Ex-Im Bank is a development bank in charge of financing enterprises operating in the commercial sector (Hernández 2016). The Convention states that its objective is to strengthen friendly relations and economic and technical cooperation between the two nations. In this direction Dehart (2018:5) points out that "... a significant dimension of Costa Rica's economic motivation for partnering with China has been its desire to construct the infrastructure with which it can leverage its regional advantages into more global economic flows."

One aspect to note is that the agreement approved by both countries is preceded by the contract agreement CONAVI-CH-EC-001, signed in June 2013. The National Roads Council (CONAVI, by its acronym in Spanish) of the Government of Costa Rica and the Chinese wholly state-owned enterprise (SOE) China Harbor Engineering Company Limited (CHEC) agreed that the latter would extend Route 32 of the Costa Rican road system (CGR, 2019). This route connects the Great Metropolitan Area of the country with the Caribbean coast, where Puerto Moín is located.

This port is Costa Rica's main maritime customs. Between 2011 and 2018, on average 32% of Costa Rica's exports were traded through these maritime customs which at the same time represented 86% of Costa Rican exports by sea (Procomer 2019). At this point, it is evident that the financing provided by China to Costa Rica was implicitly conditioned on contracting the Chinese company CHEC to carry out the project. This is consistent with the Chinese political strategy, whereby credit is a key element in promoting the participation of Chinese companies in strategic sectors in the region (Hernández 2016).

Turning now to the details of the project, the cost of the works reached \$465 million dollars, of which approximately \$14 million was applied to the designing stage and the remaining \$451 million went to the renovation and construction works (CGR 2016). The maximum term of the credit line is 20 years at an interest rate of 3.5% per year (Law No. 9293). These results support the argument from some scholars that "Chinese banks are replacing the World Bank and Western Export Credit Agencies (WECAs) by offering lower-interest loans and generally better terms" (Gallagher, Irwing, and Kolesky 2012:4).

Once the contract was endorsed, CHEC considered they had the legal grounds to begin the environmental impact study required by Costa Rican laws, which was carried out by a company with Chinese capital. In December 2016, the project obtained the environmental viability approval and CHEC was authorized to begin work on it (CONAVI 2017).

The Route 32 rebuilding project is currently under way but is significantly behind schedule. Initially, its completion was programmed for December 2018 and according to the last work plan, approved by the parties, it has been projected to be finished by mid-2020, if additional delays do not occur.

It is our understanding that the problems faced by the Chinese company and its counterpart in Costa Rica, in order to implement this project, demonstrate the lack of knowledge regarding the differences between the Costa Rican decision-making process and the role of the State, compared to the situation in China. As Dussel

Peters (2015) points out, these differences produce difficulties for defining and implementing bilateral initiatives.

Conclusions and Policy Suggestions

Although just over a decade ago some Central American countries such as Costa Rica and Panama began their diplomatic relationship with China, the impacts on trade, investment and financing have not yet reached the expected levels. In the area of financing, initiatives have been presented in several countries; however only two projects have been developed, one in Honduras and the other one in Costa Rica.

The difficulties in implementing Chinese funded projects in Honduras and Costa Rica show that, even when there are favorable opinions regarding the opportunities offered by Chinese funding, there are domestic challenges that may curtail China's interest in supporting potential projects. As DeHart (2018) argues, for the case of Costa Rica, Chinese financing is an opportunity for the country to expand and leverage its strategic domestic assets and geographic advantage. We consider that this is also true for the rest of the region.

Honduras was the first Central American country that received Chinese financing, even without having official diplomatic relations with China. However, the Patuca III project has faced challenges, which are explained by the project's lack of planning, administration and traceability by the parties involved.

Patuca III has faced three main challenges: first, the lack of resources; second, the delays and costs that exceeded the original budget; and third, unfavorable public opinion and discontent. At the beginning there were problems with shortcomings in terms of the resources needed for the project to be implemented. Later, there were controversies related to delays in the building process and the associated increasing costs, which had negative impacts on public opinion (Construcción Pan-Americana 2019).

In the case of Costa Rica with the rebuilding of the Route 32 project, the only Chinese financing ongoing in the country has faced

significant difficulties and delays which may also be expected to arise in future projects if the terms of understanding between the parties does not improve. This finding is consistent with that of DeHart (2018:3-4) who states that "...since 2007 Chinese infrastructure collaborations with Costa Rica have been the source of as much controversy as celebration...despite the apparent win-win combination of China's well-endowed state-owned infrastructure resources and Costa Rica's strong need for infrastructure, China-Costa Rican infrastructure collaborations suggest many challenges for the road forward."

One of the reasons behind the long period for the execution of a contract is the complexity of the decision-making process in Costa Rica. On the other hand, CONAVI points out the difficulties in the relationship with the Chinese company involved, due to cultural differences reflected in the working dynamics. Among other aspects, it was noted that the Chinese company has not carried out adequate planning, administration and traceability of the project which, as a result, has not advanced according to the original schedule. Another argument by CONAVI refers to the language barrier, which has made it difficult for the parties to communicate adequately on technical and legal issues (K. Solano, personal interview, August 20, 2019).

In terms of the energy sector, Costa Rica is recognized worldwide for its decarbonized energy matrix, making important advances; however, this does not include the energy consumed by the transport sector, where significant investments are required. However, for Costa Rica to take advantage of Chinese financing, it must implement institutional arrangements to simplify paperwork and establish clear and efficient procedures, seeking standards closer to those sought by the Chinese counterpart, without losing autonomy in the decision-making process in strategic sectors.

Both cases reveal the complexities of financing public projects in the region, especially regarding the decision-making process, mediated by multiple institutions participating with their own norms, which is not easily understood by the Chinese counterpart. The delays suffered by the projects are another common characteristic

in these two countries, where such delays are associated with a lack of planning and excessive regulation by the governmental institutions in charge. There are also similar problems regarding the discontent of local communities with the development of projects that have impacts on their resources and daily lives.

Chinese financing is critical for countries in the region, especially for those that have limited access to international financial resources and face serious fiscal imbalances (Myers and Gallagher 2019). Another element is the opportunity represented by the presence of the China-led Asian Infrastructure Investment Bank (AIIB) and the BRI for Central America. The AIIB and the BRI have a large amount of resources for financing projects in developing countries. In the region, only Costa Rica and Panama are affiliated to the BRI, while El Salvador is still considering it. According to Ray and Wang (2019:15) “It is likely that AIIB and BRI affiliations will continue to spread throughout the LAC region in 2019 and beyond”; this could open many doors to Chinese funding for the development of strategic projects in the region.

Likewise, if Chinese companies intend to continue financing successful projects in Central America, they must make greater efforts towards understanding the particularities of the decision-making process in the region, which varies from country to country. Additional efforts must be made to meet the expectations of the countries in the region, regarding planning, administration and traceability of the projects to be developed.

As for Chinese financing expectations in Central America, there are two elements which suggest that there is potential for further growth. One is that most countries in the region exhibit lags in priority areas for Chinese financing and investment, such as infrastructure, telecommunications and energy, representing a potential win-win situation. The other is directly connected to geo-economics and the opportunities for Chinese presence in a region with strategic locational advantages in the global economy.

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ABOUT THE AUTHORS

Rafael Arias Ramírez studied economics at the National University of Costa Rica (UNA) and the University of Minnesota. He is an associate researcher and coordinator of research at the UNA's School of Economics (ESEUNA) and an associate researcher at the IICE-UCR. He has a PhD from the University of Minnesota.

Gustavo Bittencourt is a professor and researcher in the Department of Economics in the Faculty of Social Sciences at the University of the Republic in Uruguay. He is the author of numerous works on international economics and economic development, with an emphasis on FDI and development in Latin America and Latin American relations with China. He is the Alternate President of the South American Network of Applied Economics (Red Sur).

Gina Caballero is a social and economic development specialist with over 10 years of experience working in the area of cooperation between China and Latin America. She has been the liaison official in Beijing for CAF Development Bank of Latin America building partnerships and initiatives with Chinese counterparts. In Peru she also worked for the bank's Vice-Presidency of Finance, responsible for developing relations with China's Ministry of Finance and formulating joint activities such as a China-LAC cooperation

seminar on investment and trade, as well as technical visits. In that position she also managed relations and evaluated transactions with Chinese financial institutions. She has been the liaison official for ECLAC in the Chinese capital, formulating research initiatives, doing research and coordinating relations with entities such as China's Ministry of Foreign Affairs and the Chinese Academy of Social Sciences. She has also been a consultant for governments and private companies in Latin America and China.

Diana Castro Salgado is a PhD candidate in Latin American studies at the Universidad Andina Simón Bolívar (UASB-Ecuador). As a doctoral fellow, she collaborates in the “Research Program of Bureaucracies and Latin American States” (PRIBEL). She has been an undergraduate professor in the fields of international relations and international political economy. Her current research focuses on China's relations with Latin America and its impacts on state capacity and development institutions. Diana has published several articles addressing these issues and is the author of the book *The Dragon in Paradise: Sino-Ecuadorian Energy Cooperation* (2018).

Benjamin Creutzfeldt, PhD, is a scholar at the Woodrow Wilson Center in Washington DC, affiliated with the Kissinger Institute on China and the U.S. and the Latin American Program. Prior to this, he was Resident Postdoctoral Fellow for China-Latin America-U.S. Affairs at the SAIS Foreign Policy Institute, Johns Hopkins University. He is a sinologist by training, has extensive business experience managing start-ups in China, Panama and the U.S., and spent a decade in Colombia as a university lecturer in Chinese Studies. He is also a visiting professor at the *Universidad de La Sabana* in Bogotá, Colombia.

Shoujun Cui is the founder and director of the Center for Latin American Studies at Renmin University of China (RUC) and associate professor at the School of International Studies at RUC. Dr. Cui has been an International Visitor Leadership Program at the US Department of State and a visiting fellow of the European

Commission's Marie Curie International Research Staff Exchange project. He is coeditor of the book *China and Latin America in Transition: Policy Dynamics, Economic Commitments, and Social Impacts* (Palgrave Macmillan 2016) and of *Building Development for a New Era: China's Infrastructure Projects in Latin America and the Caribbean* (University of Pittsburgh 2018).

Simone Deos is an associate professor at the Institute of Economics, University of Campinas, Brazil; she currently directs the Graduate Program in Economics at the same institution. She has been researching and publishing extensively in the fields of monetary and financial economics, focusing on financial fragility, financial regulation, financing for development and public banks among other topics. Most recently she has been focusing on the Chinese financial system.

Enrique Dussel Peters is a professor at the Graduate School of Economics of the Universidad Nacional Autónoma de México (UNAM) since 1993. Research topics that interest him include economic development, political economy, industrial organization, trade theory, NAFTA and CAFTA, and the evolution of industrial, trade, and regional patterns in Latin America and Mexico. He has conducted research on specific segments of commodity chains such as pineapples, lemons, electronics, yarn, textiles, garments, auto parts and automobiles, and pharmaceuticals, among others. He served as coordinator of the Area of Political Economy in the Graduate School of Economics at the UNAM from 2004 to 2008, and he is currently the coordinator of the Center for Chinese-Mexican Studies at UNAM. He also serves as the coordinator of the Academic Network of Latin America and the Caribbean on China (Red ALC-China). dusselpeters.com

Kevin P. Gallagher is professor of global development policy at Boston University's Frederick S. Pardee School of Global Studies, where he directs the Global Development Policy Center. He is the author or co-author of six books, including *The China Triangle:*

Latin America's China Boom and the Fate of the Washington Consensus and *The Dragon in the Room: China and the Future of Latin American Industrialization* (with Roberto Porzecanski). He serves on the United Nations' Committee for Development Policy and co-chairs the T-20 Task Force on International Financial Architecture at the G-20.

Ruben Hernández Cordero studied economics at the Universidad Nacional Autónoma de México (UNAM) and has a Master's Degree in Chinese Studies from the Yenching Academy of Peking University. He has done research about the structure of the Chinese financial system, the omnipresence of the public sector in China's banking system and how the People's Bank of China, as the monetary authority in China, has played a central role in Chinese economic policy. He was part of the Corporate Credit Risk Analysis team in one of the top Mexican banks; he worked in one of the biggest Infrastructure Private Equity Funds in Mexico and currently he is the Head of Finance of Fintech projects in a Mexican bank.

Celio Hiratuka is an associate professor at the Institute of Economics at the State University of Campinas (UNICAMP); he is a researcher at the Brazil China Study Group and at the Center of Industrial and Technology Economics Group at UNICAMP. He is also a researcher of the South American Network of Applied Economics. Currently he is the coordinator of the Brazilian Network of Studies about China and head of graduate studies at the Institute of Economics at UNICAMP. His research interests include the Brazilian industrial structure, international trade and foreign direct investment, economic development and Brazil-China economic relations. Professor Hiratuka has published several book chapters on his research topics as well as various articles in peer reviewed journals.

Carlos Marcuello Recaj is an associate lecturer in economic history at the University of Barcelona, academic coordinator at FUNIBER

(Iberoamerican University Foundation) and General Secretary of the Chinese Education Foundation in Barcelona. He is currently a doctoral candidate and has a Master's degree in Economic History from the University of Barcelona; he also has a Master's in International Relations from the Catholic University of Ávila and a degree in Human Resources from the University of Murcia. As a researcher in economic relations between Iberoamerica and China he has organized conferences and lectured at various universities and institutions in several countries throughout America and Europe. In the past he also served as Government Councilor and advisor to the Mayor at the Ayerbe Town Hall in Spain.

Jevon Minto is a Young Scholar with the Inter-American Dialogue's China-Latin America Program and a member of the Academic Network of Latin America and the Caribbean on China (Red ALC-China). He is a recent graduate of the *Benemérita Universidad Autónoma de Puebla* with a Master's in Economic Development and International Cooperation. His final research explored China's contribution to economic development in Latin America and the Caribbean through regional and sub-regional development banks. He is also a member of the Young Initiative on Foreign Affairs and International Relations.

Juan Carlos Moreno-Brid holds a PhD from Cambridge University. Since 2015 he is a full professor in the Faculty of Economics-UNAM. From 2000 to 2014 he was Research Coordinator of the United Nations Economic Commission for Latin America and the Caribbean. His main fields of expertise are development and economic growth in Latin America. He is a founding member of the World Economic Association, the second largest association of economists, with more than 16,000 members worldwide. He is President of the Executive Board of the *Centro de Investigación Económica y Presupuestaria (CIEP)*. He is a member of the Technical Advisory Council of the *Centro de Estudios Económicos del Sector Privado*, and member of the editorial committees of numerous academic journals.

Esteban Pérez Caldentey holds a Master's (1989) and a PhD (1996) in Economics from the New School for Social Research (NY, USA) and is currently chief of the Financing for Development Unit at the Economic Commission for Latin America and the Caribbean (ECLAC) in Santiago, Chile. Previously he worked for ECLAC at the Mexico City and Caribbean regional headquarters. He is part of the editorial advisory board for the *International Journal of Political Economy* and *Investigación Económica* (Mexico); co-editor of the *Review of Keynesian Economics*; and co-editor of the *Palgrave Dictionary of Economics*. He is the author of the first intellectual biography of Sir Roy Harrod (forthcoming, 2019, Palgrave Macmillan).

Carlos Eduardo Piña is a specialist in the area of political science with experience in student conferences at the national and international level. In addition, recent studies have given him tools for analyzing the international oil market, specifically in the area of oil geopolitics. His research has recently focused on tracking and analysis of the main aspects of the Chinese-Venezuelan relationship. Currently he is a research collaborator for the Academic Network of Latin America and the Caribbean on China.

Rebecca Ray is post-doctoral fellow at Boston University's Global Development Policy (GDP) Center focusing on China in Latin America. She holds a PhD in Economics from the University of Massachusetts-Amherst and an MA in International Development from the Elliott School of International Affairs at the George Washington University in Washington, DC. She has coordinated the GDP Center's work on China and development finance in Latin America since 2013.

Marlen Rodríguez Morales is an economist from the National University of Costa Rica (UNA). She is a research assistant at the CINPE-UNA and a research assistant at the research division of the School of Economics, National University of Costa Rica (ESEUNA).

Cynthia A. Sanborn is a professor of political science at the *Universidad del Pacífico* and a senior researcher at the university's *Centro de Investigación (CIUP)*. She has written numerous articles and edited books related to politics and development in Latin America, and on Chinese investment in Latin America. She is currently a member of the Executive Session on the Politics of Extractive Industries at the Columbia Center on Sustainable Investment. Sanborn has a PhD and MA in Government from Harvard University.

Xiaoyu Song holds a Master's degree in Economics from National Autonomous University of Mexico and earned her bachelor's degree at Beijing Foreign Studies University. She received scholarships from the National Council for Science and Technology of Mexico and the Autonomous University of Madrid in Spain. As a visiting scholar at the Institute of Latin-American Studies of the Chinese Academy of Social Sciences, Xiaoyu has conducted research on "The determinants of the Chinese Outward Foreign Direct Investment and Chinese financing in Latin America and the Caribbean".

Leonardo E. Stanley is an associate researcher in the Economics Department at the Center for the Study of State and Society (CEDES). He is a member of various professional associations, among others: the Latin America Studies Association (LASA); the Academic Network of Latin America and the Caribbean on China (Red ALC-China) in Mexico; the Economic Observatory, Latin American - Asia Pacific Academic Forum - a joint initiative of ALADI, CAF and CEPAL. He is an editorial board member at Cambridge University Press - Element Series. He has published several book chapters and articles in academic journals. He is author of the book *Emerging Markets and Financial Globalization: Comparing the experiences of Argentina, Brazil, China, India and South Korea*, in the International Political Economy Collection published by Anthem Press (2018).

Luis Vargas Montoya has an undergraduate degree in economics from the University of Costa Rica (UCR). He is a researcher at the International Center of Economic Policy of the National University of Costa Rica (CINPE-UNA) and a researcher at the Institute of Research in Economic Sciences of the University of Costa Rica (IICE-UCR). He is a PhD candidate at the University of Zaragoza, Spain.

Adriana Zapata Rosso holds a Bachelor's degree in Linguistics and Languages from Universidad Mayor de San Andrés (UMSA) in La Paz. As a translator and researcher at the *Centro de Estudios para el Desarrollo Laboral y Agrario* (CEDLA), one of Bolivia's most important research-focused NGOs, she has gained experience in the extractive industries, namely in zinc, indium, gold and lithium mining. In 2018, she obtained a scholarship from CECHIMEX (Center for Chinese-Mexican Studies, School of Economic, UNAM), where she conducted research on China's FDI flows to Bolivia. Currently, she is studying Mandarin and focusing on the study of China's growing presence in Bolivia's extractive industries.

Zheng Zhang is a doctoral student in the Department of Diplomacy in the School of International Studies at Renmin University of China (RUC) and is an assistant researcher at the Centre for Latin American Studies at RUC.