Ost-Ausschuss der Deutschen Wirtschaft

Position Paper

Chinese Activities in Eastern Europe – Success through market-aggressive financing offers

Introduction:

Chinese companies are no longer only growing increasingly active as investors and contractors in Southeast Asia or Africa but also in Central Asia and Eastern Europe. The Association of the German Construction Industry (Hauptverband der Deutschen Bauindustrie) and the German Engineering Federation (VDMA) have confirmed this impression.

The growing Chinese influence is also reflected by current trade figures. China has thus replaced Germany as the largest exporter as regards trade with Russia: In 2009 China's market share of exports to Russia rose to 13.65 percent while Germany's market share fell to 12.69 percent.

While the Chinese businesses are securing more and more orders for major projects for in particular in the construction, transport infrastructure, automotive, industrial plant construction, energy and telecommunications sectors in the regions mentioned, China is increasingly controlling access to strategic deposits of raw materials worldwide which could well result in supply bottlenecks for European business over the long term, in particular as regards rare metals (cf. "BDI warnt vor Rohstofflücke"/"The BDI issues a warning about the lack of raw materials", BDI press release of 25.8.2009).

Competition boosts market economies. The economic upswing in countries such as China and India is providing enormous opportunities for German business. However, free market competition will be undermined when competitors face unequal legal requirements and individual players receive massive state funding. In connection with the award of contracts to Chinese state companies in Eastern Europe reports have increased about dumping offers, aggressive financing methods and generous protection of business risks by the state. This distorts competition. It is crucial that German and European business and policy-makers react accordingly.

The Committee on Eastern European Economic Relations (Ost-Ausschuss der Deutschen Wirtschaft – OA) therefore conducted a survey among its members in April 2010 to get an overview of the current situation in Eastern Europe and determine the problems. We would like to take this opportunity to thank all member companies, supporting associations and partners who took part in drawing up this position paper with their feedback.

A. Examples of Chinese activity

On the next few pages we will provide examples of Chinese large-scale investment and the awarding of public contracts to Chinese state companies in countries the Committee on Eastern European Economic Relations (OA) deals with. The list does not claim to be complete. As far as possible the conditions under which the awarding of the contract took place will be reconstructed.

1. Eastern Europe

At the end of 2008 **Belarus** and China signed a total of 70 bilateral cooperation agreements. In March 2010 the Belarussian Central Bank entered into an agreement with the People's Bank of China enabling payment in Chinese Yuan and Belarussian roubles when exchange bilateral goods. The volume of the currency swap business totals approx three billion dollars. China granted Belarus a loan totalling 620 million USD to modernise its cement industry with Chinese technology. There have recently been complaints about the poor quality of the Chinese equipment.

On an old military base near to Sofia in **Bulgaria** a Chinese industrial zone may be built in the next few years which could also serve as a hub to transport Chinese goods to the EU ("The Chinese Dragon lands in Eastern Europe"/"Der chinesische Drache landet in Osteuropa", Wirtschaftsblatt of 29.6.2010).

In 2007 **Greece** signed an agreement on a "strategic partnership" with China. An economic agreement with China with a volume of one billion euro is currently being planned. Investment in shipbuilding, maritime traffic and telecommunications are to be the focus. A major Chinese company Cosco has already taken over the largest Greek port of Piraeus for 35 years. During the Greek debt crisis at the beginning of 2010 there were discussions on the sale of Greek government bonds worth 25 billion EUR to Peking was discussed (see article in Welt-Online, "China wants to make large-scale investments in Greece"/"China will in Griechenland groß einsteigen", 15.6.2010).

In **Moldova** the "China Overseas Engineering Group" (Covec) is to conduct infrastructure projects with a total value of one billion euro. The conditions for a Chinese loan are to be three percent interest over 15 years. Covec is a hundred-percent subsidiary of the Chinese railways which belongs to the Chinese state.

A similar case to that in Moldova has also been reported from **Montenegro**. The Export-Import Bank of China (EXIM) made a loan of 47 million dollar available for the purchase of Chinese ships.

In **Poland** the China Overseas Engineering Group (Covec) caused a stir. The subsidiary of the state "China Railway Engineering Corporation" won two public contracts for the construction of two sections of the A2 motorway between Warsaw and Lodz. The project is funded by a 500 million euro loan from the European Investment Bank, i.e. with European taxes. According to the Association of the German Construction Industry (Hauptverband der Deutschen Bauindustrie), Covec underbid the construction costs calculated by the Polish motorway administration by more than a half in both cases and was a third below the price offered by the second lowest bidder. The European Construction Industry Federation Fiec suspects the Chinese state is providing direct and thus unfair help for Covec and will probably bear any losses which may result (see FAZ article "Poland's motorway funded by the Chinese"/"Polens Autobahn aus chinesischer Hand" of 8.4.2010). It is the first public construction project in the EU which has gone to a Chinese contractor. It is suspected that the project is also to serve as a reference for similar invitations to tender in Poland, Bulgaria, Romania and Hungary.

China wants to invest a total of around one billion euro in the energy, agricultural and mining sectors in **Romania**. The China Development Bank has announced support for the expansion of wind energy. There are also ongoing talks with Chinese investors on the construction of three thermal power stations.

In **Russia** Chinese banks are increasingly providing individual loans linked to the trading business. Inter alia the Russian company AFK Sistema received a loan of 900 million dollars to buy Chinese telecommunications equipment. In February 2009 China secured access to 300 million tonnes of oil with loans worth billions: It appears the largest Russian crude oil producer Rosneft controlled by the Kremlin received 15 billion dollars from the Chinese development bank. Ten billion dollars were planned for the pipeline operator Transneft. The Chinese company CNPC had already provided an advance payment of six billion dollars to Rosneft five years ago. Rosneft thus financed the purchase of the competitor Yukos which had been crushed by the state (see Handelsblatt "Russia provides China with oil for a loan worth billions" / "Russland beliefert China für Milliardenkredit mit Öl" of 17.2.2009). The credit conditions are not known though there are reports by Russian banks that China is doing everything to develop commercial ties by providing generous loans. At the end of August 2010 Russia's Prime Minister Putin opened the section of the pipeline leading up to the Chinese border through which oil is to flow from January 2011. The project is in competition with Russian oil supplies to Europe.
Nothing is known about irregularities regarding the award of contracts in Russia, although in particular as regards the construction projects for the Winter Olympics in Sotchi 2014 the impression has arisen that there has not always been consistent compliance with the public procurement rules. In June 2010 it was announced that China wants to invest a minimum of twelve billion dollars in Russia by 2020, in particular in the gas and oil sector.
In September 2010 Russia's Minister of Finance Alexei Kudrin announced that Russia wants to sell assets worth around ten billion US dollars per annum during the next five years. According to the Minister of Finance this project also includes the auctioning of companies. As China.org has reported, the Chinese sovereign wealth fund China Investment Corp (CIC), with assets of approx. 200 billion US dollars, wants to invest. The fund is mainly interested in investing in energy, the agricultural industry and finance.

At the beginning of 2009 China and **Serbia** signed an agreement on a strategic partnership. As a result a number of Serbian orders worth several billion EUR were awarded to Chinese companies. One of the largest projects with a volume of EUR 170 million is a second Danube bridge in Belgrade which Chinese companies are to build with Serbian junior partners by 2013. The project was awarded without any call for tender. Chinese companies were also successful because the "Export-Import Bank of China" (EXIM) provided a loan of EUR 145 million for the project at an interest rate of three percent over a period of 15 years (see FAZ article "Chinese billions for the Balkans" / "Chinesische Milliarden für den Balkan" of 31.1.2010). The normal market interest rate for such a project is a minimum of six percent over a period of five years.
A second case is a contract between the Serbian power plant operator EPS and the Chinese construction company CMCEC to modernise and expand a brown coal power station in Kostolac with a volume of 1.25 billion dollar which was signed in February 2010 without any calls for tender. In this case too, the Chinese EXIM Bank provided 85 percent of the funding at an interest rate of three percent over a period of 15 years.

In September 2010 the State President of **Ukraine** Victor Janukovitch signed 13 agreements during a short state visit to China. In total, China agreed to invest USD four billion in infrastructure projects in Ukraine. The largest project is the construction of an eight-kilometre long railway line from the Kiev-Borispol airport to the centre of the Ukrainian capital. The contract was awarded to the state Chinese Engineering Corporation CMCEC in both cases. The project's value totals USD one billion and also includes the construction of four stations and supplying locomotives. It was also agreed that China would supply Chinese gas turbines for the hydro-electric power plant Schtscholkino on the Crimea (worth USD 700 million) as well as an offshore drilling platform to Ukraine (worth 200 million dollars). In addition, there is to be greater cooperation in the fields of industry, trade and space research. The Chinese investors also include the China Road Bridge Corporation and the China Exim Bank (see Schweiz Magazin 4.9.2010). Moreover, the construction of a starting and landing runways at the Kiev airport Borispol, the construction of wastewater treatment plants and a waste processing factory in the area of Kiev are under consideration as possible projects with participation of CMCEC (source: GUS Republiken Aktuell of 27.5.2010).

2. Central Asia

In 2001 a format was established for political and economic coordination between China and four of the five central Asian states (with the exception of Turkmenistan) via the Shanghai Organisation for Cooperation (SOC) – members being Russia, China, Kazakhstan, Kirgizia, Tajikistan and Uzbekistan. In 2009 China promised the Central Asian SOC countries EUR ten billion to help master the economic crisis ("Softly, softly – China is becoming increasingly attractive in Russia's backyards"/"Auf leisen Sohlen – China wird in Russlands Hinterhof immer attraktiver," FAZ of 19.6.2009). The Middle Kingdom is using the economic crisis and the weakness of other countries to increase its influence in Central Asia.

Kazakhstan is currently not meeting its international payment commitments. German companies' demands of large Kazakh banks – all of which are state-controlled – now total around EUR 500 million, EUR 300 million of this sum having been secured via Hermes which could ultimately burden the German state. Western creditor banks have therefore almost completely stopped granting new loans. For other reasons too Kazakhstan has therefore been switching to Chinese financing sources. China has thus become the country's second largest trading partner after Russia. A large part of the Kazakh oil industry is now controlled by the Chinese.

In **Uzbekistan** the following examples indicate aggressive financial practices by the Chinese banking institution: The Uzbek Ipotekabank was given a loan of more than USD 17.3 million by the Chinese EXIM Bank to import water meters from China. The loan was provided within the framework of the Shanghai Organisation for Cooperation and runs for 20 years. The loan was provided at a fixed rate of interest of two percent per annum; management, commitment fees and an insurance premium were not included. In 2007 the Uzbek Alokabank received loans totalling USD 15.5 million from the China Development Bank to modernise "Uzbektelekom". At this point in time the Alokabank had equity capital totalling approx. USD 15 million which is why a German credit institution had not provided the loan, particularly since there was no state guarantee as security but only the plant and Uzbektelecom buildings. The interest rate was 1.5 percent with a term of eight years. Neither management, commitment fees nor an insurance premium were calculated which is not customary on the market. The Uzbek Agrobank took a credit line with the Chinese EXIM Bank totalling USD 2.5 million at a fixed rate of interest of 4 percent per annum. Here too there were no further charges and no insurance premium. A state guarantee by Uzbekistan acted as security. Since 2006 the National Bank of Uzbekistan (NBU) has received a total of USD 80 million at interest rates of 1.5 percent running over nine years without further costs and securities from the China Development Bank. Loans from the EXIM Bank to the NBU are said to have been agreed at interest rates of between two and three percent.

B. Assessment:

The above examples show that China is largely taking a political-strategic approach to the expansion of its economic activities in Eastern Europe and Central Asia and not viewing it primarily from an economic stance. In some Chinese contractors' projects at least, the financing conditions provided by Chinese state banks played the key role. "As regards financing by Chinese bidders we often detect unusually high state funding, reflected by the Chinese EXIM bank's very low interest rates for long-term loans or the Chinese Central Bank's willingness to accept payment of outstanding debts both in Chinese renminbi and in local currencies", the Federal Association of German Banks noted.

The Chinese credit institutions' risk assessment appears to correlate directly with the strategic interests of the political leadership in Peking: The greater the political interest, the lower the guarantees required. The same applies to Chinese export companies which at least in some cases have submitted offers far below those of competitors, apparently in an attempt to gain reference projects for future applications. Due to these aggressive financing practices the contractors are also prepared to accept, particularly in the wake of the economic crisis, technically less developed products and services as compared to those of European bidders. Private banks and companies cannot keep up with this game, we can no longer speak of a level-playing-field.

Chinese financing's greatest advantage, for example as compared to loans covered by Euler Hermes, is that the former often does not charge for premiums for guarantees from the Chinese export credit insurance authorities. There are also often no charges for management or commitment fees. According to German credit institutions, this is the only reason why Chinese state banks can offer loans at around eight to nine percent less than Euler Hermes. This is possible because of the protection and thus indirect subsidization the Chinese state provides.

In addition to this political flanking there are the low labour costs for Chinese workers who can be requested from China by the thousand for large-scale projects. This cost advantage is additionally flanked by the internationally criticized undervaluation of the Chinese currency – the USA assumes the yuan and renminbi are undervalued by 40 percent.

The developments in Eastern Europe appear to follow a similar pattern to the Chinese activities in Africa. According to the Construction Association of German Industry (Bauverband der Deutschen Industrie**)**, during the past ten years the People's Republic of China have granted delivery-linked infrastructure loans totalling USD 20 billion available via their state EXIM bank, generally secured by raw-materials barter contracts. In addition, Chinese construction companies were able to win contracts at will due to bids far below the usual self costs - made possible by the use of cheap Chinese supplies, construction equipment and workers as well as hidden state subsidies. Due to the dominance of this "Chinese business model" the German construction industry has had to withdraw from Africa.

According to observations by the VDMA, the year-long state backing of "Chinese companies has made it possible for them to make bids 25 to 50 percent below the German price level" (see "Der chinesische Großanlagenbau – ein neuer Wettbewerber im globalen Anlagegeschäft" / "Chinese large-scale plant construction - a new competitor in the global investment business" by Klaus Gottwald, VDMA 2008, page 3). However, the gap has now lessened – for example, to between eight and twelve percent as regards cement plant construction – which is why German plant constructors' higher quality is once again playing a greater role.

An additional problem which we will not expand on at this stage is the continual violation of intellectual property rights by Chinese suppliers who now not only copy individual components but also entire industrial plants and have thus caught up with western European suppliers also as regards quality.

According to the VDMA, two out of three German engineering companies suffer from product piracy and counterfeiting.

Apart from first cases in the EU (Poland), Chinese activities can mainly be observed in transformation countries at the edge of the EU where European tendering standards are not - or not yet - anchored. In the long run the favourable financing conditions of the Chinese could have a negative impact on these countries in that the pressure to adopt European economic and democratic standards will lessen and the objective of becoming a member of the EU seem less interesting. Examples of these countries include Serbia, Belarus and Ukraine. However, in Romania and Bulgaria too, which are both already EU Member States, increasing Chinese engagement could additionally hinder the transformation process which has still to be completed and also lessen Brussels' influence. In January 2010, at the height of the crisis in Greece, the news that Chinese state banks wanted to acquire Greek government bonds, thus ensuring direct influence on a Euro-country, led to intensive discussions, however in the end this did not happen.

C. The positions of the Committee on Eastern European Economic Relations:

Behind the aggressive market conduct of Chinese state banks there is the basic problem that Chinese credit providers, as opposed to German credit providers for example, are not bound by the OECD guidelines (consensus on export credit agencies) as regards their export credit financing as China is not a member of the OECD. A possible lever against Chinese financing practices would therefore at most be for the EU to file a suit as regards the WTO subsidies agreement.

The OECD countries' export credit agencies (ECA) have been trying for years to include the Chinese ECA in the harmonisation of export credit insurance. The OECD countries and in particular the Federal Government should step up their efforts to eliminate competitive advantages for Chinese exporters in this respect in future and create a level-playing field. The general conditions of the ECA are possibly less problematic. The Chinese conditions appear not to be so very different from the European conditions. However, special financing, for example, provided within the framework of bilateral cooperation agreements, are highly problematic.

A comprehensive European response to Chinese state companies' practices in Eastern Europe should be drawn up, involving the EU Commission, European credit organisations, such as the EIB and the EBRD, and the European business association Business Europe:

1. As regards public invitations to tender within the EU and in countries with ambitions to become EU members, where EU funding plays a role, consideration of bidders from countries such as China which do not adhere to the OECD consensus and have also not signed the WTO Government Procurement Agreement (GPA), should be examined in particular and if necessary they should be stopped from bidding. The EU needs a harmonised regulation.

2. In general it is to be ensured that as regards procurement criteria for public contracts within the EU attention should be paid that no contractor should be allowed to bid who with the help of state support beat private competitors by offering dumping conditions. This is not least of all also in the interest of the participating countries who can have no interest in contracts being carried out, for example, by Chinese workers, without any local value-creation.

3. Free trade works only bilaterally. At the current GPA talks with China a regulation should be drawn up that corresponds to the remaining GPA countries' market access level. China has been negotiating for

two years on the signing of the GPA to open the majority of public invitations to tender in a contracting state for competitors from the remaining contracting states. However, at present a successful conclusion to the negotiations would appear to lie in the distant future which makes it very difficult for western European companies to be successful in state invitations to tender in China. The Association of the German Construction Industry (Hauptverband der Deutschen Bauindustrie) points out that after China became a member of the WTO it introduced a qualification system which has led to disadvantages for foreign construction companies and quasi exclusion of non-Chinese construction companies. The international legal principle of reciprocity has not been adequately observed.

4. At the same time Germany should review its own public financing offers for business abroad and make them more attractive if necessary – without violating international law of course.

5. Also as regards securing raw materials Germany and the EU should represent their interests more consistently. China is securing the raw materials of the future all over the world at the same time as reducing its exports of raw materials funded in the country, in particular rare earth-metals. These raw materials are crucial to the high-tech industry. Many of these raw materials can also be found in Russia, Ukraine and countries in Central Asia. Using Kazakhstan as a good example, the Committee on Eastern European Economic Relations has already proposed a raw materials strategy and is now having talks with the Federal Government. A possible model for such a strategy would be the natural gas pipes business which the Federal Republic agreed with the former Soviet Union in the seventies, mediated by the Committee on Eastern European Economic Relations.

6. No least of all it is also important that the EU's Neighbourhood Policy should approach transformation countries such as Ukraine, Serbia, Belarus and also Russia and the countries of Central Asia with political and business offers in order to make reform efforts there more attractive again and Chinese offers less lucrative:
The Eastern Partnership programme (for Belarus, Ukraine, Moldova, Georgia, Azerbaijan, Armenia) should result in a rapprochement of the countries involved to the EU, is however being burdened by construction faults. The EU pooled six countries which differ greatly from one another, in part in conflict with one another, and the majority of which regard the programme itself with great scepticism for a wide range of reasons. Added to this the scepticism of Russia which feels challenged by the Eastern Partnership and is undertaking its own integration efforts (e.g. tariff union). Developing the bilateral ties between the EU and the individual countries would therefore bode more promise. This should in particular include agreeing on free trade and association agreements and thus integration into the European market, as for example was the case with the EFTA countries Switzerland and Norway although neither country is yet a member of the EU.
In 2007 the EU, under German Presidency, gave itself a new Central Asia strategy to which the Committee on Eastern European Economic Relations was strongly committed. The approaches created should now be pursued more intensively.

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