

Beijing's mistaken offer: the '16+1' and China's policy towards the European Union

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Despite China's growing political and economic involvement in Central and Eastern Europe (CEE), Beijing has not succeeded in making an attractive offer to the region's EU member states – who make up the majority of the participants in the '16+1' format. The financing model proposed by China, based on loans and favouritism towards Chinese companies, has proved to be unsuitable to local conditions. Therefore, the much-discussed infrastructure cooperation has not even started. Consequently, Beijing has failed to obtain the political tools which could have weakened policy coherence at the European level, or even divided the EU. In this context, the allegations appearing in the public debate that the countries of the '16+1' have been fostering divisions within the EU seem to be substantially incorrect. As long as Central and Eastern Europe remains capable of pursuing its economic and developmental interests within the architecture of the European Union, the political risks coming from China's capital inflow will remain limited. At the same time, the EU has room to facilitate constructive economic relationships between China and the Central European region. For example, it could reduce Beijing's political pressure on CEE to use the specific, Chinese model for financing and building infrastructure. Cooperation at the EU level could also help to adapt the Chinese offer to the European business and regulatory environment.

Cooperation between China and Central & Eastern Europe, which since 2012 has been developed within the '16+1' format, has become the object of heated discussions in the European press and within think-tanks¹. There is a predominance of critical interpretations which portray China's actions as a strategy of *divide et impera*, aimed at breaking up the unity of the European Union. The eleven states which are both EU

members and participants in the '16+1' format have met with criticism from EU partners and institutions². One of the most commonly referenced arguments is the potential impact of enhanced economic cooperation with China, which is one of the '16+1's main objectives, on the political choices of the eleven European countries which are members of this format. According to this narrative, attracting Chinese capital will increase dependence on Beijing and lead to individual governments supporting China's diplomatic initiatives, as well as voting its way in international organisations, including EU forums.

¹ EU uneasy over China's efforts to woo central and eastern European states, Financial Times, 8 May 2017; <https://www.ft.com/content/2e98f6f4-089d-11e7-ac5a-903b21361b43>, China's investment in influence: the future of 16+1 cooperation, ECFR, 2017, http://www.ecfr.eu/publications/summary/chinas_investment_in_influence_the_future_of_161_cooperation7204#_ftn1; Jacopo Maria Pepe, China's Inroads into Central, Eastern and South Eastern Europe: Regional and Global Implications for Germany and the EU, DGAP 2017, <https://dgap.org/de/article/getFullPDF/29291>

² Berlin uneasy about Beijing's growing clout in eastern, southern Europe, SCMP, 18 February 2017, <http://www.scmp.com/news/china/diplomacy-defence/article/2072046/Berlin-uneasy-about-beijings-growing-clout-eastern>

The two most commonly indicated channels for the inflow of Chinese capital are direct foreign investment and the financing of infrastructure. China's economic expansion may indeed be accompanied by political risk, at the level of both the EU and the individual member states. Moreover, the worst-case scenarios of breaking EU unity in relation to China have indeed already come to pass in the case of individual countries in the region³. However, the current European debate on China's economic presence in Central and Eastern Europe contains a number of inaccuracies, which are impeding a true assessment of the scale of the phenomenon and its political implications. One of the main problems is

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the lack of precise information on the nature of China's involvement in financing infrastructure in CEE. The quality of Chinese offer has been only sporadically analysed in the context of the region's economic interests. This often leads to the hasty conclusion that the terms Beijing presents have met with unanimous enthusiasm and do indeed reflect the development needs of the region, in all its considerable political and economic diversity. Secondly, there is a lack of accurate information about the real effects of cooperation; as a result, prominent announcements by the leaders and the multi-billion dollar contracts announced by China are treated as real commitments, but in fact they often do

³ In 2016 the common position of the EU Council on China's activities in the South China Sea was blocked by Hungary and Greece, as well as Croatia and Slovenia (their attitude was most likely influenced by their own dispute over territorial waters). Another example of the lack of a common EU position was the signing in 2017 of a Joint Declaration on the principles of financing the One Belt, One Road initiative by representatives of Hungary and the Czech Republic, despite the negative recommendation of the European Commission.

not go beyond the realm of declarations. This brings about a tendency to overestimate the involvement of Chinese capital in CEE's eleven EU member states, and hence, of Beijing's political influence in the region.

China's offer to the region

The Chinese offer to finance infrastructure presented to the sixteen countries of Central and Eastern Europe in 2012 was tailored to the needs of developing countries without wide access to capital. In practice, the line of credit for the '16+1', which is worth \$10 billion, is not significantly different from the instruments Beijing has offered to the rest of the world, including South-East Asia, Africa and Latin America. As in these other regions, the financial resources are provided by Chinese state policy banks (which achieve the government's aims by means of preferential loans) such as Exim Bank and the China Development Bank (CDB), which have financed around 85% of the projects' value. These loans are associated with assigning the implementation of the whole or a substantial part of the projects to Chinese contractors, and the inclusion of Chinese suppliers when purchasing most of the components. The final cost of the loans depends on many factors, but for CEE it should be estimated at 2.5-3% annually⁴. The loans are drawn up for a relatively long period (between 20 and 25 years), and they usually also provide for a few years' grace period in their repayment. One of the most important conditions for granting a loan is the guarantee of repayment by national governments in case the companies raising the loan run into problems (the so-called sovereign guarantee). These rules form a model for funding infrastructure which promotes Chinese contractors, technology and suppliers. By exporting capital in this way, Beijing creates foreign demand for the

⁴ According to media reports, this is to be the interest rate on loans for Hungary and Serbia. See <http://hungarianspectrum.org/tag/chinese-hungarian-relations/>

wildly overgrown Chinese construction sector, which has been struggling with a drop-off in infrastructure construction within China itself.

The multi-billion dollar contracts announced by China often do not go beyond the realm of declarations.

By transferring its experiences and models of its cooperation with developing countries to Central and Eastern Europe, China is offering a debt-based model for infrastructure development within the '16+1' programme. Beijing's offer would undoubtedly be beneficial to some countries of the region, although it has important limitations. The Chinese loans, which have relatively low interest and extend over many years, are especially attractive to governments with limited access to the international system of development finance and EU funds. China's money has not so far been linked to any demands regarding domestic reforms. Due to their extensive know-how, Chinese companies are efficient and quick in constructing key infrastructure, which is particularly important for countries with low institutional capacity⁵. In the case of small economies, however, the Chinese funding model involves a risk of a sudden rise in debt. In the case of Montenegro, the signing of a single contract for the construction of a highway has increased the debt in relation to the country's GDP by 23 percent⁶. Such loans' conditions are not transparent, which makes it difficult to assess the projects' long-term viability. Significantly, contracting most of the components and materials (and sometimes even the labour force) in China means that the capital as-

signed to the project immediately flows abroad, and does not stimulate the local economies. This can significantly hinder debt repayment capacity in the future, and can also result in problems with the balance of payments (with difficulties in obtaining foreign currency to pay off the loans)⁷. Transferring the whole of the business risk to the local governments does not guarantee the involvement of the Chinese side in cultivating the project's long-term profitability.

Infrastructure: '11+5' rather than '16'

After five years of the '16+1' format, cooperation in the development of infrastructure has become clearly divided along the lines of EU membership. In the five countries of the '16' which do not belong to the EU (Serbia, Montenegro, Albania, Macedonia, Bosnia & Herzegovina), the Chinese funding model has been used to launch more than a dozen projects, worth a total of about €6 billion⁸. These include the construction of coal-fired power stations in Kostolac (Serbia) and Tuzla (Bosnia), motorways in Serbia, Bosnia & Herzegovina, Montenegro, Macedonia and Albania, as well as part of the railway route between Belgrade and Subotica (which is part of the route connecting Belgrade with Budapest). The use of loans from China's Exim Bank and the CDB in the Western Balkans is due to the lack of attractive alternatives for financing the huge infrastructure needs of the subregion. The Chinese offers frequently beat the often fragile financing from Russia (a credit line for Serbia), or from the European Bank for Reconstruction and Development (EBRD) and the World Bank, which is often linked to conditions regarding internal reforms and financial discipline, as well as the limited pre-accession funds from the EU.

⁵ However, this is linked to the idea of leaving the Chinese a certain 'regulatory freedom', including the possibility of tax exemptions. This was done in Montenegro and elsewhere.

⁶ The value of the agreement signed with Exim Bank amounted to €800 billion; the GDP of Montenegro at that time (2014) was €3.45 billion. See <http://www.reuters.com/article/montenegro-highway-idUSL5N0SP-4BI20141030>

⁷ For more on the question of Chinese loans and balances of payment in CEE, see http://hcss.nl/sites/default/files/files/reports/Goeoeconomics_Behind_OBOR_FINAL%20%283%29.pdf

⁸ www.ebrd.com/documents/comms-and.../see-china-investments.pdf

Meanwhile, in the eleven countries of the '16' which are EU members (hereafter, the EU-11), cooperation on infrastructure remains close to zero, despite their intensive political contacts with China. An analysis of the commitments made and announced at the '16+1' summits and bilateral meetings shows that, in the case of the EU member states, none of the infrastructure projects has gone beyond the stage of media speculation, political declarations or memoranda. Cooperation has not gone forward despite China's conferring obvious political priority to the development of transport (roads, airports, ports, rail) and energy infrastructure. Despite the signing of a memorandum as early as 2013, projects for nuclear power stations and the modernisation of several coal-fired power plants in Romania have not even begun⁹.

China's offers to finance infrastructure within the '16+1' format are not significantly different from the instruments Beijing offers the rest of the world.

So far, the only case where the Chinese funding model has been used within the EU is the construction of the Hungarian section of the Belgrade-Budapest railway, described in more detail below. It should be noted, though, that Chinese companies have been increasingly successful in tenders for infrastructures within the EU-11 (including the construction of power lines). However, they are merely contractors, comparable with the European companies starting in the tender; the Chinese party here is neither an investor nor a lender.

⁹ In this case, however, the offer from the Chinese policy banks was not taken up, funding for the projects was to be guaranteed by the ICBC. See <http://www.world-nuclear.org/information-library/country-profiles/countries-o-s/romania.aspx>

The EU-11's reluctance to use Chinese loans has two main causes:

(a) legal/political. The funding model proposed by China, which links loans to the appointment of the contractor (without an open tender), and also assumes that the local government will guarantee the projects (state aid), is incompatible with EU law. The use of Chinese instruments is thus associated with the risk of intervention by the European Commission. However, it should be recalled that the legal formula China offers can be also considered unfavourable from the point of view of the local communities. The contracting process is opaque, which is bad from the point of view of the local constituencies. And due to their limited participation in the tenders, this formula is not attractive from the point of view of both local and European businesses.

(b) financial/developmental. The EU member states currently have a broad choice of financing tools for infrastructure investments. The Chinese offer is just one of many options on the table, and it almost always loses out to EU funding based on grants. As the structural funds, including the TEN-T programme which focuses on the development of transport infrastructure, are effectively a kind of partial grant, the Chinese offer (which is based exclusively on loans) automatically finds itself in an unfavourable position. Even in the field of credit, there is competition for Chinese funds from the EU's instruments, which include relatively cheap and transparent loans from the European Investment Bank within the framework of the European Fund for Strategic Investments (the so-called Juncker Plan). Due to the relatively good macroeconomic situation, as well as record low interest rates in Europe, it is more favourable for most countries to contract a debt through long-term bonds than to take a loan from China. The CDB and Exim Bank, which raise capital for the Chinese market, cannot offer credits below the Chinese interest rate (and must also impose margins).

By obtaining financing for their development, the CEE states are thus approaching the infrastructure development question in a pragmatic manner, and are avoiding contracting debt in unfavourable economic conditions – debt which in addition comes loaded with the risk of violating the local legal system, and with potential political costs. Since 2012, when China made its financial offer to the region, dozens of infrastructure projects have been started in the EU-11 in the fields of energy, rail and road construction.

The EU's priorities are to adapt the Chinese offer to EU conditions, and to take account of the needs of European business.

Every year projects worth tens of billions of euros are initiated in the region¹⁰. So far, however, these have not been financed using the instruments offered by China. In 2015-2017, the projects initiated in the EU-11 based on loans from the so-called Juncker Plan, which have mostly focused on infrastructure, have reached the value of €4.8 billion¹¹. The region's infrastructure needs remain very substantial; but for now it can, and does, take advantage of a very wide range of development offers from the EU.

The only deviation from this trend is the project to modernise the Budapest–Belgrade railway connection on the Hungarian side. The funding and implementation agreement for this project was signed in 2013, and on its basis a Chinese/Hungarian consortium was created to implement the project, with a value of US\$1.67 billion (a total of US\$2.89 billion including the

Serbian section). The details of the project remain opaque; the feasibility study has been classified for 10 years. The European Commission has started an investigation with regard to the project, due to suspected breaches of EU law, including in the tendering procedures.¹² The motives of the Hungarian side are unclear. The upgraded stretch of track between Budapest and Kelebia has not been included in the TEN-T network, which has narrowed down its financing options. At the time of the agreement, Hungary was in a worse economic situation than at present, and had difficulty attracting foreign investments. However, it cannot be ruled out that in this case, the political calculation on the part of the government of Viktor Orbán could have been given priority over purely economic calculation – with the aim of strengthening his country's bilateral relationship with China. It must be stressed, however, that this project is a clear exception to the general trends in the financing of infrastructure within the EU-11.

China's attempt to adapt

The inadequacy of the Chinese model for financing infrastructure in relation to the development needs of the EU-11 has been communicated to China by the local participants in the '16+1' format. Beijing seems to have taken note of the current ineffectiveness of its policy, and is trying to adapt its activities to local circumstances. One essential course of action is to create instruments in which Chinese financial institutions and companies would act as genuine investors, locating their own funds in the region and assuming part of the business risk. In parallel with the establishment of its credit line, Exim Bank has created a private equity fund (focusing on the multiplication of capital

¹⁰ In the period 2007-2015, the average value of contracted projects within the framework of European funds – less the contribution of the states themselves – ran at around €20 billion euros annually for the EU-11. A substantial part of this sum was assigned to the upgrading of infrastructure. See <https://assets.kpmg.com/content/dam/kpmg/pdf/2016/06/EU-Funds-in-Central-and-Eastern-Europe.pdf>

¹¹ This figure does not include cross-border projects. See <http://www.eib.org/efsi/efsi-projects/index.htm>

¹² EU sets collision course with China over 'Silk Road' rail project, *Financial Times*, 20 February 2017, <https://www.ft.com/content/003bad14-f52f-11e6-95ee-f14e55513608>

through the acquisition and sale of private companies) called the China-CEE Fund, which has US\$435 million at its disposal. So far it has confined itself to investing in existing companies (including wind farms), and despite announcements to this end, the fund has not been enlarged with any further financing. Since 2015 the creation by the Chinese commercial bank ICBC of a new Sino-CEE Financial Holding Fund has been discussed with local governments. This would be targeted at long-term investments in infrastructure projects in the region. Creating this type of instrument, however, requires a balance between local interests (new infrastructure, the possibility of local businesses getting involved) and Chinese interests (an increase in demand for Chinese components), while at the same time respecting EU law.

Beijing has failed to obtain the political tools which could have weakened policy coherence at the European level, or even divided the EU.

Further adjustments of this kind would mean a change in China's role in the region, from being a lender to becoming a genuine investor. However, this would require a certain amount of flexibility on the part of Beijing, as well as coordination within the region. The current offer presented in the '16+1' framework does not derive from global trends in Chinese foreign policy; the Chinese institutions involved apply the financing rules described above around the world. This is demonstrated by the development of financial instruments within the framework of the One Belt, One Road project; the majority of the funds for infrastructure development in Eurasia announced by Xi Jinping during the One Belt, One Road forum in 2017 are supposed to come from credit lines from

the CDB and Exim Bank¹³. The Asian Infrastructure Investment Bank (AIIB), founded in 2015, seems to offer a more transparent and open funding model, although so far its activities have been limited to Asia. The inertia of the Chinese institutions involved, and the fact that China is used to applying its own rules for finance, may increase the political pressure to apply them in Central and Eastern Europe.

In the face of increasing debate on the EU's future role in financing investment in the Central European region, a scenario is possible whereby the Chinese offer to the EU-11 becomes more attractive in an indirect way – by limiting the alternatives. The distance between Central Europe and the rest of the EU as regards the level of infrastructure is still very large; the region will still be wrestling with the need to expand its energy and transport infrastructure in the coming years. At the same time, the countries in the region have still not yet built up enough of their own capital which could meet their investment needs, and so they continue to depend on capital from the rest of the world. So far the local governments have showed a degree of pragmatism, opting for methods which maximise their financial and developmental benefits. If the next EU budget after 2020 reveals potential limitations to funding for the development of Central and Eastern Europe – because of a significant reduction in the figures, or if funds are directed to sectors which do not cover the development objectives in the region – then China's offer could automatically become more attractive. This would put the countries in the region in a much more difficult situation, in which they will have to consider their further support for economic development, and whether they should utilise the financing conditions presented by China, which are not always favourable to them.

¹³ The credit lines announced in the meantime for the implementation of the initiative amounted to US\$38 billion for the CDB, and US\$20 billion for Exim Bank. The Silk Road Fund investment fund was then increased by about US\$15 billion. The capital at the AIIB's disposal runs at around US\$100 billion.

Implications for EU policy

- Due to the low attractiveness of the Chinese offer to finance infrastructure, the risk of a breakdown of cohesion within the EU as a result of CEE's economic dependence on China remains small. Nor will the development of political cooperation between Central & Eastern Europe with China undermine European legislation on tenders and public aid. However, building up CEE's support for the EU's general agenda regarding China remains a challenge due to the risks that could be observed in the cases of many other EU member states – individual leaders within the region may find it more attractive to pursue their interests by building up bilateral relations with China. A uniform position is thus in part dependent on considering the region's objectives as part of the EU's policy towards China.
- The use of the debt model to finance infrastructure, which threatens a breach of EU law and macroeconomic risks, will remain negligible – as long as the EU continues to make an attractive developmental offer to the region. It is also possible that the Chinese offer will be successfully adapted to the region's circumstances (including EU law), and that the participation of Chinese capital will increase. This would allow the creation of synergies between the EU's policies

and the actions of China, including the acceleration of real convergence. However, there is a risk of an adverse scenario: namely, that China fails to adapt, while the EU simultaneously reduces its offer of development deals. Due to the still pressing need to upgrade their infrastructure, in the long term this may encourage the countries of the region to take advantage of the Chinese debt model. This could result in an increase in the legal, political and economic risks described above.

- The EU has the space to facilitate constructive economic relationships between China and CEE, and to counter potential threats. The priorities remain: to adapt the Chinese offer to EU conditions, and to take account of the needs of European business. It is important to reduce Beijing's political pressure to use the current model to finance infrastructure development within the EU. An important legal challenge will lie in increasing the openness and transparency of the process, as well as supporting a change in the nature of the Chinese commitment from one based on debt to one based on investment, while finding a balance of positions between all the interested parties. This is a job for the EU's institutions, for specialised agencies such as the as EU-China Connectivity Platform, as well as for the member states concerned.

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