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The New Silk Road: Latvian Branch

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EXECUTIVE SUMMARY

- Russia has increasingly redirected cargo export flows to its own Baltic Sea ports leading Latvia to look for alternative potential sources of new transit business. One such important source is China.
- At the same time, China has sought to establish trade links across Eurasia through the New Silk Road (NSR) initiative. The NSR aims to increase the frequency of train transit to Europe in order to: (i) decrease transport costs due to increased economies of scale; (ii) support manufacturing in the economically lagging western regions of China; and (iii) increase China's geopolitical leverage over neighboring states in Central Asia.
- Rail transportation from Europe to China takes 10-15 days, while sea shipment takes around 30-45 days. This is relevant for products with a short time-to-market aspect such as electronics and high-end consumer goods.
- Only two major NSR projects, related to a rail connection between Europe and China, have been initiated thus far, though neither has yet gained substantial investment:
 - The Khorgos – East Gate Special Economic Zone in Kazakhstan, a dry port on the border with China.
 - The Great Stone industrial park near Minsk, Belarus.
- Latvia could transport goods from China to the Nordic states due to its geographical position and access to the Russian gauge rail network. It is in competition with the Duisburg inland port in Germany, which is the current European redistribution centre for rail freight from China to the Nordic region.
- However, given the current very low levels of rail freight flows from China to the Nordic states, potential additional flows of containers via Latvian sea ports are negligible – less than 1 percent of the current traffic flow. In the long run, the flow of goods might reach an additional 50,000 containers per year or around 12 percent of the current container flow.

WHAT IS THE NEW SILK ROAD?

“The Belt and Road initiative, meeting the development needs of China, countries along the routes and the region at large, will serve the common interests of relevant parties and answer the call of our time for regional and global cooperation.”

Keynote Speech by H.E. XI Jinping President of the People’s Republic of China at the Boao Forum for Asia Annual Conference 2015

A key talking point of the 16+1 summit held in Riga in November 2016 concerned the future development of the “The New Silk Road” (NSR, known in China as the “The Belt and Road initiative”), a collection of economic and political activities put forward by the Chinese government to promote the favorable treatment of Chinese trade across Eurasia.¹ These activities cover both overland and maritime trade. Maritime trade activities, the so-called “Maritime Silk Road” initiative, focus on cooperation with Southeast Asian, South African and

South European countries. The “Silk Road Economic Belt” initiative focuses on overland trade flows with the key objective of promoting connectivity and economic cooperation with Central Asian countries (particularly Kazakhstan, Uzbekistan and Kyrgyzstan) that lack a good transport infrastructure. Such closer integration will lead to cheap and efficient overland trade flows of Chinese manufacturing goods to Western European markets. It will also lower the cost of natural resources, primarily coal and oil, flowing from Central Asia to China.

Envisioned trading flows of The New Silk Road.

Figure 1



¹ The annual 16+1 summit brings together the heads of government of China, eleven Central-European EU member states and five Balkan countries.

NSR activities include acquisition, construction and financing of transport infrastructure (highways, railways, pipelines and airlines) and manufacturing facilities, organization of international roundtables and negotiations to support Chinese investments. While discussions about the feasibility of the NSR have been ongoing for over a decade, they have intensified during

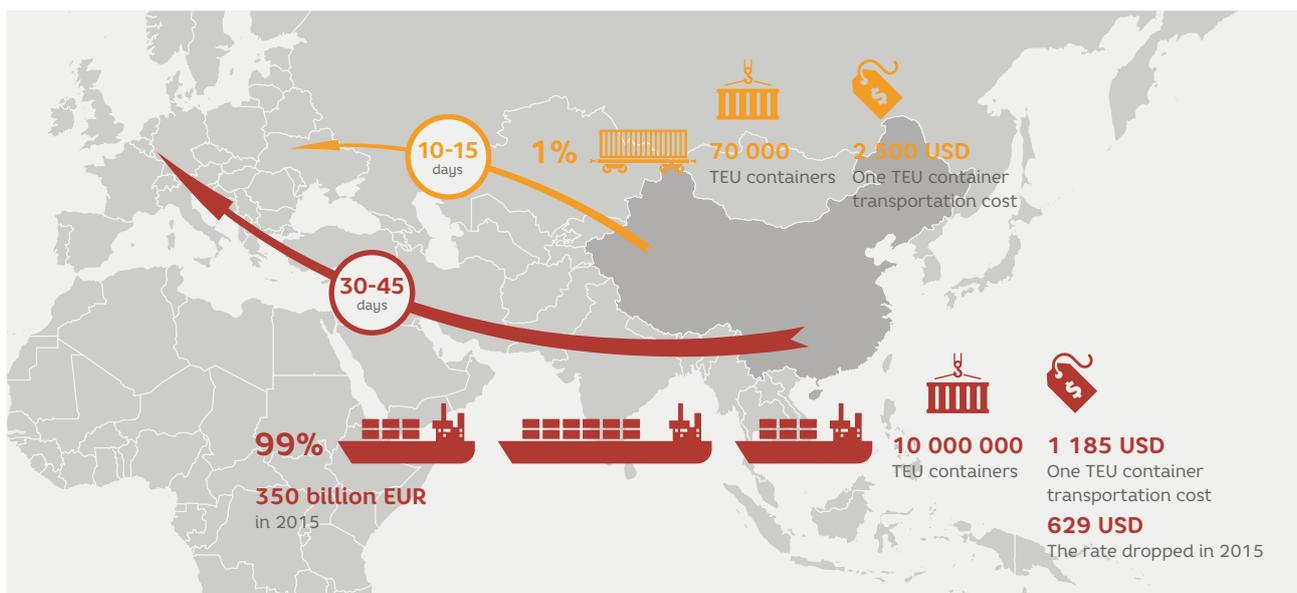
the last couple of years, although most activities remain in the (pre-) planning phase.

This policy brief overviews key NSR elements related to rail freight to and from Western Europe, outlines Latvia's possible involvement in the project and briefly discusses the NSR branch that might intersect Latvia.

WHY A NEW SILK ROAD?

Why a New Silk Road?

Figure 2



ECONOMIC RATIONALE

The main economic goal of the NSR is to attain sufficient economies of scale (a high frequency of train departures and a large variety of destinations) to lower transportation prices, because the cost of building and maintaining infrastructure may be spread across multiple rail shippers. This would make rail freight an attractive supplement to deep water shipping.

More than 99 percent of Chinese exports to Europe (worth 350 billion EUR) were shipped by sea in 2015. Overall trade flows between China and the EU exceeded 10m. TEU containers in 2015.² In contrast, rail freight amounted to less than 70,000 TEUs.³ This is not surprising given that rail transportation is from two to four times more expensive than maritime shipping.

² The twenty-foot equivalent unit (TEU) is a standard measure of cargo capacity in transportation.

³ Pantea, Significance and PWC. 2015. Study on the analysis and evolution of international and EU shipping. Zoetermeer.

One TEU container costs around 2,400 USD to transport by rail from China to Germany's inland port Duisburg, the largest TEU transport hub in the world, from which the cargo is redistributed further around Europe.⁴ The average shipment price of a TEU container from Shanghai to Northern Europe by sea in the last seven years was 1,185 USD. In 2015 the rate dropped to 629 USD.⁵ Although seasonality of demand, changes in oil prices and other factors mean that transportation prices vary over time, the ratio of sea/rail shipment prices has remained consistently low.

The key advantage of rail transportation is the shorter delivery time. While maritime shipping takes 30 – 45 days, rail freight from China might reach core European markets within 10 – 15 days. Moreover, shorter travel time improves efficient use of capital. While the combined monetary value of goods in one container might be substantial, it is essentially "frozen" when the goods are in transit. Quicker delivery means faster capital turnover and lower loss in interest rate payment for this capital. Expediency is important for the products for which a short time-to-market aspect is crucial (e.g. targeted business-to-business equipment for factories, high-end consumer goods, car parts and electronics).⁶ Such products constitute a noticeable share of Chinese

export, as in 2015, 30% of all Chinese exports to the EU were office and telecommunication equipment and 2.4% was transport equipment and 17% was power generating, electrical and non-electrical machinery.⁷ Thus, there is potential for greater demand for rail freight transportation.

The choice of transport is largely driven by product value, its physical weight and generalized transportation costs, which include monetary and time costs, reliability and variability of travel times, frequency of dispatch. Products with a high value/weight ratio tend to be transported in expensive and high-speed transport modes (airplanes). Products with a low ratio are transported in cheap, slow ships. Rail transport is in between. A reduction in price due to the NSR will not affect the export of the most low or high value/weight ratio products, but will stimulate more intensive export by rail of medium range products. Lower rail rates might also change the industrial composition of exports by allowing Chinese firms to trade products which are currently not profitable for export, such as agricultural goods (high-quality fish and meat), which currently account for 2 percent of the total export. At present, the two main good types carried by rail are laptops and car parts.

POLITICAL RATIONALE – CHINESE REGIONAL POLICY

Political considerations are complementary to the economic rationale. The principal domestic political motivation for developing the transport infrastructure is to secure the stability of the economically lagging western Chinese regions, as uneven geographical development of Chinese economy increasingly causes social unrest.⁸ While strong economic growth made China increasingly wealthy, high-productivity

export-oriented industries are concentrated mostly in eastern coastal areas with access to large seaports in close proximity to Shanghai, Hong Kong and Tianjin, which is 115 km away from Beijing.⁹ Figure 3 shows the GDP per capita in EUR in 2014 across Chinese provinces, as well as the location of major seaports on the east coast of China.

⁴ Price quote is from *Trans Eurasia Logistics GmbH*, a subsidiary of *Deutsche Bahn* and *Russian Railways*. Duisburg is located on the river Rhein, 200 km away from the sea. <http://www.trans-eurasia-logistics.com>.

⁵ *The Review of Maritime Transport 2016*, p. 53, UNCTAD/RMT/2016, United Nations Publication. This recent decline is in large part due to the oversupply of maritime cargo capacity that emerged in expectation of increasing world trade volumes immediately before the recent financial crisis.

⁶ *Forbes Magazine*, 28 Jan 2016, <http://www.forbes.com/sites/wadeshepard/2016/01/28/why-china-europe-silk-road-rail-transport-is-growing-fast>.

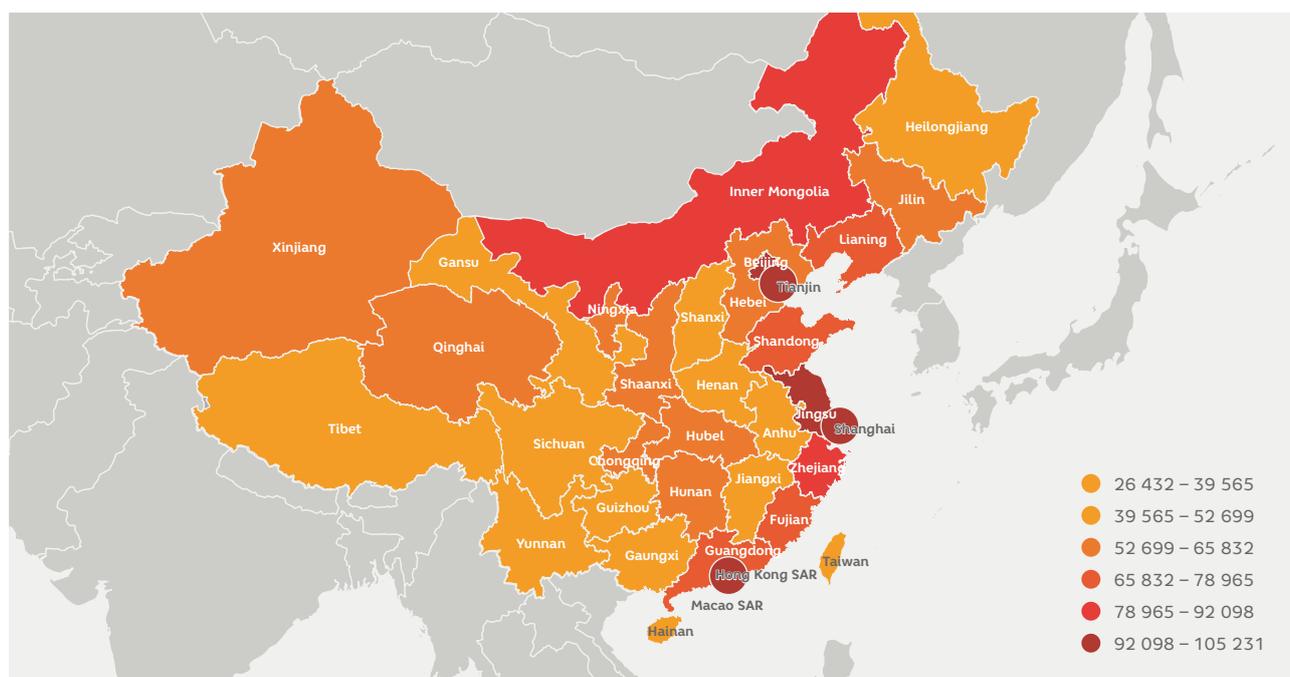
⁷ European Commission, Directorate-General for Trade, 21 Jun 2016. Trade in goods with China. Other types of export goods with large share in total export are electrical machinery (10 percent), textile and clothing (12 percent), chemicals (5 percent), other semi-manufactures (8 percent).

⁸ For example, ethnic minority protests in the western provinces of Xinjiang (in 2009) and Tibet (in 2008). Elizabeth Van Wie Davis. 2013. *Ruling, Resources and Religion in China: Managing Multiethnic State in the 21st Century*. London: Palgrave Macmillan.

⁹ In 2015 the difference in GDP per capita between some coastal and peripheral provinces was more than double, e.g., 11 000 USD vs 25 000 USD in PPP in, respectively, western province Xinjiang and the coastal province of Jiangsu.

GDP per capita across Chinese provinces in 2014, in EUR.¹⁰

Figure 3



Cheap sea shipping and the location of manufacturing firms has created a self-reinforcing circle of economic incentives that lead to the extensive use of sea shipping and neglect of rail for the transit of goods from China to Europe. An inefficient internal transport system plays a large role in the geographical disparity in China.¹¹ The lack of a reliable and competitively priced transport infrastructure makes the western provinces an unattractive location for export-oriented firms,

although recent policy initiatives facilitate creation of new economic production activities also in the western regions. The Chinese government has invested substantial funds in high-speed rail connections between the central regions, primarily focusing on passenger traffic. Nevertheless, with the current dominance of shipping, the western provinces will likely remain disadvantaged in comparison to the eastern provinces in terms of both speed and cost of shipping.

POLITICAL RATIONALE – CHINESE FOREIGN POLICY

The geopolitical motive for the NSR is often highlighted by the media – China wants to establish itself as a regional power by promoting trade as an instrument to integrate neighboring countries more closely with the Chinese economy.¹² New trade routes allow China to secure the supply of energy and natural resources as well as support export-oriented industries. Development of inland trading routes serves to hedge political risks created by over-reliance on sea routes. China has limited

political and military influence over the security of sea trading routes. For example, the Chinese Navy has one aircraft carrier as opposed to the 12 that the US Navy deploys. Eighty percent of Chinese oil imports come through the Malacca strait in Southeast Asia between Malaysia and Indonesia. A potential blockade of this route by a third party might have a large negative impact on the Chinese economy. This motivates China to search and develop alternative inland routes.

¹⁰ National Bureau of Statistics of China. 2016. <http://data.stats.gov.cn/english/mapdata.htm?cn=E0103&zb=A0301>.

¹¹ A Handbook of International Trade in Services, Christopher Findley, p. 357, in ed. Mattoo, Aaditya, Robert M. Stern, and Gianni Zanini. Oxford University Press, 2008.

¹² The Wall Street Journal. 9 Nov 2014. China Sees Itself at Center of New Asian Order.

NSR: WORDS AND DEEDS

Media and policy makers have paid a lot of attention to the NSR initiative, as its scale and potential impact on the world trade flows and economy are very impressive. While no one wants Latvia's businesses to miss out on the opportunity of participating in the NSR, it is important to evaluate the track record to date and assess feasibility of potential projects. What has been done in terms of investments and infrastructure projects?

Two major projects have been implemented within the NSR framework. The first is the Khorgos – East Gate Special Economic Zone in Kazakhstan, a dry port development on the border with China. The rail gauges in China and the former states of the Soviet Union differ, so trains must stop and either adjust train platforms or shift freight to a different train. A new facility that moves containers from one type of train to another was commissioned in Khorgos in July 2015 with a capacity

of 0.5 m. TEU per year. The Kazakhstan government has financed the construction in order to create a logistical, manufacturing and trade centre. To facilitate private investment (primarily from China) in the area, a special economic zone was created with no corporate income tax, value added tax, land or property taxes. However, it is yet to see substantial private investment.

The China-Belarus “Great Stone” development park near Minsk, Belarus, is another NSR project that started in 2015. The government created a special economic zone with strong tax preferences (e.g. zero profit tax for the first 10 years) to attract foreign investment. To facilitate investments, the government built the necessary infrastructure for the potential manufacturing and high-tech firms as well as residential buildings. The declared goal is to create a satellite city next to the capital city and international airport which would specialize in export-oriented production.

Maritime Silk Road: Chinese acquisition of the Port of Piraeus in Greece.

The port of Piraeus on the Mediterranean Sea is a few kilometers away from the Greek capital city Athens. Being the first major European port on the route from China to Europe via the Suez Channel, it is the fifteenth largest passenger seaport in the world (20m. total passengers), and a major cargo port in the south of Europe.

In 2016 China Cosco Holding acquired 67% of shares in the port previously owned by the Greek government.¹³ Chinese investors aim to make Piraeus the largest transit port in the Mediterranean.¹⁴ This ambitious goal is in line with the growing use of the so-called transshipping (shipping to intermediate destinations). As with the hub-and-spoke strategy in aviation, transshipping allows companies to exploit economies of scale and move freight in ultra-large vessels between major seaports (hubs), and then redistribute freight further using either smaller ships or different transport modes (rail, road). Piraeus will



be developed as a hub port within the Maritime Silk Road framework. One of the proposed plans is to upgrade a rail line from Athens to Budapest via the Balkan countries.¹⁵

Overall planned Chinese investments in Piraeus amount to more than half a billion USD.

This acquisition demonstrates that sea routes will remain important for international trade with China. Moreover, Chinese firms are prepared to acquire relevant infrastructure to expand and control trade routes.

¹³ Stamouli, N. 2016, 6 Jul.. China Cosco to Invest Over \$552 Million in Port of Piraeus. The Wall Street Journal.

¹⁴ Heymann, E. 2016, April. Container shipping. Frankfurt am Main: Deutsche Bank Research.

¹⁵ Bauranov, A. 2016, September. The Port of Piraeus – Opportunity for Railways in South East Europe? European Railway Review.

Table 1 summarizes the main NSR projects related to China – Europe rail freight development. Most of the projects are still in the (pre-) planning stage.

New Silk Road projects related to the rail freight initiative

Table 1

Project	Date	Accomplishments	Planned works	Key highlights
BELARUS				
Sino-Belarus Industrial Park “Great Stone”, Minsk	<ul style="list-style-type: none"> Started in 2015 	<ul style="list-style-type: none"> 300 workers from China and Belarus construct necessary infrastructure that will be needed to turn the area into a core industrial sector of a Minsk high-tech satellite city. <i>China Merchants Group</i> (one of the largest trucking, logistics, financial services and real estate investment company in China) acquired 20% stakes in the park. 	<ul style="list-style-type: none"> The park will have 92 sq. km of production and living areas, offices and shopping malls, financial services, and research centers with an emphasis on high-tech and competitive innovation productions with high export potential. Park will host more than 200,000 residents, which will be a large job creator for Belarus. 	<ul style="list-style-type: none"> The zone is in close proximity to the international airport and the Berlin – Moscow highway, it is also linked by rail to China and the rest of Europe, and it is some 300 – 400 km from the Baltic Sea. Klaipeda, as well as Riga and Ventspils are the closest seaports that will compete for the cargo flows to consumers. 30 companies from China and Belarus have been negotiating contracts. Authorities have set the minimum investment at 5 million USD (4.4 million EUR) for each investor.
KAZAKHSTAN				
Development of special economic zone Khorgos-East Gate at Kazakhstan – China border (5 740 hectares)	<ul style="list-style-type: none"> The Khorgos – East Gate Special Economic Zone was announced on 2 July, 2014. Began operations in August 2015. 	<ul style="list-style-type: none"> China has invested in the container port that currently has capacity to process 540,000 TEU annually. 	<ul style="list-style-type: none"> Out of China’s 40 billion USD ‘Silk Road infrastructure fund’, 2 billion USD will be allotted for a new investment fund to support “capacity cooperation” with Kazakhstan. Invest more than 600 million USD over five years to build logistics and industrial zones around Khorgos. 	<ul style="list-style-type: none"> The 600 hectares of infrastructure area is divided into three integrated and bonded areas, a dry port (Khorgos Gateway), a logistics zones and an industrial zone.
POLAND				
Regular rail freight service between Chengdu and Łódź	<ul style="list-style-type: none"> Started in 2013 	<ul style="list-style-type: none"> More than 250 trains since 2013. In 2016 the train frequency increased from one to two trains per week. 	<ul style="list-style-type: none"> Plans to process 1,000 trains per year starting from 2017. 	<ul style="list-style-type: none"> Travel time is 11 days. Large share of cargo from China is computer components. Cargo volumes from Poland are much lower than from China, and are mainly agricultural goods.

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Project	Date	Accomplishments	Planned works	Key highlights
LITHUANIA				
Promote investment in joint railway and Klaipeda port projects	Ongoing	<ul style="list-style-type: none"> China Merchants Group, a state-owned giant and the parent of the mainland's largest port operator, CMHI, signed a letter of intent with Lithuania's Port of Klaipeda in November 2015 to attract Chinese investment. 	<ul style="list-style-type: none"> The port will give sea access to landlocked neighbor Belarus where China Merchants plans to invest 5 billion USD in the "Great Stone" industrial park. 	<ul style="list-style-type: none"> Klaipeda is the biggest container port on the Baltic Sea. It handled 40 million tons of cargo in 2016, a year-over-year increase of 4%. Container traffic in Klaipeda increased by 13% to 443,000 TEUs in 2016.
RUSSIA				
Kazan – Moscow high-speed railway	Planned to be completed by 2022 Expected to start in 2017.	<ul style="list-style-type: none"> On 1 May 2016, the rail operator announced that a Russian-Chinese consortium won the first 360 million USD contract to undertake planning, design and surveying works towards the project between 2015 and 2017. 	<ul style="list-style-type: none"> Total investment in the project which will reduce travel time between the cities from 12 hours to 3.5 hours is 16.7 billion USD. During its first year in operation, 10.5 million passengers are expected to board its trains. 	<ul style="list-style-type: none"> Rail link will allow trains to run 400 km/h along a 770 km route between Moscow and Kazan. The project's total cost will be 60% financed by Russian Railways, with the remaining 40% to come from Chinese investment.
CHINA				
Lianyungang – Khorgos Expressway G30	Planned construction is 2011 – 2030.	<ul style="list-style-type: none"> First Highway Engineering has recently won the bid for the section of Lianyungang –Khorgos Highway in Xinjiang, with a contract value of 442 million yuan and a construction period of three years (starting from 2016). 	<ul style="list-style-type: none"> KTZ had drawn up a 2.7 billion USD investment program to modernize 126 locomotives, 4 172 freight cars and 250 passenger cars, repair 700 km of rails as well as construct new lines. 	<ul style="list-style-type: none"> 4,243-kilometre-long expressway in China that connects the cities on the border with Kazakhstan.

LATVIA AND THE NEW SILK ROAD

Latvia could benefit from the NSR through increased transit flows and the development of last stage assembly activities. In 2015, the transport industry accounted for 9.5 percent of Latvia's total value added. The transport and storage sector multiplier in Latvia is 2.66, according to OECD data. This means that 1 EUR of spending in the transport and transit industry leads to 2.66 EUR of total expenditure in the economy. The redirection of transit flows to Russian seaports has motivated Latvian authorities to explore options to diversify transit routes.

Latvia has several comparative advantages in the transit sector. First, Latvia's geographic position can attract transit flows heading towards Northern and Northwestern Europe from Eastern and Northeastern Chinese provinces. The shortest distances between North and Northeastern areas of China and Scandinavia and Northwestern Europe go through the Baltics and Latvia in particular.

The Latvian route is especially advantageous for the shipment of goods to Sweden and Norway, as Latvian seaports are geographically well suited to handle containers heading toward Stockholm or other Nordic seaports. From the capital city of the western province Xinjiang, Urumqi (population 3 million), it takes approximately 3,300 km to reach Tianjin by rail, 4,000 km to reach Shanghai or 4,660 km to Hong Kong. At the same time, Riga is just 5,700 km away from Urumqi on a rail route via Dostyk on the Chinese – Kazakh border crossing and Moscow. A functioning land route will make the week-long eastward detour to coastal areas redundant for exporting firms from Chinese western areas.

However, current levels of rail freight flows from China to the Nordic states are very small. Exports to Sweden and Norway accounted for 3 percent, or around 10 billion USD, of the total Chinese export volume to Europe in 2015. Another 2 percent, or 6 billion USD, headed towards Denmark, so 5 percent in total for Sweden, Norway, Denmark.¹⁶ About 50,000 TEUs arrived in Europe by rail from China in 2015. Assuming that 5 percent of these have been intended for Nordic markets, the current potential amount of additional TEU containers to Latvia is 2,500 per year. This is negligible (less than 1 percent) in comparison to the 400,000 containers that Latvia's sea ports shipped in 2015.

However, the long run might look more optimistic as the goal of the NSR is to increase the efficient transport of rail freight and thus decrease costs. There are various projections of what the share of rail freight in Chinese export might be in the long run. The OECD forecasts that 0.5 – 1 million TEU containers, or approximately 2.5 – 5%, of the total export volume of 20 million TEUs per year might be transferred by rail in 20 years.¹⁷

This estimate gives a potential range of an additional 25,000 – 50,000 TEU containers per year in 20 years. This estimate does not account for potential additional flows due to the “Great Stone” project or similar endeavors, which aim to bring final assembly lines of Chinese manufacturing firms closer to Europe. This would potentially create more transport flows to Latvia, however, the flow levels will be determined by the strength of competition from the Lithuanian seaport of Klaipeda as well as road and railroad flows directly to Poland and Europe.

Nevertheless, geography dictates that the Latvian transit industry cannot diversify potential rail traffic routes from China. These come either exclusively via Russia and, possibly, also through Kazakhstan and Belarus. Current Russian transportation policy facilitates the development of Russian ports on the Baltic Sea and encourages transit flows to be rerouted from seaports in the Baltic states to Russia. This might create concerns that Russia will not cooperate with the Latvian transit industry and effectively deny it access to the Chinese transit flows. There are several reasons to believe that this will not happen:

- First, strong competition among Central European countries creates incentives for cooperation between Russian and Latvia, as there is a threat that Chinese transit flows might move southward (through the Caucasus and Turkey) or by sea thus bypassing Russia altogether;¹⁸
- Second, Latvia, as a member state of the European Union, might provide more efficient custom clearance and better value-for-money than Russia. Table 2 shows the three main routes and several branches/deviations.

¹⁶ According to the UN Comtrade database, <http://comtrade.un.org>.

¹⁷ Transcontinental infrastructure needs 2030/2050. Paris: OECD, 2011.

¹⁸ Although the Trans-Caucasian route is logistically more complicated, as it involves crossing many countries (and ferry transportation is more susceptible to weather changes than rail), it is less reliable in terms of overall travel timing.

Potential New Silk Road rail routes from Beijing to Europe.¹⁹

Table 2

Route from Beijing	Approximate duration, days	Countries involved	Break-of-gauge before seaport
TRANS-SIBERIAN route		China, Russia	Zabaykalsk at Russia-China border crossing
Latvian branch (Riga)	11	+ Latvia	None in addition to Zabaykalsk
German branch (Duisburg)	17	+ Belarus, Poland, Germany	+ Brest at Belarus-Poland border crossing
Lithuanian branch (Klaipeda)	14	+ Belarus, Lithuania	None in addition to Zabaykalsk
TRANS-ASIAN route		China, Kazakhstan, Russia	Dostyk at China-Kazakhstan border crossing
Latvian branch (Riga)	11	+ Latvia	None in addition to Dostyk
German branch (Duisburg)	22	+ Belarus, Poland, Germany	+ Brest at Belarus-Poland border crossing
Lithuanian branch (Klaipeda)	14	+ Belarus, Lithuania	None in addition to Dostyk
TRACECA route (Transport Corridor Europe-Caucasus-Asia)		China, Kazakhstan	Khorgos at China-Kazakhstan border crossing
Poti (Georgia) via Turkmenbashi (Turkmenistan)	14	+ Uzbekistan, Turkmenistan, Azerbaijan, Georgia	Ferry in Turkmenbashi
Poti (Georgia) via Aktau (Kazakhstan)	12	+Azerbaijan, Georgia	Ferry in Aktau

Currently, most TEUs heading toward the Nordic states arrive at the Duisburg inland port within 17 days. Duisburg inland port is one of the major destinations of rail freight transit from China to Europe with around 20 trains per week arriving from China. Duisburg serves

as a hub for further shipment across Western Europe and the Nordic region. A high frequency rail shuttle service travels to Copenhagen (and further) up to 5 times a week.

¹⁹ Potential for Eurasia land bridge corridors & logistics developments along the corridors. Behrens R., Burgess A., Roggenkamp M., Roest Crollius A., Wagener N. F-23032012, Retrack, 2012.

Selected indicators of Duisburg inland port, Riga and Ventspils seaports performances.

Table 3

	Duisburg	Riga	Ventspils
 AREA	1 400 ha	1 962 ha + 445 ha free industrial territories	1 508 ha + 700 ha free industrial territories
 TRANSPORT SYSTEM	Network with more than 400 train connections per week to over 80 national and international destinations; Transport node for five highways	Network with European and Asian countries by sea and rail; Integration within 1 520 mm rail gauge transportation system	
 MAXIMUM DEPTH	4 meters	16 meters	17.5 meters
 THROUGHPUT (in 2015)	20 000 ships	3 588 ships	1 352 ships
 CARGO STORAGE SITE AREA	2 million m ²	2 million m ²	n/a
 NUMBER OF PORT COMPANIES	300+	60+	20+
 NUMBER OF EMPLOYEES IN PORT COMPANIES	45 000	20 000	4 000
 SALES (in 2015)	217 million EUR	58 million EUR	38 million EUR
 TOTAL CARGO HANDLED (in 2015)	69 million tons	40 million tons	23 million tons

There are only a few countries in between China and Latvia. Depending on the route geography, only Russia might be additionally involved in the transit process. This cuts complexity and simplifies transit logistics with

fewer border crossings and gauge changes and means that it would only take 8 days for a container train to get from Urumqi in China to the Riga port.

MAJOR CHALLENGES

BACKHAUL problem

One of the main challenges to make rail transportation attractive is to solve the backhaul problem, meaning the disproportionality of westbound as compared to eastbound flows. This disproportionality leads to an increase of transport costs per ton, as fixed infrastructure costs are borne by fewer users. The export of goods from Europe to China was 170b. EUR in 2015, which is less than half of exports from China to Europe the same year. This disparity means that some transport has to return to China empty. According to *Kazakhstan Railways*, the China-Europe route via Kazakhstan handled 581 westbound trains with 32,179 TEUs and 205 eastbound trains carrying 17,774 TEUs in 2015. The difference was probably shipped by sea.

The backhaul problem is a complex issue which is not easily solved. Scandinavian countries export approximately 60 percent less than they import from China. The possibility of attracting good flows to China might be an important factor in establishing a direct rail connection via Riga.

The high-speed rail project *Rail Baltica*, which will connect the three Baltic capitals with Warsaw, will have a logistical terminal in Salaspils, near Riga, that will transfer containers from the European-gauge rail system to the Russian-gauge rail system. This creates an additional opportunity to channel goods from the Baltics to China.

COORDINATION problem

The trade route from China to Europe involves many countries and firms. Each state or a firm has an incentive to price a tariff that generates the largest profit for a respective state and firm. As a result, the total price for the whole route that the customers face can be very high. This, in turn, leads to low transit volumes and small profits for all parties involved. This problem is less important in sea shipping, where one operator

is typically in charge of the entire shipment process. Coordination among states and firms is important and creates healthy competition for sea shipment. One stop agency, an institution that handles bureaucracy matters in coordinated way on behalf of a logistic firm, is a good solution for red tape reduction, which is part of such coordination problem. However, an agreement on the overall tariff structure requires even deeper cooperation.

OWNERSHIP OF INFRASTRUCTURE

There is a lack of developed rail infrastructure to accommodate additional containers. Moreover, transit flows might be footloose and sensitive to changes in tariffs and the political environment and be rerouted even in the short run.

To prevent this happening, leading logistic firms should be encouraged to acquire infrastructure facilities in Latvia. Moreover, the construction of manufacturing or assembly lines, such as the Great Stone project, would create a strong incentive to keep transit flows directed through Latvia.

CONCLUSION

The New Silk Road, or “One Belt, One Road”, is an ambitious project put forward by the Chinese government to develop alternative trading routes to deep water shipping. One of the project’s aims is to create feasible rail routes from China to West European markets. While these routes are currently expensive, travel time savings render them attractive for products with a short time-to-market perspective. Furthermore, potential scale economies due to the intensive use of rail infrastructure can decrease transport costs.

Latvia’s geographic position makes it conceivable that some part of Chinese exports to the Nordic states can go through Latvia’s sea ports. However, the current and projected trade volumes to the Nordic region carried by rail are small by the standards of Latvia’s transportation industry. In the short run additional cargo is less than 1 percent of the current trade flow, although within the next 20 years this might grow to 12 percent.

Attracting new freight flows is an important activity that railroad firms should undertake. Nevertheless, Latvia’s geography means that this will not substantially substitute freight from Russia. Indeed, China’s New Silk Road is unlikely to yield substantial benefits to the Latvian economy over the next 20 years.

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Latvia's economic growth can only be achieved through joint efforts. *Certus Think Tank* engages with entrepreneurs, researchers and public sector decision-makers to generate ideas to drive Latvia's economic growth, balancing the principles of a liberal market economy with focused state support for the development of Latvia's most competitive economic sectors.

Riga. Certus Think Tank. 2017.