5. Special section

5.1. WHAT DOES CHINA'S BELT AND ROAD INITIATIVE MEAN FOR CESEE, AND HOW SHOULD THE EU RESPOND?

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China's Belt and Road Initiative is important for the CESEE region, and especially for the Western Balkans. While it will bring much-needed infrastructure upgrading, the initiative is also associated with certain risks, including increased political and economic dependence on China, and a potentially unsustainable rise in public debt levels in some countries. The EU should respond with a 'Big Push' investment initiative of its own, framed as a complement to the Belt and Road Initiative, rather than as its competitor.

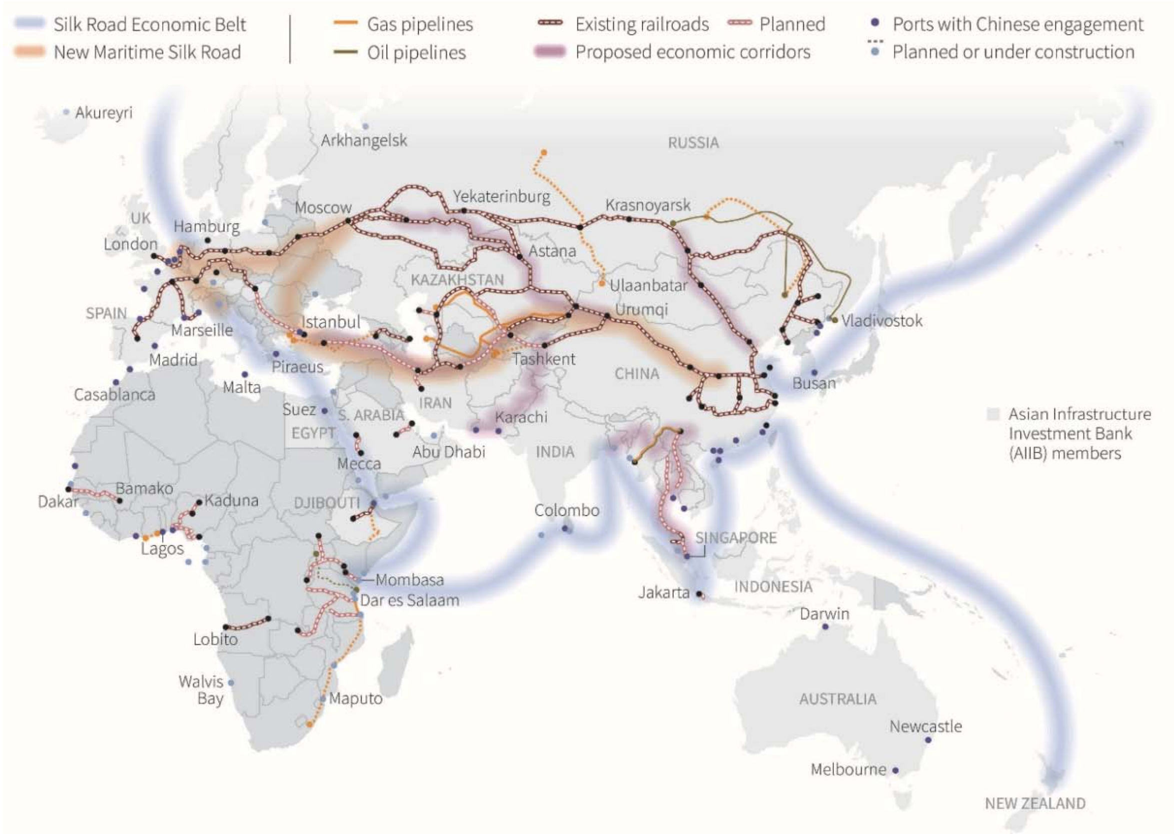
5.1.1. The Belt and Road Initiative in brief

Proposed by Chinese President Xi Jinping, the Belt and Road Initiative (BRI) – also known as One Belt, One Road, or the New Silk Road – celebrates its fifth anniversary this year. The ultimate goal of the BRI is to facilitate economic connectivity between Asia and Europe along two major components: the land-based Silk Road Economic Belt and the sea-based 21st Century Maritime Road (see Figure 32). The Silk Road Economic Belt will connect China to Europe via land transport corridors extending throughout Central Asia, the Middle East and Russia, while the Maritime Silk Road will link the South China Sea and the Mediterranean Sea via the Strait of Malacca, the Indian Ocean and the Suez Canal. In addition, six envisioned economic corridors will bridge the Silk Road Economic Belt and the Maritime Road: (1) China–Indochina Peninsula; (2) Bangladesh–China–India–Myanmar; (3) China–Pakistan; (4) New Eurasian Land Bridge via Kazakhstan and Russia; (5) China–Central Asia–West Asia; and (6) China–Mongolia–Russia. While the initial focus is on improving transport and energy infrastructure connectivity, the initiative also seeks closer cooperation along other dimensions, including facilitation of trade and financial policy cooperation.[22]

The BRI – which already covers 65 countries of Asia, Europe and Africa – will potentially span over 100 countries, making the endeavour truly ambitious. The undertaking is backed by financial infrastructure involving multiple sources: the Silk Road Fund (USD 40 billion), the Silk Road Gold Fund (USD 15 billion) and the China–Central and Eastern Europe Investment Cooperation Fund (USD 11 billion). In addition, the project is supported by bilateral funds (China–Russia, China–India, China–Africa development funds), recently established banks that focus on infrastructure investment (the Asian Infrastructure Investment Bank and the New Development Bank) and Chinese policy banks (the Export-Import Bank of China, the China Development Bank and the Agricultural Development Bank of China). Further support comes from complementary initiatives by the World Bank, the European Bank for Reconstruction and Development (EBRD) and other international development organisations operating in the region.

22 See also Urban (2016) and Barisitz and Radzyner (2017) for the discussion of the BRI routes.

Figure 32 / New Silk Road



Source: World Economic Forum, based on Mercator Institute of China Studies.

Given its significant scale and dedicated funding, it is likely that the BRI is capable of transforming the region. At the same time, the commitment of China to the BRI is motivated by pragmatic considerations, including the need to revisit its economic development model and spur growth in its lagging regions, secure access to strategic resources and export markets, and promote the Chinese yuan and China's general economic and geopolitical influence in the region (see Adarov, 2018 for a detailed discussion).

5.1.2. The BRI and the '16+1' initiative place the Western Balkans in the limelight

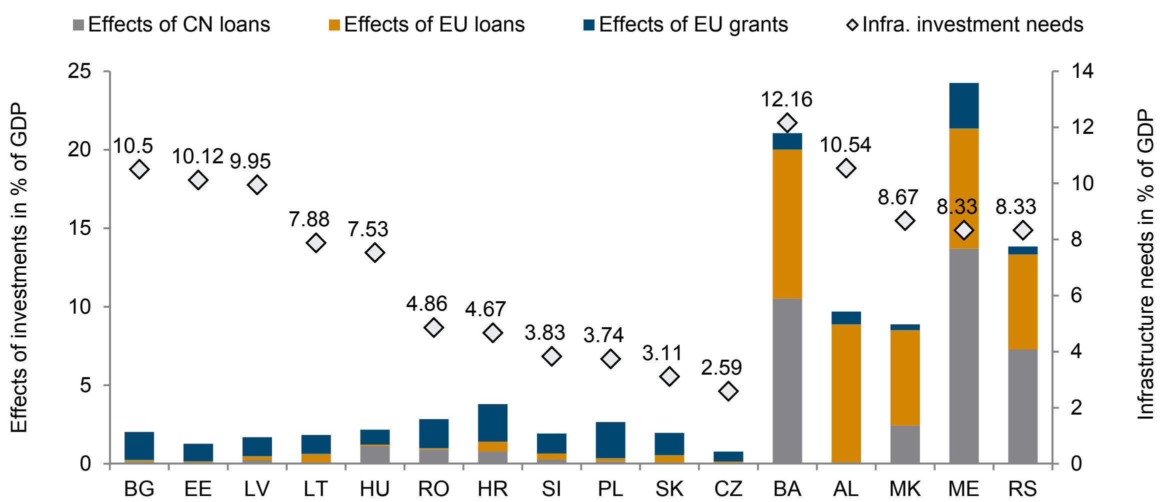
China's interest in CESEE was revealed in 2012, with the diplomatic initiative '16+1', encompassing 11 EU Member States of Eastern Europe and five Western Balkan economies (excluding Kosovo). However, within CESEE, the region set to be most substantially impacted is Southeast Europe, and especially the Western Balkans. The Western Balkan region has recently received significant public and political attention in Europe thanks to Chinese investments. With the China Ocean Shipping Company (COSCO) acquiring a majority stake in the port of Piraeus (the biggest port in Greece), the logical overland transport connection to Western European markets runs through the Western Balkans.

As a result, economies in the Western Balkans could turn out to be the main beneficiaries of China's BRI projects in Europe. These countries face substantial infrastructure investment needs of more than 8% of their GDP per annum over the period 2018–2022 (Figure 33; EBRD, 2017). These needs are strongest in transport and energy infrastructure. There are barely any West–East railway links in the region, no high-speed railway lines, and the motorways are underdeveloped.

Estimating the trade-induced economic effects of infrastructure investment, a recent wiiw study found that the GDP effects of Chinese infrastructure projects are highest for Montenegro (14% of GDP), Bosnia and Herzegovina (11%) and Serbia (7%); these effects will materialise over the several years needed for the infrastructure construction work. Taken together with EU loans and grants, the GDP effects might amount to as much as 24% of GDP for Montenegro, 21% for Bosnia and Herzegovina, 14% for Serbia, 10% for Albania and 9% for Macedonia (Grübler et al., 2018).[23] Obviously, the effects would be substantially lower if those investments financed by Chinese resources used primarily Chinese production and supply networks. On the other hand, if recipient countries manage to link infrastructure construction projects to local employment, the effects could be even higher in the medium to long run, as increased employment would result in further spending – and therefore greater national income.

Figure 33 / Western Balkans potentially benefiting most from the BRI

Infrastructure investment needs per annum (2018–2022) contrasted with expected GDP effects of EU and Chinese infrastructure financing, as a percentage of GDP



Note: wiiw calculations of GDP effects based on European Structural Investment Funds (ESIF), Connecting Europe Facility (CEF), Trans-European Transport Network (TEN-T), Western Balkan Investment Framework (WBIF) and European Fund for Strategic Investment (EFSI) data on EU grants and loans and the China Global Investment Tracker for Chinese construction projects. Ranking according to infrastructure investment needs as a percentage of GDP for EU members and Western Balkan states.
Sources: EBRD Transition Report 2017–2018; Grübler et al. (2018).

However, despite these positives, there are three key reasons for caution in relation to CESEE (and particular Western Balkan) involvement in the BRI. First, there is an issue surrounding the transparency of public procurement in BRI projects, and compliance with EU law. The Belgrade–Budapest railway link, for example, led to a dispute between Hungary and the EU over public procurement rules. In late 2017,

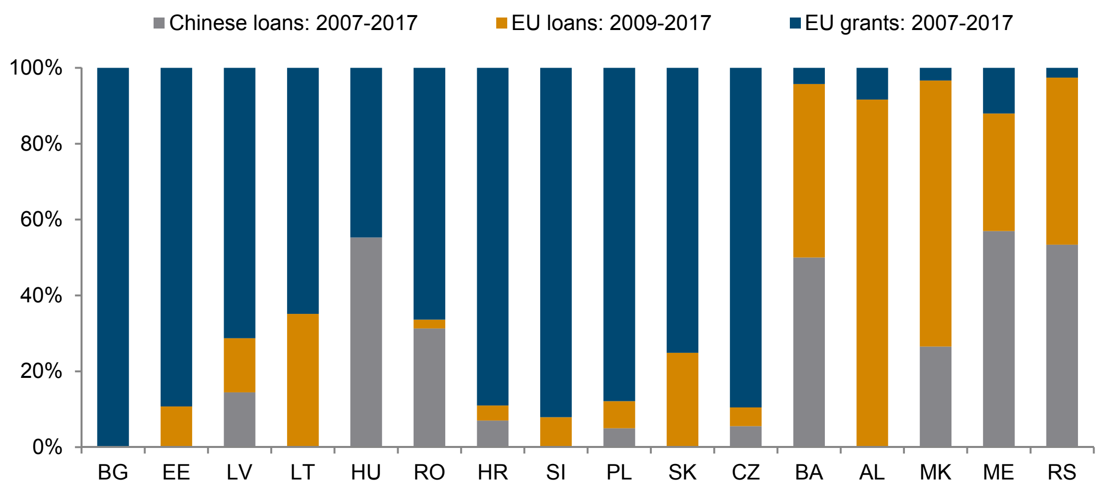
23 The underlying model assumes 'business as usual', meaning that (i) investment funds actually turn into real investment and thus trigger demand in the construction industry and (ii) products and services needed by the construction industry are sourced from the same countries as in the past.

the case was officially solved during the 6th CEE–China summit, when the project tender was launched. However, criticism of the procurement process persists and worries remain about potential future infringement proceedings against Hungary or other economies targeted by Chinese financing.

Second, Chinese financing comes in the form of loans, which need to be paid back. In the context of discussions about the complementarity or substitutability[24] of Chinese and EU financing in the region, it is important to stress the difference between loans and grants. The former may boost growth in targeted economies, but may potentially create the risk of debt unsustainability. With grants this is not the case, as they do not have to be paid back. With EU Member States having better access to EU grants (Figure 34), but economies outside the EU primarily having to use loans (e.g. from the EU or China), the medium- to long-term effects of infrastructure financing may differ significantly for these country groups.

Figure 34 / Debt trap of less concern within the EU

Comparison of loans and grants provided by the EU and China for infrastructure investments



Note: 100% refers to the sum of EU and Chinese financing of infrastructure investments in the BRI investment fields of transport, energy, environment and information and communication technology (ICT).
Source: European Commission ESIF, CEF, TEN-T, WBIF, EFSI data; China Global Investment Tracker; wiiw calculations.

Third, there is a risk that these Chinese loans will contribute unsustainable public debt in some CESEE countries. There is very limited literature so far on the risk of debt default associated with loans for public infrastructure investment. Hurley et al. (2018) examined 68 countries and found that BRI infrastructure financing has severely increased the risk of debt distress in eight economies. Among these is Montenegro, due to a BRI motorway project linking the port of Bar with Serbia. The costs of the first of three phases amounted to more than USD 1 billion, or roughly a quarter of Montenegro's GDP. Without highly concessional funding for the remaining two phases, Montenegro's economy could drift towards debt default. Similar concerns led Malaysia to withdraw from three BRI projects in August of this year.

[24] Discussions on substitutability of funding intensified after statements by Hungary's Prime Minister Viktor Orbán: 'If the European Union cannot provide financial support, we will turn to China': https://bbj.hu/economy/orban-if-eu-doesnt-pay-hungary-will-turn-to-china_143836

For Sri Lanka, the concerns have become a reality: it has had to hand over its port of Hambantota and 60 square kilometres of land for 99 years to China due to payment difficulties.[25]

5.1.3. A European response to the BRI

How economic ties between CESEE and China evolve in the coming years will depend partly on the political and financial engagement of the EU with its neighbourhood. Some five years after the BRI was launched, the EU responded to ongoing debates in Europe by presenting an investment strategy for the Western Balkans in May (EC, 2018a), a proposal for an InvestEU Programme in June (EC, 2018b) and its vision for connectivity between Europe and Asia in September (EEAS, 2018). However, all these activities are small, compared to the global aspirations of the BRI. A more significant reaction by the EU to China's initiative has yet to materialise.

We (Holzner et al., 2018) argue for a 'Big Push' in infrastructure investments in Europe and its neighbourhood (beyond the borders of the EU), not least for the following reasons: i) the EU should respond to the BRI, in order to ensure that its own priorities are also reflected in infrastructure development in its neighbourhood; ii) the wider region has a persistent, 200-year-old infrastructure problem, and the BRI alone will not tackle this – more and better infrastructure will unlock untapped growth potential; iii) the region is economically underdeveloped, especially in terms of industrial capacities, and 'Big Push' infrastructure investment is the best way to solve this.

We propose the construction of a European Silk Road that links industrial centres in the West with densely populated, but less-developed regions in the East of the European continent, thereby providing for more growth and employment in the short, medium and long term. This initiative should not be viewed as competition to the BRI, but as a complementary project. Besides economic benefits, it would also entail important political advantages, with more cooperation thanks to transnational, joint infrastructure measures.

After its completion, the European Silk Road would extend overland for around 11,000 kilometres on a northern route from Lisbon to Uralsk (on the Russia–Kazakh border) and on a southern route from Milan to Volgograd and Baku. The central parts – which should be given priority in construction (solid lines on the map shown in Figure 35) – would be the route from Lyon to Moscow in the north, and from Milan to Constanţa in the south. The southern route would link Central Europe with the Black Sea area and the Caspian Sea littoral states. The European Silk Road would consist of a higher-tier motorway (i.e. one with fewer entries and exits than current motorways in the region, meaning faster transit) and a high-speed railway line with a string of logistics centres, seaports, river ports and airports. These would set new European standards, including in e-mobility and autonomous driving. The two routes connect the most populous regions of Europe on a West–East axis. The previously mentioned Western Balkans are not included, as they lack relevant population density and are already covered by a number of infrastructure initiatives from both the EU and outside players. Nevertheless, future extensions of the suggested European Silk Road might well include North–South connections, also covering the Balkans.

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[25] See e.g. Maria Abi-Habib, 'How China got Sri Lanka to cough up a port', *New York Times*, 25 June 2018: https://www.nytimes.com/2018/06/25/world/asia/china-sri-lanka-port.html

Our cost estimates yield an investment volume of around EUR 1,000 billion for the European Silk Road, which is far below the highest estimates for the Chinese New Silk Road of up to EUR 7,000 billion. The investment costs would be offset by potential positive effects on GDP, employment and trade.

In a baseline scenario, we calculate that the European Silk Road would have the potential to increase the GDP of the countries involved by about 3.5% over an investment period of 10 years, and to increase employment by 2 million. Under particularly favourable circumstances, and with interest rates remaining low, the employment increase across Europe could be as much as 7 million. Savings in transport time – for instance, on the northern route of the European Silk Road this would average 8% – could enable the countries involved to raise their exports to Russia by more than 11%.

Figure 35 / Proposal of a European Silk Road on a northern and southern route

Source: GEOATLAS.com, own route design.

To expand the pan-European market, the potential for enhanced economic integration is substantial. In addition, we also propose a trust fund, designed to bridge the gaps in infrastructure in Europe and construct a European Silk Road with the aid of an infrastructure investment push. With the currently extremely low interest rates (and in view of the immense economic effects anticipated), a 'self-financed' investment might be expected (IMF, 2014).

Conclusion

The BRI will facilitate massive improvements in cross-border infrastructure and connectivity throughout the Eurasian continent, delivering positive short- and long-run economic effects. However, it is important to be fully aware of the risks that the initiative may entail, including debt unsustainability, the long-term economic and political dependence of participating countries on China, and the use of business practices and regulations that are possibly inconsistent with EU standards and values. Assessing these risks is vital, particularly for the Western Balkan region, which is at the core of loan-financed BRI investments in Europe (given that it has limited access to EU grants).

So far, the reaction of the EU to the BRI has been limited. We suggest a more proactive stance and practical engagement in the form of massive 'Big Push' infrastructure investment in Europe, which would also help facilitate economic development in lagging regions. Rather than a competitor to the BRI, the European Silk Road should be regarded as a complement to it – one that is better geared to the needs and goals of the EU.

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