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China's Road: into Eastern Europe

by Michal Makocki

The EU and its eastern partners have found themselves among the focal points of China's ambitious economic project, the Belt and Road Initiative (BRI), which aims to revive economic, cultural and political exchanges along the ancient Silk Road. Given their geographical location at the crossroads of Eurasian routes, eastern Europe and the Caucasus are expecting to benefit from substantial infrastructure investments and new commercial opportunities. For the EU, China's endeavour to establish new economic corridors in the region covered by the block's Eastern Partnership (EaP) policy, poses both opportunities and challenges.

The BRI could potentially support the EaP's goals by generating wealth in the region and helping to diversify its economy. However, to a substantial degree it is also up to the EU to make sure that the economic promise that BRI carries is actually delivered on and that the high hopes some of the eastern partners have in Chinese investments are justified. Indeed, this aspect is stipulated in the June 2016 EU China strategy, which stresses that 'it is in the EU's interest to work with China to ensure that any Chinese involvement in the EU's eastern and southern neighbourhoods helps reinforce rules-based governance and regional security.' It is therefore pertinent to look at eastern Europe's relations with China and explore the best policy solutions to achieve synergy between European and Chinese projects in the region.

On the Road

Not surprisingly, given the ever stronger economic links with China, the BRI was met with a rather warm welcome from the EU's eastern partners. For certain EaP countries, China is already one of the most important economic partners. This is, for example, the case with Ukraine, which has become one of the main suppliers of grain to China. In Belarus, China has created an industrial park and promised infrastructure financing as part of the BRI during the last visit by President Xi Jinping in May 2015. China has also joined the European Bank for Reconstruction and Development (EBRD) to tap into investment opportunities in eastern Europe.

China's promise that the BRI will generate large-scale investments in eastern European infrastructure is seen by many as a panacea to sluggish domestic economic development and a way to bridge the massive infrastructure gap between the region and the EU. Additionally, several eastern European governments hope that BRI infrastructure will extend their trade reach and thus diversify the markets for their own products.

Eastern European expectations concerning the economic potential of the BRI are partly warranted by developments on the ground. In the last year, the land-based container traffic between Europe and China has increased to more than 30,000 containers, an impressive achievement given that four years earlier few (if any) cargo trains operated on this route. And additional Chinese economic engagement and infrastructure projects in Central Asia mean that traffic is to likely increase further.

Further to the south, China's project is stimulating local investments in support the creation of new freight corridors such as the Trans-Caspian route, which connects Europe with Kazakhstan and China through the Caucasus and the Caspian Sea. This route already allowed trains operated by Kiev to bypass Russia's transit ban on Ukrainian goods by shipping cargo through the Black Sea, Georgia, and Azerbaijan. Georgia is also betting on increased commercial opportunities and signed up to a Free Trade Agreement with China in the latter half of 2016.

Quality and reality

These early achievements suggest that the BRI might have the potential to open up new economic markets and to create greater wealth and stability across Eurasia. The EU is in a good position to help eastern Europe fully tap into the BRI's economic potential. The EU can play an advisory role, showing in what areas and ways the BRI creates the greatest possible added value to national economic development and supports the jointly-agreed goals of the EaP. But China's promises – and their related implications – need to be carefully analysed.

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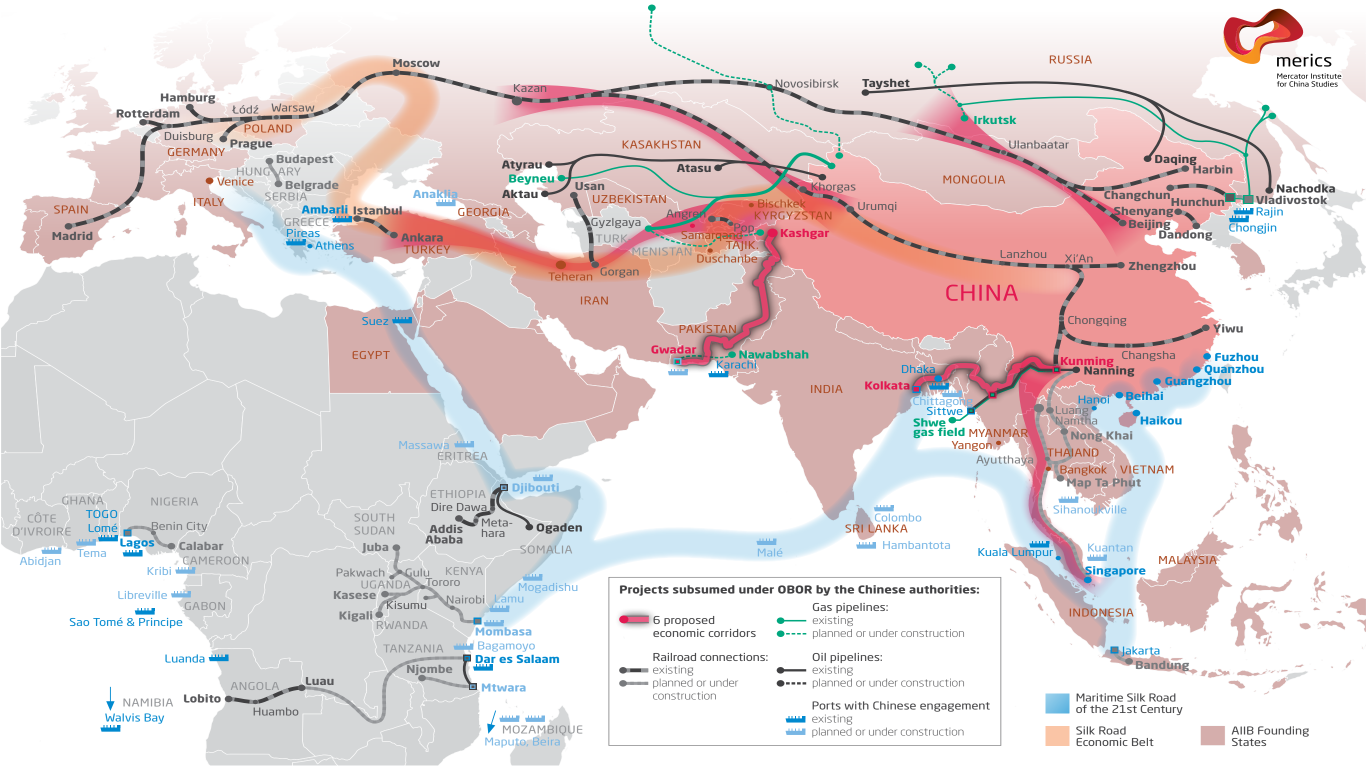
Eastern Europe's rather positive perceptions of Chinese financing do not necessarily match with the reality of China's practices. An evaluation of the existing evidence of Chinese investments along the 'New Silk Road' suggests that recipient countries and the EU can expect a number of shortcomings. Examples from other regions suggest that it is unlikely that Chinese investments will prove to be a silver bullet for fixing EaP countries' lack of adequate infrastructure, nor will they help to advance overall, sustainable economic development.

First, the availability of Chinese financing might be working against the governance standards envisaged by the EU with regard to the eastern partners, as the latter may feel less inclined to comply with complex EU rules if presented with an alternative source of funding. China's objective has been to promote its own model of infrastructure construction which starkly contravenes EU rules on public procurement and state aid. As such, Chinese projects may also work against the EU's rules and norms, to which EaP countries have signed up to through Association Agreements. BRI-related financing – and the accompanying aversion by Chinese firms to transparency – might also fuel corruption and prop up regional oligarchs who view government predation as a business opportunity.

Second, Chinese investors have a tendency to shift the burden of risks associated with infrastructure investments entirely to the receiving country. Unlike the EU's financing instruments, for example, Chinese funding rarely involves grants. Instead, Chinese banks extend financing on the basis of sovereign guarantees from the recipient countries. This, in turn, might negatively affect fiscal stability, thereby also reducing the likelihood of recipient countries being able to acquire more funding from other international players, such as the World Bank. A relevant example, albeit from a different region, is China's BRI-related financing of a motorway in Montenegro. The country suffered a lowering of its credit rating by agencies Moody's and Standard and Poor's due to fears that the Chinese loan for the construction of the motorway could ultimately undermine fiscal stability. Another consequence was the withdrawal of the World Bank's $50 million budget support fund due to the concerns over the same loan. This example draws attention to the fact that Chinese financing can lead to competition over domestic resources and capacities and may crowd out the EaP and other multilateral instruments. Accordingly, China's model of conducting infrastructure deals may imperil key macroeconomic reforms agreed under the EaP and undermine macro-financial assistance programmes.

Another serious downside of Chinese BRI-related financing is that it (sometimes) has a tendency not

China's Belt and Road Initiative (BRI)



Source: Mercator Institute for China Studies (MERICS)

to bring real value for money. As this infrastructure financing is often tied to the provision of equipment or services by Chinese contractors, governments are unable to select the best financial offer through open public procurement tenders. For example, Chinese loans extended to Ukraine under the previous regime of President Yanukovych had to be renegotiated due to concerns over their terms and conditions.

Some Chinese companies also have a patchy record of compliance with environmental or social standards. One of the best known examples in the region was the inability of Chinese engineering company COVEC to build a highway in Poland that was in full compliance with EU environmental guidelines, with the company demanding additional exemptions from labour, social and taxation laws for Chinese labour and machinery involved in the project.

EU member states also need to monitor potential shifts in political allegiance among eastern partners. Chinese pragmatism has proven to be a double-edged sword: while Beijing helped Ukraine circumvent Russian transit bans, other Chinese state-owned enterprises (SOEs) were allegedly interested in building a bridge between the annexed Crimea peninsula and the Russian mainland. Moreover, Chinese investments in separatist or breakaway territories in the region may further fuel conflicts, and China's *rapprochement* with Moscow may limit its potential to play a positive role in the neighbourhood.

China has already demonstrated that it will respect Russia's perceived sphere of influence. For example, due to Russian sensitivities, China did not allow Moldova (and possibly other EaP countries) to join the 16+1 mechanism when it was created. Similarly, in May 2014 Russia forced China to formally acknowledge Russia's role in the post-soviet space and agree to consider the 'interests of Russia during the formulation and implementation of Silk Road projects'. This agreement was further extended through the officialising of cooperation between the Silk Road and the Eurasian Economic Union, agreed in May 2015 in Moscow. While recent press reports have discussed the possibility of Ukraine joining the 16+1 mechanism, no formal talks on accession have actually been held.

Chinese projects will also have security implications, including the assessment of hybrid threats to the region: because of its political rapprochement with Russia, China may be amenable to Russian pressure. The safest (and politically sensitive) option would be to allow Chinese SOEs to develop non-strategic portions of infrastructure connectivity to China, while supporting the strategically vital ones through EU or domestic funds. This would protect the sovereignty of EaP countries – a key goal of the EU's partnership initiative.

Engaging China

Looking beyond the economic potential, China's growing investment role in the EaP countries poses a number of potential challenges from an EU point of view. This makes a structured response to Chinese BRI projects, as called for by the recent EU Strategy on China, even more desirable.

First of all, any response should be guided by the principle of assisting eastern European partners in obtaining the best possible conditions from Chinese counterparts while respecting the mutual commitments to the EaP. Through the EaP, the EU and the region have already established a comprehensive policy framework which can incorporate China. The region's engagement with Beijing should thus ideally be embedded within European Neighbourhood Policy (ENP) Action Plans or Association Agendas, which every partner country has individually negotiated with the EU. Under the transport component of the EaP, a list of priority infrastructure projects for the regional transport network has already been agreed upon. The best approach could be to identify a pipeline in the list of priority corridors and projects to be undertaken by China, and offer to co-finance or co-implement the initiative. Such an approach would also take into account China's willingness to tap into existent regional plans or networks.

However, Chinese participation does not have to be limited to the list of priority projects. Additional proposals could be agreed jointly, as long as they fit with the wider regional transport strategy, are linked to TEN-T networks, and comply with EaP principles. Silk Road-related projects embedded in EaP Action Plans and following ENP principles will likely be of higher value than those agreed bilaterally (where China would be able to push projects according to its own priorities). More specifically, the EU could propose co-financing Chinese projects which promise the greatest possible economic added value and which align with EaP goals. For example, EU support could be given to those projects which aim to diversify energy sources and decrease energy dependence on hydrocarbons from Russia, build connections to the EU market or increase intraregional links between EaP countries.

If the fiscal stability of partner countries is a priority, China could be encouraged to participate in the construction of the region's infrastructure through *investments* rather than project *lending*. By investing in the projects, rather than just lending money, China would be forced to take on its corresponding share of risk. That would subsequently act as a guarantee that the Chinese expect projects to be commercially viable. Such an approach will also help make sure that China brings actual development to the recipient countries rather than build 'white elephants' or support vanity projects. By embedding Chinese projects in national development strategies, such an approach will share the profits from Chinese projects more equally and beyond political elites. This, in turn, will bring more economic stability rather than exacerbate the socioeconomic fault lines within the region.

The EU may also have to acknowledge its limited leverage when it comes to influencing Chinese corporate behaviour (although it can help shape the environment in which Chinese companies operate). It is local frameworks and structural conditions, rather than the EU's direct engagement, that will put BRI projects on a sustainable footing. Past records of Chinese undertakings suggest that countries with higher standards of governance are in a better position to properly assess the true costs and benefits of any Chinese deals. Improvements in the rule of law and the business environment will therefore allow EaP countries to get better value for money and address key deficiencies in China's model of infrastructure construction.

All this means there is a serious demand for the EU's experience in creating high quality regulatory environments. EU support will be crucial to strengthen environmental and social regulations, thereby boosting the capacity of EaP partners to conduct environmental and social impact assessments of any infrastructure projects, including Chinese ones. For example, the EU could use European Neighbourhood Instrument (ENI) grants to allow for an appraisal of a project's feasibility and development according to shared European rules and principles. Finally, assistance could also be offered to engage international law firms or consultancies for advice over deals with Chinese SOEs.

Michal Makocki is an Associate Analyst at the EUISS and a former Senior Visiting Academic Fellow at Mercator Institute for China Studies in Berlin.

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