BRICs versus the West
How Developing Countries Choose Their Creditors

DRAFT
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Abstract

The ways in which developing countries obtain credit have changed dramatically over the past 15 years. The influence of long-standing actors has declined, while powerful new actors have arisen. In particular, Brazil, Russia, India, and China — the so-called BRICs — have become important lenders to developing countries. One might think that every developing countries would be eager to obtain BRIC loans. After all, they do not come with strings attached, while Western loans require recipients to cut expenditures and lower inflation. Yet puzzlingly, not all developing countries want BRIC loans. In fact, there is a remarkable diversity in developing countries’ responses to loan offers. Countries such as Ecuador turned down recent loan offers by the IMF and borrowed from China. In contrast, Colombia explicitly rejected Chinese loan offers and instead borrowed from Western creditors. What explains countries’ decisions among competing loan offers? This book argues that distributional consequences of loans — i.e., who does or does not benefit from a particular loan — differ across creditors. Since loans can have powerful but unequal effects, domestic interest groups in recipient countries prefer certain creditors over others. The book shows that governments cater to whichever domestic interest group is politically dominant when deciding between competing loan offers by borrowing from the group’s preferred creditor. Understanding why certain loans are chosen is critical for gaining insights into the effects these loans might have on growth and democracy in the recipient countries.
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Chapter 1

How Do Developing Countries Decide Between Creditors?

The most important transformation in the international economy over the last two decades has been the rise of Brazil, Russia, India, and China. These countries — also called BRICs — experienced massive economic growth and play an increasingly critical role in the global economy. Besides being important trading partners, these countries have also become important lenders to developing countries. To clarify, Brazil, Russia, India, and China are not new lenders. This group of emerging economies has made government-to-government loans since the 1970s. Yet, prior to 2000, the lending volume by BRICs was almost comically small. For example, the loan commitment of China to the Maldives in 1995 totaled $1,560 — one thousand five hundred and sixty dollars. Similarly small loans were given by Russia ($1,100 to Zambia in 1987), India ($14,160 to Bangladesh in 1993) and Brazil ($12,100 to Bolivia in 1982).

However, since the year 2000, BRIC lending has changed significantly. BRICs have dramatically scaled up their global loan book over the past decade. This is particularly true for China, but the trend is the same across each of these four countries. Figure 1.1 illustrates that the lending volume of China, Brazil, India, and Russia has increased
The sudden willingness to provide large loans is captured by an anecdote told by a former Peruvian Vice-Minister of the Economy. Representatives of the Chinese Development Bank approached him to inquire whether there were any projects that they might help finance. The minister then gave the Chinese delegation a list of potential projects they might be interested in, the largest of which had a cost of $2 million. The response by a member of the Chinese delegation was telling: “Don’t you have anything larger?” (Interview 47, 2011).

Instead of lending tiny amounts, BRICs are literally lending billions of dollars. The largest loans given by BRICs since 2000 include a $9.8 billion Chinese loan to Angola, a
$10 billion Russian loan to Vietnam, a $2 billion Brazilian loan to Angola, and a $1.02 billion Indian loan to Bhutan. This trend is expected to continue, as reflected in newspaper headlines such as “China Development Bank Releases $95 Billion Lending Plan” (Reuters, 2015). Observers note that the “absence of political strings, competitive interest rates, and flexible repayment schedules compared with Western counterparts, make China’s loans highly attractive.” (Bloomberg, 2011).

Figure 1.2: Graph compares the share of total loan volume provided by a creditor in the years 2001 and 2011. The importance of BRIC loans increased dramatically while the traditional creditors lost market share.

The expansion of BRIC loans to developing countries has affected western creditors. Figure 1.2 illustrates this trend. There are four types of creditors from which countries can borrow: bilateral loans from western governments (DACs\(^1\)), bilateral loans from emerging

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\(^1\) Western governments that provide bilateral loans to developing countries are organized within the
creditors (BRICs), multilateral loans from International Financial Institutions (IFIs) like the World Bank and the International Monetary Fund, and loans from private creditors such as bondholders and commercial banks.

With the rise of BRIC lending to developing countries, western governments have lost market share. In 2001, western governments lent 13% of the total lending volume to developing countries that year, while international financial institutions such as the World Bank and the IMF provided 19%. Private creditors were the largest provider of loans to developing countries, accounting for 66% of the total lending volume. In contrast, BRIC lenders provided a mere 1% of the total lending volume in 2001.

A decade later, the situation had changed considerably. BRICs have drastically expanded their share in the loans market. In 2011, they provided 23% of the total lending volume to developing countries. Correspondingly, the traditional lenders’ shares in the market declined. The position of DACs is half what it was, and IFIs have lost about a quarter of their original share. Private creditors remain the largest provider of finance to developing countries, although their share shrunk from 66% to 55%.

The rise of BRICs and the simultaneous decline of traditional creditors have significant implications for developed and developing countries alike. It is important to understand the reasons why some developing countries obtain loans from BRICs, as the rise of BRIC lending has stirred up widespread concern. How will BRIC loans change the balance of power between developing and developed countries? What are their implications for economic development? How will BRIC loans affect the prospects for democracy in the developing world?

Commentators are agonizing over the potentially harmful effects BRIC lending might have on the power of western democracies in the world. BRIC lending to oil producing countries has caused anxiety in the United States about its energy security (The Financial Development Assistance Committee, hence the abbreviation DACs).
Times, 2011). Others worry that if debt is repaid in oil, repaying Wall Street bondholders with cash will no longer be a priority (Hausmann, 2015). U.S. companies have voiced concerns over increased competition in developing countries, as China often demands that borrowers award contracts to Chinese companies (The Economist, 2015b). As strategic competition between China and the United States increases, commentators worry that China may increase its soft power by offering massive new funding for infrastructure projects (Reuters, 2014a).

These examples suggest that the rise of BRIC loans causes a decline in western power over developing countries. Some analysts suggest that “[China’s] loans are empowering anti-American regimes in Latin America” (The Financial Times, 2011). It is therefore not surprising that the U.S. government has lobbied allies to steer clear of China’s loans. “The fear is that […] China will start to provide pariah states with a means to evade western financial sanctions, thus subverting the diplomatic order as well as the financial one” (The Economist, 2015a). In contrast, Russia’s president Vladimir Putin emphasized how BRIC loans can provide developing countries with the means to avoid the “harassment” of countries whose foreign policy clashes with that of the United States or Europe (The Economist, 2014). The emergence of BRICs as alternative creditors undermines the monopoly of western lenders. It does not mean that western democracies have less political influence. However, it does imply that developing countries have a choice. For this reason, they may be able to evade desires by external actors to shape domestic politics (Mosley, 2003). Understanding how developing countries decide which creditor to use illuminates how globalization actually increases the room for small states to maneuver in a globalized world.

Furthermore, understanding a government’s motivation for choosing a Chinese loan is important for predicting the effect this loan will have on the economic development of the recipient. The rise of BRIC lending creates the possibility for developing countries to adopt a new model of economic development. Currently, there are two dominant paradigms
regarding which development path countries should follow — the Washington Consensus or Industrialization by state intervention. On the one hand, the neoliberal Washington Consensus aims to utilize countries’ existing comparative advantages by liberalizing their markets. Clearly, the IMF’s structural adjustment conditions ask loan recipients to move in this direction. On the other hand, a new paradigm focuses on creating new comparative advantages using industrialization policies inspired by the success of the East Asian Tigers. BRIC loans that fund large-scale infrastructure projects assist in this effort.

It is not yet clear which development path will prove more effective. The World Bank and International Monetary Fund were criticized for attaching too many conditions to loans, which might have harmed development in some recipient countries. In contrast, the no-strings-attached approach of BRICs may create its own problems. As an Economist article recently observed, “China, by contrast, is undemanding, worryingly so. Chinese loans to Venezuela have bought that country’s leaders time to wreck the economy” (The Economist, 2015a). As a result, analysts comment “Who gave the country [Venezuela] the rope with which to hang itself? Mostly China” (Hausmann, 2015). By explaining how governments choose their creditors, the book provides insights into which development path a country follows, and ultimately, its prospects for lifting millions out of poverty.

In addition to economic development, BRIC loans — Chinese loans in particular — might affect the prospects for democracy in developing countries. Critics have argued that Chinese loans undermine democracy in recipient countries as they lack ‘good governance’ conditions. However, alternative scenarios are possible. For example, as I will argue in later chapters, IMF loans benefit the capital owners who are already rich. In contrast, workers — the numerically largest actor in developing countries — benefit economically from BRIC loans. Therefore, emerging creditors might contribute to a reduction in inequality in developing countries that are typically characterized by high inequality. Following the research by Boix (2003) and Acemoglu and Robinson (2006), reduced inequality should make democracy more likely. Therefore, surprisingly, Chinese loans might have an indirect
pro-democratic effect. Understanding the reasons for governments to choose Chinese loans over IMF loans is therefore crucial for predicting the likely effects these loans have on democracy.

1.1 The Facts: New Choices for Developing Countries

While there is — and continues to be — disagreement whether the rise of BRICs is ‘good’ or ‘bad,’ one fact remains: The emergence of new creditors expands the choices available to developing countries when they want to borrow money. As a result, the monopoly position of traditional creditors is undermined when governments turn away from established lenders. One might think that every developing country would be eager to obtain BRIC loans. After all, they do not come with strings attached, while western loans require recipients to cut expenditures and lower inflation.

Puzzlingly, not all developing countries want BRIC loans. In fact, there is a remarkable diversity in developing countries’ responses to loan offers. Countries such as Ecuador turned down recent loan offers by traditional lenders and borrowed from China. In contrast, Colombia explicitly rejected Chinese loan offers and instead borrowed from western creditors. The following section illustrates how differently countries respond to the expanded set of creditors.

Ecuador  On October 15, 2006, none of the candidates in the first round of the Ecuadorian presidential elections obtained an absolute majority. In the second round on November 26th, voters were asked to decide between Álvaro Noboa of the right-wing party Partido Renovador Institucional de Acción Nacional, and Rafael Correa running for the social movement Alianza PAIS. Correa won the presidential election with 57% of the vote. After his election — on December 15, 2006, a full month before being sworn into office — Correa announced that his administration would re-negotiate Ecuador’s external debt, stating that “La vida antes que la Deuda” — life should take priority over debt. Correa’s words
were followed by action as Ecuador paid off all loans from the International Monetary Fund (IMF) at once and in full on April 20, 2007, thereby fulfilling one of his campaign promises.

A month later, in July 2007, Correa issued a decree instituting the ‘Comisión para la Auditoría Integral del Credito Público’ [Commission to Audit the Entirety of Public Debt], abbreviated as CAIC. Its task was to examine the legitimacy of different types of debt (multilateral, bilateral, private and domestic debt) that Ecuador had accumulated over the years and determine whether these debts should be repaid. While these investigations were ongoing, interest payments came due on November 14, 2008 for the remaining government bonds held by private creditors. Correa declared that he would not pay the interest payments on these bonds until CAIC’s findings were obtained. CAIC’s final report was presented on November 20, 2008 in Quito, in front of a large crowd of Ecuadorians along with a televised ceremony. The commission recommended suspending the debt repayment on many of the remaining bonds. Following the recommendation of the commission, the government suspended payments on the principal of the Global12-Bonds as well as the Global15- and Global30-Bonds, making Ecuador’s default official.

On April 24, 2009, after it was clear that Ecuador had no intention of repaying this debt, creditors were willing to accept the conditions of a debt swap. The Global Bonds were exchanged for new bonds worth only 30% of the original face value. Two days after this announcement, Ecuadorians were again called to the ballots to vote in the first round of a presidential election. However, this time the result was unexpected, as for the first time since 1979, a second round of voting was unnecessary. Correa had gained an absolute majority with 51.9% of all votes in the first round.

Notably, Ecuador’s behavior towards traditional western creditors differed markedly from its behavior towards the emerging creditors, particularly the BRICs. While Correa effectively stopped servicing existing debt from traditional western creditors, he continued to pay interest and principal on debt owed to BRICs. For instance, in January 2007, the installments due on loans to Brazil for the San Francisco hydropower project were paid
on time. During this time, when Ecuador needed to take out new loans, credit offers by traditional creditors were explicitly rejected. Instead, the government obtained several loans from China, Brazil and Russia. For example, Ecuador announced on February 20, 2009 that it would borrow $1.7 billion from China. This was only the first of several major loans from China, which through 2013, totaled $7.64 billion in loans. In contrast, Ecuador obtained only $182.21 million from all 23 western governments combined. The key insight is that Ecuador’s turn towards BRIC creditors occurred simultaneously with its decision to not use western creditors anymore.

**Colombia** While Ecuador turned away from traditional western creditors and towards BRIC loans, neighboring Colombia did the opposite, even though China made several loan offers to Colombia. Interviews with Colombian public officials revealed that loan proposals by the China Export-Import Bank were received on several occasions, but each time they were rejected by the government (Interview 18, 2011). I triangulated this information obtained from Colombian sources through interviews with representatives of the Chinese government. The economic advisor to the Chinese ambassador confirmed loan offers were made, but also that the Colombian government was hesitant to accept these offers (Interview 25, 2011). In addition, China offered to finance several public works projects. In 2005, the Colombian government wanted to build an alternative to the Panama Canal, the Canal Seco [Dry Canal]. The government inquired whether foreign creditors — the Chinese among them — would be interested in financing this project. The Chinese were initially thought of highly, but they were not selected for the project (Interview 11, 2011; Interview 1, 2011). Furthermore, Colombian officials confirmed that the Chinese offered a loan to the state-owned enterprise ColPetrol. Yet again, this loan offer was rejected (Interview 38, 2011). Finally, Colombia rejected a Chinese loan offer for financing a hydropower project, the Acueducto Metropolitano de Bucaramanga. Instead, it favored borrowing from a regional multilateral organization, the Andean Development Cooperation (CAF). Even though these negotiations fell through, Columbia still did not use Chinese money,
Table 1.1: Table displays which creditor provided the largest loan, conditional on the number of loans a country obtained in a particular year. The data shows that significant variation exists as different countries rely on different creditors.

<table>
<thead>
<tr>
<th>Creditor with largest loan</th>
<th>1 creditor percent</th>
<th>1 creditor cases</th>
<th>2 creditors percent</th>
<th>2 creditors cases</th>
<th>3 creditors percent</th>
<th>3 creditors cases</th>
<th>4 creditors percent</th>
<th>4 creditors cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>BRIC</td>
<td>9.86%</td>
<td>34</td>
<td>14.41%</td>
<td>49</td>
<td>15.48%</td>
<td>39</td>
<td>16.30%</td>
<td>16</td>
</tr>
<tr>
<td>DAC</td>
<td>23.19%</td>
<td>80</td>
<td>16.47%</td>
<td>56</td>
<td>15.87%</td>
<td>40</td>
<td>24.50%</td>
<td>24</td>
</tr>
<tr>
<td>IFI</td>
<td>46.96%</td>
<td>162</td>
<td>41.76%</td>
<td>142</td>
<td>29.76%</td>
<td>75</td>
<td>23.50%</td>
<td>23</td>
</tr>
<tr>
<td>Private</td>
<td>20.00%</td>
<td>69</td>
<td>27.35%</td>
<td>93</td>
<td>38.89%</td>
<td>98</td>
<td>35.70%</td>
<td>35</td>
</tr>
<tr>
<td></td>
<td>100.00%</td>
<td>345</td>
<td>100.00%</td>
<td>340</td>
<td>100.00%</td>
<td>252</td>
<td>100.00%</td>
<td>98</td>
</tr>
</tbody>
</table>

but rather borrowed from a private market actor, Bancolombia.

Colombia received Chinese loan proposals simultaneously with western loan offers. Yet, instead of borrowing from the Chinese, Colombia continued to borrow from traditional creditors. Since 2009, the Colombian government borrowed a total of $4.30 billion from western bilateral creditors, but not a single dollar from BRICs. The Colombian government’s decision to use western creditors was *simultaneously* a decision against BRIC lenders.

1.2 The Puzzle: Significant Variation of Borrowing Patterns

The accounts of Ecuador and Colombia exemplify the variation in borrowing decisions across countries. For example, significant variation exists regarding the source of a country’s largest loan in a particular year. Table 1.1 displays the data for the period between 2004 and 2013 for 156 countries. The first column summarizes lending by countries that only received a single loan in a particular year. At this point, it is unclear whether these countries chose to obtain only one loan or if they did not have access to additional creditors. However, even if we assume that these countries had access to only one creditor, we see substantial variation in which types of creditors offered loans.

However, the more interesting scenario concerns countries that without doubt had access to multiple creditors. For this reason, I restrict the sample to countries that obtained
Table 1.2: Table displays which creditor provided the largest loan, conditional on the type of recipient country. Different ‘tiers’ of countries exhibit significant variation with respect to their largest creditor. This suggests that countries have access to different types of creditors, irrespective of economic or political circumstances.

<table>
<thead>
<tr>
<th>Income classification</th>
<th>cases</th>
<th>Largest creditor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low income</td>
<td>343</td>
<td>BRIC 12% DAC 26% IFI 57% Private 5%</td>
</tr>
<tr>
<td>Lower middle income</td>
<td>388</td>
<td>BRIC 16% DAC 21% IFI 31% Private 31%</td>
</tr>
<tr>
<td>Upper middle income</td>
<td>268</td>
<td>BRIC 10% DAC 10% IFI 26% Private 53%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sovereign debt rating</th>
<th>cases</th>
<th>BRIC</th>
<th>DAC</th>
<th>IFI</th>
<th>Private</th>
</tr>
</thead>
<tbody>
<tr>
<td>BBB range</td>
<td>100</td>
<td>12%</td>
<td>3%</td>
<td>31%</td>
<td>54%</td>
</tr>
<tr>
<td>BB range</td>
<td>208</td>
<td>15%</td>
<td>6%</td>
<td>32%</td>
<td>47%</td>
</tr>
<tr>
<td>B range</td>
<td>280</td>
<td>12%</td>
<td>19%</td>
<td>44%</td>
<td>25%</td>
</tr>
<tr>
<td>CCC range</td>
<td>29</td>
<td>17%</td>
<td>17%</td>
<td>38%</td>
<td>28%</td>
</tr>
<tr>
<td>no rating</td>
<td>380</td>
<td>14%</td>
<td>33%</td>
<td>41%</td>
<td>13%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Region</th>
<th>cases</th>
<th>BRIC</th>
<th>DAC</th>
<th>IFI</th>
<th>Private</th>
</tr>
</thead>
<tbody>
<tr>
<td>East Asia &amp; Pacific</td>
<td>104</td>
<td>16%</td>
<td>24%</td>
<td>18%</td>
<td>41%</td>
</tr>
<tr>
<td>Europe &amp; Central Asia</td>
<td>201</td>
<td>13%</td>
<td>12%</td>
<td>43%</td>
<td>32%</td>
</tr>
<tr>
<td>Latin America &amp; Caribbean</td>
<td>223</td>
<td>10%</td>
<td>14%</td>
<td>35%</td>
<td>40%</td>
</tr>
<tr>
<td>Middle East &amp; North Africa</td>
<td>86</td>
<td>23%</td>
<td>14%</td>
<td>23%</td>
<td>40%</td>
</tr>
<tr>
<td>South Asia</td>
<td>60</td>
<td>25%</td>
<td>22%</td>
<td>38%</td>
<td>15%</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>361</td>
<td>10%</td>
<td>26%</td>
<td>48%</td>
<td>15%</td>
</tr>
</tbody>
</table>

loans from two, three, or all four types of creditors in a particular year. These countries must have had access to multiple creditors. If so, they decided to obtain their largest loan from one particular creditor. Interestingly, significant variation continues to exist regarding which creditor provided the largest loan. Irrespective of the number of loans obtained, BRICs provided the largest loan in about 15% of cases. DAC provided the largest loan in about 19% of country years, followed by IFIs and private creditors in about 32% of the time.

Furthermore, countries at the same level of development also have vastly different borrowing profiles. Table 1.2 shows which creditor provided the largest loan in a particular country-year. However, this time the data is split by the characteristics of the recipient
country. First, I divide the sample into low-, lower-middle, and upper-middle income countries according to the World Bank income classification scheme. One might have expected that only the poorest developing countries choose to obtain their largest loan from BRICs while richer economies would rely less on these emerging creditors. However, this is not the case: Between 10% and 16% of countries chose to obtain their largest loan from BRICs in a particular year — irrespective of their income classification.

I also split the sample by the sovereign debt rating that countries received from rating agencies such as Standard and Poor or Moody’s. Conventional wisdom would suggest that countries with low credit ratings — such as the CCC range, which includes CCC-, CCC, and CCC+ — would be unable to borrow from traditional creditors and therefore be ‘forced’ to turn to BRICs. Yet, the data reveals that between 12% and 17% of countries obtained their largest loan from BRICs — irrespective of their sovereign credit rating. Lastly, I divide the sample by region to analyze whether BRIC loans are given primarily to particularly poor or geographically close areas while ignoring richer and more distant regions. Yet, the data reveals that BRIC loans are similarly common across regions.

The data presented in Table 1.2 shows that different ‘tiers’ of countries exhibit vast variation with respect to which creditor they primarily use. Splitting the sample by income classification, sovereign debt rating, and region controls for differential access to private capital as well as different needs for infrastructure investments. It is remarkable that the substantial variation in the choice of creditors exists even after splitting the sample along these dimensions.

A different way of looking at the data is to examine whether a particular creditor dominates a country’s borrowing. After all, a creditor might be the ‘largest’ only because its loan is a small amount larger than that of a competitor. Table 1.3 displays data on those recipient countries that received more than 50% of incoming loans from one of these four types of creditors. Clearly in these cases, a particular creditor is dominating the borrowing portfolio of a country.
Table 1.3: Table displays how often a creditor type dominates a country’s borrowing portfolio in a particular year. A dominating creditor exists when a single lender provides more than 50% of incoming loan volume. The data shows that borrowing portfolios are typically dominated by a single creditor and that only few countries have balanced portfolios.

However, even from this point of view, the data exhibits significant variation in borrowing patterns. In 18% of the cases, governments obtained more than half of the newly obtained loan volume in a particular year from BRICs. In contrast, western governments were the dominating creditor only in 11% of cases. IFIs and private creditors play a significant role, as they provide more than half of new borrowing volume in 37% and 27% of the observations in the sample, respectively. In 7% of the cases, governments borrowed from multiple creditors in such a way that they did not obtain more than 50% of funds from a single source.

1.3 The Implication: The Decision for One Creditor is a Decision Against Another

The wide variation of creditors used is remarkable, considering that the sample only includes poor developing countries. In particular, the rise of BRIC lenders from virtually nonexistent actors to the most important creditor in almost a fifth of all developing countries over the course of ten years is extraordinary. However, a number of other developing countries still rely on traditional creditors as their main source of loans. This variation is the outcome of interest that needs an explanation.
Why does this variation exist? At first sight, it is surprising that almost all developing countries have a dominating creditor. Table 1.3 shows that only 7% countries had a balanced loan portfolio where no creditor supplied more than 50% of the total loan volume obtained that year. Why are the large majority of borrowing portfolios characterized by one big loan from one creditor only occasionally supplemented by small loans from other creditor types?

Most governments of developing countries face constitutionally mandated limits on the amount of debt that a country can obtain. For example, article 290 of Ecuador’s constitution requires that the overall debt stock not exceed a specific threshold. The total external debt stock may not exceed 40% of Ecuador’s gross domestic product (GDP). This limit is rigorously enforced as the constitution also created a supervisory body, the Debt and Finance Committee [Comité de Deuda y Financiamiento]. This commission has to authorize any new loan that both federal and state governments intend to obtain, with the explicit objective of ensuring that the new loan does not cause Ecuador’s debt to exceed the limit of 40% of GDP. In interviews with public debt officials in the Ecuadorian Ministry of Finance, it became clear that government representatives are acutely aware of this limit. For example, in response to the question whether Ecuador can afford new loans, one official responded without hesitation that “Our external debt is currently at 29% of GDP, as we have a debt stock of $17 billion and a GDP of about $60 billion” (Interview 84, 2011).

Similarly, Colombia has a self-imposed limit of debt which is enforced in two ways. First, Congress must approve the overall amount of debt that the country is allowed to hire in a particular year. This is part of the process by which Congress approves the annual budget (Interview 32, 2011). In addition, each individual loan is subject to the scrutiny of the supervisory body, the Inter-Parliamentary Public Debt Commission [Comisión Interparlamentaria de Crédito Público (CICP)]. This commission must authorize each loan the government wants to obtain. Furthermore, one of the mandatory criteria requires the
analysis of whether this new loan will increase Colombia’s overall debt stock to an ‘unsustainable level’ (Interview 32, 2011). While the constitution does not clearly define what constitutes an unsustainable level, the process does suggest that the Colombian government faces an overall debt limit.

Governments understand that they cannot borrow an unlimited amount. Because of this debt ceiling, interdependency exists when choosing amongst creditors: A government’s choice for one creditor — say, a BRIC loan — is simultaneously a decision against another creditor — such as a western loan. This interdependency introduced by the limits on the amount that can be borrowed implies that a country cannot get several large loans from multiple creditors. While countries may obtain loans from all four types of creditors, they typically rely on a single creditor to provide the bulk of new loans. Due to this borrowing constraint, a government’s choice for one creditor is simultaneously a choice against other creditors.

This insight is significant. Analyzing a government’s decision for or against a single creditor in isolation would be methodologically flawed, as it would misrepresent a crucial characteristic of the situation in which the government makes its decision. It would ignore the interdependency that exists between the creditors. Instead of focusing only on the determinants of the choice for or against a single creditor, it is necessary to analyze the choice amongst competing creditors.

The experience of a former U.S. Department of State advisor illustrates this insight. “Cambodia was considering a $600 million loan from the World Bank that had conditions about transparency, anti-corruption, and accountability. The Cambodians basically told the World Bank to go to hell and the next day they received a $601 million loan from the Chinese with no conditions” (BBC News, 2011). If we were to analyze Cambodia’s decision against the World Bank loan without taking into consideration the alternative loan offers its government received from the Chinese, we would likely misjudge why Cambodia decided against the loan from the World Bank. Cambodia’s decision cannot be understood
without reference to the full set of options that Cambodia had at the time it made the decision. This interdependence must be taken seriously. For this reason, my book analyzes governments’ decisions amongst competing loan offers simultaneously instead of examining the determinants of a government’s decision for or against a single creditor. How do developing countries decide between competing loan offers from different types of creditors? It is worth emphasizing that this is a novel question that has not yet been asked nor answered.

1.4 The Argument: Distributional Consequences and Societal Coalitions

I argue that a government’s choice among competing creditors can be explained with reference to distributional consequences of loans and social coalitions in the recipient country. The term ‘distributional consequences’ refers to the way in which economic decisions create winners and losers. With respect to loans, the IMF and China might offer a government exactly the same amount of money — but with different strings attached. Because of the differences in conditions, one societal group would benefit from the IMF loan but not from the Chinese loan, while the opposite would be the case for another group. For example, the domestic financial sector in the recipient country has an interest in a stable banking sector and low inflation. IMF loans typically come with conditions that require the recipient government to balance the budget, liberalize the economy, and avoid inflation. In contrast, Chinese loans are often attached to particular investment projects. This implies increased competition for the domestic financial sector, as an external actor now finances investment projects that it previously funded. The differences in conditions attached to these loans imply that the IMF loan would have positive distributional consequences for Finance, while the distributional consequences of the Chinese loan for Finance would be negative. Even though the IMF and the Chinese offer the exact same amount of money,
Finance prefers the IMF loan to the Chinese loan.

In contrast, domestic workers might prefer the Chinese loan to the IMF loan. As mentioned above, the conditions attached to IMF loans require the recipient government to balance its budget; in many cases this is accomplished by cutting social expenditure. Similarly, the requirement to liberalize the economy does not always have positive consequences for workers. For these reasons, the distributional consequences of an IMF loan for labor are negative. The opposite might be the case with loans from China. If Chinese loans are associated with additional investment projects that would not materialize otherwise, these loans might provide employment opportunities for workers that were previously unavailable. For these reasons, Labor would prefer a loan from China to an IMF loan.

While the examples above only refer to two specific creditors — the IMF and the Chinese government — my explanation is based on the conflicting preferences between economic groups over the following four types of creditors: a) western governments, b) multilateral institutions such as the IMF or World Bank, c) private foreign banks or the bond market, or d) the BRICs consisting of Brazil, Russia, India, and China.\(^2\) I begin building my theory by analyzing the kind of conditions that are attached to loans from each of these creditor types. Because the conditions attached to each type of loan differ, each tends to create a different set of relative winners and losers.

In a second step, I examine the characteristics of three domestic interest groups: the domestic financial sector, the domestic industrial sector, and Labor. Each of these groups uses different types of resources to make a living: mobile assets, fixed assets and wages, respectively. Each group has distinct interests because their livelihood depends on different types of assets. Finance would want a stable banking sector and low inflation to preserve the value of its assets. Industry is interested in a market for their goods and continued investment. Labor requires employment opportunities and reasonable wages since they do

\(^2\) I group Brazil, Russia, India, and China together. Clearly, China is the largest of these new creditors. However, their lending conditions are exceptionally similar since they require the money lend to be used for specific investment projects. The distributional consequences of their loans for the social groups in recipient countries — who are the central actors in my theory — are therefore very much alike.
I then combine the information on what interest groups want with the distributional consequences of creditors to derive which type of loan is preferred by what societal group. As illustrated by the example above, it is likely that Finance would be in favor of IMF loans, seeing that conditions attached to these loans are designed to prevent banking crises and ensure an efficient market system. In contrast to Finance, Labor is interested in higher wages and employment opportunities. IMF loans are unlikely to serve these interests. In contrast, BRIC loans are typically tied to specific investment projects that result in employment opportunities. By comparing the interests of the three actors to the characteristics of the four borrowing options, the distributional consequences allow me to derive a preference profile for each actor across the different types of creditors.

Do these preferences determine which loan the government will obtain? I show that it is possible to predict which of the competing loan proposals a government will choose by analyzing which social coalition is politically powerful in a country. If politicians want to get re-elected, they have every incentive to cater to the interests of powerful social groups. In fact, if their borrowing decision can satisfy two (instead of just one) interest groups, even better. In this case, the government will want to borrow from the type of creditor that two interest groups jointly prefer, that is, the creditor with the most favorable distributional consequences for the politically powerful coalition. In short, by analyzing which coalition dominates politically, I can explain why some governments turn to BRICs and others turn to the IMF or private foreign creditors.

I show that there are three distinct types of social coalitions that politicians respond to when deciding between competing loan offers. If Labor and Industry are dominating the political landscape and Finance is comparatively weak, the government will tend to borrow from BRIC creditors, as this is the jointly preferred creditor of these two interest groups. If, however, Finance and Industry are dominant, their joint preferences provide the government with the incentive to borrow from multilateral institutions and private
creditors. Lastly, in the case where Finance and Labor are strong and Industry is an unimportant actor, then the government will tend to obtain bilateral loans from western governments. In sum, the differences in the distributional consequences across societal coalitions combined with information on the political strength of these coalitions allow me to predict the government’s choice amongst competing loan offers.

This book tackles a question that has not been asked before: How do developing countries decide between competing loan offers? This explicit comparison between different types of creditors is novel. For this reason, my argument expands existing scholarship on sovereign debt in several ways. First, existing approaches to sovereign debt focus on countries’ decisions to borrow from a single creditor in isolation. For example, scholars have analyzed whether or not a country receives a loan from the IMF (Copelovitch, 2010b; Vreeland, 2003b, 2007; Thacker, 1999). Others have analyzed whether or not governments borrow from private creditors (Eichengreen, Hausmann and Panizza, 2004; Tomz, 2007). In contrast, I focus on the choice among multiple creditors.

Second, this study puts the actions of recipient countries squarely at center stage. Their governments decide which creditor to use. This differs from most existing approaches that explain lending patterns primarily from the perspective of creditors. For example, multilateral loans are explained by the politics among the most powerful shareholders within these institutions (Thacker, 1999; Stone, 2004; Copelovitch, 2010a,b), while developing countries appear to have no voice in the decision-making process. Chinese loans have been explained with reference to its hunger for natural resources (Sanderson and Forsythe, 2012; Carmody, 2013; Economy and Levi, 2014; Caceres and Ear, 2013; Andrews-Speed and Dannreuther, 2011).

What is common to these approaches is that the presence or absence of a loan is explained only from the creditor perspective. Debtor countries are typically viewed as passive partners that merely need resources and will take whatever they are offered. Yet, developing countries are not passive actors. Many examples exist where the governments of
these countries made conscious choices with respect to their borrowing strategy. Vreeland (2003b) provides the example of Tanzania, whose government decided not to obtain an IMF loan despite the obvious need for external resources. Similarly, the government of Uruguay actively sought out an IMF loan even though, by all accounts, it did not need one. Similarly, some authors have granted agency to developing countries when it comes to their decision to not repay loans. Drazen (2000, p. 587) notes that a country may have the technical ability to repay a debt but still make a political decision not to do so. Scholars have therefore analyzed the conditions under which debtors make the political decision to default (Tomz, 2007; Schultz and Weingast, 2003). Developing countries have motivations, incentives, and preferences. It is necessary to account for their agency when analyzing sovereign debt. To be clear, I do not dismiss supply side arguments; it is obvious that creditors have a say in which country they are lending to. However, I do argue that the supply side perspective must be complemented with a demand side approach that takes recipient countries’ actions seriously.

Besides explaining the decision among multiple creditors and conceptualizing recipient countries as actors with agency, I incorporate the preferences of these domestic interest groups into the analysis. Some scholars have already begun to do this. Putnam (1988, p.457) notes that “International negotiations sometimes enable government leaders to do what they privately wish to do, but are powerless to do domestically.” For example, a government might want to implement unpopular economic reforms such as devaluations or austerity measures, but faces fierce domestic opposition. In these situations, the government could obtain an IMF loan with conditions requiring the very same reforms the government was previously unable to push through the parliament. In other words, the conditions of an IMF loan provide the recipient government with leverage to implement reforms against domestic resistance (Remmer, 1986; Edwards and Santaella, 1993; Vreeland, 2003b). Clearly, domestic interest groups play a key role in these approaches. However, we do not know what actors constitute the resistance against IMF loans, why they oppose
the conditions attached to IMF loans, or what they want instead. We only know of their presence.

Yet, we can make inferences about the likely winners and losers of government debt. In his pioneering work, Frieden (1991) shows that capital inflows lower interest rates due to an increased supply of funds, which in turn, reduce savings and increase investment. Similarly, the local currency appreciates as increased supply of foreign currency in the domestic economy cheapens the price of foreign currency. Frieden subsequently identifies winners and losers: The reduced interest rate advantages local borrowers because the cost of borrowing is reduced while the profits of local lenders are undermined. At the same time, the appreciation of the local currency benefits importers but hurts exporters. Frieden’s approach focuses on the effect of increased debt in general — irrespective of the type of creditor that provided the loan. I expand on Frieden’s analysis by examining the specific distributional consequences of different types of creditors. This allows for analyzing the political dynamics that lead governments to accept loan proposals from one creditor but reject loan offers by others.

1.5 The Empirical Strategy: Combining Qualitative with Quantitative Evidence

The empirical strategy of my book combines qualitative with quantitative evidence. I pursue this mixed-methods strategy in order to illuminate the puzzle from multiple angles. My argument suggests that different governments will pursue contrasting borrowing strategies. Therefore, testing this argument requires a truly comparative approach. For this reason, I conducted several months of fieldwork in Ecuador, Peru, and Colombia. I conducted more than 112 interviews with a wide range of actors. I interviewed domestic representatives of the public sector (Prime Ministers, Finance Ministers, Senators, and representatives from Public Debt departments) to verify whether governmental decision-makers are taking
domestic interest groups into account when deciding between creditors. I subsequently interviewed actors in the domestic private sector (domestic banks, business associations, labor representatives). Through these conversations, I verified the theoretical expectation regarding which type of actor — Finance, Industry or Labor — hopes to benefit from which type of loan. Finally, I spoke with international actors such as representatives of multilateral institutions (IMF, IBRD, and IDA) as well as Germany, American, French, and Chinese lending organizations. I also interviewed Chinese officials, both from the public sector (Chinese Development Bank, Chinese embassies) as well as the private sector (Chinese banks, Chinese mining companies). The interviews with these actors confirmed that domestic considerations of recipient countries are an overlooked driver of lending patterns.

The purpose of the interviews was two-fold. First, I wanted to understand the motivations of individual actors. It was insightful to learn that “Ecuadorian subcontractors are actually paid quite generously by the Chinese” (Interview 87, 2011) because the prices are not ‘right’ (i.e., set by market standards) due to the lack of a competitive bidding process for projects funded with Chinese loans. Similarly, the preferences of financial actors were made quite clear when a high-level executive of an Ecuadorian investment bank noted that “[The Chinese] grab you by the [expletive deleted] and take advantage of you.” The second purpose of the interviews was to trace the process by which these preferences are translated into borrowing decisions. For each country, the qualitative insights allowed me to analyze what type of societal coalition dominates the political landscape. They also illuminated how politicians are responsive to the interests of the dominant social groups, which ultimately shapes the borrowing decisions by politicians. Readers interested in the qualitative evidence in particular are referred to Chapter 4 as well as parts of Chapter 3.

Qualitative evidence has many advantages, but it is impossible to compare more than a handful of countries at a time. However, it is important to test whether my argument is generalizable beyond Ecuador, Colombia, and Peru. For this reason, I complement the qualitative work with statistical analyses. Quantitative approaches allow me to test if
borrowing decisions of a larger set of countries follow the predictions of my theory. The lack of data represented the biggest hurdle. Since Chinese lending data are state secrets, researchers have pursued various strategies to estimate capital *outflows* from emerging lenders with limited success. In contrast, I analyze all capital *inflows* to recipient countries. Once I collected all inflows to developing countries originating from China, I was able to reverse engineer Chinese lending data. The resulting dataset covers the annual borrowing activities of 152 developing countries from Western and BRIC creditors for the years 2004–2013. Readers interested in the quantitative analyses are referred to Chapters 5 and Chapter 6.

### 1.6 Plan of the Study

Why do some governments accept loan offers from some creditors while simultaneously rejecting loan offers by other lenders? Why do some governments rely primarily on western creditors while others favor borrowing from emerging lenders such as BRICs? Chapter 2 presents the theoretical framework that explains the variation in borrowing patterns. I argue that analyzing the distributional consequences of the different types of loans available across three domestic interest groups is likely to provide answers to these questions. I also contrast my theory with several alternative hypotheses.

A theory is only as good as the evidence supporting it. Chapter 3 therefore verifies the theory’s fit with reality. In particular, I examine whether my argument regarding the process by which governments decide between loan offers is accurate. Do governments really have a choice amongst creditors? If they do, is the choice for one creditor really a choice against another? Do the preferences of societal actors match the theoretical expectations, and do politicians take these preferences into account when deciding between competing loan offers?

Chapter 4 illustrates how this process plays out in Ecuador, Colombia, and Peru. Each of these countries represents one of the three types of coalitions that are crucial to explain
a government’s borrowing decision. First, a Corporatist Coalition between Labor and Industry that marginalizes Finance characterizes Ecuador. Consequently, the Ecuadorian government caters to this political dynamic by favoring BRIC loans over western creditors. Secondly, Colombia heavily relies on private creditors as well as western loans while it rejects loan offers by BRICs. I show that the government’s borrowing choices match the preferences of the Capital Coalition between Finance and Industry, which dominates the Colombian political landscape. Finally, a Consumer Coalition is present in Peru. The government prefers bilateral loans from western governments, as they cater to the joint preferences of domestic Finance and Labor. In short, these illustrations show how the domestic political dynamics play out differently in these countries, resulting in different borrowing decisions.

I complement the qualitative evidence with statistical analyses to test whether my argument is generalizable to a larger set of countries. A quantitative test of my argument requires two steps. First, I need a measure that captures which type of coalition is politically dominant in a particular country at a particular time. While my fieldwork allowed me to identify which coalitions were present in Ecuador, Colombia, and Peru, obtaining this information for all developing countries presented a challenge, which is addressed in Chapter 5. I then use the newly created variables capturing the coalition type to predict the type of creditor that a government will prefer in Chapter 6.

Chapter 7 reviews the implications of the findings for the ‘real world.’ What does the emergence of BRICs as creditors imply for the power of developing countries in an increasingly globalized world? Are BRIC loans ‘good’ for economic development? What are the implications for traditional creditors? What are the implications of Chinese loans for the prospects of democracy in the recipient country? My findings provide insights to these questions.