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China's *Balkans Silk Road*: Does it pave or block the way of Western Balkans to the European Union?

The presence of China in the Western Balkans has become increasingly visible. Once only remotely interested in this part of Europe, the world's second biggest economy is involved in a multitude of projects: investing considerably in infrastructure development and thereby advancing its influence along the *Balkans Silk Road*. Engagement in this part of Europe only accounts for a fraction of China's global strategic investment. Yet, the fact that it converges with the European Union's commitment to the European integration of the Western Balkans renders it particularly relevant. How do the ambitions and plans of the European Union (EU) and China relate to each other? What are the chances that China's engagement will provide the economic boost, needed to catch up with the EU on its path to accession? To what extent could China's engagement weaken the Western Balkans' European perspectives?

In order to reflect and analyse these and other questions the Austro-French Centre for Rapprochement in Europe (ÖFZ/CFA), the Institut français des relations internationales (Ifri), the Centre international de formation européenne (CIFE), the German Institute for International and Security Affairs (SWP) together with the Cooperation and Development Institute (CDI) organised an international conference in Brussels on 15 November 2017 in the framework of the *"Western Balkans Reflection Forum Initiative"*. The conference brought together key experts from China, the Western Balkans as well as EU member states at the premises of the Austrian Permanent Representation to the EU. The challenges of China's engagement in the region closely link to the connectivity agenda of the *"Berlin process"*. Since 2014 the *Berlin process* has been promoting regional cooperation in the Western Balkans to support the integration of these countries into the EU. The projects of the *Berlin process* and of the EU itself have increasingly been measured against the commitment, speed and "efficiency" of Beijing's initiatives (Flessenkemper 2017). It also remains to be seen how the enlargement strategy of the European Commission of February 2018 will be able to respond to these challenges (European Commission 2018). This paper discusses some of the main points that were analysed during the seminar in Brussels which was held under Chatham House Rules.

China's rising interest for the Western Balkans

After decades of "gravitational pull" characterised by China's strategy of attracting foreign companies through joint ventures to invest in China, recent developments indicate a shift in Beijing's strategy, which started with China's *go-out-policy*. The result is a "gravitational push" by China at the global level, whereby Chinese companies are encouraged to invest overseas and consolidate China's global presence and reach.

In Europe, this "gravitational push" first became clear to the broader public in 2012 with the "16+1 framework". Since then China has been regularly meeting and increasing cooperation with 16 countries in Central, Eastern and South-Eastern Europe, among them eleven EU member states and five Western Balkans states. This framework, aimed at improving trade and economic relations between China and its partners, is instrumental in advancing China's differentiated interests in the region, where some partners - especially Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia – seem to be the main focus of Chinese activities. In order to strengthen the operational dimension of the "16+1 framework" and to increase its strategic character, China went on to launch its *Belt and Road Initiative (BRI)* in 2013. The objective of the *Belt and Road Initiative* is to connect China with the rest of Asia, Europe and Africa through efficient trade corridors. As one of these corridors is planned to run through the Western Balkans before reaching Western Europe, China has accordingly focussed attention on developing its *Balkans Silk Road* in the past few years. The grouping together of of EU and non-EU countries in the "16+1 framework" could prove challenging for the EU and its internal cohesion, as these groupings do not fit easily into the agreed EU formulas for relations with third countries. China, however, considers these activities the framework as complementary to the institutionalised EU-China relations and tries to benefit from these bi- and multilateral cooperation initiatives (Wacker 2017). An example of this broader connectivity approach, bringing together EU member states and non-EU countries, is the

Framework Agreement on Cooperation in Facilitating Customs Clearance between the Chinese, Hungarian, Serbian and Macedonian Customs, signed in December 2014. Lately, against the backdrop of these developments, China´s role and influence in EU institutions and member states increasingly attracts critical analysis and scrutiny (Benner et al. 2018).

Serbia holds a particular position among China´s Western Balkans partners: it accounts for almost half of China's total trade volume with the region with €3,3 billion in 2015-16. Although the EU28 remain by far the main investors and economic partners in all Western Balkans countries, their relative weight in the region is being challenged by China's economic diplomacy. For example: China has become the third trading partner in Bosnia and Herzegovina and in Montenegro and the fourth in Macedonia, Serbia and Kosovo (Bastian 2017). Albania benefits from long-standing diplomatic relations with China from the Cold War period. This may explain that Chinese imports come second after the EU; furthermore China has become the third biggest export market for Albania after the EU and Serbia (World Trade Organisation 2016).

In general, however, the EU offers access to less costly and potentially larger funds and grants for infrastructure and economic development than China. Yet EU funding is built on multi-source financing schemes, following a series of compliance rules, and they are often contingent on the fulfilment of conditions in the field of good governance, the rule of law and the fight against corruption. It can therefore take up to several years for applicants to lead their project through the whole cycle of project management, with at times a long administrative period between the feasibility and bankability phases and the final project implementation. In the context of EU co-funding, projects only become visible to Western Balkans citizens in mid-term, sometimes long-term.

China, in contrast, usually offers flexible instruments to finance projects, many of them highly visible such as roads and bridges, which are connecting the dots of the imaginary *Balkans Silk Road*. Loans are typically granted in a top-down manner by state-owned development banks with less stringent accountability procedures, so that the funds can become quickly available. Loans, moreover, are offered as state-to-state instruments to national and local administrations in Western Balkans states with the advantage that, once granted, politicians can use them to boost their electoral success. Despite being seemingly favourable in terms of interest rates or period of repayment schedules, and offering a welcome source of capital in the otherwise economically struggling Western Balkans. However, these loans come at a cost: they necessarily increase the level of public debt which needs to be repaid, with interest; furthermore there are currency exchange rate risks and many of the projects struggle to generate the necessary revenue (e.g. via road tolls and other user fees) for their long-term maintenance and viability.

Chinese investments in the Western Balkans

Chinese investments in the Western Balkans concentrate mostly on three economic sectors: transport, energy and industrial production. However, the single biggest investments can be found in the transport sector. In the transport sector China can already look back at a range of strategic acquisitions and investments in the Western Balkans and beyond. Its most significant investment so far has been the acquisition of the Port of Piraeus in Greece, which Beijing intends to use as starting point for its *Balkans Silk Road* (Tzogopoulos 2016). To connect the Port of Piraeus to Central Europe, China has offered state-to-state loans for building roads and modernising railways throughout the Western Balkans. Chinese investments are considered a windfall, given the transport infrastructure deficiencies and their considerable economic implications that plague the region. Poor connectivity makes the transport of goods time-consuming and comparatively expensive. After the construction of the *Mihajlo Pupin Bridge* over the Danube in Belgrade in 2011 (i.e. shortly before the launch of China's 16+1 initiative), China also supported the construction of segments of highways along *Pan-European Corridors* in Serbia and Macedonia. After the end of the conflicts in former Yugoslavia corridor number X was planned as a more than 2,000 kilometres long link between Salzburg, Ljubljana, Zagreb, Beograd, Niš, Skopje, Veles and Thessaloniki. The Danube river is another corridor (number VII) which is also part of the EU Strategy for the Danube Region. Investments by the EU have been modest and slow so far. Now, China is involved in the planned construction of a high-speed rail link between Budapest and Belgrade. The individual projects have also created controversy for allegedly fostering corruption. Some projects were not publicly tendered and hence are in breach of EU competition law. China is not only pushing for more transport infrastructure connectivity in the Balkans; it is also encouraging, as mentioned, cross-border cooperation between custom services to facilitate trade flows.

The other two sectors are energy and industrial production. Engagement in both is considerably less visible and less extensive. In the energy sector, China has invested in several facilities throughout the region.

Chinese companies have bought existing hydro- and thermal-power plants in Macedonia and Bosnia-Herzegovina and have constructed a new thermal power plant in Bosnia-Herzegovina. Finally, China is involved in developing industrial production projects. Its most prominent investments in that area have been the acquisition of the Serbian steel mill from the *Zelezara Smederevo* conglomerate and the opening of production lines in the auto industry through its *Mei Ta Industrial Company* in Serbia (Bastian 2017).

How much do the Western Balkans benefit from Chinese investments?

As can be observed in the transport sector, the Chinese strategy in the Western Balkans overlaps with the EU's connectivity agenda in terms of the desired outcome. Yet it would appear that China is contributing to a much needed transport infrastructure in a more effective way than the EU. Indeed: the EU requires transparent and demanding compliance procedures and also expects multiple sources of funding, including the mobilisation of national funds in the Western Balkans countries themselves to encourage the long-term commitment to, and sustainability of the projects. In the other two sectors - energy and industrial production - Chinese investments also provide a significant influx of capital in a region struck by deindustrialisation and struggling to attract foreign investors. The economic situation of Bosnia and Herzegovina, Montenegro and Serbia remains difficult with real GDP levels below those of 30 years ago (Bonomi & Reljić 2017). No surprise then that China is occasionally perceived in the Western Balkans as the partner that recognises the potential of the region overlooked by the EU and helping the region to develop.

Chinese credit financed investments - no matter how low the interest rates of their loans are - increase the level of (public) debt in the Western Balkans, and consequently, their dependence on China (as far as repayment is concerned). In fact, the countries attract hardly any private foreign direct investment from China that would stimulate their economic growth without negatively impacting their public finances. Neither do they receive concessions or public grants, nor are they venturing into public-private partnerships. What China is offering, i.e. state-to-state loans, is economically the least favourable instrument to enable the Western Balkans countries to finance their investments. The negative impact of Chinese investments on public finances is reinforced by the widening trade imbalance between China and the region. For instance, Chinese imports to Serbia in the first six month of 2016 were US$ 773 million, Chinese exports from Serbia during the same period were a mere US$ 12 million (Bastian 2017).

The impact of Chinese investments is not limited to macro-economic considerations. Their lack of transparency has also been a point of criticism. Chinese investment procedures in the region mostly do not include public tenders, i.e. transparent and open public procurement based on the principles of fair competition (Makocki & Nechev 2017). This means that Chinese investments fail to stimulate competition between companies involved in various projects and possibly foster corruption. In other words, they do not foster the emergence of a social market economy and risk undermining the EU's economic governance norms.

In addition, Chinese investments pay little attention to advancing environmental and social standards in the Western Balkans. They respond first to Chinese interests and mostly mobilise other Chinese resources, including the detachment of Chinese workers on construction sites. The obligation that the recipient countries must use Chinese contractors for at least a part of the project means that only a part of the workforce and material is sourced locally, which reduces the mobilisation of local economic dynamics. Positive spill-over effects in terms of employment creation are therefore limited. Furthermore, working conditions on the construction sites are usually harsh, at least for Chinese workers, and not in line with European standards to which the Western Balkans countries aspire.

Moreover, state-to-state loans are criticised for their propensity to support the status quo in regimes, which stifle democratisation. The top-down, state-driven logic of state-to-state loans attribution opens opportunities for local and national potentates to take credit for the construction projects, while hiding their economic impact on national public finances. The loans risk fuelling interest networks at the local and national level as well as collusion between politicians, bureaucrats and businesspeople (Makocki 2017). Unlike EU investments, China does not link its investment strategy to any political conditionality.

Chinese investment interests in the region are nevertheless broadly in line with the economic and development objectives of the EU for the region. Chinese companies benefit from the political stability in the region, which in turn is strengthened by the EU membership perspective. Beijing does not ideologically oppose the political transformation of the countries in the region into democratic polities. In order to develop synergies between the Chinese *Belt and Road Initiative and the Investment Plan for Europe* (also referred to as "Juncker Plan"), the *Silk Road Fund* and the *European Investment Fund* signed a Memorandum of Understanding at the occasion of the 19th European Union-China Summit in Brussels on 2 June 2017 (European Investment Fund 2017). A China-EU Co-Investment Fund will accordingly be launched with a budget of €500 million. The aim is to foster EU-China cooperation across Europe in the field of strategic investments while making sure that these investments are compatible with the sustainable development goals promoted by the EU.

Outlook

China is moving into a structural development gap and is meeting real investment needs in the region, a dynamic the EU has been slow to acknowledge. An obsolete infrastructure, deindustrialisation, an unattractive business climate, stagnating reforms and recurrent political crises have been a challenging reality for the Western Balkans countries for over two decades – despite the EU's *Stabilisation and Association process* and enlargement strategy. Until the launch of the Berlin process the EU seemed to have lost momentum in its effort to integrate the region. China will not be a game-changer in that respect, but it will be a motivating factor for the EU to step up its engagement in the Western Balkans and embrace a constructive partnership with China. The challenge for the EU and the Western Balkans countries is to keep sight of the many facets of the strategic objective of European integration while keeping the door open for co-operation with China. Nevertheless, from the European Union's point of view, more efforts are needed in the Western Balkans to dovetail Chinese investments with the EU's connectivity agenda and their aspiration to fully meet European standards and norms as future EU member states. Only then will the *Balkans Silk Road* smooth the way of the Western Balkans to join the European Union.

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