INTESA SANPAOLO

The One Belt One Road Initiative: an Opportunity for Western Balkans

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Index

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Executive Summary

The economic weight of China in the world economy has significantly increased over the last 15 years, and in several ways. In 2015, China's share of world GDP (evaluated as Purchasing Power Parity) reached 17.1% and is currently the world largest. This share is likely to increase further in the future, when considering that China's GDP growth rate differential compared with the world economy is still expected by major research centres to be around 3% and that, in addition, China's share of the world's GDP is still lower than China's share of the world population (19%).

At an international level, this striking economic performance does not seem to have been accompanied by a corresponding expansion of China's geopolitical role. China is often reported to meet G2 talks with the US and renminbi has been now included by the IMF in the SDRs' basket of currencies. The Asian country, however, has actually been kept out, for example, of the negotiations of both the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP), and has not yet been granted market economy status by the EU. At a domestic level, it has also seen increasing imbalances in parallel, from high overcapacity in some sectors, mainly in heavy industry and state-owned enterprises (which have seen massive internal infrastructure investments), to unprecedented levels of demand for energy commodities, as well as environmental pollution due to their inefficient use.

From China's perspective, the One Belt, One Road (OBOR) Initiative can actually be regarded as a long-term project that can contribute to at least partly address both its foreign geo-political deficit and domestic economic imbalances. The OBOR Initiative is mainly oriented towards strengthening connectivity and improving integration through infrastructure investments in the countries along the ancient Silk Road. The Action Plan released by the Chinese authorities in March 2015 (following comments made in 2013 by the President Xi Jinping) has been announced in a timely fashion in a geopolitical context period when US global pre-eminence is gradually shifting towards a multipolar world, Russia is trying to redefine its sphere of influence in Europe and Asia, the Gulf states and Iran are competing to extend their influence in the MENA region, and the EU is struggling against potential break-up forces.

The OBOR Initiative can also contribute to addressing the efforts (made since the 12th Five-Year Plan 2011-2015 and continued with the 13th Five-Year Plan 2016-2020) to rebalance the country's growth model by channelling domestic overcapacity in the steel and cement sectors into foreign infrastructure investments and by supporting the manufacturing sector while reducing its dependence on foreign technologies. The architecture of the Action Plan is in this context designed to ensure that China secures routes towards commodity-exporting countries and to creating favourable conditions for a global extension of Chinese (state-owned) large enterprises.

The OBOR Initiative aims to develop connectivity both inside China, and between China-Asia and Europe. Inside China, the Action Plan involves several provinces: a) In Northwestern and Northeastern regions: Xingjiang, Shanxi, Gansu, Ningxia Hui and Qinghai, Inner Mongolia, Heilongjiang, Jilin, and Liaoning; b) In Southwestern region: Guanxi, Beibu Gulf Economic Zone, Pearl River – Xinjiang Economic Zone, Yunnan, and Tibet; c) In Coastal Regions: Hong Kong, Macao, and Taiwan; d) In inland regions: key city clusters along the middle reaches of the Yangtze River, around Chengdu and Chongqing, in central Henan province, around Hohhot, Baotou, Erdos and Yulin, and around Harbin and Changchun. In 2015 many provinces published their own specific plans for participating in the Initiative.

In relations with Asia and Europe, the Action Plan of the OBOR Initiative identifies six main economic corridors along land and sea routes where the main transport and energy infrastructure projects are located, intersecting with different countries' national plans in particular: I) The new Eurasian Land Bridge; II) The China – Mongolia – Russia Economic Corridor; III) The China – Central Asia – West Asia Economic Corridor; IV) The China – Indochina Peninsula Economic Corridor; V) The China – Pakistan Economic Corridor; and VI) The Bangladesh – Chian – India – Myanmar Economic Corridor.

The Action Plan does not contain specific allocations for the entire initiative or for single projects. Rather, it appears to be more of a guideline to which all relating projects must comply to obtain support. The implementation may span a very long period (up to 35 years according to various scholars), significantly reaching completion perhaps in time for the 100th anniversary of the People's Republic of China in 2049.

The financing of the OBOR Initiative would be mainly provided by (Chinese participated) multilateral institutions, some of which have been set up in the last few years, including the Asian Infrastructure Investment Bank and the New Development Bank (former BRICs Bank), but also by the Chinese Silk Road Fund – specifically established in 2014 under the framework of the OBOR Initiative - and by China's policy banks. The action plan also welcomes an active financing role by sovereign wealth funds of countries along the Belt and Road as well as by commercial equity investment funds and private funds. In Europe, China and the EU have also focused on the necessity to identify synergies between the OBOR Initiative and the Junker Plan, i.e., the EFSI (European Fund for Strategic Investment). Co-funding could come in this respect from the European Investment Bank (EIB).

From the point of view of the countries along the Silk Road, the OBOR Initiative – by some feared as possibly China's tool to pragmatically pursue an expansionary foreign policy – can certainly be considered and taken as a significant opportunity to improve their infrastructure (a preliminary step to any effective growth enhancing trade and industrial development), owing to massive investments involved in ports, roads, railways and pipelines. The initiative appears to be particularly attractive when considering that it is being proposed in the context of particular economic and financial distress for some emerging and transition economies, with international trade seen to decelerate, capital flows to partially reverse to advanced countries and actual and potential growth harmfully faltering.

Now, if these circumstances generally also recur among most of the countries along the Silk Road, they are even more present in the case of CEECs region and the western Balkans in particular. Despite the improvement seen over the last 15 years, the CEECs region still has a significant economic gap to narrow with respect to the European Union. In the last five years, the GDP level evaluated at PPP with respect to the Euro Area still averaged in a range from 20% in Albania to 80% in Czech Republic, with the western Balkans showing the highest economic gaps. In the whole region, the differential GDP growth rate abruptly narrowed after the financial crisis of 2009, with a severe impact on the economic convergence process towards the EU.

A number of theoretical and empirical contributions highlight the important role played by international trade and foreign direct investments in fostering both productivity and economic growth. A panel regression on a sample of 28 countries and 15 years of annual data run of Total Factor Productivity (TFP) on Foreign Direct Investment over GDP growth and on Trade Openness growth provides further evidence supporting those results.

Any initiative, then, devoted to encouraging both foreign investment and trade can represent a powerful tool to boost productivity and add to economic growth. This has been and is certainly the case of the investment projects supported by the EU Commission through the Pre-Accession Assistance and the Structural Funds Schemes devoted to the CEECs region. And it is also expected to potentially come true with regard to the investment projects designed in accordance with The Medium Term Agenda for Cooperation between China and CEECs (the so-called 16+1 Group) outlined in November 2015 in Suzhou, just a few months after the official launch of the OBOR Action Plan.

The total amount of investment potentially targeted at the western Balkans by the OBOR Initiative – mainly in transport infrastructure and energy supply – can currently be roughly estimated at around USD 11Bn. This value (which has to be compared with the so far modest amount of Chinese outward FDI stock towards the western Balkans of around USD 57M at the end of 2014) alone would increase the amount of total FDI in the western Balkans from USD 52Bn recorded at the end of 2014 to around USD 63Bn, with an estimated impact on Total Factor Productivity (and GDP) growth in the order of almost 1%.

Two factors, however, can make finalisation of the OBOR Medium Term Agenda between China and CEECs less linear than expected, and also put some sand in the wheels of the initiative. These concern the effective level of local enterprises' involvement in the realisation of the investment projects and the financing tools specifically considered. These two issues deserve proper attention, in our view.

The operational model of all the Chinese projects realised so far is quite similar. The projects are generally delivered by Chinese state-owned enterprises as principal contractor and financed by loans at favourable terms by Chinese banks. Agreements, however, have also envisaged the possibility for local companies to be sub-contracted with up to 50% of a project's value, an opportunity that would increase locally the chance of a successful finalisation of the OBOR Initiative. In the case of construction of the Sino-Serbian Bridge over the Danube, for example (successfully completed), the value of construction works was split approximately 50:50 between the Chinese, who were in charge of construction of bridge, and local companies, which worked on the construction of access roads and the paving of the bridge.

Considering the USD 10.5Bn total potential value of OBOR projects in the western Balkans, in case of a participation of 50% by SME's and on the assumption of a share of around one-third to be debt-financed, this may give rise to significant financing requirements that are to be provided locally by the domestic banking systems.

In terms of financing, one major issue refers to local governments' commitments to controlling budget deficits and external debt among western Balkan countries. The provision of only debt-financed investments and state-by-state loans in this regard could clearly limit the full potential of the Agenda. Additional ways of financing (which may include PPP and Concessions Schemes, among others) should also be considered among the possible sources to be accessed.

Having said that, the large set of Investment projects involved in the OBOR Initiative in western Balkans represent in our view an extraordinary chance for local industry, especially for SMEs - which represent more than 99% of the total number of enterprises in the region and account for around 60% of total employment. Among SMEs not only the medium-sized companies will have the largest opportunity but also the smaller companies as sub-contractors.

1. The One Belt One Road Initiative

Silvia Guizzo

Owing to years of double-digit growth, China's weight in the global economy has been rising steadily over the past 15 years and has now reached critical levels. China's share of world exports, at 11.4% in 2015, is the world largest in a single country ranking and second only to the Euro Area (25.5%). Similarly, China's share of world GDP, ie, 17.1% in 2015 (the Purchasing Power Parity, or PPP, being equal), overtook the Eurozone in 2011 and the United States in 2014, and is currently the world largest. China has been a major attractor of Foreign Direct Investment (FDI) since the 2000: China Mainland inward FDI stock was fourth-largest in the world in 2014, with a quota of 4.4% (UNCTAD), after the US, the UK and Hong Kong. However, this striking economic performance has produced some imbalances as well, that include - to name just a few - high overcapacity in some sectors, mainly in heavy industry, as well as an unprecedented level of environmental pollution which threatens the country's future growth trajectory.

All of China's policies in the 12th Five Year Plan (2011-2015) and the reforms framework outlined by the third Plenum Decision in December 2013, were aimed at more balanced and sustainable growth over the long term. The recently approved 13th Five Year Plan (2016-2020) proposals are no different and aimed at accelerating the rebalancing of the economy through demand- and supply-side reforms. Legal and socio-political demand-side reforms aim at increasing incomes – and, hence, private consumption – by expanding rural land and migrants' rights, as well as coverage of welfare services. The supply-side reforms, on which the government seems much more focused, are intended to reduce overcapacity (mainly in the steel and cement sectors, but also in some other areas), reduce corporate leverage, and residential property high inventory. They also are intended to move the manufacturing sector up the value chain, reduce dependence on foreign technologies (aspiring for innovation leadership status), expand the service sector ("*Made in China 2025*" and "*Internet Plus*" initiatives), promote energy efficiency and reduce pollution.

At the same time, China is sticking to its strategy of promoting the renminbi internationalisation and gradually liberalising the capital account specifically by encouraging Chinese corporations to "*go global*". Besides being a strong attractor of FDI, China has also become an important investor in the last few years: China's outward FDI stock grew to 3% of the world total in 2014 from just 0.6% in 2007, and China's outward FDI flows have been over 5% of the world total since 2009. In fact, China also aims to assume a more relevant geopolitical role at both regional and international levels, reflecting its relevant weight in the world economy. Given this spirit and based on this framework, China has developed the One Belt, One Road (OBOR) Initiative with the primary objective of strengthening regional connectivity and improving integration mainly through infrastructure spending and stronger trade ties with the countries along the ancient Silk Road.

1.1 The OBOR Initiative and the Action Plan

President Xi Jinping first hinted at development of the One Belt, One Road Initiative in autumn 2013. During a visit to Kazakhstan[1] in September 2013, he proposed that China and the Central Asian countries cooperate to build an "*economic belt along the Silk Road*," a trans-Eurasian project spanning from China's coastal provinces though Central Asia and Russia to the Baltic States, referred to as the Silk Road Economic Belt.

[1] On 7 September 2013, during his state visit to Kazakhstan, speech at Nazarbayev University.

A month later, during a state visit to Indonesia[2], Xi Jinping proposed building a cohesive China–ASEAN cooperation and offered guidance in building a "*new maritime silk road*", referred to as the 21st Century Maritime Silk Road, and designed to connect China's coasts to Europe through the South China Sea and the Indian Ocean along one route and to the South Pacific Ocean islands through the South China Sea along another. The initiative entails further development for both the Inner and Western Chinese provinces along the *Belt* and the Pearl River Delta and Hong Kong area along the *Road*.

The President focused on strategic planning regarding the OBOR Initiative in November 2013, during the Third Plenum, and in December 2013, during the annual Central Economic Work Conference. Since then, the initiative has become the centrepiece of China's foreign policy and economic strategy, and moved rapidly forward during 2014, when the first phases of some related projects were started, and on 28 March 2015, when the National Development and Reform Commission (NDRC), the Ministry of Foreign Affairs and the Ministry of Commerce, with authorisation from the State Council, jointly issued an Action Plan on the Belt and Road Initiative[3].

Embracing the trend toward a multipolar world, China emphasises that the initiative is animated by and should be joint with a "spirit of cooperation" among countries in all fields to reach "inclusiveness, mutual learning, common development and prosperity". The document often refers to the OBOR as a "win-win cooperation" initiative in line with President Xi Jinping's promotion of the concept of "*a community of common destiny*"[4]. The Action Plan highlights that the initiative is in line with the purposes and principles of the UN Charter, and it upholds the Five Principles of Peaceful Coexistence which are defined as: "mutual respect for each other's sovereignty and territorial integrity, mutual non-aggression, mutual non-interference in each other's internal affairs, equality and mutual benefit, and peaceful coexistence". Moreover, the Action Plan stresses that any project linked to the initiative should be made through consultation in order to integrate the development strategies and the existing investment programmes of the countries along the *Belt and Road*.

The Action Plan does not contain allocations for the entire initiative or for single projects. Rather, it appears to be more of a guideline to which all relating projects must comply to obtain support. Concrete details on allocations are very scarce. During the opening speech at the APEC CEO Summit in Beijing on 9 November 2014, President Xi Jinping commented that China's total outbound investment will total USD1.25Tn over the next 10 years[5]. More recently[6], China Development Bank, one of the country's policy banks, said it is going to invest more than USD 890Bn in more than 900 projects involving 60 countries in the coming years as part of its efforts to bolster the OBOR Initiative. The implementation may span a very long time period (as long as

[2] 3 October 2013 speech at the Indonesia Parliament during his state visit to Indonesia.
[3] "Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road" available at http://en.ndrc.gov.cn/newsrelease/201503/t20150330_669367.html .
[4] For instance, see President Xi Jinping, "Let the Sense of Community of Common Destiny Take Deep Root in Neighbouring Countries", Conference on the Diplomatic Work with Neighbouring Countries, 25 October 2013, http://www.fmprc.gov.cn/mfa_eng/wjb_663304/wjbz_663308/activities_663312/t1093870.shtml
[5] See *Financial Times*, 9 November 2014, Jamil Anderlini: "China foresees outbound investment of $1.25tn in a decade" http://www.ft.com/intl/cms/s/0/806fe102-67de-11e4-acc0-00144feabdc0.html#axzz48LE55OBr
[6] During the ASEM (Asia-Europe Meeting) Industry Dialogue on Connectivity held in Chongqing on May 27 2015. See Asia Unhedged: "China to invest $900 billion in New Silk Road" 29 May 2005, available at: http://atimes.com/2015/05/china-to-invest-900-billion-in-new-silk-road/

35 years, according to various scholars), reaching completion in time for the 100th anniversary of the People's Republic of China in 2049[7].

The main actors involved both in the realisation and in the financing of the projects

The financing of the OBOR Initiative will be mainly provided by multilateral institutions, some of which set up in the last few years, but also by the Chinese Silk Road Fund and by China's policy banks.

The Asian Infrastructure Investment Bank (AIIB) is a multilateral development bank founded by China to finance Asia's huge infrastructure needs and to promote "interconnectivity and economic integration in the region". In contrast to the US, many European countries, including Italy, appreciated the initiative, and representatives from 22 countries signed a MOU for its constitution in 2014. The Bank has been in operation since the end of 2015, with an initial capital level of USD 100Bn. It is headquartered in Beijing.

The Silk Road Fund (SRF) was established in December 2014, with USD 40Bn in assets under management as initial capital. The Fund mainly provides investment and financing support for trade and economic cooperation and connectivity under the framework of the OBOR Initiative in collaboration with domestic and international enterprises and financial institutions.

As the official website states, the New Development Bank (NDB, former BRICs Bank) is a multilateral development bank operated by the BRICS states (Brazil, Russia, India, China and South Africa) "as an alternative to the existing US-dominated World Bank and International Monetary Fund" and was founded in 2015. Each country is assigned one vote independently of their capital contribution. It is headquartered in Shanghai, with an initial subscribed capital level of USD 50Bn and an initial authorised capital level of USD 100Bn.

Other financing will be provided through commercial lending by the main Chinese policy banks, namely the Bank of China, the China Development Bank, the Agricultural Development Bank of China, and the Export-Import Bank of China. During the summer of 2015, the China Development Bank and the Export-Import Bank of China were recapitalised to the amounts of USD 48Bn and USD 45Bn, respectively, using forex reserves with the intent of supporting Chinese outward investment.

China became a member of the European Bank for Reconstruction and Development (EBRD) in December 2015 and has a strong commitment to cooperate with the bank's projects and programmes as well as with those of the European Union. EU programmes potentially affected by the could be existing plans on railway networks, such as the Trans-European Transport Networks (TEN-T) in particular in the Priority Axis no. 22 (Athens-Sofia-Budapest-Vienna-Prague-Nuremberg/Dresden) and Priority Axis no. 23 (Danube Bridge – Vidin-Calafat between Bulgaria and Romania). Both China and the EU have focused on the necessity to identify synergies between the OBOR and the Junker Plan, ie, the EFSI (European Fund for Strategic Investment), since the 17th EU-China summit in June 2015. In April 2016, the European Commission and China concluded technical work allowing Beijing to start investing up to EUR 10Bn under the

[7] "One Belt, One Road: China's great leap outward" in European Council on Foreign Relations, China Analysis, June 2015

plan[8]. Co-funding could also come from other multilateral institutions, such as the European Investment Bank (EIB).

The action plan stresses the need to enhance the role, and **exploit existing cooperation mechanisms,** of institutions such as the Shanghai Cooperation Organization (SCO), ASEAN Plus China (10+1), Asia-Pacific Economic Cooperation (APEC), Asia-Europe Meeting (ASEM), Asia Cooperation Dialogue (ACD), the Conference on Interaction and Confidence-Building Measures in Asia (CICA), the China-Arab States Cooperation Forum (CASCF), the China-Gulf Cooperation Council Strategic Dialogue, Greater Mekong Subregion (GMS) Economic Cooperation, and Central Asia Regional Economic Cooperation (CAREC).

The Action Plan also welcomes an active role in financing by sovereign wealth funds of countries along the *Belt and Road* and encourages "commercial equity investment funds and private funds to participate in the construction of key projects of the Initiative".

1.2 The discussion around the initiative

Complementary to the intent of peaceful coexistence and mutual benefits, China's initiative also has a strong **economic and geopolitical basis**:

- Experiencing a "new normal" growth path, more sustainable but lower than in the past, and aspiring to move up the value chains, Chinese investors are keen to seek better returns and more profitable opportunities abroad. On the one hand, increased infrastructure investment overseas is expected to **absorb some of China's overcapacity** and workforce in construction and heavy industries, supporting the restructuring of these sectors. The same can hold for infrastructure investment in the least developed areas in China, also involved in the OBOR Initiative with the aim to support more balanced regional development and generate positive spill-over effects. On the other hand, Chinese corporations, through foreign investment, can **access high technology and well-known brands** that are less available at home and at the same time expand their customer bases by gaining a presence in international markets. **Innovation** has been placed at the core of the 13th Five-Year Plan and China has committed to positioning a group of major corporations (so called "backbone companies") to become global leaders in ten priority strategic industries.
- Economic reasons intersect with strategic and geopolitical ones to **counterbalance the leading role of the US at an international level**. The OBOR Initiative offers a way to **access foreign markets** mainly through bilateral agreements since China has been kept out both the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP), and has not yet been granted market economy status by the EU under Section 15 of the Chinese WTO Accession Protocol, in anti-dumping proceedings[9]. The EU has also been reluctant to yield to

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[8] For more details, see: http://www.euractiv.com/section/innovation-industry/news/brussels-clears-way-for-china-to-pour-billions-into-juncker-plan/

[9] The correct interpretation of the relevant section of the Chinese WTO Accession Protocol has come under debate, as well as whether the section stipulates automatic granting of Market Economy Status to China after December 2016. On 12 May 2016 the European Parliament passed a resolution stating that China is not yet eligible for being granted the Market Economy Status and that there is no case for relaxing anti-dumping rules against the country (full text available at: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P8-TA-2016-0223+0+DOC+XML+V0//EN&language=EN). Although the resolution is not binding it sends a clear signal to the European Commission, which must issue a proposal on the matter buy the end of this year. For more detail on the subject see EPRS - European Parliamentary Research Service: "Granting Market Economy Status to China - An analysis of WTO law and of selected WTO members' policy". November 2015.

recent Chinese pressure to open up the possibility of a future Free Trade Agreement (FTA), although it has launched negotiations on a Bilateral Investment Agreement[10].

- Securing long-term access to natural resources and commodities remains a top priority for the Chinese authorities, and the OBOR Initiative will enable China to diversify sources and routes by reducing reliance on the Strait of Malacca and dependence on the Middle East, still the first supplier of oil and petroleum products to China.

- The OBOR Initiative can also foster renminbi internationalisation by further encouraging the international use of the renminbi not only as invoice currency but also as an investment currency in Asia and in Europe, where in the recent years China has granted its banks' subsidiaries clearing bank licences and where CNH (renminbi offshore) bond issuance has been active. Chinese policy and commercial banks will continue to "go global" to support both Chinese and local firms in countries along the OBOR, with the new Asian Infrastructure Investment Bank and the Silk Road Fund will play key roles in jump-starting investment.

Although the initiative has been welcomed by many countries, as the participation in the AIIB proves, it has not been immune to critiques and expressions of concern, and intense debate has been carried out in countries along the OBOR:

- In Europe. The European Union lacks a strong and unified foreign and industrial policy, and is a significant global force only in trade. According to political analysts, its interests in China are basically mercantilist, since China is mainly viewed as a huge and promising market and, recently, as a source of otherwise scarce capital[11]. Member states' governments have hence striven to achieve an edge over each other by competing for favours from China with a short-term perspective and no unified long-term vision. The risk is that this helps Beijing to gain both economic and geopolitical influence in the EU without conceding many benefits in exchange.

- In India. Political analysts underline that the Indian government has, on different occasions, signalled its concerns about the evolution of the concept of connectivity in the region and abroad[12], very likely hinting indirectly about China's reach. China's approach, cooperative based on Chinese rhetoric, is instead viewed by India as more unilateral[13]. Tangible concerns regard in particular the China-Pakistan Economic Corridor, because it involves projects in territory that India claims both vs China and vs Pakistan, namely the completion of the Karakorum Highway[14].

- In South East Asia: Concerns are similar to those of India and are compounded by China's claim of sovereignty over several South China Sea islands that has already given rise to disputes with ASEAN member states, namely Vietnam, the Philippines and Indonesia.

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[10] EU and China announced the launch of negotiations on 21 November 2013 during the 16th EU-China Summit, more detail available at: http://europa.eu/rapid/press-release_IP-14-33_en.htm.
[11] Guy de Jonquières, "The EU and China: Redressing an Unbalanced Relationship", ECIPE Policy Brief no. 1/2016.
[12] India's Foreign Secretary, S. Jaishankar, stressed that "Connectivity itself has emerged as a theatre of present day geopolitics…" and that "…Naturally, every country tends to look at these questions from the view point of its own best interests. Connecting Asia successfully requires the judiciousness and wisdom to reconcile these differing points of view and agree on something that all stakeholders can live with". You can find the Speech by the Foreign Secretary at Raisina Dialogue in New Delhi (March 2, 2015): http://www.mea.gov.in/Speeches-Statements.htm?dtl/26433/Speech_by_Foreign_Secretary_at_Raisina_Dialogue_in_New_Delhi_March_2_2015
[13] See Tanvi Madan, "What India thinks about China's One Belt, One Road initiative (but doesn't explicitly say)", March 14, 2016, in Brookings, "*Order form Chaos*" blog
[14] India pushed for a provision in the charter of AIIB that requires project financing in disputed territory to have the agreements of disputants. See note 11

- In Africa: Africa has been a key destination for Chinese FDI in order to gain access to primary commodities (energy-related, but also agricultural). However, observers claim that Official Development Aid (ODA) flows and grants are mainly used to promote Chinese foreign policy goals, while less concessional forms of official financing promote the economic interests of the Chinese state as well as Chinese firms operating abroad, although there is no evidence that this is any different for other influential donors, such as the US[15].

1.3 The maritime and overland routes and key infrastructure projects

The Initiative's main intent is to encourage connectivity among the countries along the OBOR and to facilitate trade mainly by developing transport, energy and information and communication infrastructure as well (cross-border optical cables). The other important goal is to facilitate trade by developing single windows in border ports, lowering non-tariff barriers, supporting cross border e-commerce, and building a service trade support system. As well as transport and energy, the Initiative is open to other fields of cooperation, including agriculture and fishery, industrial chains, financial integration, tourism and culture, healthcare and medicine, science and technology, and NGOs.

The OBOR Initiative aims to develop connectivity both inside China, and between China-Asia and Europe. Inside China, the Action Plan identifies the involved provinces:

- In Northwestern and Northeastern regions: Xingjiang, Shanxi, Gansu, Ningxia Hui and Qinghai, Inner Mongolia, Heilongjiang, Jilin and Liaoning.
- In Southwestern region: Guanxi, Beibu Gulf Economic Zone, Pearl River – Xinjiang Economic Zone, Yunnan, Tibet.
- In Coastal Regions: Hong Kong, Macao and Taiwan.
- In inland regions: key city clusters along the middle reaches of the Yangtze River, around Chengdu and Chongqing, in central Henan province, around Hohhot, Baotou, Erdos and Yulin, and around Harbin and Changchun.

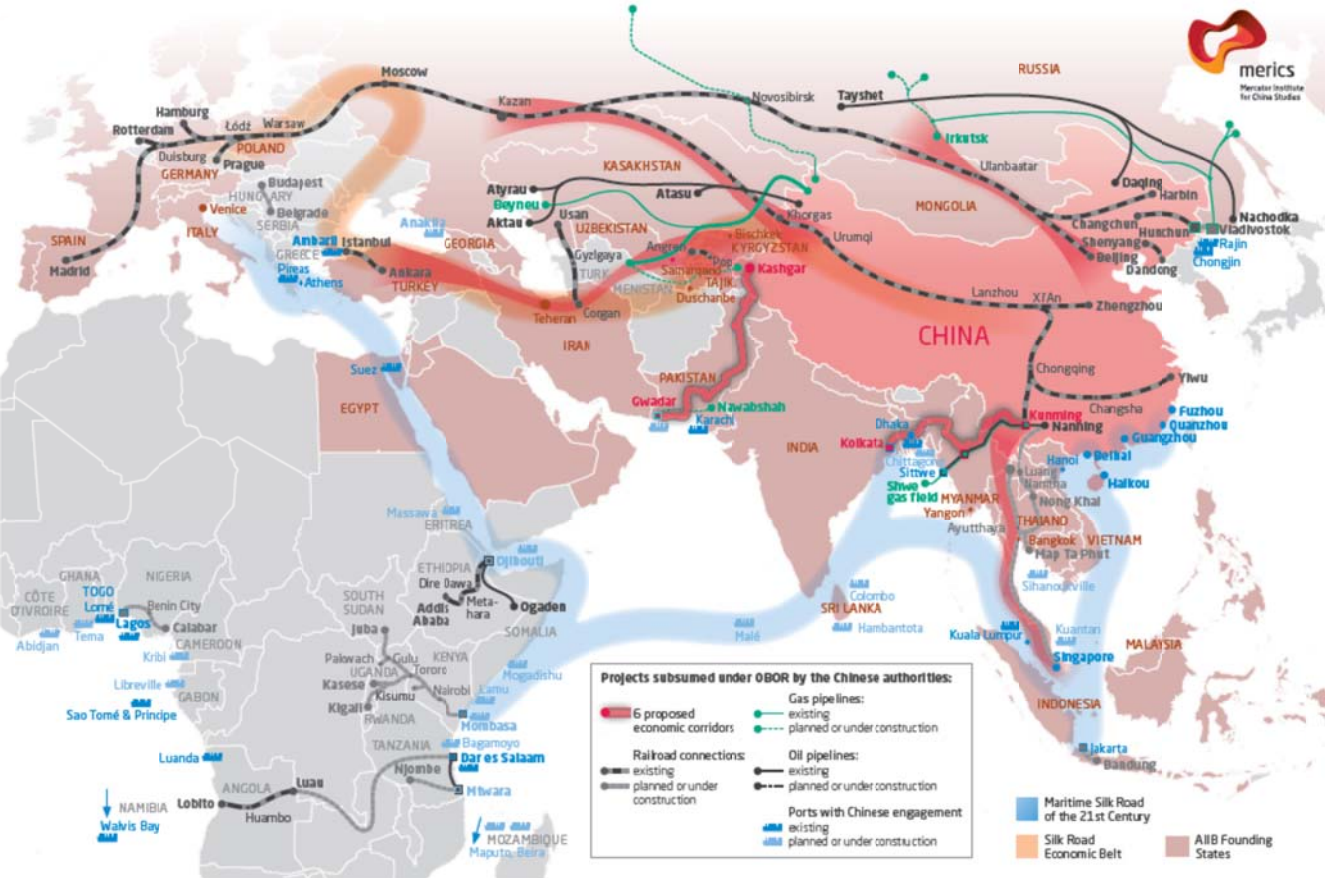
Note that in 2015 many provinces published their own plans for participating in the Initiative[16].

As far as China's connectivity with Asia and Europe, the Action Plan identifies six main economic corridors along land and sea routes where main transport and energy infrastructure projects are located, intersecting with different countries' national plans.

[15] Dreher, Axel, Andreas Fuchs, Bradley Parks, Austin M. Strange, Michael J. Tierney. 2015. Apples and Dragon Fruits: The Determinants of Aid and Other Forms of State Financing from China to Africa. AidData Working Paper #15. Williamsburg, VA. Accessed at http://aiddata.org/aiddata-working-paper-series

[16] For detailed information on provinces plans see: http://beltandroad.hktdc.com/en/official-documents/official-documents.aspx

Main corridors and project along the OBOR Initiative



Source: MERICS - Mercator Institute for China Studies - Berlin

The New Eurasian Land Bridge

- The corridor's main projects focus on improving railway connections running from the port of Lianyungang in Jangusu Province all the way to Western Europe via Lanzhou and Urumqi to the Alashankou crossing on China's western frontier. The line connects there with Kazakhstan Railway and then run through Russia and Poland to Rotterdam. An international freight train from Lianyungang in Jansu to Kazakhstan through Xinjiang province began running in February 2015, complementing the existing lines. Cargo can be transported all the way to Rotterdam in less than 14 days[17]. Other freight trains start in different locations, such as Chongqing and Xian, and then join this route. A freight train from Yiwu, in Jinhua, Zhejiang province, to Madrid has been running since November 2014. The carriages pass through Kazakhstan, Russia, Belarus, Poland, Germany and France.

- In Europe, three potential sub-corridors are envisaged, connecting China to the Baltic, the Adriatic and Black Sea ports, affecting Central and Eastern European countries and the Balkan states (see more details on parts no 2 and 3 of this report). The aim is to develop intermodal connections linking the main ports to the inner territories as well as to build energy infrastructure. Main projects aim to build and renovate railway infrastructure along the Balkans and Southern European countries to connect them to Piraeus Port, which China regards as a gateway to Europe. The Chinese shipping company China Cosco Holding Co

[17] Lianyungang Sino-German Industrial Cooperation: http://lianyungang.de/en/investmentmarket-coverage/logistics-and-infrastructures.html

(COSCO) had been operating two container terminals in Piraeus, under a 35-year concession it acquired, since 2009. COSCO then formally acquired 67% of Piraeus Port Authority in April 2016 for EUR 368.5BN. As part of the deal, the company agreed to invest another EUR 350M in improving facilities[18]. The total value of the deal is some EUR 1.5Bn[19], including additional investment, as well as revenue of EUR 410M, dividends and interest, Greece expects to collect under the 36-year concession deal. A container **train from the Greek port of Piraeus**, through Greece, Macedonia, Serbia and Hungary **to the final destination in Czech Republic**, was tested in the middle of 2014 by the Serbian Railway[20]. Cargo then continues **to Hungary, Austria and Germany**. The freight transportation company *DB Schenker* has run the rail route from Hungary to Piraeus since December 2014 as a regular weekly service in order to open a new gateway to Asia or Africa. The company estimates that the transport time between Hong Kong and Hamburg via Piraeus shortens the duration by eight days versus the traditional sea route[21]. The upgrade of the Budapest-Belgrade railway with Chinese financing is also part of the Initiative (see more detail in part 3 of this report)

- In Eastern Europe, the OBOR intersects with, and could link with and provide funds to **Rail Baltica**, which is one of the top priority projects under the TEN-T package of transport infrastructure projects within the EU. The 729-km route aims to integrate the Baltic States in the European rail network, linking Finland, Estonia, Latvia, Lithuania and Poland, with an extension reaching down into Germany[22]. The project could cost EUR 3.68Bn and is expected to be 85% financed by the European Union, including a EUR 124M contribution granted under the TEN-T programme[23].

The China – Mongolia – Russia Economic Corridor

- The route involves **high-speed train and road links** along two lines to connect the Bohai Bay to Western Europe: one from Beijing-Tianjin-Hebei to Russia via Hohhot in inner Mongolia, and one from Dalian to Chita in Russia via Shenyang, Changchun, Harbin, Manzhouli and Inner Mongolia. International freight trains are already operating and connect major Chinese cities including Guangzhou, Shenyang, Suzhou and Tianjin. This corridor is also of interest to **Russia's Transcontinental Rail Plan** (which also involves road and rail links between Moscow and Beijing), **Mongolia's Prairie Road Program** (also known as the Steppe Road, consisting of projects including gas and oil pipelines but also road and railway construction) and to **China's Beijing-Tianjin-Hebei Integration Plan**. According to the China-Britain Business Council, in May 2015, President Xi Jinping signed a series of infrastructure agreements worth USD 25Bn with Belarus, Russia and Kazakhstan regarding high-speed rail, energy infrastructure and aerospace, as well as industrial parks providing financial services, such as RMB settlement[24].

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[18] Under the deal, COSCO will buy 51% of the Piraeus port for EUR 280.5M and the remaining 16% for EUR 88Bn after five years and once it completes investments of EUR 350M over the next decade. Asia Times, 8 April 2016: "China's COCSO completes purchase of Greece's biggest port": http://atimes.com/2016/04/chinas-cocso-completes-purchase-greeces-largest-port/

[19] WSJ, 8 April 2016, Nektaria Stamouli: "Greece Signs Deal to Sell Stake in Port of Piraeus to China's Cosco", http://www.wsj.com/articles/greece-signs-deal-to-sell-stake-in-port-of-piraeus-to-chinas-cosco-1460130394

[20] Savez za Željeznicu, "Container train between Piraeus and the Czech Republic competes with port Rijeka": http://www.szz.hr/en/container-train-between-piraeus-and-the-czech-republic-competes-with-port-rijeka

[21] DB Schenker Press Releases, 1 December 2014, "DB Schenker shortens transport times between Asia and Europe by a week", http://newsroom.schenker.at/eng/Presseinfo/Pressearchiv-2014/Piraeus

[22] More detail on TEN-T and on Rail Baltica is available at: http://ec.europa.eu/transport/themes/infrastructure/index_en.htm and at http://railbaltica.info/en/ .

[23] Eva Gray: "Connecting Eurasia: mapping the myriad of high-speed rail routes", 9 July 2015: http://www.railway-technology.com/features/featureconnecting-eurasia-mapping-the-myriad-of-high-speed-rail-routes-4593227/

[24] China-Britain Business Council: "One Belt One Road, A role for UK companies in developing China's initiative".

The China - Central Asia – West Asia Economic Corridor

- This corridor is mostly important as a gateway for oil and natural gas and runs from Xinjiang to Western China through Central Asia to Iran, Turkey and the Arabian Peninsula. The China-Central Asia gas pipeline is the world's longest. Construction began back in 2008 and consists of three lines (A, B and C) of which the third one became operational in 2014[25]. It starts at Gedaim on the border of Turkmenistan and Uzbekistan, runs through central Uzbekistan and southern Kazakhstan, and ends at Horgos in Xinjiang. From there, it will be connected to China's second West-East gas pipeline, which is under construction. In September 2013, China signed inter-governmental agreements with Uzbekistan, Tajikistan and Kyrghyzstan regarding another line project (line D)[26].

- The corridor also includes support for the completion and link of some important rail infrastructures connecting central Asia, in particular, Kazakhstan to Iran, Turkey and Russia, cooperating with national railway infrastructure plans. The Astana-Almaty high-speed train, of which construction started in 2011 with Chinese participation, is already operating. Another project links Russia to Kazakhstan[27]. The project's total cost of just over USD 28Bn will be 60% financed by Russian Railways, with the remaining 40% to come from foreign investment. A Russian-Chinese consortium won the first USD 360M contract to undertake planning, design and surveying works on the project between 2015 and 2016[28].

- Two other important railways along the corridor, whose implementation began in 2007, are expected to be completed in the next few years. The Baku-Tblisi-Kars (BTK) railway, connecting Azerbaijan, Georgia and Turkey, and the Kars-Edirne high-speed railway. The latter, running in Turkish territory, aims to connect the city of Kars (near the border with Georgia and Armenia) to the city of Edirne (near the border with Greece and Bulgaria) via the Marmaray Rail tunnel under the Bosporous (opened in 2013). The Istanbul-Ankara high-speed line, part of this route, was inaugurated in the summer of 2014, and was built by a consortium of two Chinese and two Turkish firms[29].

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[25] For more detail on China-Central Asia gas pipelines see China National Petroleum Company (CNPC) at http://www.cnpc.com.cn/en/FlowofnaturalgasfromCentralAsia/FlowofnaturalgasfromCentralAsia2.shtml

[26] See previous note

[27] Russian Railways, 30 April 2016, "Russian-Chinese working group discusses prospects for construction of Moscow - Kazan High Speed Main Line": http://eng.rzd.ru/newse/public/en?STRUCTURE_ID=15&layer_id=4839&refererLayerId=5074&id=106849

[28] Eva Gray: "Connecting Eurasia: mapping the myriad of high-speed rail routes", 9 July 2015: http://www.railway-technology.com/features/featureconnecting-eurasia-mapping-the-myriad-of-high-speed-rail-routes-4593227/ ; "Chinese company wins $390mn contract to develop Russian high-speed railway" 13 May 2015: https://www.rt.com/business/258241-china-russia-railway-construction/

[29] Frans-Paul van der Putten, Mike Meijnders: "China, Europe and the Maritime Silk Road", Clingendael, Netherlands Institute of International Relations, March 2015

- The corridor also covers the **Middle East**[30]. China has proposed a comprehensive cooperation strategy with Middle Eastern countries (known as the "1+2+3" strategy) considering energy cooperation as the core, infrastructure construction and trade and investment facilitation as "the two wings" (areas), and high- and new technologies in the fields of nuclear energy, space satellite and new energy as "the three breakthroughs"[31]. The strategy aims to treble bilateral trade with the Gulf states in the next decade and to push forward the **China-Gulf Cooperation Council** (GCC) Free Trade Agreement negotiations that are expected to be concluded in 2016. In order to further tap into the potential of cooperation with the industrialisation of Middle Eastern countries, China will set up a USD 15Bn special loan and provide regional countries with USD 10Bn of commercial loans. With the **UAE and Qatar**, China will launch a USD 20Bn joint-investment fund for supporting infrastructure development and high-end manufacturing industries in the Middle East[32].

- China signed a number of Investment Agreements with **Jordan** in September 2015 worth over USD 7Bn, including a USD 1.7Bn project to build Jordan's first oil shale-fired power plant in the Attarat area, in the south of the Kingdom, to produce around 900 megawatt of electricity, and a USD 2.8Bn investment to construct the national railway network, in addition to an accord with China corporate giant Hanergy to build a 1,000 megawatt renewable energy power plant at a cost of nearly USD 1Bn[33].

- Besides Pireaus, China is also involved in other ports in Europe as well as in Asia. Along this West Asia Corridor Chinese, COSCO has a minority share in the **Suez Canal** Container Terminal, part of the Port Said East Port at the northern end of the Suez Canal. A number of Chinese companies have been active in construction works at Port Said East Port and al Adabiya port, and have attempted to be more involved in the expansion of the canal, but the contracts were awarded to a Dutch-Belgian-UAE consortium. In December 2014, **Egypt** and China agreed to increase cooperation on the Suez Canal[34], and in January 2016, they announced a Five-Year Plan for strengthening their comprehensive strategic partnership. In January, China and **Iran** also announced plans to commit to a 25-year comprehensive cooperation agreement and signed a MOU on the joint promotion of OBOR[35].

[30] The Corridor actually extends also to central Africa, as the map on page 11 shows, but these projects are beyond the scope of this report.
[31] China's Arab Policy Paper, January 2016: http://news.xinhuanet.com/english/china/2016-01/13/c_135006619.htm
[32] Zhao Minghao "China's Middle East Opportunity" available at: http://www.chinausfocus.com/foreign-policy/chinas-middle-east-opportunity/
[33] Jordan Times, Omar Obeidat: "Jordan, China sign agreements worth $7b, including national railway deal", 11 September 2015, http://www.jordantimes.com/news/local/jordan-china-sign-agreements-worth-7b-including-national-railway-deal
[34] For a detailed overview of China maritime interests in Europe see: Frans-Paul van der Putten, Mike Meijnders: "China, Europe and the Maritime Silk Road", Clingendael, Netherlands Institute of International Relations, March 2015
[35] Full text available at: http://www.president.ir/en/91435 .

- China is also cooperating with Israel to build a railway that connects the Red Sea port of Eilat, in the Gulf of Aqaba, and the Mediterranean port of Ashdod, south of Tel Aviv, and also the port of Haifa. The two governments signed a cooperation agreement in July 2012. The 180km line from Eilat to Ashdod will run through the Arava Valley and Nahal Zinn. The cost of the line was initially estimated at USD 4.9Bn (NIS 20Bn)[36], but it was subsequently revised upward by the Israeli Minister of Finance to something between NIS 30Bn and NIS 50Bn in 2014. The project has encountered some scepticism and still lacks all approvals required at different ministerial levels, although it is considered of "national interest". The Chinese have promised to bring attractive financing from government banks, but no formal plan has been presented yet[37]. A Beijing-based contracting firm, China Harbor, was also chosen to build a new port in Ashdod in 2014 (estimated cost of USD 864M/NIS 3.3Bn), and in March 2015, the Shanghai International Port Group won a tender to operate the city of Haifa's new port beginning in 2021 for a 25-year period[38]. China and Israel have increased cooperation in the last few years in other fields as well, ranging from research (cooperation for USD 5M investment from China and USD 1M in Israel, to name the most recent one in joint scientific studies[39]) to tourism.

The China - Indochina Peninsula Economic Corridor

- This corridor is intended to link the Pearl River Delta Economic Circle (around Guangzhou, Hong Kong and Shenzhen) with the ASEAN states, above all with the South-East Asian countries of Cambodia, Laos, Myanmar, Thailand and Vietnam. New high-speed railways and motorways are expected to run from the Pearl River Delta in South China to Singapore via Nanning in Guangxi Province and Hanoi in Vietnam.

- The construction of a 427km railway to connect the Laos capital to the Chinese border started in December 2015. The USD 6.04Bn Laos-China joint venture project is expected to be completed in four to five years[40], and 70% of the funding will come from China. A MOU on building two lines (total length of about 870km) of dual track railway in Thailand, connecting the Laos border to Bangkok and then east to Thailand's Map Ta Phut industrial zone, was signed in December 2014[41] but construction has been delayed repeatedly, as many of the terms of the project, which will cost THB 400Bn on preliminary estimates, remain to be sorted out. The Thai government stopped the project in May 2016 apparently because of Chinese pressure to attach the right to develop commercial property at the stations and along the forthcoming rail track (from Bangkok to the northeastern city of Nong Khain near Laos[42]) to the project. The government said it is willing to resume the projects once this issue is cleared up. Perhaps the most noteworthy, although controversial, recent deal in the region relating to high-speed technology was signed in Indonesia in October 2015. Indonesia's National Development Planning accepted a USD 5.5Bn bid from a Chinese consortium to build a new 140km railway between Jakarta and Bandung, despite fierce competition from Japan. The construction of the railway was due to begin by the end of 2015 and conclude in 2019[43] and China Development Bank was to provide three-quarters of the funding on generous terms and with no guarantee required from the Indonesian government. However, as of May 2016,

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[36] Amiran Barkan "Israel, China agree to build Eilat railway" 3 July 2012: http://www.globes.co.il/en/article-1000762276

[37] Amiran Barkan, "Eilat railway hits financing buffers" 25 May 2014 http://www.globes.co.il/en/article-eilat-railway-hits-financing-buffers-1000940302

[38] Bloomberg News, Avi Bar-Eli: "Chinese company to run new Haifa port", 24 March 2015

[39] See: "China and Israel sign multi-million dollar research deal", 14 December 2015, http://www.timesofisrael.com/china-and-israel-sign-multi-million-dollar-research-deal/

[40] http://www.straitstimes.com/asia/east-asia/chinas-dream-of-rail-link-to-s-e-asia-coming-true

[41] More on China-Thailand railway cooperation on Thailand Ministry of Transport: http://maps.mot.go.th/pao/about_EN.html

[42] Bloomberg News, C. Anstey, T. Jordan and C. Blake : Xi's Silk Road Dream for China Hits a Speed-Bump in Thailand" 5 May 2016

[43] Kevin Smith: "China steps up railway diplomacy in east Asia", 3 February 2016, http://www.railjournal.com/index.php/asia/china-steps-up-railway-diplomacy-in-east-asia.html?channel=000

the Indonesian Transport Ministry has not granted all permissions because the Chinese-Indonesian consortium had not submitted all the necessary documents[44].

- The initiative in this region aligns with the goals of the Pan-ASEAN Rail Transit that involves extending and upgrading rail links connecting ASEAN capitals – more specifically, Bangkok to Kuala Lumpur to Singapore. China Railway Group Ltd is seeking to win the race for the high-speed rail project linking Kuala Lumpur in Malaysia and Singapore which could cost between USD 9.7Bn and USD 14.5Bn[45]. In March, the Group announced it will spend USD 2.0Bn to set up its regional centre in the Bandar Malaysia land bank, which is projected to become Malaysia's first integrated transit-oriented city and mixed-use cluster[46]. The OBOR should also align with the goals of the Greater Mekong Sub-Region programme, which with support of ADB and other donors, helps the implementation of high-priority projects in different fields to spur economically sustainable development in the region.

The China – Pakistan Economic Corridor

- This corridor is planned to connect Kashgar in Xinjiang province to the port of Gwadar in Pakistan, offering a shortcut to the Middle East and Africa by bypassing the Strait of Malacca. China has signed agreements worth USD 45.6Bn for the economic project spread over the next 15 years in the form of commercial loans, of which USD 33.8Bn is for power generation plants and USD 11.8Bn for infrastructure[47]. China has been involved in a solar power plant project worth USD 1.5Bn in Pakistan since 2015, and in other energy infrastructure projects worth a total of around USD 3.7Bn[48]. The main goals of the corridor are the development of the Gwadar Port, where a Chinese company has been granted a big tract of land under a 43-year lease to set up tax-free business, the upgrade of the 1,300km Karakorum Highway, the construction of a railway connection between Gwadar and Kashgar, and the laying of a USD 44M fibre-optic cable from the Chinese border to Islamabad[49].
- AIIB signed a MOU with its counterpart the Asian Development Bank (ADB) on joint project financing on 2 May 2016[50]. The first batch of projects will include the M4 highway project in Pakistan, which is a 64km stretch of motorway connecting Shorkot to Khanewal in Punjab Province. According to the announcement, the lenders will work together in sectors such as energy, transportation, telecommunications, and rural and agricultural development. AIIB and ADB plan regular high-level consultations and joint data collection to promote the implementation of the UN's Sustainable Development Goals as well as the COP21 climate agreement.

[44] According to the FT, this project, China's first of this kind in Southeast Asia, is seen as a test of the ability of Chinese companies to operate in a complex democracy such Indonesia. Moreover, it is being closely watched by countries such as India, Malaysia and Singapore, which are considering the virtues of Chinese high-speed rail vs the well and long utilised Japanese expertise and know-how. See FT, "Japan cries foul after Indonesia awards rail contract to China", 1 October 2015, and "Chinese $5.5bn high-speed rail project held up in Indonesia", 28 January 2016
[45] Financial Times, Hafiz Noor Shams: "China takes the lead in Malaysian mega-projects 9 March 2016
[46] China Railway Group and its Malaysian joint-venture partner Iskandar Waterfront Holdings Bhd, bought a 60% stake in Bandar Malaysia Sdn Bha (the project owner of the Bandar Malaysia area) by the beleaguered state investment fund 1Malaysia Development Berhad (1MDB) for USD 1.82Bn. http://www.aseantoday.com/2016/03/high-speed-rail-project-goes-to/
[47] China Brief Volume 15, Sudha Rmamachandran:"China-Pakistan Economic Corridor: Road to Riches?" 31 July 2015 and China Daily 22 April 2015 :"Backgrounder: China-Pakistan Economic Corridor"
[48] See details on Xinhua: Chen Peng, "China-Pakistan Economic Corridor gains momentum in Pakistan" 19 August 2015, http://news.xinhuanet.com/english/2015-08/19/c_134534217.htm
[49] The Diplomat, Adam Hodge: "Karakoram Highway: China's Treacherous Pakistan Corridor" 30 July 2013
[50] "AIIB, ADB sign MOU to strengthen cooperation for sustainable growth", 2 May 2016, http://euweb.aiib.org/html/2016/NEWS_0502/102.html

The Bangladesh-China-India-Myanmar Economic Corridor

- The corridor aims to connect Kolkata in India to Yunnan province capital Kunming (K2K) passing through Myanmar and Bangladesh, with Mandalay and Dhaka among the focal points[51]. The corridor envisages the building/upgrading of rail and road transport, energy and telecommunication infrastructure. The Bangladesh-India-China-Myanmar (BCIM) Forum on Regional Cooperation, which was founded in 1999, could enhance cooperation on the Initiative. India-China cooperation seems to have improved significantly since Prime Minister Modi visited China in May 2015, and the two countries signed agreements worth USD 22Bn[52] covering telecom, steel solar energy and film while independent on OBOR scope. Nonetheless, cooperation in the area is not easy because some projects are located along the border of Arunachal Pradesh on which the two countries have not yet resolved disputes.

[51] The Hindu, 26 June 2015: "China, India fast-track BCIM economic corridor project", http://www.thehindu.com/news/national/china-india-fasttrack-bcim-economic-corridor-project/article7355496.ece
[52] BBC News, 16 May 2015, "India and China sign deals worth $22bn as Modi ends visit": http://www.bbc.com/news/world-asia-china-32762930

2. China and CEECs[53] Cooperation

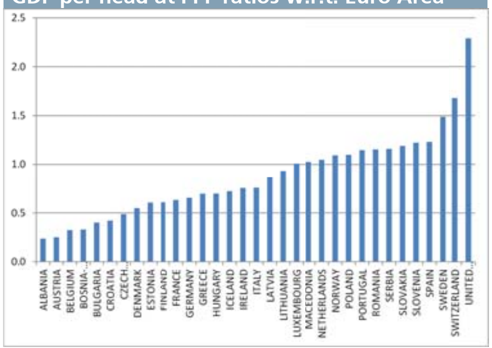
Antonio Pesce

The CEECs region had grown at a rapid pace from 2002 until the global slowdown in 2008. In the five-year period from 2002-2006, the differential growth with the Euro Area had been around 2-4. It jumped even further in 2007, a year of very significant growth in Emerging and Transition Economies. This fast economic growth had helped CEECs to narrow the economic gap with respect to the Euro Area, but starting from 2008, due to the slowdown, the narrowing path has weakened and now it need to be restored. It has become clear that Foreign Direct Investment (FDI) and international trade have an important role in economic convergence of CEECs, based on projects supported by the European Union Commission. The One Belt One Road Initiative could further support this convergence.

2.1 CEECs economic gap

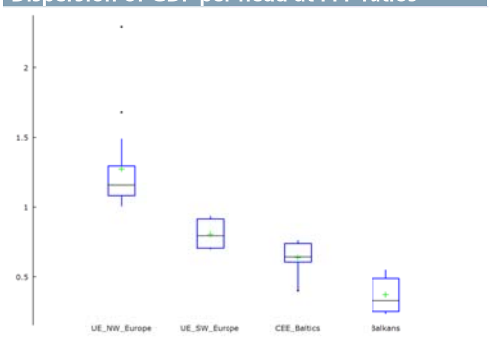
Despite the improvement observed in the last years, with average GDP growth at about 2.0% over 2010-2015, the CEECs region is still experiencing a significant economic gap with respect the more developed European countries. GDP at purchasing power parity (ie, GDP at PPP) with respect to the Euro Area in the five years from 2010 to 2015 averaged from 20% in Albania to 80% in Czech Republic. The Balkan area[54] showed the highest gap, followed by the CEE/Baltics areas[55], and EU South West European[56] countries. We would note that the GDP at PPP is higher in EU North West European[57] countries than in the Eurozone.

GDP per head at PPP ratios w.r.t. Euro Area



Source: own elaboration on national statistical data sources, EIU data provider

Dispersion of GDP per head at PPP ratios



Source: own elaboration on national statistical data sources, EIU data provider

Such gaps reflect different levels of competitiveness. The notion of competitiveness can mean different thing to different authors. A country is qualified as highly competitive if it has the right combination of institutions and policies, such as effective governance and an enabling business environment, infrastructures and the means to achieve high levels of productivity. As shown in the following graphs, a lower GDP at PPP ratio corresponds to lower competitiveness as measured by the Global Competitiveness Index[58] (GCI).

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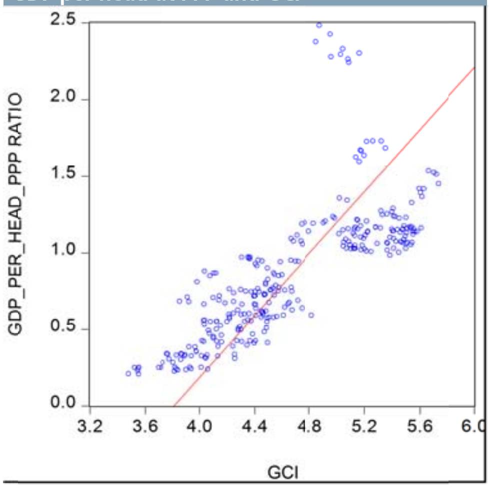
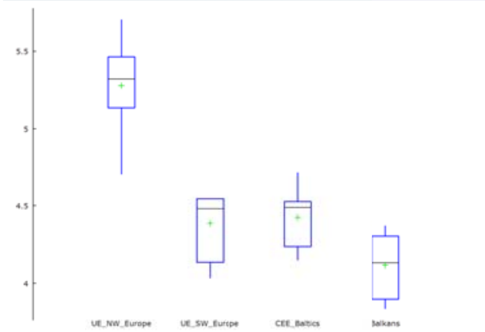
[53] Albania, Bosnia Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia, Slovenia
[54] Albania, Bosnia Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania, Serbia
[55] Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia
[56] Greece, Italy, Portugal, Spain
[57] Austria, Belgium, Denmark, Finland, France, Germany, Iceland, Ireland, Luxembourg, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom
[58] Synthetic index computed by the World Economic Forum to assess the national competitiveness of 151 countries

GDP per head at PPP and GCI



Source: Own elaboration on national statistics and World Economic Forum data

Dispersion of GCI



Source: own elaboration on World Economic Forum data

The graph above on the left shows the competitiveness gap of the Balkan region with respect to the other areas. On average, the GCI of the region is 3.9 (from 3.4 in Albania to 4.3 in Bulgaria), which is well below the 4.4 average in both the CEE/Baltic area and EU South West Europe, and even smaller than the 5.3 average of North West Europe.

One of the main reasons why the GCI is lower for the Balkan area than the other regions is the lack in infrastructure. Infrastructure is one of the four pillars (the so-called basic requirements: Institutions, Infrastructure, Macroeconomic Environment, Health and Primary Education) of the GCI. In the Balkan region, in spite of differences between countries, it ranks poorly, mostly due to the limited passenger-carrying capacity in airline traffic and also because of the poor quality of overall infrastructure, including roads, ports and railways.

GCI 2015-16 Balkan countries and by region

	AL	BH	BU	CH	MA	MO	RO	SE	Median CEE/Baltics	Median EU S.W.E.	Median EU N.W.E.
Institutions	3.38	3.87	3.32	3.59	4.26	3.96	3.56	3.21	3.91	3.73	5.42
Infrastructure	3.52	3.67	4.06	4.72	3.73	4.10	3.65	3.93	4.67	5.54	5.67
Macroec.Environ.	3.82	4.23	5.45	4.44	4.93	4.46	5.20	3.51	5.29	3.67	5.44
Healt and Educ.	5.85	5.99	6.03	5.91	5.64	6.31	5.51	5.76	6.22	6.32	6.46
GCI	3.84	4.02	4.37	4.13	4.26	4.23	4.30	3.90	4.49	4.48	5.31

Source: World Economic Forum GCI database

In the Balkan area, in 2014-2015, the pillar of Health and Primary Education performed relatively well and is currently close to the median values of EU North West Europe. This pillar is stronger than the others, for which performances are actually quite poor. In particular, among the other pillars, Infrastructure is the component of the global index which shows a high gap when compared with EU Western Europe. Its median value is 3.9, and spans from a low of 3.5 in Albania to a high of 4.7 in Croatia. Clearly, the competitiveness of a country is a complex phenomenon. It is the result of many different factors. It is determined not only by the above-mentioned pillars, but also by a large set of (material and immaterial) factors, such as the efficiency of markets, market size, the openness of international trade channels, or the propensity to innovate. Some authors[59] highlighted that, despite the heterogeneity between countries, some critical elements in the Balkan area are the inefficient use of talent (ie, the

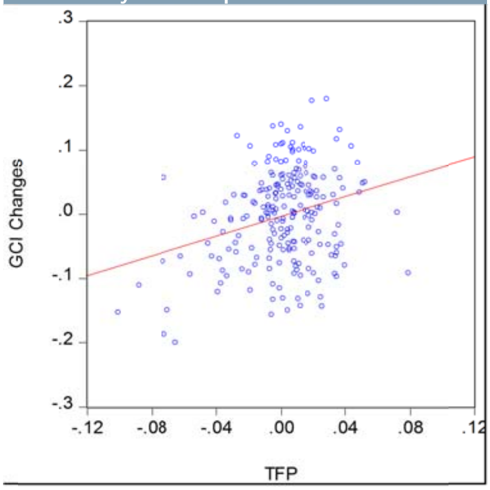
[59] Sanfey P. et al (2016) "How the Western Balkan can catch up" WP N. 186, EBRD

capacity to attract talent from abroad and retain talent), and the reliance on informal relationships rather than on professional management skills, both of which affect the productivity of production factors (TFP) and determine the competitiveness of a country.

2.2 Productivity and competitiveness to narrow the economic gap

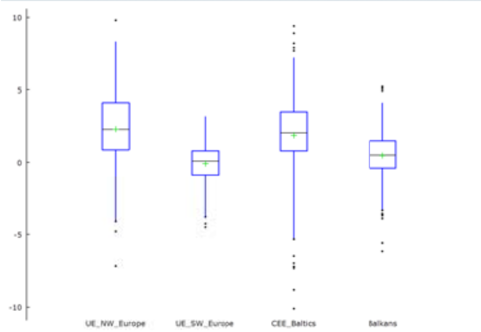
As shown in the graph below, productivity is highly correlated with an improvement in competitiveness; so, it is reasonable to think that improvement of productivity could enhance the competitiveness of the Balkan area and in this way facilitate its convergence with EU Western Europe.

Productivity and competitiveness



Source: Intesa elaboration on World Economic Forum database and EIU data

Dispersion of productivity



Source: Intesa elaboration on EIU data

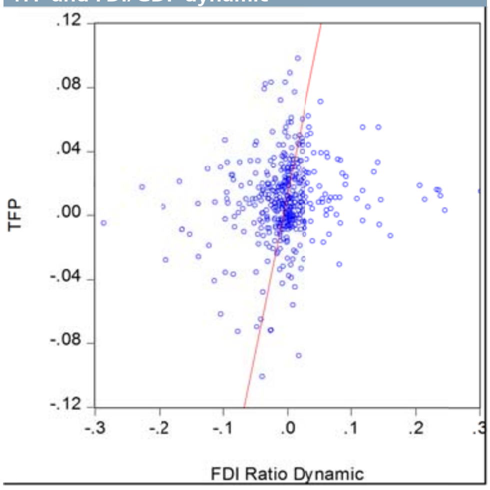
In this context, we see it as useful to investigate the elements of the TFP required for the Balkans to narrow the economic gap. Foreign Direct Investment flows (FDI) represent one of the main ways that the TFP profile can be influenced. As acknowledged by a vast body of literature on the topic[60], FDI represents an important vehicle for technology, innovation and knowledge transfers, stimulating competition, providing financing to local enterprises, and boosting domestic investments as a result. In the graph on the left below, the TFP is crossed with the FDI/GDP ratio growth experienced by the countries of the Balkan area, CEE and Baltics region and EU Western Europe in the last ten years. The scatter shows a positive relationship between the two variables, with relatively stronger TFP performance in countries benefiting from relatively higher FDI/GDP ratios dynamic.

A number of theoretical and empirical contributions highlight the important role played by international trade in fostering productivity and economic growth. D. Dollar and A. Kraay (2003)[61] find that in a large cross-section of countries, rapid growth in the very long run is related to high levels of international trade and sound institutions. H. Badiger (2007) finds that in addition to trade and institutions[62], free trade agreements are a further determinant of productivity.

[60] See among the others Arrabitel et el. (2007)
[61] D. David and A. Kraay (2003), Institutions, Trade and Growth, Journal of Monetary Economics, vol. 50, pp. 133-162
[62] H. Badinger (2007), Trade policy and productivity, European Economic Review

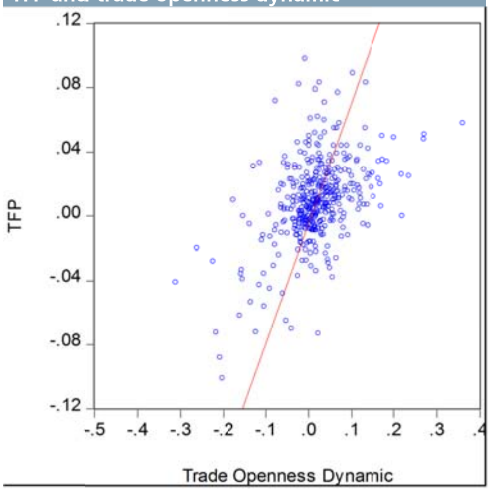
The TFP is crossed in the graph on the right below against changes in a traditional measure of International Trade Openness[63]. The scatters indicate a positive relationship. These results seem to support the view that productivity has grown in a context characterised by increasing trade openness.

TFP and FDI/GDP dynamic



Source: Intesa elaboration on national statistic and EIU data

TFP and trade openness dynamic



Source: Intesa elaboration on national statistics and EIU data

Measuring the elasticity of TFP to both FDI and international trade openness proves interesting. A panel regression line has been estimated on a sample of 28 countries and 15 years of annual data of Total Factor Productivity (TFP) vs Foreign Direct Investment on GDP growth (FDI/GDP) and Trade Openness growth. Based on the results of the estimated regression[64], it emerges that, as we expected, foreign investment and trade have a significant positive effect on TFP.

$$\begin{array}{cccccccc} TFP_t & = & 0.01 & + & 0.03 & \left({}^{FDI}/_{GDP}\right)_t & + & 0.14 \quad TO_t \\ & & (0.001) & & (0.014) & & & (0.015) \end{array}$$

The above estimation – an increase of 10% of FDI ratio, all other variables remaining constant – shows that the TFP improves by 0.3%. Given that the TFP is a component of GDP growth[65], this means that FDI growth would have a positive direct impact on per head real GDP by contributing 0.3 pp to its dynamic.

2.3 The Medium-Term Agenda for Cooperation between China and CEECs Region

Initiatives devoted to enhancing foreign investment and openness regarding trade help to boost TFP and economic growth. Projects supported by the European Union Commission have had a very important role in this respect, such as the Pre-Accession Assistance (with an amount of 5.1Bn Euro from 2007 to 2013), which provides funding for a broad range of projects and programmes covering areas such as education, health, consumer protection for candidate countries or potential candidate countries in EU membership, or the Structural Funds (227 Bn Euro planned for 2014-2020 period), which finance regional policy, social and training

[63] It is the ratio of the sum of imports plus exports over GDP

[64] Panel estimation (on 28 countries from several regions: Balkans, CEE and Baltics area and Western Europe) with fixed effects given to the results of the Hausman test. Standard error in brackets

[65] From the growth accounting approach (see Bosworth and Collins, 2003), the real GDP growth can be approximated by the weighted sum of the dynamics of production factors (labour and capital) plus the TFP

programmes, as well as agriculture for EU countries. More recently, under the name of the "Belt and Road initiative[66]" a series of initiatives were started to develop infrastructures and new projects involving China and 16 Central and South Eastern European Countries (CEECs), the so called 16+1 group, along different economic and political dimensions.

The role of China in the CEECs region has been quite modest in absolute terms until recently, but in the last few years, it has increased rapidly, with both a strong growth in trade (between China and CEECs, which reached about Euro 60Bn in 2014, (Comtrade), and of stock of China's foreign direct investment (from USD 47.7M in 2004 to USD 1697M in 2014, namely 35 times higher than in 2004, see table below). For some countries, FDI increased significantly: for Romania, the stock of China's FDI increased more than four times in 10 years from 2003 to 2013, and for Serbia, it increased about eight times in six years from 2007 to 2013 (see table below). In 2012, the Chinese government announced a USD 10Bn fund for promoting investment in the CEECs region, and in late 2014, it announced a USD 3Bn fund for the Balkan region. The importance of China's Balkan investments clearly seems to be on the rise due to China's 2013 announcement of its aim to rebuild a "Silk Road".

China's outward FDI Stock in CEE/SEE Countries (unit: USDM)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Albania			0.5	0.5	0.5	0.5	4.4	4.4	4.4	4.4	7.0	7.0
Bosnia & Herzegovina	1.5	4.0	3.5	3.5	3.5	3.5	5.9	6.0	6.0	6.1	6.1	6.1
Bulgaria	0.6	1.5	3.0	4.7	4.7	4.7	2.3	18.6	72.6	126.7	149.9	170.3
Croatia			0.8	0.8	7.8	7.8	8.1	8.1	8.2	8.6	8.3	11.9
Czech	0.3	1.1	1.4	14.7	19.6	32.4	49.3	52.3	66.8	202.5	204.7	242.7
Estonia	0.0		1.3	1.3	1.3	1.3	7.5	7.5	7.5	3.5	3.5	3.5
Hungary	5.4	5.4	2.8	53.7	78.2	88.8	97.4	465.7	475.4	507.4	532.4	556.4
Latvia	1.6	1.6	1.6	2.3	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Lithuania			3.9	3.9	3.9	3.9	3.9	3.9	3.9	7.0	12.5	12.5
Macedonia			0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	2.1	2.1
Montenegro					0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Poland	2.7	2.9	12.4	87.2	98.9	109.9	120.3	140.3	201.3	208.1	257.0	329.4
Romania	29.8	31.1	39.4	65.6	72.9	85.7	93.3	125.0	125.8	161.1	145.1	191.4
Serbia					2.0	2.0	2.7	4.8	5.1	6.5	18.5	29.7
Slovakia	0.1	0.1	0.1	0.1	5.1	5.1	9.4	9.8	25.8	86.0	82.8	127.8
Slovenia			0.1	1.4	1.4	1.4	5.0	5.0	5.0	5.0	5.0	5.0
Total	42.0	47.7	71.0	239.8	301.0	348.2	410.6	852.6	1,008.8	1,334.0	1,435.8	1,696.5

Source: Ministry of Commerce of the People's Republic of China, CEIC data provider.

To promote the China-CEECs cooperation, four meetings between the leaders of the 17 (ie, 16+1) countries were organised in the last few years. The first meeting was held in Warsaw in 2012, followed by Bucharest in 2013, Beograd in 2014, and the last one in Suzhou in 2015. The cooperation guidelines agreed during the meetings, together with the "Medium-Term Agenda for Cooperation" (Suzhou 2015), state the intention to develop several initiatives up to 2020 spanning green energy, cross-border optical cables, people to people exchange, international trade cooperation, and improvement of the region's infrastructures putting in place a network of land, sea and air passages with the enhancement of road networks, railways, land-water transportation channels, cooperation on maritime logistics and aviation infrastructure.

The "Medium-Term Agenda for Cooperation" has an inclusive approach: it seeks to develop synergies with major EU initiative[67] and wish to enhance cooperation with the most important international financial institutions, such as the Asian Infrastructure Investment Bank, the

[66] The initiative raised by the Chinese President Xi Jinping of jointly building the Silk Road Economic Belt and the 21th-Century Maritime Silk Road (see chapter 1)
[67] EU-China 2020 Strategic Agenda for Cooperation

European Investment Bank and the European Bank for Reconstruction and Development. The initiative focuses on nine economic and social-political areas:

1) Economic cooperation, namely China and CEECs plan to facilitate mutual investment and trade. To this end, the "China-CEEC Ministerial Meeting on Promoting Trade and Economic Cooperation" will be held once every two years. China and CEECs will support the role of the "Warsaw-based China-CEEC Business Council" and the "China-CEEC Investment Promotion Agencies Contact Mechanism" in sharing important information to facilitate and create new business-to-business networking opportunities.

2) Cooperation on connectivity, namely cooperation regarding infrastructure development, including roads, airports, ports, logistics, railways, telecommunications, and oil and gas pipeline networks by considering also the EU's existing network priorities and their extension to the Western Balkans.

3) Cooperation on industrial capacity and equipment manufacturing, which also involves joint nuclear power projects and cooperation regarding hydropower generation.

4) Financial cooperation, where, in particular, China and CEECs intend to examine the possibility of creating a China-CEEC financial company. The countries will encourage cooperation with international financial institutions as well as with national or regional financial institutions.

5) Agricultural, forestry and quality inspection cooperation. The "China-CEEC Agrotrade" and "Economic Cooperation Forum" will be held alternately in China and one of the CEECs on an annual basis.

6) Cooperation in science, technology, research, innovation and environmental protection, in line with the 2030 Agenda for Sustainable Development of the United Nations.

7) Cultural, educational, youth, sport and tourism cooperation. China and CEECs will enhance "people-to-people" contacts. The "China-CEEC Cultural Cooperation Forum" at the ministerial level and the "China-CEEC High-Level Symposium of Think Tanks" will be organised on a regular basis occurring alternately in China and one of the CEECs.

8) Health cooperation. Joint research on the healthcare system will be conducted and workshops will be organised on a regular basis, and the "China-CEEC Health Ministers' Forum" will be held on a regular basis.

9) Cooperation at the local level. China and CEECs intend to support their provinces, regions and municipalities in taking part in the cooperation programmes, with the intention of boosting local development.

The implementation of the guidelines for China-CEECs cooperation could then allow for both an enhancement of the infrastructures in the CEECs and an improvement in trade openness. In this way, the China-CEECs cooperation could help the CEECs to enhance productivity, fostering an acceleration of economic convergence with the EU. Until now, the implementation of the guidelines has been at an embryonal level with respect to the ambitions of the initiative. But some important activities have already been completed or are under way. For example, among the most important infrastructures, the section of the Corridor 11 Highway, valued more than USD 200M, being built by Shandong Highway Corporation is ongoing, while the Zemun-Borca Bridge in Belgrade and the restructuring of the Kostolac thermal power plant have been completed.

Among the agreements signed in 2014, construction of the Belgrade-Budapest High-Speed Railway (HSR) has attracted a lot of attention. HSR represents the first section of the of a high-speed rail connection from the Greek port of Piraeus to Central Europe, traversing Macedonia, Serbia and Hungary. Several other projects are under discussion, such as the building of a new bridge close to the Serbian capital of Belgrade, which is estimated to cost EUR 470M.

Based on the projects realised and planned in the Balkan region (see chapter 3) as a result of the "One Belt One Road Initiative", the stock of FDI should grow from USD 52Bn in 2014 to about USD 63Bn in the next four years. This could result in the TFP improving by 0.7 pp[68] in four years, with per capita GDP growth potentially experiencing indirect contribution[69] to about 0.7 pp.

[68] This result comes from the regression estimated in the previous chapter and, as a comparative state exercise, measures the direct impact of the "One Belt One Road Initiative" on the TFP all other variables remaining constant

[69] Note that from the growth accounting approach, as shown in note 13, the real GDP growth can be approximated by the weighted sum of the dynamics of production factors (labour and capital) plus the TFP

3. The One Belt One Road Initiative in the Western Balkans

Branka Babic and
Tijana Matijasevic

The Western Balkan countries (Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Serbia) have been encompassed by the One Belt-One Road (OBOR) initiative, and are then one of the beneficiaries of China's Action Plan in Central and Eastern Europe. A series of bilateral agreements on economic, industrial and scientific cooperation have been signed, with various business forums and trade fairs for entrepreneurs held, in order to explore economic and trade potential and intensify cooperation and exchange.

At first glance, the Western Balkan region represents a relatively small market for China in terms of trade, and is seemingly not very relevant as a source of commodities either. However, China's interest in investing in the Western Balkans appears to primarily lie in its strategic geographical position, as the region is well placed to serve as a link between Eastern and Western markets.

Due to geographic proximity and tariff-free access to EU-markets, the Balkans have been recognized as a gateway to Europe in the OBOR initiative. Hence, in this region China is mainly focused on investments in infrastructure and access to Central and Western European markets. It considers the Balkans an integral part of a planned land-sea express route, which should link the Port of Piraeus in Athens, the first major European container port for ships entering the Mediterranean from the Suez Canal, through the Balkans and further to EU markets. The aim is to establish faster placement of Chinese goods on the European market and a wide network of highways, railways, ports and logistic centres have been constructed for this purpose. By developing transit trade Chinese companies can considerably cut their costs and integrate into the EU industrial system - once the Balkan projects are completed, transit time for Chinese products will be reduced from roughly 30 to 20 days.

There are also other advantages which can be exploited in terms of the OBOR initiative in this part of Europe:

- Owing to free-trade agreements with the EU, there could be potential for Chinese companies to avoid trade restrictions and anti-dumping regulations and export products directly to a market of 800 million people
- Favourable taxes and labour costs - although there are differences among countries, total tax burdens, as well as unit labour costs, are lower compared to the EU average, which is important for export-oriented companies specialising in labour-intensive industries. The low labour costs are complemented by a relatively educated population
- Business regulations are still not in line with those from the EU as most of the Western Balkan countries are not EU members. Therefore, having not-so-strict rules could be also considered as an advantage for Chinese investors, although only in the short run, as regulations are expected to improve during the EU accession process.

3.1 The main Chinese/OBOR projects in the Western Balkans

Current Chinese economic policy in the Balkans aims primarily at transport infrastructure and energy supply projects, with prospects for manufacturing activities. China appears ready to risk its own funds and invest in such projects, which has generally been very welcomed given that the Western Balkan countries are lacking foreign investments as discussed in Paragraph 2.

Most of the Chinese (implemented or underway) investments are in Serbia. The relationship between Serbia and China started rapidly developing upon the establishment of a strategic partnership back in 2009. Serbia enjoys the status of being China's strongest and most consistent ally in Eastern Europe, on the back of compatibility on the issues of sovereignty and territorial integrity (supporting each other on Kosovo and Tibet), but also its strategic location, which could make it a hub in China's attempt to link its OBOR project to Central Europe.

The breakthrough project was the 2010 Sino-Serbian Friendship Bridge across the Danube in Belgrade, with an agreed value of USD 255m. The bridge was opened in 2014, while all access roads were completed by the end of 2015. The project was mainly financed by a loan from the Export-Import Bank of China (EXIM), with China Road and Bridge Corporation the main contractor. The project was soon followed by the first phase of the revitalisation of thermal power plant Kostolac, which was facilitated with another USD 293m state-to-state loan on preferential terms.

Other countries have also struck deals with China on joint energy and transportation projects.

The most important OBOR projects affecting or going to affect the Western Balkans are reported in the table below. The total amount of potential investment involved is around USD 11bn[70] , of which USD 3.85bn is in Serbia, compared to a total amount of Chinese FDI of USD 1.1bn in the Western Balkans, of which USD 172.4m is in Serbia.

[70] Refers to the most important projects currently, which are shown in a table, not taking into account the value of completed projects (Stanari, Sino-Serbian Friendship Bridge; as well as Kostolac's first phase, which is almost complete)

The most important projects in the Western Balkans:

	Project	Value	Contractor/Funding	Sector
Bosnia and Herzegovina	Stanari thermal power plant, generating 300MW	c. EUR 560m	China's Dongfang Electric Corporation/Chinese Development Bank funding the project with EUR 350m	Energy supply
	Agreed construction of Block 7 of the thermal power plant in Tuzla - generating 450 MW	c. EUR 722m	Elektroprivreda BiH signed the contract with China Gezhouba Group and Guangdong Electrical Power Design Institute/China's EXIM Bank 85%, JP Elektroprivreda BiH 15%	Energy supply
	Banovici thermal power plant - announced construction of new block 350 MW in second half of 2016	c. EUR 405m	China's Dongfang Electric Corporation	Energy supply
Serbia	China-Serbia Friendship Bridge between Zemun-Borca, opened in 2014, promoted as the first bridge built by China in Europe	USD 255m	China Roads and Bridge Corporation (CRBC)/The funding was provided by EXIM Bank (85%)	Infrastructure
	The revitalization of the thermal plant Kostolac - the first phase (renovation of an existing power station, construction of desulphurization systems and an upgrade of accompanying transport infrastructure)	c. USD 345m	Contractor China Machinery and Engineering Cooperation/EXIM Bank loan of USD 293m	Energy supply
	Second phase of Kostolac power plant upgrade - construction of the third block of the thermal power plant Kostolac B, generating 350MW, and expansion of the production in the surface coal mine Drmno from 9 to 12 million tonnes yearly). Completion expected in 2019.	c. EUR 715m	China Machinery Engineering Corporation/EXIM Bank with the loan of USD 608m	Energy supply
	Construction of a new part of the thermal power plant Nikola Tesla B3	Total value estimated at EUR 2bn	Contractor will be Chinese consortium China Environmental Energy Holdings	Energy supply
	Modernisation of the rail road Budapest-Belgrade-Bar, with the project expected to start by the end 2016 and to be completed in two years.	The project value is initially estimated at EUR 800m, negotiations are ahead	Chinese companies led by China Railways/EXIM Bank (except the section Stara Pazova-Novi Sad, which is funded by the previously agreed Russian loan)	Road Infrastructure
	Construction of highways stretches in Corridor 11, Obrenovac-Ub and Lajkovac-Ljig, total length of around 50 km. The realisation started in June 2014, the completion is expected by mid 2017	c. USD 334m	Shandong Hi-Speed Group/EXIM Bank (USD 301m), Republic of Serbia (USD 33m)	Infrastructure
Montenegro	The construction of the Bar-Boljare highway towards the border with Serbia	c. EUR 810m	CRBC / EXIM Bank with loan of EUR 700m	Infrastructure
Macedonia	MoU signed with China International Water and Electric Corporation on the construction of 12 mini hydro power plants, not started yet	Project value is estimated at EUR 1.5bn	China International Water and Electric Corporation / Chinese Development Bank to fund 85% of the project	Energy supply
	Highway stretches Kicevo-Ohrid and Miladinovci-Stip, with the total length of around 110 km	The project value is estimated at EUR 580m	Sinohydro corporation/EXIM Bank funds up to 90% of the project	Infrastructure
Croatia	MoU signed between Croatia and China on establishment of an economic-technological zone around the Port of Rijeka. China interested in a 30-year concession and in construction of a container terminal in the Port of Rijeka, the so-called "Zagreb Coast" with the accompanying infrastructure (rail to Zagreb)	N/A	Chinese naval company China Ocean Shipping Company (COSCO)	Infrastructure
Albania	Construction of 280km highway between Montenegro and Albania, planned to start in the second half of 2016.	USD 3bn (total value including Montenegro)	China Pacific Construction Group	Infrastructure

Sources: Serbian Ministry of Construction, Transport and Infrastructure, The Ministry of Energy and Mining, Belgrade Chamber of Commerce, Council for European Studies, various local and foreign media

Looking at announced projects and/or the projects underway currently, it seems that China is pushing forward with the New Silk Road project by accelerating investments in the infrastructure links and energy plants in the region.

Regarding infrastructure investments, the flagship project agreed between China, Serbia and Hungary is the construction of the railways from Budapest to Belgrade, with a total length of 350km, of which 142km is in Serbia, designed for electrified passenger and cargo trains with a maximum speed of 200km/h. It is the first trilateral project of cooperation between China and CEECs countries in the field of transport infrastructure that has entered the process of realisation. The construction of the Serbian section of the railway will be carried out by a consortium of Chinese companies led by China Railway. The project, to be financed by China's EXIM Bank, should start by the end of 2016 and last for two years. Upon completion, the travelling time between the two capitals will be reduced from eight hours to around three hours.

China is also planning to upgrade the Greek railway northern route to Macedonia through Thessaloniki and the Macedonian railway line that would connect Greek lines to the upgraded north-south route in Serbia and the Belgrade-Budapest railway. Once all the projects are completed, the high-speed rail connection will extend all the way from Piraeus to Budapest. By reducing shipping time, the new line will make Chinese products more competitive in the European market, helping offset rising costs at home.

When it comes to the road infrastructure in Serbia and Montenegro, China is also financing the construction of several sections of the Corridor 11 highway from Belgrade to the Port of Bar in Montenegro. In Serbia, construction of two sections — Obrenovac-UB and Ljig-Lajkovac — is currently underway, 90% funded by EXIM Bank, and with Shandong Hi-Speed Group as main contractor, while two additional highway sections (Surcin-Obrenovac and Preljina-Pozega) will also be funded by the loans from China. In Montenegro, it was agreed that Chinese companies will construct the highway from the Port of Bar to Boljare on the border with Serbia, and they are currently working on the most difficult part from Podgorica to Matesevo. Completion of the projects should enhance the connectivity of both countries into the trans-European transport network, attracting more international flows of both goods and passengers.

In Macedonia, EXIM Bank provided a loan to cover 90% of the construction value of two stretches of highway - 50km Miladinovci-Stip highway connecting the capital of Skopje to the town of Stip and the 57km Kicevo-Ohrid highway, built in the west of Macedonia to improve connection with its tourism centre Ohrid. The projects will be built by Sinohydro Corp from China, but Macedonian construction companies, as sub-contractors, will benefit from the cooperation as well.

China Pacific Construction Group signed a deal to build the 280km-highway between Montenegro and Albania worth USD 3bn, which is planned to start in the second half of 2016.

On the other side, Maritime Silk Road has also attracted interest from the Croatian port of Rijeka, but with no concrete deals so far.

As stated, the energy sector is an additional area of investments within the OBOR initiative in the Balkans. It offers large potential to exploit, taking into account several large energy projects in the pipeline, required improvements in energy efficiency in the years ahead (the losses in distribution in some countries account for up to 30% of gross electricity consumption), as well as regional cooperation, with increasingly coordinating energy needs and integration into the EU energy market. It is also an opportunity for China to roll out its green expertise as it aims to become a leader in the clean energy niche.

In Bosnia and Herzegovina, a Chinese consortium was named preferred bidder to construct a coal-fired power generation unit in Tuzla. This deal is one of the largest investments in the country's energy infrastructure, worth c. EUR 785m. With previous investment recently completed in thermal power plant Stanari, Chinese investments in the energy sector in Bosnia will exceed EUR 1.3bn.

According to recent media reports, another project has been also planned to start in the second half of 2016 related to construction of 350 MW block in Banovici thermal power plant, which should involve Chinese Dongfang Electric Corporation whose bid proposal value of EUR 405m would be accepted by Bosnian authorities.

In Albania, it was recently announced that China's Geo-Jade Petroleum had taken over oil exploration and production rights in the country from Canada's Bankers Petroleum for USD 442m.

Although currently postponed, various hydroelectric power projects in Macedonia have also been planned.

An example of energy cooperation is Serbia's project Kostolac, which involved China in several phases. In the first phase, China Machinery and Engineering Corporation was engaged in revitalising two blocks of the thermal power plant, with the possibility for local contractors to participate with up to 50%. In total, 85% of the value of the project is covered by the loan from China's EXIM Bank, with a grace period of seven years and an annual interest rate of 2.5%.

In the second phase, construction of a new 350MW block has been agreed, the first new energy facility in almost three decades. The most important project planned in the forthcoming period relates to construction of a new block of thermal power plant Nikola Tesla, with an estimated value of EUR 2bn, where the main contractor will be a Chinese consortium led by China Environmental Energy Holdings.

The Investment model in the Western Balkans

The model of investing in countries in the region has been to a large extent based on a loan-and-build model, where state low-interest long term loans are offered to governments in order to fund between 85% and 90% of the total project costs, provided that a Chinese company is a principal contractor. The agreements usually stipulate the possibility for the engagement of local companies as sub-contractors, with stakes of up to 40-50% of the project's value.

Modalities of cooperation are likely to diversify, but there are still many uncertainties in this regard. One of the issues that has arisen with Serbia, and could be easily translated in other West Balkan countries, relates to the local government's commitment to control external debt and budget deficits, which negatively affects the prospects of China. New ways of financing, including PPP and concessions, are considered as potentially more suitable for financing capital projects, however this may not meet the preferences of China. One example is the Belgrade-Budapest railway project, with the Serbian government actively working to reduce the costs bellow the initially announced project budget of EUR 800m. Commercial terms of the loan with China's EXIM bank are yet to be negotiated. In financing the initial works Serbia is currently using its own budgetary means or a Russian loan previously approved for Serbia's railway modernisation project on Corridor 10[71] .

[71] The loan from Russia was agreed in 2014 for the reconstruction of six sections of Corridor 10 (total length 112km), with Russia's state railway company the main contractor responsible for project implementation.

China might face similar challenges with some other countries from the region, which also have quite restrictive, debt-burdened budgets. Bearing this in mind, seeking alternative ways to finance the projects could create room for local financial institutions to get more involved.

The current FDI from China

FDI from China has been modest in the Western Balkan countries so far, with Serbia attracting the most of the FDI from China in the region.

FDI inflow from China in the period 2007-2015 amounted to c.EUR 127m[72] in Serbia, but still accounted for less than 1% of total FDI inflow. In all other Western Balkan countries FDI from China hasn't exceeded the level of EUR 10m.

The following table is the overview of direct investments from China (partly realised, partly under way), according to the investment registry of the Serbian Development Agency. The total value of investments in Serbia is planned to reach EUR 172.4m, mainly routed to the automotive industry.

China direct investments in Serbia

No	Company	Origin country	Industry	Municipality	Planned investment in EUR mln
1	Everrest Production	China	Textile	Ruma	15.0
2	Diplon-Belmax center	China	Retail trade	Belgrade	32.0
3	Johnson Electric	China (Hong Kong)	Automotive	Nis, Obrenovac, Sombor	65.0
4	Tesla Solar	China	Electronics	Raska	0.4
5	MEI TA	China (Taiwan)	Automotive	Obrenovac	60.0
Total:					172.4

Source: Serbian Developmet Agency

As far as other projects in Serbia are concerned, at the meeting held in November last year, Chinese Premier Li confirmed China wants to push forward with construction of industrial parks[73] along banks of the River Danube, in order to attract Chinese investors to the country.

He also said that the Chinese Government had been encouraging domestic companies to enhance cooperation on production capacity in areas including iron and steel to provide high-quality construction materials at low costs for Serbia's infrastructure construction. This resulted in the recent acquisition of Zelezara Smederevo by Chinese steelmaker HBIS, which signed a deal to buy the Serbian steelmaker for EUR 46m, announcing additional investments of USD 300m, including investment in a galvanizing facility that would supply the construction and automotive industry.

Works on stretch between Belgrade and Novi Sad on the route to Budapest were previously agreed to be financed from this loan.

[72] Source: Serbian Development Agency

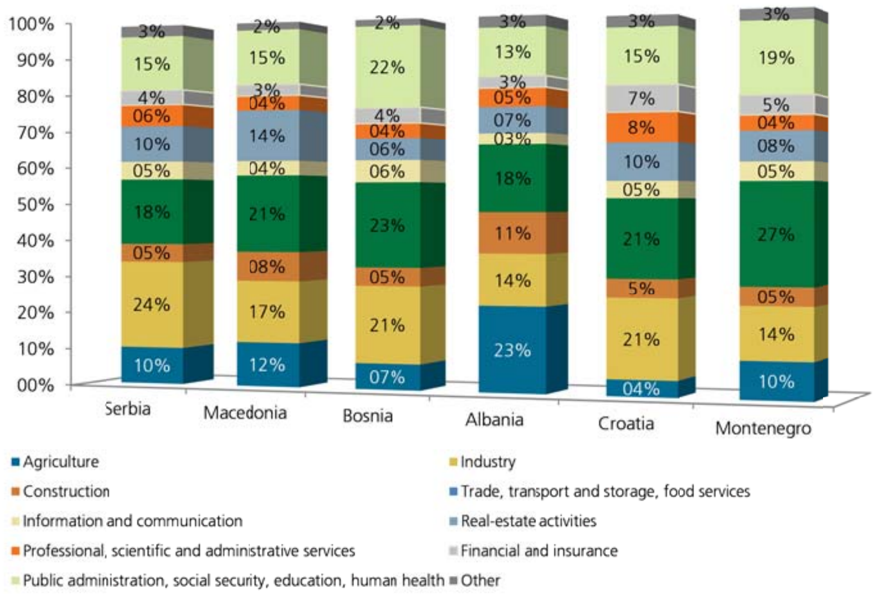
[73] In Nov 2015, China Road and Bridge Corporation signed a MoU with the Serbian Government to develop a Chinese industrial park. The company also signed an initial agreement with the Serbian Ministry of Transportation and infrastructure on building a highway.

3.2 Impact of Chinese and OBOR related investments on industrial sectors and SMEs in the region

As already mentioned, Chinese investments in regional transport and energy infrastructure are deemed highly important and could be one of the key growth drivers in the Western Balkans area, which is considerably lagging behind the EU in terms of GDP per capita, as well as global competitiveness ranking.

Looking at business activities, the main beneficiaries so far have been the construction and energy sector (electricity supply), but also some of the manufacturing sectors supplying these two sectors with raw materials and related equipment.

GVA structure by business activities in the Western Balkans countries in 2014



Source: National statistics offices

The acceleration of the capital projects is expected to further bolster performance of these sectors in terms of better GDP contribution, which is in particular important for the construction and civil engineering sector, which suffered most after the 2008 economic crisis. The current GVA structure could be enhanced, especially by improving the share of the industry, in almost all of the countries.

3.3 Impact on SME sector and its potential financial needs

The operational model of all capital projects realised so far with China was quite similar – financing was enabled by favourable loans from one of the Chinese banks, the projects are delivered by Chinese state-owned enterprises as principal contractors, where integral parts of the deals are also materials, equipment and labour. However, agreements usually include the possibility for local companies to be sub-contracted with up to 50% of the project's value. Using the construction of the Sino-Serbian Friendship Bridge over the Danube as an example of a successfully completed project, the value of construction works was approximately split 50:50 between Chinese companies, which were in charge of construction of the bridge, and local companies, which worked on the construction of access roads and paving of the bridge.

In Serbia, as the country with most investments currently, large local companies with strong reference lists have been so far engaged as main sub-contractors of the Chinese contractors. SMEs could usually participate only as members of the consortiums or simply as their material suppliers or providers of specific services. However, their engagement in recent years seems to have been growing, since many large companies went bankrupt after being negatively affected by the crisis, while some large road construction groups lost the capacity to serve their own liabilities, losing ground in the market as well. New players have then shown up on the market, taking over large projects, but widely hiring SMEs, which survived the crisis, as sub-contractors, due to lack of own capacity to perform all agreed works.

An increasing number of investment projects to be realised with China creates new opportunities for local industry to get engaged and benefit from this cooperation, employing a significant workforce in the capacity of sub-contractors. Among SMEs, the medium sized companies will have the largest opportunity, but there is also an opportunity for smaller companies to get involved as sub-contractors.

SMEs represent more than 99% of the total number of enterprises in the region, accounting for around 60% of total employment. However, estimates related to Serbia, as the largest country in the region, show they contribute only 34% to GDP, much lower than the 55% contributed by SMEs across the EU, so it is crucial to support their growth and innovation. The micro segment is prevailing in the structure (nearly 90% of SMEs in Serbia) and such a high fragmentation is not a good basis for the improvement of competitiveness, to reach economies of scale or to break into new markets.

SMEs, small and micro companies in particular, have relatively low capital bases and are relying more on the external funds in business financing. Aggregate financial reports of the SME segment in Serbia are showing capitalisation of c.15%, while some 35-40% of their assets have been financed through loans and/or leasing facilities. Considering the value of the projects currently in progress or yet to be realised with China, this creates a significant opportunity for banks to participate in the financing of local companies with both cash and non-cash support. In case of a participation of 50% of SMEs to the USD 11bn value of OBOR projects in the Western Balkans, this may give rise to around USD 2bn of additional financial needs, which could be locally financed.

The necessary local bank support could be expected to come from three main directions:

- off-balance facilities - guarantees needed in order to participate in the projects – such as performance bonds (usually 10% of contract value), advance payments (20%) and warranty L/Gs (5%), and/or letters of credit in case of agreed delivery of equipment from abroad;
- bridge financing, especially when longer payment terms against interim certificates are contracted (which could be possible, due to lower negotiating power of local companies – e.g. during construction of the Sino-Serbian Friendship Bridge, agreement with local sub-contractors stipulated payments on a six-monthly basis);
- PP&E financing, especially as new equipment is increasingly needed to improve capacity to efficiently perform agreed works and stay competitive in the market (this is especially highlighted when taking into account that due to a lack of large-scale investment projects in the previous periods, technical equipment in the region is generally outdated and needs to be renewed);

Banca Intesa Beograd, as primary bank in Serbia, has provided support to local corporate clients engaged in the projects with China (Sino-Serbian friendship bridge, first phase of TE Kostolac) primarily with off-balance facilities (guarantees and letters of credit in the case of imports of equipment) and to a minor extent with bridge financing. As per their experience, realisation of the agreed works had been regular, with no significant delays, as well as payment for performed works, since the funds assigned for project financing have been provided from the Chinese loans.

SMEs access to finance

One of the most important issues generally facing SMEs is their difficulty accessing finance, which is one of the main obstacles to their development. Results of a USAID Business survey conducted in Serbia in 2015[74] show that only 15% of small companies took new loans in the previous year, and these were primarily utilised for the purchase of new equipment or to finance inventories. Around 40% of respondents didn't have any need for new financing, while of the companies that did need funding, the main reasons they did not take loans were: 1) use of their own funds instead of loans (increase to 25% versus 14% in 2014); 2) banking products did not correspond to their needs or risk profile; 3) banking procedures require too much time or money. Many cited collateral requirements of the banks as one of the main obstacles for taking the loans.

There is certainly potential to be utilised by the local banks to develop their offering in accordance with the wider spectrum of needs of SMEs, especially if we bear in mind that more than 50% of value added is generated by this segment.

There is also plenty of room for the state to improve existing state support programs in this segment and to align them with best EU practice in order to improve SMEs' access to financing. With the structural reform process taking place in the region, their development is gaining in importance - to drive economic growth and create new jobs, especially after the announcement of major job cutting in the public sector due to fiscal consolidation.

In Serbia 2016 was named a "year of entrepreneurship", with more focus put on designing co-financing and state guarantee programmes to enable companies in the early stages of development or those not having proper collateral (property) to get access to bank loans. In contrast, in previous years when direct grants and subsidising interest programs had the primate, this did not stimulate banks to adjust their offering to the real needs of small companies.

One of the opportunities for SMEs could be the EU programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (COSME), in particular components referring to access to finance and access to markets, as it has become available for many countries of the region such as Albania, Macedonia and Montenegro, and most recently for Serbia.

[74] Survey conducted on the sample of 1,008 enterprises (representative sample of all registered businesses in Serbia with at least three employees) as part of a USAID business enabling project. The survey covered many areas relevant for doing business, among them access to financing.

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Important Information

Intesa Sanpaolo – International Research Network