CHINESE 'HIGHWAY TO NOWHERE' HAUNTS MONTENEGRO

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The government has described the 165 km (103 mile) highway, with its imposing bridges and deep-cut tunnels, as the construction of the century and a pathway to the modern world.

It is designed to link the port of Bar on Montenegros Adriatic coast to landlocked neighbor Serbia. But once the first, challenging 41 km stretch through mountains north of the capital is completed, the government faces a difficult choice.

A Chinese loan for the first phase has sent Montenegros debt soaring and forced the government to raise taxes, partially freeze public sector wages and end a benefit for mothers to get its finances in order.

Despite those measures, Montenegros debt is expected to approach 80 percent of gross domestic product (GDP) this year and the International Monetary Fund says the country cannot afford to take on any more debt to finish its ambitious project.

There is a big question about how they complete it, said an EU official who requested anonymity. Their fiscal space has shrunk enormously. They have strangled themselves. And for the time being this is a highway to nowhere.

The road is at the heart of an intense debate about Chinese influence in Europe, both within EU member states and countries aspiring to join the bloc such as Montenegro and its Western Balkan neighbors Serbia, Macedonia and Albania.

As Beijing extends its economic reach under the ambitious Belt and Road Initiative (BRI), poor countries across Asia and Africa have seized on attractive Chinese loans and the promise of transformative infrastructure projects.

This has allowed them to develop in ways that may not have been possible without access to Chinas vast foreign exchange reserves. But some countries, such as Sri Lanka, Djibouti and Mongolia, have found themselves weighed down by debt and ever more reliant on Beijings largesse.

Montenegro is the first country in Europe to find itself in this position as its government presses on with its dream of a gleaming new highway to lead the nation to a brighter future.

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This highway is a big deal in Montenegro. It reminds people of Tito and the days of grand socialist projects in the region, said academic Mladen Grgic, referring to former Yugoslavias long-time communist leader Josip Broz Tito.

But its a trap. Now that its been started, the politicians cant stop it ▯ no matter how harmful it might be. And frankly they dont want to, said Grgic, author of a 2017 study on the highway.

NOT BANKABLE

The idea of building a highway from the coast to Serbia can be traced back to 2005, a year before Montenegros vote for independence from its neighbor. The project was championed by Milo Djukanovic, who has served as president or prime minister of Montenegro nearly uninterrupted since 1991.

The government hopes the highway will give an economic boost to the countrys underdeveloped north, bolster trade with Serbia and improve road safety as Montenegros narrow, winding mountain roads are notoriously dangerous.

Having recognized that there is little scope to take on more debt, the governments options for building the next three phases of the highway are limited.

The option it now favors is a public private partnership (PPP) in which an outside partner would build and operate the highway, then run it under a concession from the state for 30 years to get a return on their investment.

China Road and Bridge Corporation (CRBC), the large state-owned Chinese company that is building the first section, signed a memorandum of understanding (MOU) in March to complete the rest of the road on a PPP basis.

But European lenders worry that Montenegro would need to offer costly revenue guarantees to make that work, potentially deepening its financial woes.

We told them that their PPP model was not bankable, that they would be taking on risks they dont know how to manage, said an official from the European Investment Bank (EIB), the European Unions lender.

The IMF cautioned the government in May against a PPP solution that could introduce large contingent liabilities. One official suggested Montenegro would be better off waiting until it joined the EU before finishing the highway.

Once it is part of the EU, Montenegro would have access to more structural and cohesion funds from Brussels. But the process of joining the bloc could take a decade or more, despite a loose target date of 2025 floated by the EU this year.

FEASIBILITY STUDIES

Doubts about the highway surfaced after two feasibility studies, conducted in 2006 and 2012, showed it was not economically viable.

Reuters reviewed copies of the studies, the first carried out by French firm Louis Berger for the Montenegrin government, and the second by U.S. company URS for the EIB. Both concluded there would not be enough traffic to justify a concession.

Louis Berger estimated the government would have to pay 35 million to 77 million euros a year in subsidies to make a toll-based system attractive to outside investors.

URS looked at each section of the highway and concluded that all possible combinations were economically unworkable. It recommended a more modest upgrade of existing roads.

The low current traffic volumes and the weak economic forecasts mean that the economic benefits of the proposed route do not provide adequate return on the investment, URS said.

To justify the grand highway envisioned by the Montenegrin government, URS said internal rates of return of 8 percent would be required but it estimated they would be below 2 percent.

Ivan Kekovic, an engineer who was involved in the project in its early years but later issued an open letter to parliament warning against it, told Reuters that average traffic of 22,000 to 25,000 vehicles a day would be needed to justify a highway of the proposed scale.

Daily traffic on the busiest stretch, from the capital Podgorica to the port of Bar, is less than 6,000 vehicles.

Early attempts to build the highway, first with a Croatian consortium and then with a Greek-Israeli one, collapsed after both groups failed to provide bank guarantees in time.

Critics breathed a sigh of relief, convinced the project was dead. Then China appeared on the scene.

CHINA FILLS VOID

Economics professors at the University of Montenegro were paid by the state-funded Export-Import Bank of China to conduct a new feasibility study.

This one found the highway was viable, according to the government. But this study has never been made public and attempts by Reuters to see it were unsuccessful.

China Communications Construction Co., CRBCs parent firm, did not respond to a request for comment about the studies.

MANS, an EU-financed anti-corruption watchdog, pressed the government to provide members of parliament with data to support its vision before a vote to approve the highway in 2014. It refused.

We have no doubt that the data that the ministry of transport used in order to justify the construction of the highway are fabricated, said Dejan Milovac, deputy executive director at MANS.

The government denies manipulating the numbers and says the highway will deliver long-term economic and social benefits that prove the skeptics wrong.

Zorana Mihajlovic, deputy prime minister of Serbia, which is building a stretch of highway with Chinese help to link with the Montenegrin road, took a similar view.

There are investments that may not be economically justifiable from a short-term perspective, but which are strategically important, she told Reuters.

The six Western Balkan countries Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro and Serbia - are surrounded by EU member states. But the region has suffered from under-investment and poor governance since the independence wars of the 1990s, making it an economic laggard.

Over the past decade, as the EU struggled with a succession of crises and put enlargement of the bloc on hold, other powers, including Russia and Turkey, have moved in to fill the void.

China has been especially active. In 2012, it began holding annual 16+1 summits with eastern and southern European states to discuss investment opportunities, infuriating Brussels.

A year later, it unveiled BRI, its grand plan to secure land and maritime trade routes from Asia to Europe and Africa.

The Western Balkans, strategically positioned on Europes southern flank, is a key access point for China to reach central Europe and beyond.

Chinas investments in the region total more than 6 billion euros - including highways, rail lines and power plants. Serbia, the largest economy in the region and Beijings long-standing ally, has received the lions share.

Montenegro could be attractive to China for a number of reasons. It gives Beijing a port of entry into Europe from the Adriatic, and close economic and political ties with the government in Podgorica could prove valuable for China if Montenegro becomes an EU member.

DISBELIEVERS

The 809 million euros Montenegro received from Chinas Export-Import Bank covers 85 percent of the cost of the first section of the road.

The dollar-denominated loan carries a 2 percent interest rate, 20-year repayment schedule and 6-year grace period attractive terms but a major long-term burden for a country of roughly 620,000 people.

Under the terms of the contract, an arbitration court in China would have jurisdiction in the event of any legal dispute. CRBC won commitments that all imported construction materials, equipment and other goods be exempt from customs and value-added tax. Chinese workers were given 70 percent of the work.

Some 3,605 workers are busy building the first section of the highway. Roughly two-thirds of them are from CRBC, one of the largest engineering and construction firms in the world.

Four camps of neat blue-roofed bungalows house the Chinese workers. Dotting the area are billboards in Chinese and English exhorting them to be meticulous and responsible.

CRBC expects to build the future sections of this project, Kang Shifei, deputy project manager for CRBC, told Reuters on a blazing hot afternoon in June, beneath the giant pillars that will support a kilometer bridge above the Moraca canyon.

Because the government did not hedge against currency swings and omitted a vital turnpike from its original blueprint, the cost has continued to rise. It is now approaching 1 billion euros, nearly a quarter of Montenegros GDP.

A March report from the Washington-based Center for Global Development which examined the debt risks associated with BRI listed Montenegro as one of eight highly vulnerable countries, alongside Djibouti, the Maldives, Laos, Mongolia, Tajikistan, Kyrgyzstan and Pakistan.

The remaining three-quarters of the highway will plow through less mountainous terrain. The IMF estimates it will cost another $1.2 billion to complete.

Prime Minister Dusko Markovic has said it will be finished at any cost and promised to deepen cooperation with China in other areas, including hydropower and tourism. He has dismissed critics as disbelievers.

But opposition politicians are worried – about the countrys finances and about Chinas role.

Dritan Abazovic, head of the United Reform Action opposition party, said it was normal for an economic power such as China to seek a role in the region, alongside the EU, United States and Russia.

But because of the scale of the project, he worries the deal with the Chinese will end up giving Beijing much more influence over Montenegro.

It puts the Chinese in a very very comfortable position, he said.

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