CENTER FOR THE STUDY OF DEMOCRACY

THE CHINESE ECONOMIC FOOTPRINT IN CENTRAL AND EASTERN EUROPE: IMPACT ON ENERGY TRANSITION AND CLIMATE

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In the past decade China has launched and promoted its first global infrastructure and economic development platform – the Belt and Road Initiative (BRI). It seeks to link China with Europe and countries in Asia, Africa, Latin America, and the Pacific. The BRI binds the countries along its way in large-scale China-financed infrastructure projects, which enhance China's economic and political leverage.

In Europe, China has sought to engage differentially with its regions, segmenting its approach towards Northern, Southern, and Central and Eastern Europe (CEE). On the latter, China has set up the 17+1 initiative, including all former Communist countries and Greece, focusing on transport and energy infrastructure in particular.[1] China, similar to Russia, has sought to exploit the region's need for capital investment coupled with laxer governance and rule of law standards, undervalued assets, and governments' willingness to engage with non-transparent authoritarian deals.

The increased Chinese economic footprint could contribute to the **entrenching of the existing state capture[2] networks** in the countries of the region, reducing the democratic viability of Central and Eastern Europe. Chinese-backed loan agreements come with little or no governance strings attached, which allows

KEY POINTS

- To expand its economic influence, **China has exploited a number of domestic governance deficits in CEE**, including: lack of transparency of intergovernmental agreements, circumvention of national competition and public procurement law, as well as inconsistency with EU objectives.
- Around **USD 14 billion** in Chinese funds have entered the region in the form of grants, development loans, mergers and acquisition of domestic assets, and concession agreements.
- Loan-based intergovernmental agreements have raised the spectre of **debt traps** for the small regional economies.
- A long-lasting effect of Chinese investment is a **synergy of failures**, including: delayed energy transition, non-compliance with European environmental standards, and increased dependency on coal-fired power generation.
- **The EU** should reinforce its position as the primary driver of economic development in the CEE region by filling the funding gap for the implementation of strategic economic development projects.
- The EU should develop clear **governance guidelines** for Chinese-backed projects that would be used by national governments as a form of preapproval.

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[1] This paper reviews Chinese economic footprint in the following countries: Albania, Kosovo, Montenegro, Bosnia and Herzegovina, Serbia, North Macedonia, Croatia, Bulgaria, Romania, Greece, Hungary, and Czechia, which the analysis collectively refers to as Central and Eastern Europe. The assessment does not focus on the Baltic countries, Poland, and Slovakia. It is important to note that most large Chinese-led infrastructure projects take place mostly in non-EU countries in South East Europe.

[2] Stoyanov, Alexander, Alexander Gerganov, and Todor Yalamov. *State Capture Assessment Diagnostics*, Sofia: Center for the Study of Democracy, 2019.

national governments to use them to directly benefit loyal, local oligarchic networks. This increases China's state capture power[3] in the region. On the one hand, it binds local oligarchs as (sub)contractors in the large-scale projects. On the other hand, it provides leverage and influence over the strategic decision-making of national governments, pulling them away from Euro-Atlantic democratization efforts through rule-based conditionality.

The negative impact on governance is most strongly felt in non-EU states where the EU legislation and principles of equal access on state aid, competition and public procurement transparency have not been implemented, leaving a lot of room for manipulation. In these projects, China's state-backed companies often find themselves in the position of single bidders that receive preferential treatment.

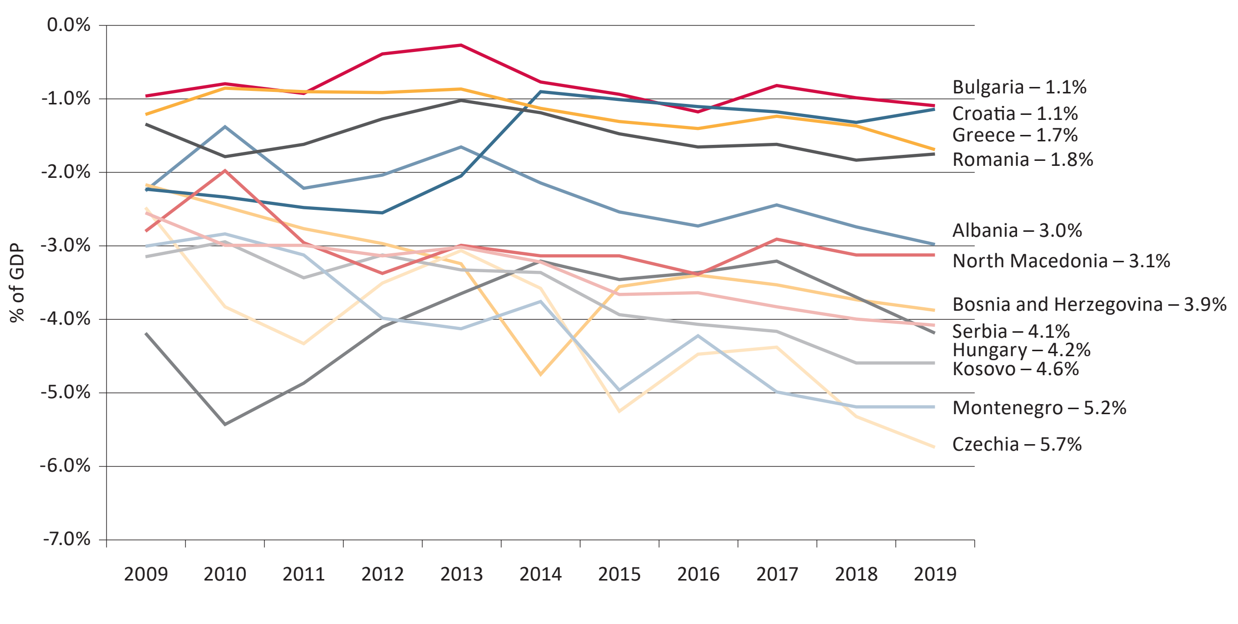
Measuring the Chinese Economic Footprint

Since the financial crisis of 2008, economic links between China and CEE countries have intensified. Revealing the actual size of the Chinese economic footprint[4] in CEE requires a look at trade relations, investment, debt, and corporate ownership and presence.

Trade and Investment Patterns

The trade turnover between China and CEE countries has been **steadily rising in the past decade**. China continues "running chronically large and growing trade surpluses with almost all of the countries from the original 16+1 group".[5] As a function of the size of their economies, Poland, Czechia, Hungary,

Figure 1. Bilateral trade deficits as % share of GDP between China and selected CEE countries



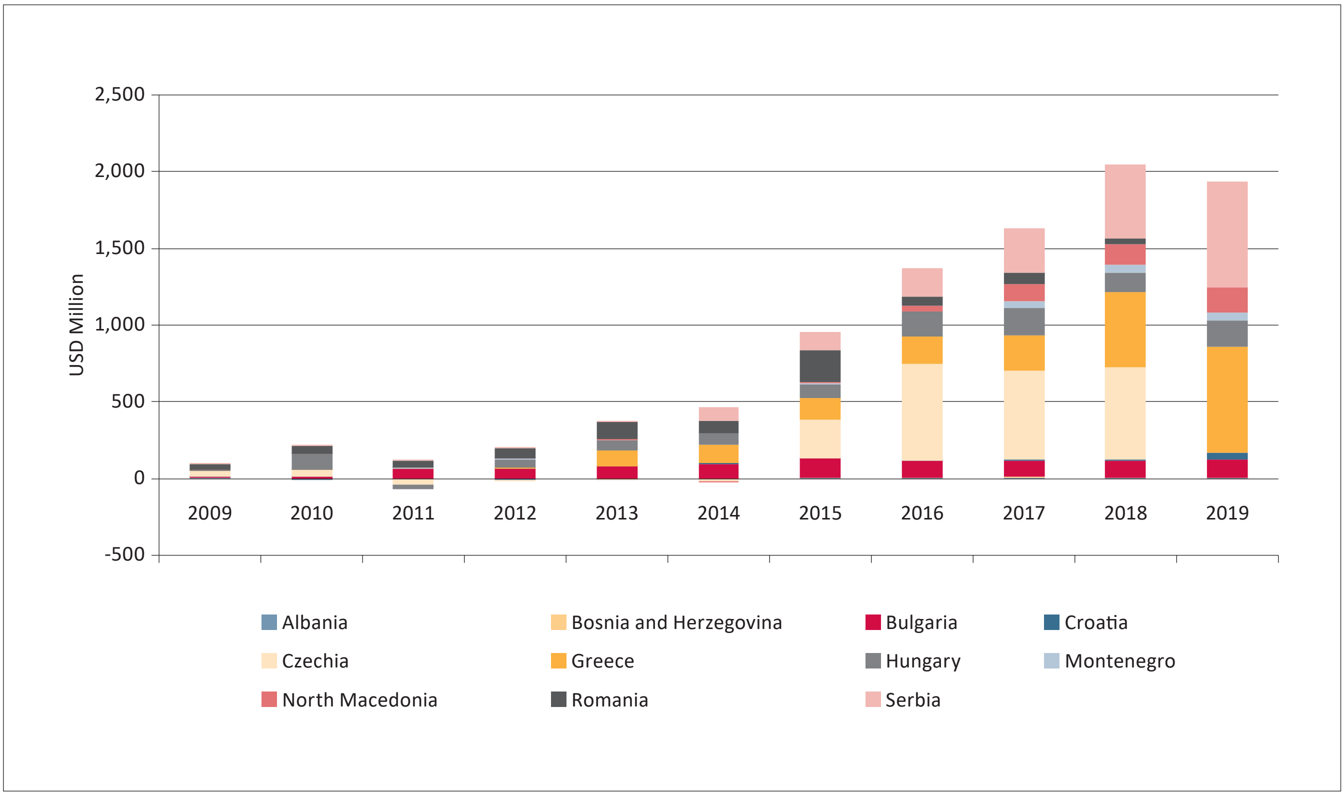
Source: *COMEXT of Eurostat.*

[3] Shentov, Ognian, Ruslan Stefanov, and Martin Vladimirov, editors. *The Kremlin Playbook in Europe*, Sofia: Center for the Study of Democracy, 2020.

[4] For an overview of CSD's economic footprint methodology, please see Shentov, Ognian, Ruslan Stefanov, and Martin Vladimirov, editors. *The Russian Economic Grip on Central and Eastern Europe*, Routledge, 2019.

[5] Pencea, Sarmiza. "Romania-China Trade and Investment Relations against the Backdrop of "One Belt, One Road" Strategy." *Romanian Economic and Business Review* 12, no. 2, Summer 2017: 17.

Figure 2. Chinese Foreign Direct Investment Stocks (USD Million)



* *There are no Chinese FDI reported in Kosovo.*
Source: *National Central Banks.*

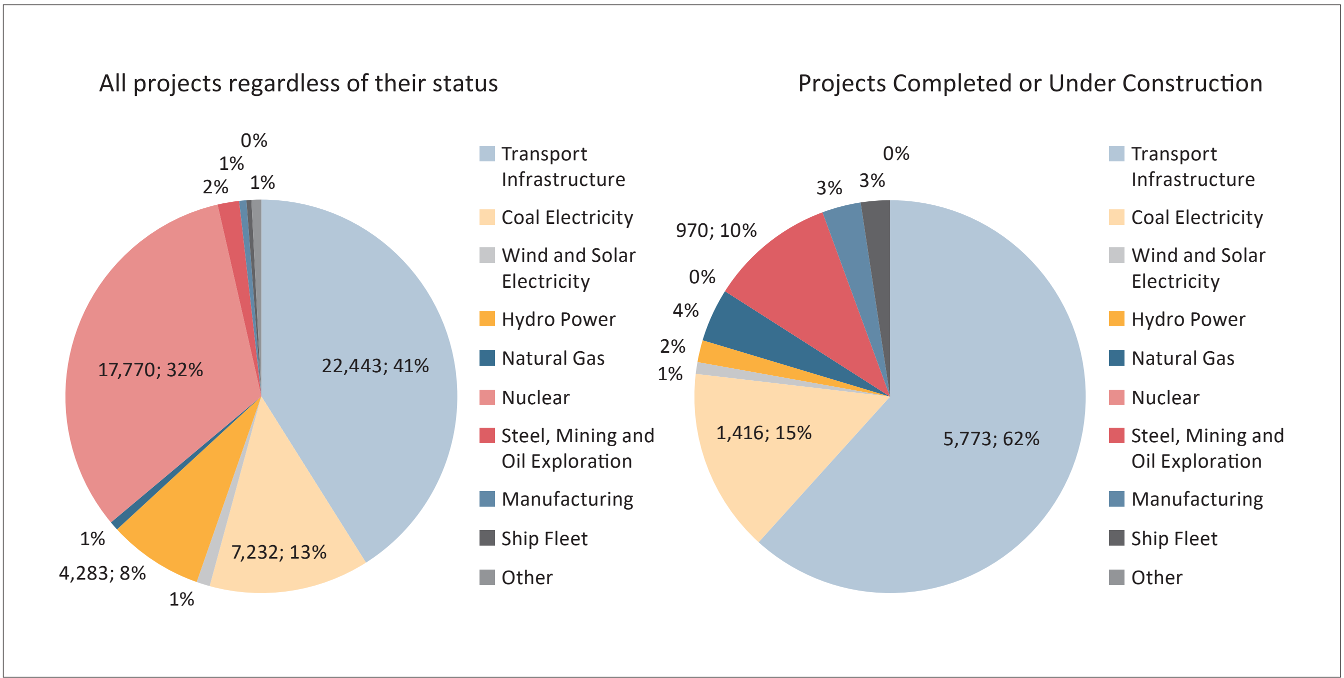
Slovakia and Romania logically constitute 80% of all trade exchanges with China in the region.[6] The average bilateral trade deficit of CEE countries with China has remained largely stable increasing from 2.4% of GDP in 2009 to 3.3% in 2019. In some countries such as Czechia, however, the trade exposure to China has doubled to nearly 6% of GDP (Figure 1).

A notable rise in the trade dependence on China is clearly visible also in most Western Balkan countries, which could be related to the growing imports of goods that Chinese companies have been using in the implementation of large infrastructure projects. Balance of payments vulnerabilities have often been used as leverag by China in other parts of the world to impose political pressure on governments to change their foreign policy priorities or give up control over strategic assets. The interdependence between the regional economies and China could undermine the political will of CEE governments (especially of non-EU countries in SEE) to join Euro Atlantic foreign policy decisions or declarations that go against Chinese geostrategic interests.

Chinese investments in CEE have been focused **in a few key sectors – transportation, energy, manufacturing, and telecommunications**. Chinese capital inflows in the region are a small share (2.7%) of the total Chinese investments in the world. Yet, they represent a transfer of significant financial resources relative to the size of the economies from the region, especially in the Western Balkans. Similar to the deepening trade ties, Chinese investment has also been growing significantly over the past decade. Chinese foreign direct investment (FDI) stocks have grown from less than USD 100 million in 2009 to around USD 2 billion in 2019 (Figure 2). Serbia and Greece have accounted for most of the largest and most strategic, new investment. However, the official FDI stocks statistics provided by the national central banks underesti-

6 Bastian, Jens. *The potential for growth through Chinese infrastructure investments in Central and South-Eastern Europe along the "Balkan Silk Road",* Athens; London: European Bank for Reconstruction and Development, 2017, pp. 33-34.

Figure 3. Allocation of Projects/Acquisitions by Sector (as % out of the total Chinese investment projects and USD Million)



* *Chinese companies have expressed interest in becoming strategic investors in three of the planned nuclear power plant projects in CEE but in all three cases the talks are still in preliminary stages or have been suspended.*

Source: *CSD based on a country-by-country review of projects.*

mates the true value of Chinese investments in the region.[7] In addition, as the EU and US have grown more aware of aggressive intellectual property and corporate practices by state-owned Chinese companies, China, similar to Russia, has started using more aggressively corporate obfuscation tactics (e.g. offshore havens).

A more realistic picture of the Chinese economic footprint in the region is the **total value of Chinese financial flows into CEE**. An estimated USD 13.74 billion in Chinese funds have entered into the region in the form of grants, development loans, mergers, and acquisition of domestic assets and concession agreements. Some 2/3 of the inflows have happened in the past five years.[8] This value omits many of the smaller transactions that have been dispersed among different private Chinese companies. Chinese investment in the region is thus likely higher than that of Russia (around USD 12.2 billion) but is still a fraction of the combined different EU flows to CEE. Chinese projects and large-scale asset acquisitions in CEE that have been completed or are under execution are estimated at around USD 10.4 billion.[9] The total pipeline of projects at different stages of development could be worth more than USD 51.5 billion.[10]

For some of the smaller economies like Montenegro and Bosnia and Herzegovina, Chinese-led projects make up around a quarter and a fifth of the countries' GDP, respectively. This makes Chinese economic presence in these countries a structurally-indispensable

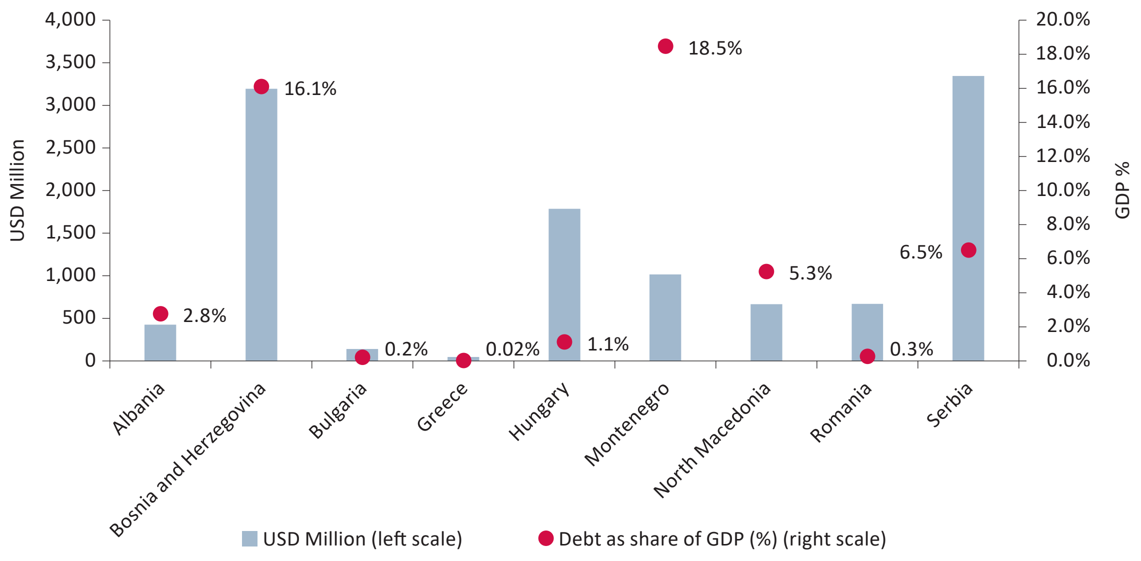
[7] Most central banks do not report the ultimate beneficial ownership of the foreign direct investment flows coming in the country but only the last country of origin. This means that Chinese investments channeled through subsidiary entities registered in a third country such as an offshore jurisdiction would be reported by central banks as originating from that same third country. Many Chinese-controlled overseas companies resemble a corporate ownership structure that obfuscates the ultimate beneficial ownership and could mask Chinese investments as Western capital flows.

[8] CSD estimates based on the China's Global Development Footprint Database developed by AidData, a Research Lab at William & Mary and an overview of Chinese-funded projects and other initiatives in each of the 12 countries analysed.

[9] Ibid.

[10] Ibid.

Figure 4. Debt Exposure to China by country (as share of GDP)



Source: *CSD based on global development and national central bank databases.*

factor. As most Chinese projects are financed via intergovernmental loans, the Chinese economic footprint has translated into a significant debt exposure (Figure 3). On average, Chinese project-linked loans are estimated at 5.6% of GDP in the region.

In general, China has been much more active in the Western Balkans than in other CEE countries, investing billions of US dollars in large-scale infrastructure projects that exceed the macroeconomic and administrative capacity of governments to manage them. North Macedonia and Montenegro have both taken up large loans from China without performing an in-depth cost-benefit analysis or holding a public discussion about the long-term risks associated with a potential debt trap (Figure 4). The future financial obligations of Montenegro in particular could put the government in a position, in which it is unable to honor debt repayments. The loan agreement stipulates that any dispute will be resolved in Chinese courts making it highly unlikely that Montenegro would be able to win a ruling in its favor. The results could be ruinous for Montenegro, potentially forcing the country to alter political positions, lease the already-built infrastructure to China, or accept harsh repayment conditions in the case of a default. While official BRI policy documents assert the rights of sovereignty of all participating countries, if China perceives a threat to its investments, this might lead to a "developmental internationalism in order to minimize the many political, cultural, and legal risks associated with the project.[11]

The attractiveness of the Western Balkans versus EU member states is that the **Chinese investments do not need to comply with the EU's strict transparency, competition, and environmental rules** on issues such as public procurement, impact assessment, and state aid.[12]

[11] Carrai, Maria Adele. "China's Malleable Sovereignty along the Belt and Road Initiative: The Case of the 99-Year Chinese Lease of Hambantota Port." *N.Y.U. Journal of International Law & Politics,* vol. 51, Summer 2019.

[12] Serbia has been the most welcoming country to Chinese investment as more than half of all Chinese projects (by value) in the region that have been commissioned or are underway are located in the country. A total of 19 projects or large company acquisitions have been identified, which involve the building of major transport infrastructure, including the construction of parts of the EU's Pan-European transport system comprising Corridor X railway and highway sections, Corridor XI highway, as well as the Mihajlo Pupin bridge and the Belgrade metro network. Chinese companies have also bought some of the largest industrial complexes in the country, including the Smederevo steel plant and the copper mining and smelting complex, Bor. China is also investing in the modernization of two of the largest lignite-fired power plants, Kostolac B3 and Kolubara B Power Stations.

The Chinese interest in using excess capacity to produce new, but often obsolete, energy infrastructure abroad, is also visible in the **allocation of projects and asset acquisitions by sector**. Around a quarter of the ongoing projects are coal or heavy-industry-related and most of the rest is taken up by large-scale transport infrastructure development. The concentration of Chinese projects in carbon-intensive sectors is also driven by the priorities of the domestic ruling elites. These elites cater to the socio-political groups that depend on the heavy industry, the coal-based energy sector, and the public-procurement-driven construction spending.

Even as Chinese representatives have claimed that they are ready to "invest in wind and solar", **China has so far invested in only 14 low-carbon projects** in the whole CEE region with a total value of USD 319 million, amounting to just a fraction of the total Chinese capital inflows in the region. The most well-known projects are the Minos concentrated solar power (CSP) on the Greek island of Crete, the Kupres 1 wind park in Bosnia and Herzegovina, and the Mozura Wind Power Plant (roughly 100 MW in total); all the rest are small hydro power plants with no clear environmental and economic feasibility.

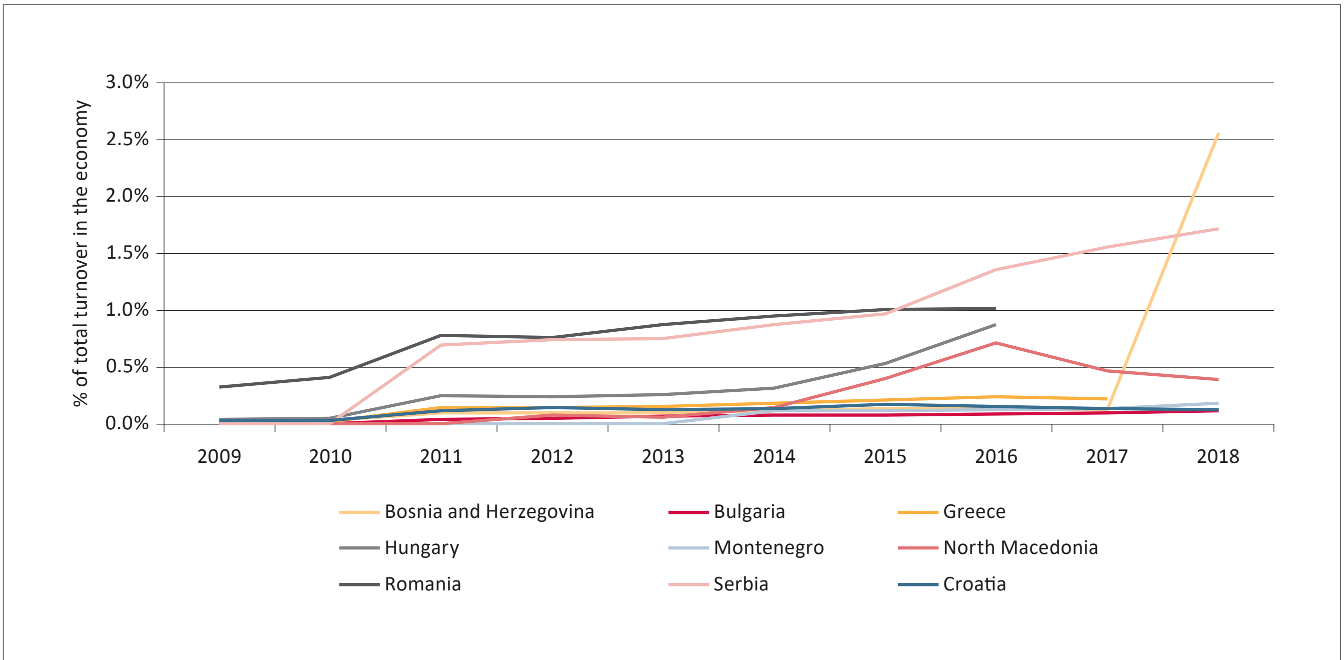
Corporate Footprint

The growing Chinese investment activity has so far not translated into a more visible presence of large Chinese companies in CEE. **Chinese firms control on average less than 1% of the economy's total turnover in each country** of the region in 2019. The notable exceptions are Serbia and Bosnia and Herzegovina, which have seen the Chinese corporate presence rise from practically zero to around a little over 2% (Figure 5).

Somewhat surprisingly, the list of Chinese companies operating through domestically-registered subsidiaries does not include the infrastructure construction giants implementing the large-scale projects mentioned above. This is because they do not own and are not the investors in the projects but contractors. In addition, instead of working with subsidiaries registered in the country where the project is implemented, these companies operate mostly with local subcontractors.

Most of the big Chinese corporations operating in the region are **consumer goods producers** such as the Slovenian-based electrical appliances manufacturer Gorenje, international energy, mining and metallurgical enterprises, including: HBIS Group, Zijin Group,

Figure 5. Chinese companies turnover as share of the total turnover in the economy (%)



Source: *CSD calculations based on public and private corporate databases.*

agricultural and logistical firms (COFCO, Syngenta and COSTCO), the IT and telecommunication giants Ingram Micro (owned by the HNA Group) and Huawei, as well as the global textile company Tom Tailor (owned by Fosun). The local subsidiaries of this handful of Chinese companies that are global leaders in their respective industries generate more than 90% of the Chinese-controlled revenue in the region, yet there are close to **10,000 firms in the region with Chinese ultimate beneficial ownership**.

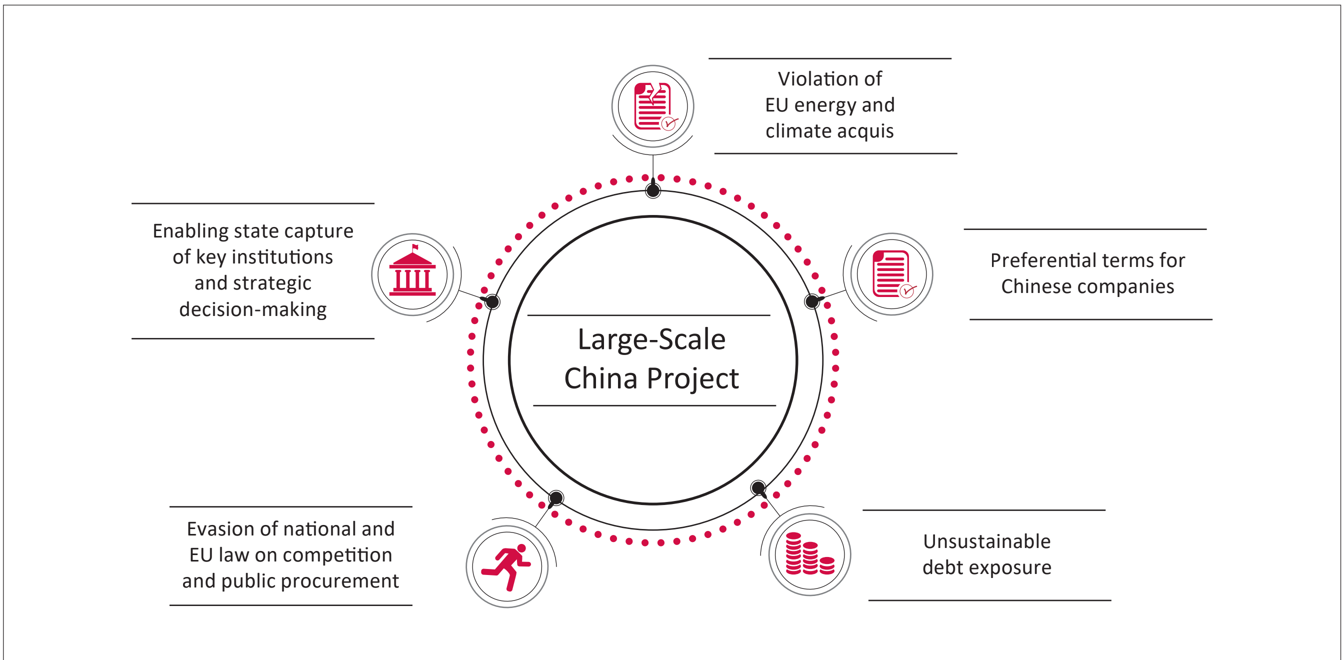
Domestic companies with Chinese ultimate beneficial ownership control assets of between USD 1 and 2 billion, which is similar to the turnover indicator and is only a very small fraction of the total assets in the economy. On average, Chinese-owned domestic entities have been employing very few workers directly in CEE (between 1,000 and 5,000 annually over the last decade). Yet, in Romania, Serbia, Czechia and Hungary, where the number of registered Chinese-owned companies is much higher, the number of employees has been on average over 10,000 annually.

While the Chinese direct corporate footprint seems marginal compared to the presence of EU-based or even Russian companies, **China has a much bigger indirect corporate presence**. All of the China-backed large-scale transport and energy infrastructure development projects in the region are implemented by Chinese contractors in partnership with local construction and engineering firms that become heavily dependent on these large-scale contracts. Although Chinese construction companies employ Chinese workers and import Chinese equipment to implement the projects, local subcontractors are also involved and usually play a key role as intermediaries to the government. An analysis of the share of the projects that is executed by domestic firms and the level of dependence that local companies have on the import of Chinese goods would be critical to understanding the true extent of the Chinese corporate footprint in the region.

Governance Vulnerabilities and Impact on Energy and Climate Policy

To expand its economic and political influence in CEE, **China has exploited a number of domestic governance deficits**, including: lack of transparency of intergovernmental agreements, circumvention of national compe-

Figure 6. Governance Deficits in Chinese Large-Scale Projects in CEE



Source: *CSD.*

tition and public procurement law, and inconsistency with the objectives and conditionalities related to EU membership or accession aspirations (Figure 6).

Chinese investment has become **increasingly attractive to CEE governments**, as the Chinese-supported initiatives have not come with the conditions for structural reforms that EU funding requires. Many of the projects are allocated without open tenders, without the embedding of anti-corruption measures and are not based on an evidence-based cost/benefit assessment. China often finances investments in, e.g. lignite power plants or transport corridors, that are not aligned with the strategic priorities of the countries, nor commercially viable in the current market environment and regulatory framework. The funding comes in the form of (intergovernmental) loans, which might not have good governance requirements but still carry heavy strings attached, including: the mandatory use of Chinese contractors, labor, and equipment, while transferring the risks associated with the projects onto CEE governments. Politicians in CEE countries often support such projects even when they lack financial or market logic, as they are used for the expansion of their political and state capture power domestically. Many of the large infrastructure projects exploit and further entrench corruption risks and the capture of key institutions.[13]

Lack of Transparency of Intergovernmental Agreements

Projects implemented within the BRI framework usually depend on large loans from Chinese development and export banks. The loans are usually disbursed as an outcome of intergovernmental agreements (IGAs) that are signed without any prior public discussion or feasibility assessments. In some countries (Serbia, Montenegro, and Bosnia and Herzegovina), IGAs are exempted from national competition, public procurement and import tariff laws, opening the door for allowing preferential treatment towards the Chinese companies taking part in the projects. Sometimes IGAs lead to the development of ad-hoc legislation that justifies the country's involvement.[14]

Although the loans often have seemingly beneficial repayment terms and low interest rates (often lower than those of international financial institutions), the agreements carry specific loan conditions particularly with regards to contractors, which could alter their return for the benefit of China. Many bilateral loans entail the hiring of Chinese contractors (e.g. some 7,000 Chinese employees of the CRBC helped complete the Sino-Serbian 'friendship' bridge in Belgrade) or the supply of Chinese materials, thereby recycling the financing (and profits) back to Chinese enterprises.[15] The loans also stipulate specific concessions such as labor law exemptions, VAT exemptions, profit guarantees (for concessions), which can all significantly contrast with initial promises. Even when not outright hidden behind business secrecy clauses, such conditions are not necessarily known or easily accessible to the public.[16]

Loan-based intergovernmental agreements have also raised the **spectre of debt traps for some of the small regional economies.** Chinese direct lending for infrastructure projects mostly comes in the form of long-term repayment and low-interest loans from the Chinese EXIM bank, which covers 85% of the project capital, with the remainder financed by the host countries.[17]

13 Rogers, Samuel. "China, Hungary, and the Belgrade-Budapest Railway Upgrade: New Politically-Induced Dimensions of FDI and the Trajectory of Hungarian Economic Development." *Journal of East-West Business* 25, no. 1, February 2019.

14 In Montenegro, the government approved the construction of the Podgorica – Kolasin motorway in 2014 (estimated to cost between 20 and 25% of the country's GDP), on the basis that it would boost the national economic growth, under a special law classifying the project as of "national significance". Levitin, Oleg, Jakov Milatovic, and Peter Sanfey. "China and South-Eastern Europe: Infrastructure, trade and investment." EBRD, July 2016.

15 Seghier, Milan. "The Coronavirus Pandemic Lets China Score a Win in Serbia", *Transatlantic Take, March 23, 2020.*

16 Horn, Sebastian, Carmen M. Reinhart and Christoph Trebesch. "China's Overseas Lending", Working Paper 26050, National Bureau of Economic Research, July 2019.

17 Rogelja, Igor. "Building the Balkans: How Chinese financing in energy and transport is altering Southeast Europe," 2018.

Box 1. Debt-trap diplomacy in Montenegro

The long-term financial risk is well exemplified in Montenegro, which over the last 8 years signed two major highway construction deals with China worth close to EUR 1.84 billion. Both are implemented through loans from the EXIM bank that finances 85% of the project at a 2% annual interest rate, a 5-year grace period and a 20-year repayment schedule. The agreement that governs the two highway projects stipulated the involvement of the Chinese state-owned infrastructure giant, China Road and Bridge Corporation, and the use of Chinese construction workers, even though Montenegro faces an unemployment rate of 15.7%. The projects were also exempted from taxes and custom fees. Both the IMF and the World Bank have suggested that such projects were fiscally irresponsible: they have contributed to the exponential growth of public debt, which has soared above 70% of GDP.[18]

Preferential Treatment and State Aid

The Chinese-developed projects are exhibiting numerous **market competition distortions**. Local policy-makers have provided Chinese contractors with preferential treatment by giving them exclusivity in opaque public procurement procedures and by granting them state aid in the form of tax exemptions and the circumvention of labor standards. In the case of coal investments, the Secretariat of the Energy Community requires that subsidies for coal-related activities be reported in a transparent manner and be subject to a legal assessment according to the Treaty's state aid criteria. However, local governments have not been transparent about the exact terms of the projects and have implemented national legislative changes to enable the legality of the investments.

Large-scale projects based on intergovernmental agreements with China are often inconsistent with public procurement procedures and standards, and are often the result of closed-door negotiations. For instance, no public tender procedure was conducted for several Serbian projects – Kostolac B3 power plant and the Pupin Bridge – as Serbia and China signed an annex to their intergovernmental agreement exempting them from tender obligations, leaving room for Chinese companies to avoid EU and national law. In addition, concessional loan contracts signed with development banks very often include a clause stipulating

Box 2. State Capture and Chinese Energy Projects

One of the most notable cases has been the construction of the lignite-fired Stanari thermal power plant in Republika Srpska (Bosnia and Herzegovina). The project, valuated at USD 674 million, was developed by the private Energy Financing Team (EFT), which is controlled by the Serbian businessman Vuk Hamovic with close ties to the ruling Republika Srpska government. But 2/3 of the financing came from the China Development Bank that was guaranteed with a lien on EFT's concession rights for the exploration of the nearby lignite mine. The potential change of ownership of the concession rights in the future, in the case of a default on the loan, became possible only after the entity government of Republika Srpska changed the domestic laws to allow the possibility for the transfer of rights.[19] Furthermore, the government limited the costs for the plant operator by reducing the concession fees for coal power generation from 3.6% to 0.2% of total revenues, while completely exempting it from coal mining fees. Albeit the Chinese Development Bank officially dealt directly with EFT, such a project would have never been secured without the direct government intervention to bypass legal obstacles.

[18] IMF Country Report No. 19/293, International Monetary Fund, September 2019.

[19] "Environmental issues and Chinese capital in Bosnia and Herzegovina: Stanari coal power plant, ESIA SEE". *Environment South East Europe*, May 22, 2020.

that any arbitration dispute will be decided by Chinese courts.[20]

Unlike its own BRI projects, which have remained closed for competition, **China has been able to tap into EU regional funds in order to implement infrastructure projects** in the region. In 2020, Chinese companies have doubled the amount of EU-based public procurement contracts they have secured, to nearly EUR 2 billion (around EUR 3.9 billion in the last decade).[21] A case in point is the construction of the Pelješac bridge in Croatia, where 85% of the costs were funded with EUR 357 million from the EU Cohesion Funds. This represented the first EU tender to be won by a Chinese company. However, as with projects funded by non-EU resources, there have again been allegations about the presence of anti-competitive practices in the bidding process.[22]

Impact on Energy, Climate and Environmental Policy

Both the development of large-scale Chinese transport and energy infrastructure projects in CEE correlates with high corruption risks. Chinese energy projects appear particularly worrying due to their impact on global warming, air quality and emissions, landscape degradation, and biodiversity.

A potentially more long-lasting effect of Chinese investment in CEE countries is what can be described as "a synergy of failures", which includes the **delayed transition to cleaner forms of energy** (in particular in Western Balkan countries), **non-compliance with European environmental standards,** and increased **dependency on coal-fired power generation**. The Chinese-driven projects in the region share one key similarity – the disregard for or, at the very least, the avoidance of the countries' long-term environmental policies and sustainability. Chinese projects contribute to the policy lock-in of governments in carbon-intensive and climate damaging industries, including coal-fired power generation and heavy metallurgy (e.g. the Smederevo steel plant in Serbia). Similarly, the construction of highways largely serves the economic objectives of China while sucking out vital public resources from the process of low-carbon economic transformation.

The growing **Chinese presence in the energy sector** could undermine the 2030 and 2050 targets of EU member states for carbon emissions reduction and the implementation of the energy acquis of the six EU aspiring countries in the Western Balkans. The unavoidable coal phase-out over the next decade would be delayed with disastrous economic consequences in terms of stranded assets and painful transition for coal-dependent workers. Similarly, the employment of foreign workers to implement and operate the projects goes against the overall Just Transition Strategy for re-skilling workers in carbon-intensive sectors. Even when Chinese investments are geared towards energy transition objectives, RES investments are not in line with the EU energy policy agenda, prioritizing local, urban, and regional initiatives for energy transition that focuses on decentralization and democratization of energy supply.

Chinese investments in the **coal sector** are derailing the process of the implementation of the energy and climate acquis by Western Balkan countries and are delaying the phase-out of lignite-fired power plants in the EU member states of the region.[23] This has

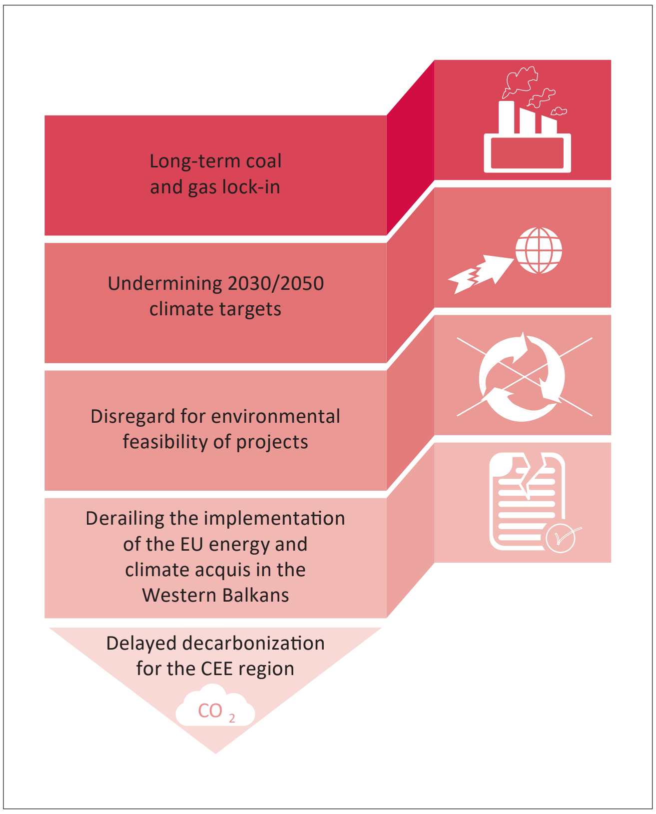
[20] Gallop, Pippa, Ioana Ciuta and Wawa Wang. "Chinese-financed coal projects in Europe." *CEE Bankwatch Network*, December 10, 2019.

[21] Michaels, Daniel and Hinshaw, Drew. "Chinese Companies Win Billions in European Taxpayer-Funded Contracts". *The Wall Street Journal,* December 17, 2020.

[22] Several other bidders in the tender filed lawsuits or anti-trust complaints questioning the unusually low prices offered by the China Road and Bridge Corporation (CRBC) that ultimately won the bid. The Chinese firm amounted to EUR 279 million. Prtoric, Jelena and Giovanni Vale. "China's 'bridge to Europe' drives a wedge between Croatia and Bosnia." *Equal Times*, March 20, 2019.

[23] The Energy Community Treaty aims at extending the EU internal energy market rules and principles (the energy and climate acquis) to South East Europe and the Black Sea region with the help of a legally binding framework. The gradual inclusion in the treaty of legislation on renewables, energy efficiency, climate change and air pollution control created a policy vehicle to promote and jumpstart the energy transition across the European continent. The EU Large Combustion Plant Directive (LCPD) and the Industrial Emission Directive (IED) set emissions limit for existing power plants that translate into high operating costs for existing plants and construction costs for new ones that would not comply with the technological requirement.

Figure 7. Impact of the Chinese Economic Footprint on the CEE Climate and Energy Policy



Source: *CSD.*

broader policy implications for the whole European continent, as in 2016 the 16 coal-based TPPs in the Western Balkans emitted as much sulphur dioxide pollution as all the 250 TPPs in the EU.[24] Hence, Western Balkan governments' coal support policies have been in direct conflict with their obligations to the *Energy Community Treaty* that mandates the gradual shutdown of polluting power plants while cancelling subsidies for the coal sector and redirecting the funds to long-term investment in renewable energy sources.

In addition, Southeast Europe possesses the largest lignite reserves in Europe, which represents a tempting long-term energy policy choice to ensure power supply with a cheap and plentiful resource that can be found at shallow depths, despite the disastrous air quality and environmental effects that the excavation and combustion of lignite resources produce. In addition, Western Balkan governments have insisted they are investing in cleaner coal by modernizing coal plants and mines. The justification is that they lack the available funds for transforming coal-dependent regions and reskilling workers employed in the sector.

EU funds are also insufficient to facilitate the transition, as the whole IPA program budget for 2021 – 2027 is about EUR 12.6 billion for all six countries and all areas of intervention. Small EU member states such as Bulgaria are receiving more over the same period.

Even when China has expressed readiness to "invest in wind and solar", CEE governments have generally not embraced a full-scale policy of renewable energy support.[25] Governments have not ensured a permissive regulatory and governance framework that incentivizes green investment and innovation. China is yet to deliver on its promise of greening its BRI agenda by introducing a Green Belt and Road Investment Strategy[26] for its projects, which include: embedding sustainability into corporate governance, understanding environmental, social, and governance risk in host countries, disclosing environmental information for all projects, enhancing stakeholder outreach, utilizing green financial instruments, adopting green supply chain management, and building capacity through collective action. Such pledges do not correspond with the reality on the ground and could be interpreted as a green washing campaign that aims to dispel EU concerns about the long-term impact of Chinese economic presence in the region.

Corruption and State Capture Risks

Chinese investment has come with inevitable risks for the rule of law and the level of corruption in CEE. Many of the large infrastructure projects exploit and further entrench corruption risks and the capture of key institutions.[27] These governance vulnerabilities have facilitated the creation of incumbent webs of political and

[24] Beyond Coal Project. "Chronic coal pollution – EU action on the Western Balkans will improve health and economies across Europe", Health and Environment Alliance (HEAL), 2019.

[25] Gallop, Pippa, Ioana Ciuta and Wawa Wang. "Chinese-financed coal projects in Europe." *CEE Bankwatch Network*, December 10, 2019.

[26] Goh, Brenda and Cadell, Cate. "China's Xi says Belt and Road must be green, sustainable", *Reuters,* April 25, 2019.

[27] Rogers, Samuel. "China, Hungary, and the Belgrade-Budapest Railway Upgrade: New Politically-Induced Dimensions of FDI and the Trajectory of Hungarian Economic Development." *Journal of East-West Business* 25, no. 1, February 2019.

business networks to effectively control access to government law and policy making.[28] In this respect, the combination of weak rule of law, kleptocratic elites, and ineffective regulatory institutions have enabled the entry of Chinese capital, which in turn could further exploit local vulnerabilities and break down democratic governance institutions.[29]

In addition, **China has invested in sectors, traditionally seen as vulnerable to state capture** – energy, infrastructure and mining. Chinese state banks and SOEs are willing to tolerate corruption and limited transparency. The construction of the Kichevo-Ohrid highway in North Macedonia serves as a prime example. It was marred by bad planning and a lack of a comprehensive environmental impact assessment. The project raised allegations of corruption and illegal party financing, and ultimately resulted in a money-laundering scandal that implicated the former Prime Minister Nikola Gruevski.[30]

Similarly, the Chinese-funded modernization of the Budapest-Belgrade railway, has also revealed state capture practices.[31] In 2016, the European Commission started preliminary infringement procedures against Hungary over the obscure procurement and tendering procedure for the project.[32] When the Hungarian government ultimately agreed to launch a tender, the pro-government businessman Lorinc Meszaros easily won the contract in partnership with two Chinese companies.[33] Hungary's "flagship" Belt and Road railway initiative illustrates that China has been leveraging its close ties with Hungarian politicians and well-positioned businessmen to engage in the implementation of large-scale projects within the EU legal and regulatory environment.

An economic restructuring based on the modernization and decarbonization of the energy system, as well as the reorientation towards industries with higher added-value, will bring workers back to Europe's fastest depopulating region. The artificial prolongation of the current policy of supporting investments entrenching domestic state capture networks would only widen the economic gap with Western Europe. It would also strengthen existing governance deficits preventing a full-scale economic reform.

EU Policy Framework on China

The EU has taken on a more proactive role in tackling Chinese economic influence in its member states and accession countries. The policy shift has come over the last decade, as Chinese companies have become increasingly bold in investing in strategic technological, financial and energy companies around Europe.[34]

28 Stoyanov, Alexander, Alexander Gerganov, and Todor Yalamov. *State Capture Assessment Diagnostics*, Sofia: Center for the Study of Democracy, 2019.

29 Morrell, John. *Channeling the Tide: Protecting Democracies Amid a Flood of Corrosive Capital*, Washington, D.C.: Center for International Private Enterprise, September 2019.

30 Zoran Nechev and Ivan Nikolovski. *Hustled Into a Dead End: The Delusional Belief in Chinese Corrosive Capital for the Construction of the North Macedonia's Highways*, Washington, D.C. Center for International Private Enterprise, September 2020.

Konstantinos Tsimonis et al, "A Synergy of Failures: Environmental Protection and Chinese Capital in Southeast Europe." *Journal of Current Chinese Affairs* 48(2), May 2020. The project was initially judged as financially unviable by Western financial institutions, which made Chinese capital an attractive alternative for the North Macedonian government. The loan involved the selection of a Chinese contractor from a list of Chinese state-owned enterprises, disregarding public procurement rules, leading to the selection of Sinohydro. The World Bank had flagged the company for engagement in fraudulent activities. Sinohydro had proposed much higher prices (above 300% of market value) which led to invoices from Sinohydro to the North Macedonian PESR several times higher than the invoices from the North Macedonian subcontractors to Sinohydro for the actual works performed by them. An investigation followed by the Special Prosecutor office which charged the-then North Macedonian Prime Minister and his Transport minister for abuse of power leading to personal benefit of over EUR 155 million from the state budget. Krstinovska, Ana. "Exporting Corruption? The Case of a Chinese Highway Project in North Macedonia". *China Observers, November 6,* 2019.

31 The agreement to complete the railway connection comes on the back of the Russia-led nuclear power plant project, Paks II, worth an estimated EUR 12.5 billion.

32 Spike, Justin. "EC Launches Infringement Procedure Concerning Budapest-Belgrade Railway Project." *The Budapest Beacon*, September 16, 2016.

33 Being a childhood friend of PM Orban, Mr. Meszaros grew one of the largest business empires in the country after Mr. Orban came to power in 2010 and since then has been able to accumulate close to EUR 1 billion in wealth. He owns and controls companies, which are present in almost all sectors – banking, media, energy, agriculture, and construction, and which have won in questionable manner numerous EU-funded public projects.

34 Le Corre, Phillipe. Chinese Investments in European Countries: Experiences and Lessons for the "Belt and Road" Initiative*.* in *Rethinking the Silk Road: China's Belt and Road Initiative and Emerging Eurasian Relations.* M. Mayer (ed.). Palgrave Macmillan. 2018.

However, a common European strategy for both setting limits to the Chinese economic presence in strategic industries and charging ahead with key items for cooperation, such as on joint climate policy and a green and resilient recovery, is yet to emerge.

The European Commission issued a *Strategic Outlook,* in which China was labelled as a **systemic rival** "promoting alternative models of governance" and a strategic competitor "failing to reciprocate market access and to maintain a level playing field". The communication set out **measures to counter the growing Chinese presence in Europe**[35] and to ensure that countries in its neighbourhood adhere to EU values, norms, and standards, including those on rule of law, market competition, and climate objectives. These measures involve an EU call on China to deliver on existing joint EU-China commitments, including the reforming of the WTO, in particular on subsidies and forced technology transfers, as well as concluding bilateral investment agreements by 2020. Yet, the signing of the long-delayed EU-China trade deal in the last days of the German Presidency and of 2020 has widely been seen as a coup for Chinese diplomacy and could signal further EU concessions to the rising global power.

Although for most countries in Central and Eastern Europe, EU integration is the only viable long-term geopolitical direction, **in the Western Balkans, Chinese finance has been seen as an alternative driver for economic development** based on investment in the expansion and modernization of transport and energy infrastructure, as well as the revival of debt-ridden industrial behemoths. However, in countries with widespread state capture practices, the benefits from these projects are likely to be accrued by the local political-oligarchic elites, and hence, could ultimately be harmful for long-term economic growth.

In this sense, it is crucial that the **EU demands** from national governments that **Chinese investments are consistent with long-term policy objectives, especially on energy and climate**, as well as with competition law. This should be the case not only when EU funds are used for project implementation, but also when national and Chinese resources are utilized for the same purposes. To counter the growing role of Chinese capital in the region, the EU should expand its financial support through its multilateral banking institutions for projects that increase the energy, transportation, and digital connectivity of the region and assist directly in mitigating the negative effects of a coal phase-out. This is especially true for the non-EU countries that lack significant public resources to facilitate these structural reforms. Without **filling the financial gap for the implementation of more sustainable projects**, governments in the region would be incentivized to seek a no-strings-attached support elsewhere.

Where deemed economically and environmentally feasible, the EU could also work in tandem with China to implement these strategic infrastructure projects. Yet, in many cases EU companies are not allowed to bid as the project agreements are tailored for Chinese contractors. At the same time, the **EU could better leverage its European Green Deal policy framework** to strengthen its negotiating position vis-à-vis China.[36] Hence, the EU could use a **green conditionality** for third-country energy investments and in exchange promise co-financing support for environmentally sustainable projects. The CEE region has an enormous untapped green energy potential that is bound to become more and more attractive for investors. Setting up clear standards for the environmental sustainability of these projects and effectively monitoring their implementation can create a barrier for capital from China and at the same time incentivize cooperation between the EU and China on bankable initiatives.

What's next

The growth of the Chinese economic footprint and political influence has locked-in a number of countries in CEE in long-term, large-scale and costly infrastructure projects that have contributed to an excessive

[35] *Joint Communication to the European Parliament, the European Council and the Council: EU-China – A strategic outlook*, European Commission and High Representative of the Union for Foreign Affairs and Security Policy, Strasbourg, 12.3.2019.

[36] Oertel, Janka. *The new China consensus: How Europe is growing wary of Beijing. European Council on Foreign Relations*, Policy Brief, European Council on Foreign Relations, September 2020.

dependence on Chinese capital. The Chinese-led investments are often not consistent with EU rules on climate, energy, decarbonization, technical standardization, competition, public procurement, etc.

Based on the preliminary mapping of Chinese economic footprint in Central and Eastern Europe, the following non-exhaustive list of policies could be considered for reducing its negative impact on domestic governance as well as energy and climate policies:

- **Targeted funding instruments for large-scale economic development projects.** The EU should reinforce its position as the primary driver of economic development in the CEE region by filling the funding gap for the implementation of strategic economic development projects, such as the completion of transportation corridors, the modernization of energy grids, the housing and industrial buildings stock, and the kick-starting of energy transition investments. The approval of the EUR 9 billion EU *Economic and Investment Plan* for the six Western Balkan countries, which is a sum that is roughly equivalent to the Bulgarian portion of the Multiannual Financial Framework (MFF), is an important step forward. However, this will hardly be sufficient to implement all the necessary projects or facilitate the economic reforms to accelerate growth in the region.
- **Implement EU-wide governance standards for Chinese investments.** The EU should develop clear governance guidelines for the implementation of Chinese-backed projects that would be used by national governments as a form of pre-approval. Foreign-backed investments should be in line with EU's strategic and energy policy, whilst also complying with rules on competition, public procurement, and technical standardization. The pre-screening of Chinese-led projects and acquisitions should become an integral part of the national security strategies and included publicly in annual reporting/threat assessment.
- **Include the Western Balkans in its rule of law mechanism.** The EU should introduce its strong climate and rule of law conditionality for the disbursement of its funding for the Western Balkans. The new funding framework could be used to replace Chinese loans for the implementation of energy and transport infrastructure projects. The EU should continue reassuring the Western Balkan countries of their European future. However, it should also demand that governments in the region commit to closing governance gaps that have been exploited by domestic and foreign-backed state capture networks to take control of strategic economic sectors and lucrative assets. Countries fulfilling the EU rule of law and good governance criteria could have access to the same amount of funding as an EU member state.
- **Enhanced regulatory role of the Energy Community**. The Energy Community should have its powers expanded to ensure the implementation of the EU energy and climate acquis on its members in the Western Balkans through the introduction of tougher sanctions for non-compliant behavior. The Energy Community should cooperate with national regulatory authorities to ensure that any new energy infrastructure projects are in line with the acquis even before a final investment decision is taken.
- **Closing national governance loopholes.** National governments in the region should close key governance gaps that have been exploited by China to promote its investments. They need to start conducting detailed assessments of the feasibility of large-scale projects and a compliance check to ensure intergovernmental agreements are in line with national and EU law, especially on non-discriminatory access to public procurement of any domestic or EU company.
- **Strengthened capacity of independent regulators.** CEE countries need to strengthen the capacity and independence of key institutions, including the energy, anti-trust, and environmental regulators. Regulators need to have the power and capacity to prevent large-scale Chinese-led projects or strategic asset acquisitions that distort market competition, undermine the long-term energy policy framework, and ignore EU environmental and technical standards.