

# Maximizing the impact of Chinese investment in Pakistan

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## Abstract

*Chinese investment is enhancing energy security, stimulating economic activity and establishing Pakistan as a regional services hub for multimodal trade. As with any foreign investment, there can be crowding out of local industry, social disruption and environmental damage. An enlarged external exposure is placing pressures on the balance of payments. However, the overall impact will likely be positive, as improved infrastructure will catalyse key productive sectors, and exports. Vibrant economic activity, in turn, will attract investment from other countries. The ensuing cross-border flows would improve the external accounts and enhance integration in the global economy. Proactive industrial policies, partnerships and effective economic management can potentially sustain a growth momentum that would set Pakistan on a path to becoming an upper middle-income country by 2030.*

**Keywords:** Pakistan, China, FDI, CPEC

**JEL classification:** F21, F63, O53.

## 1. Introduction

The China-Pakistan Economic Corridor (CPEC) is Central Asia's gateway to the Arabian Sea. It will link China's landlocked Western Province of Xinjiang to Pakistan's Gwadar port and reduce the maritime transit distance by 75 percent. The completed corridor will relieve congestion on the circuitous sea passage and generate new trade.

CPEC is just one segment of China's One-Belt-One-Road Initiative but for Pakistan it is all-important. Launched in April 2015, CPEC has restored Pakistan's stature regionally, and pulled the economy out of a prolonged slump. The inflow of Chinese investment will accelerate growth and, with appropriate policies, unleash economic externalities that can potentially transform Pakistan into an upper middle-income country.

This is admittedly a positive scenario. Achieving it will require effective macroeconomic policies to accommodate pressures from an enlarged external exposure. There is also need for fresh industrial policies to facilitate long-term development. Above all, domestic enterprises and local governments will have to play an active role to ensure that the Central Asian transit corridor is a vibrant economic corridor for Pakistan.

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## **2. China-Pakistan Economic Corridor**

CPEC envisages a comprehensive renewal of infrastructure across the breadth of Pakistan. It involves: renovation of the Karakoram Highway; the building of connecting expressways; upgrading of railways; laying of oil and gas pipelines and fibre optic cables; enlarging power capacity; establishing economic zones; and construction of world-class shipping and air terminals. It will take 15 years and require skills, machinery and capital upward of US\$45 billion (and as much as US\$65 billion), mobilized through foreign direct investment, grants, concessional loans, joint ventures and public-private partnerships. By end-2018, US\$18.9 billion had already been invested.

The list of infrastructure is long, partly to make up for decades of past neglect (with respect to the upkeep of railroads, repair of highways and expansion of national power supply). Even so, the overall cost of CPEC is not particularly high when spread over its 2015-2030 span: between 3 and 4 billion dollars per year—about 1 percent of Pakistan's gross domestic product (GDP). CPEC is plausible in other respects as well.

First, CPEC is a collection of standalone projects. The projects are individually funded and executed, largely with Chinese expertise and capital. The 'turnkey' mode may inhibit domestic inputs but Pakistan has limited capacity in undertaking infrastructure projects (World Bank, 2007), and given China's skill in project delivery, the risk of delay or loss is low. By end-2018, 9 energy projects have already been completed, 13 other projects are under construction and another 20 are in the pipeline.

Second, CPEC is an economic endeavour. The Peshawar-Karachi Motorway will be a tolled facility. Investment in infrastructure is generally attractive (World Bank, 1994). Rates of return on private concessions in developing countries (in Latin America) average 7.2 percent in power and 5.2 percent in transport (UN, 2008, pp. 141-142). The long duration of the concessions assures profitability (the concession for Gwadar port is 43 years). Experience (in South-East Asia) suggests that large outlays can be recouped over an extended lifetime with appropriate user charges for the services generated.

Third, CPEC is market driven. Projects are primarily implemented by corporate contractors, which are incentivized with concessional finance from China, and with tax exemptions, procurement guarantees and security safeguards from Pakistan. However, as a market operation, the liabilities associated with incentives and guarantees would need to accord with the future recovery of financial and social (e.g., environmental) costs. In the interim, the international exposure to commercial cross-border transactions, and corporate debt denominated in foreign exchange, would also swell and will need oversight.

Fourth, CPEC is a 'win-win' partnership. Objectives may differ, gains may vary, cultures may clash, but there are net benefits for all. Although China invests more and receives more monetary returns from CPEC, the expected percentage increase in real GDP is twice as large for Pakistan (UN, 2017, chapter 2). Importantly, both countries are

committed to a sustained, cordial engagement at a high political level. There is an agreed long-term plan, operational matters are addressed in regular, bilateral meetings of senior officials, and progress updates are posted publicly on-line to promote transparency and accountability.<sup>1</sup> Within Pakistan, there is unprecedented cooperation at federal and provincial levels, and between civilian and military authorities. This is a robust basis for success.

### 3. Chinese investment

China's foreign direct investment (FDI) in Pakistan is recent but rising rapidly. The first major investment was in 2007 (in telecommunications) and the cumulative stock of all Chinese investments at the end of 2015 was only US\$1 billion (see Table 1). However, Chinese investment is increasing while traditional investment has been slowing. By end-2017, China had overtaken the United States, the United Arab Emirates and Japan, and by end-2018, China was not far behind The Netherlands, the third largest foreign investor in Pakistan.

**Table 1: Largest foreign investors in Pakistan**

Country	Foreign direct investment (US\$ billion, stock, end-year)			
	2015	2016	2017	2018
United Kingdom	9.9	12.1	11.6	11.9
Switzerland	5.7	7.2	6.2	6.3
Netherlands	2.1	4.1	3.9	4.0
China	1.0	1.4	2.7	3.6
Japan	1.3	2.3	2.1	2.2
United Arab Emirates	3.8	2.1	2.2	2.2
United States	1.8	2.0	1.9	2.0
<i>Memorandum:</i>				
Total (all countries)	34.4	42.0	41.6	42.1

*Source:* State Bank of Pakistan.

Chinese investment is also different (see Table 2). Traditional investment has been resource-seeking (in extractive industries) and mainly market-seeking (in manufacturing and services). These latter areas are vulnerable to economic conditions. Traditional investment has therefore slowed with low economic growth. However, Chinese investment is mainly in strategic assets related to CPEC infrastructure (power, construction and transport), where the principal determinant is potential growth and related non-pecuniary gains, rather than current conditions. There are, of course, common determinants—security, energy and bureaucracy—and as these concerns are addressed within CPEC, the overall investment climate should improve for all.

<sup>1</sup> See the official portal: <http://cpec.gov.pk>.

**Table 2: Types of investment**

<b>Sector</b>	<b>China</b>	<b>Other countries</b>
FDI stock, end-2015	\$1 billion	\$33.4 billion
<i>Distribution:</i>		
Extractive	1%	25%
Manufacturing	7%	36%
Communications, finance, services	30%	28%
Power, construction, transport	62%	11%

*Source:* State Bank of Pakistan.

In terms of new investment, China is, for now, the largest investor. Chinese investments account for the bulk of all FDI inflows into Pakistan since 2016, and for 58 percent of the net inflows of US\$3.47 billion in the 2017-2018 fiscal year. As a consequence, the profile of inward investment is shifting towards services: infrastructure (58 percent in power and construction), finance (10 percent) and other services (9 percent in communications, trade, transport, storage, tourism). This shift will likely continue as CPEC establishes Pakistan as a regional services hub.

#### **4. Potential impact**

Foreign direct investment has direct and indirect effects in host economies, and these effects vary according to economic sector, policy regime and level of development. In this respect, Chinese investment is no different from other foreign investment. The cumulative impact of FDI is hard to assess *ex post* and is certainly much harder to do *ex ante*. There is extensive analysis and prescription on FDI but the basic policy guidance remains, simply, to maximize the positive and minimize the negative.

Foreign direct investment mobilizes financial resources, creates jobs, transfers technology and skills, augments industrial capacity and stimulates the local economy. These effects are generally positive and, in the case of infrastructure, amplified by the scale of activity.

**Finance** is a key feature of CPEC. The large outlays for CPEC are financed only partially by FDI, and chiefly by funds mobilized through development finance and commercial loans. These leveraged funds amplify the impact of Chinese investment. Although the bundling of equity and non-equity arrangements for infrastructure projects is a global practice (UN, 2008, p. 127), the leverage is particularly high for Chinese investment, as evidenced in the high degree of debt to equity.

To illustrate, the US\$2 billion coal-fired power project at Port Qasim is financed with 25 percent equity and 75 percent debt (arranged by the Export-Import Bank of China). Moreover, 49 percent of the equity is from a Qatari partner (Al Mirqab Capital). Thus, the lead Chinese investor (POWERCHINA Ltd) is able to leverage a foreign direct investment of US\$250 million into a US\$2 billion venture. Pakistan receives FDI from China and Qatar, and a physical investment that is quadruple the value of the inflow. The

downside of these projects is the liabilities incurred by the public sector, in guaranteeing to purchase energy at tariffs that ensure an attractive rate of return to independent power producers (IPPs). Pakistan's past experience with IPPs has been problematic, yielding a crippling "circular debt" between utilities and producers (Malik, 2015). Proper management of IPP contracts applies to all energy projects, not specifically to Chinese investment.

**Employment** in CPEC projects is potentially large. Around 700,00 direct jobs will be created in 2015-2030 (UN, 2017, chapter 5).<sup>2</sup> To date the recruitment of Pakistani workers has been mainly at low skill levels, with Chinese professionals and managers filling 20 percent of the 38,000 jobs created in 2015-2017 (ACCA, 2017, p. 15). To illustrate, construction of the 392-kilometre highway between Multan and Sukkur employed 22,000 labourers during 2016-2019. The Sahiwal power plant, now operational, employed 3,000 labourers and semi-skilled workers for construction and has a technical school to train 200 engineers for operations. The Port Qasim power plant engaged 5,000 workers in construction, and for operations would create 500 trainee and engineering jobs annually. While there is potential for learning within the CPEC projects, the demand for technical, professional and managerial skills would need to be met in the education sector. The bulk of the jobs are for contractual work at minimal wage, but would benefit low-income families and boost local commerce in the less-developed regions of the country.

**Technology** is primarily embodied in imported capital equipment and engineering services of Chinese contractors and workers. An immediate benefit is the acquisition of production capabilities, and the crucial longer-term benefit is the potential for learning skills for the operation, maintenance and upgrade of production processes. The principal areas for technology transfer are power plants and multi-modal transport. To illustrate, the Port Qasim coal-fired power plant utilizes efficient thermal technology and sustainable management operations (e.g., recycling seawater, desalination and desulfurization of flue gas). The energy infrastructure is being diversified with solar and wind power stations. The envisaged fibre optic networks will provide advanced digital services. The transshipment port facilities at Gwadar will be first class like China's Shenzhen Port and will be built in half the time (5 years instead of 10).<sup>3</sup> The downsides of technological leapfrogging are the relatively high costs of imported equipment, parts and supplies, and the on-going need for foreign expertise in operations and maintenance. Additionally, Pakistan's experience with 'turnkey' projects has been mixed, marked by rapid depreciation of capital plants and limited mastery of the skills for efficient production.

**Economic activity** is stimulated by Chinese investment through linkages with domestic industry. Backward linkages create demand for construction materials and

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<sup>2</sup> Estimates of direct job creation range from 400,000 jobs (ILO, 2016) to 800,000 jobs (Pakistan Planning Commission, cited in ACCA, 2017). A high figure of 2.3 million jobs was reported by Wu (2017).

<sup>3</sup> See Iftikhar, Xie, Shakeel, Jamali, Cheema & Shahid (2019).

transport services. Public-private partnerships (PPPs) engage Chinese investors with local companies, banks and provincial authorities. To illustrate, the cement and steel industries have increased production and are investing in enlarged capacity (World Bank, 2017a, p. 5). A Pakistani conglomerate, Engro, is the lead partner in the Thar Block II coal-mining project (*The Economist*, 2018). However, the typical linkage is a supplier relationship in which local companies must compete with imports on the basis of low cost, high quality, and timely delivery, and even when these conditions are met, the local supplier must still overcome a tendency for Chinese firms to import through established ties in the home country. Thus, local content may likely fall short of expectations.

Chinese investment has spawned novel support services. Chinese is now being taught in 19 universities and at dozens of private institutes. Pakistanis are also pursuing studies in China, with some 20,000 having already graduated and another 25,000 enrolled in engineering, science, medicine and other disciplines. There is also demand for security services. An army division of 15,000 personnel has been assembled to safeguard projects. At the provincial level, some 2,600 police officers in Sindh and another 4,200 officers in Khyber Pakhtunkhwa will protect foreign workers. These numbers will increase with the establishment of the economic zones. Protection services provide value and their cost is recoverable. More generally, the expenditures of the projected 100,000-plus Chinese workers and their accompanying families will have multiplier effects for food, retail, finance, tourism and consumer industries.

The major economic stimulus will be from forward linkages. The energy projects will mitigate the recurrent power shortages that have crippled industrial output for years and are estimated to have held back economic growth by some 2 percent per annum (Pakistan, Ministry of Finance, 2013, p. 1; IMF, 2017, p. 65; World Bank, 2017b, para 3).<sup>4</sup> As the energy shortage is overcome, the industrial and economic growth rates should pick up towards full potential. In addition, potential growth can be expected to rise over the medium-term, with the establishment of economic zones to augment industrial capacity and with improvements of the transport infrastructure making all sectors more productive.<sup>5</sup> The export sector would become more competitive.<sup>6</sup>

Overall, energy security, transport efficiency and economic diversification are estimated to boost the level of real GDP by at least 2 percent and possibly as much as 7 percent (UN, 2017, Figure 2.2). Thus, Chinese investment might potentially infuse a significant growth momentum in the host economy that, if sustained, could elevate Pakistan to an upper middle-income country by 2030.

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<sup>4</sup> “In the industrial sector alone, power outages in 2009 cost \$3.8 billion (about 2.5 percent of GDP). Half a million jobs and exports worth \$1.3 billion were lost,” writes Alahdad (2014, p. 3).

<sup>5</sup> Generally, a 1 percent increase in the stock of infrastructure is associated with a 1 percent increase in gross domestic product (World Bank, 1994, p. 2). Thus, the planned 5 percent increase in transport infrastructure would increase GDP by 5 percent.

<sup>6</sup> A 10 percent reduction in transport costs would increase exports by 2 percent (UN, 2017, Foreword).

## 5. Maximizing the impact

Any high growth scenario hinges on domestic factors. The stimulus of foreign investment can spread widely or dissipate quickly, depending on the absorptive capacity of the local economy. Unfortunately, the provinces that need investment the most have the least capacity to absorb it, limiting real economic growth. Also, infrastructure can be underutilized or be a basis for economy-wide productivity, depending on the propensity to invest of industry. Hence, a key driver is domestic investment—public investment to enlarge absorptive capacity and private investment for industrial growth.

The other key driver is exports. As already noted, ‘turnkey’ projects are import-intensive, which worsens the trade balance in the short-term. The import of heavy machinery should hopefully subside in time, though the need for parts and materials would persist. External borrowing can finance the deficit but creates debt. Infrastructure projects are also services that earn revenues locally and remit profits externally over the long-term.<sup>7</sup> Without a rapid and substantial increase in exports, there is risk that trade deficit and financial outflows would imperil the balance of payments and choke off the growth momentum. Unfortunately, Pakistan’s investment and export performance has been lacklustre for decades. Alarmingly, acute pressures on the balance of payments surfaced in 2017-2018, and worsened in 2018-2019 as net inflows of foreign direct investment fell by 50 percent.

The CPEC timeline aims at an “early harvest” of power projects to ease the energy deficit. This is necessary but insufficient. There is need for a concomitant “big push” on investment and exports led by industry. Private investment needs to double to meet the minimum threshold for dynamic growth.<sup>8</sup>

*Energy security* is planned as an “early harvest” of CPEC projects. However, Chinese investments in power generation require parallel public investments in power transmission. By 2018, more power was being generated than could be distributed. The weakness of public power distribution companies (DISCOS) threatens to aggravate the energy “circular debt”. Maximizing the impact of the “early harvest” will therefore require downstream investment in distribution capacity, closure of transmission leakages, competitive pricing with more efficient delivery, and full cost recovery from users. There

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<sup>7</sup> Foreign direct investment peaked in 2006-2008 with large inflows in banking and telecommunications. However, these services subsequently generated significant outflows of profits.

<sup>8</sup> As discussed elsewhere (Hamdani, 2014, pp. 273-274), gross fixed capital formation in Pakistan has, for decades, been well below the minimum threshold necessary for dynamic growth (estimated at 20 to 25 percent of GDP). It was 14.2 percent of GDP in 2016. Private sector investment (which accounts for two-thirds of the aggregate) would need to double (from 10 percent to 20 percent of GDP) in order to attain the threshold for dynamic growth.

have been improvements but more progress is needed.<sup>9</sup> Where the DISCOS lack funds, public-private partnerships (PPPs) can raise financing, including from Chinese investors who have offered US\$1.8 billion to acquire a 66 percent majority stake in the Karachi power distribution company (K-Electric) and, importantly, plan to invest US\$9 billion over 3 years to upgrade operations.<sup>10</sup>

**Special economic zones** (SEZs) are planned in order to promote industrial expansion and diversification. The plan could be more ambitious: the envisaged 9 zones is a minimal number for an economy the size of Pakistan. Also, the planning of SEZs should be expedited as zones typically take 5 years to come into full operation (Zia, Yong, Javed & Malik, 2018). The zones should follow global best practice: open to both domestic and foreign enterprises and operated as a service, providing state-of-the-art facilities (roads, power, water, sewerage, security and other common services) at tariffs that recover running costs. The zones should also target industries suited to particular locational advantages. Thus, the Gilgit-Baltistan zone targets resource-based industries; the Balochistan and Nowshera zones target agricultural industries; and the Faisalabad and Port Qasim zones target heavy industry. In order to attract light manufacturing from China, the zones should be designed as industrial clusters rather than SEZs (Rasiah, 2018). The aim is to attract industry that is largely reliant on local content, with potential for export-oriented production (either of finished goods or intermediate products that feed into global value chains). Maximizing the impact of the zones will therefore require provinces to adopt proactive industrial policies that cultivate linkages with the domestic economy.

**Transport infrastructure** will expand and diversify trade in the medium and longer-term. Establishing export processing zones and dry ports adjacent to the transport corridor would reduce costs, improve delivery and facilitate integration in global value chains. In the interim period—while imports are rising faster than exports—there is need to “harvest low-hanging fruit” in traditional exports, agricultural products, agro-industry and tourism (Ahmad & Khalid, 2018). Although China is Pakistan’s second largest export market, the trade deficit with China increased 50 percent in 2015-2017, to US\$12 billion. Their bilateral free trade agreement had limited benefits for Pakistan (Chaudhry, Jamil & Chaudhry, 2017) but its second phase will improve market access for a wider range of commodities over 15 years, initially increasing Pakistan’s US\$1.2 billion exports to China by US\$500 million,<sup>11</sup> and potentially to as much as US\$12 billion if

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<sup>9</sup> Reforms include reduced federal subsidies and increased revenue collection from users (World Bank, 2017b, para 66).

<sup>10</sup> As reported by Salman Siddiqui, “Shanghai Electric to finally acquire K-Electric this year,” *The Express Tribune*, 8 June 2019 (<https://tribune.com.pk/story/1987719/2-shanghai-electric-finally-acquire-k-electric-year/>) and Murtaza Ali Shah, “K-Electric acquisition to position Pakistan as investment destination: CEO,” *The News*, 14 February 2019. (<https://www.thenews.com.pk/print/431811-k-electric-acquisition-to-position-pakistan-as-investment-destination-ceo>).

<sup>11</sup> As reported by Amin Ahmed, “New FTA with China to increase exports by \$500m, says Dawood,” *Dawn*, 24 April 2019 (<https://www.dawn.com/news/1478060>).

Pakistan is able to capture 20 percent of those Chinese imports that Pakistan produces but are now sourced elsewhere.<sup>12</sup>

It is important to view the transport infrastructure as a services platform. There is revenue to be earned from handling charges at the sea and air terminals. Additionally, a toll on the transit traffic with China can earn upwards of \$2 billion per year.<sup>13</sup> The fee would be attractive to shippers if accompanied by administrative measures to streamline procedures and expedite transit. Such efficiency measures would also increase the volume of total trade on the economic corridor.<sup>14</sup> An efficient multimodal transport network would establish Pakistan as a regional services hub.

**Public-private partnerships** can develop absorptive capacity. Large sections of the planned economic corridor pass through areas with low potential for backward and forward linkages. There are fears that CPEC opportunities will not flow to local youth (UNDP, 2017). Support for social integration includes schools, training centres, hospitals, and water and sanitation facilities. Foreign companies provide such support as part of corporate social responsibility. To illustrate, Engro is building schools in Tharparkar. The China Road and Bridge Corporation is funding dormitories in Mansehra. Hospital and educational facilities are being constructed in Gwadar city. These relatively few activities need to be replicated more broadly through public-private-civic partnerships.

Maximizing the impact of Chinese investment would also require a strengthening of the legal, regulatory and institutional framework. In the legal sphere, the legislation for build-operate-transfer projects (BOTs) and public-private partnerships (PPPs) should be updated to reflect global best practice. Rules for the tendering of public projects need transparent application, and procedures should facilitate contractual bidding by domestic industry and small and medium-sized enterprises. There is also need to reinforce

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<sup>12</sup> US\$64 billion of China's imports are goods that Pakistan produces, see Hina Aslam, "Pakistan China Free Trade Agreement (FTA): where we are and where we are going?" Daily Times, 24 July 2019 (<https://dailytimes.com.pk/436023/pakistan-china-free-trade-agreement-fta-where-we-are-and-where-we-are-going/>).

<sup>13</sup> A 0.5 percent transit fee on the US\$400 billion trade between China and the Middle East and Africa would generate an annual income of US\$2 billion. If the corridor were to handle only half of the existing ocean trade, or some 10 million containers, then a tariff of US\$250 per container would raise revenue of US\$2.5 billion. "We may be able to recover our financing costs through the toll income, if we are successful in claiming 30% of the Chinese trade with Africa and the Middle East," says Hasaan Khawar, "CPEC toll income—myth and reality," *The Express Tribune Opinion*, 26 October 2017 (<https://tribune.com.pk/story/1541404/6-cpec-toll-income-myth-reality/>). Husain (2018) suggests transit revenue as high as US\$4-6 billion annually.

<sup>14</sup> Trade facilitation measures can double the potential increase in exports generated by the economic corridor (UN, 2017, Figure 3.4).

protections of financial and property rights, and for investor-friendly mechanisms for commercial arbitration and dispute resolution.<sup>15</sup>

In the sphere of public management, the various authorities for power, ports, roads and railways need professional staffing and greater autonomy to operate as self-sustaining services. The State Bank has augmented its instruments for managing external capital flows, including investment bonds, portfolio accounts of non-resident investors, bilateral currency swap arrangements with China and use of the Chinese Yuan in foreign exchange transactions. The State Bank should also issue renminbi-denominated bonds in Hong Kong. In this way, financial flows between State and private capital can be increasingly intermediated through international markets, thereby permitting competitive terms with due risk management.

#### **4. Minimizing the negative**

Foreign direct investment can ‘crowd out’ local industry and result in capital outflows, social disruption and environmental damage. Such impacts can be mitigated but not entirely avoided. The Chinese presence in Africa has been marked with instances of labour unrest and allegations by local industry of uncompetitive business practice (*The Economist*, 2011). The Government of Sri Lanka was overwhelmed with an unsustainable public debt burden (Abeyratne, 2018). In Pakistan, domestic steel producers have had difficulty in competing with cheaper Chinese imports (Rehman, 2017) and there is anecdotal evidence of crowding out in other industries.<sup>16</sup> There have been large imports of machinery, parts and materials from China that could be partially sourced locally but are ostensibly unavailable, unsuitable or costly. The CPEC policy framework should incorporate standards to discourage excessive bundling of ‘turnkey’ projects and to encourage ‘learning by doing’ and best business practice.

Unfortunately, Pakistan’s past experience with ‘turnkey’ projects—from fertilizer plants to hydro-dams—has not been stellar. Projects were built, operated and never fully transferred. Projects relied on a continuous stream of imports and management fees that, when interrupted, led to obsolescence. It is important that CPEC not replicate this experience. All major projects should have facilities to encourage ‘learning by doing’, including training of local staff to master maintenance and servicing of plant and

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<sup>15</sup> The Chief Justice of the Supreme Court has called attention to the need to "deal with grey areas in the legal and administrative landscape which may hinder our country from taking full advantage of the numerous opportunities provided by CPEC" as quoted by Muhammad Hanif, “CPEC: CJP Highlights Legal Aspects to Boost FDI,” *Pakistan Observer*, 9 May 2018 (<https://pakobserver.net/cpec-cjp-highlights-legal-aspects-to-boost-fdi/>).

<sup>16</sup> According to Kamal & Malik (2017, p.7): “The anecdotal evidence suggests that local manufacturing of ceramics, electric machinery and equipments, chipboard, plywood, bicycles, etc., and a number of small scale industries have also been affected, among others, by low cost imports from China”.

machinery, and eventually to assume management of entire operations. The success of Engro should be emulated widely.

As with any FDI, Chinese investments will generate capital outflows, stemming from repayment of loans and remittance of profits. Energy projects have attractive rates of return embedded in IPP contracts. Prior FDI in power in 1995 meant significant foreign exchange outflows in excess of \$1 billion per year for a decade (Hamdani, 2015). FDI in telecommunications and banking in 2007 also produced significant outflows. The costs of such infrastructure projects can be recouped from the services provided. However, the revenues are earned in local currency while the repatriations are in foreign exchange, generating significant capital outflows. Looking forward, the annual outflows of CPEC (and other) energy projects are estimated to balloon to US\$4 billion in 2024 (IMF, 2017, p. 68). Hence, total FDI inflows will need to rise to absorb future outflows. This is not a herculean task: in previous years, Pakistan has attracted annual FDI flows at twice-current levels.

Finally, the social and environmental impacts need to be monitored. Although CPEC projects include renewable energy, civil society demand greater assurance on the sustainability of operations that rely on coal, consume large amounts of water and are located in fragile ecosystems (Ebrahim, 2017). These are largely shared concerns that should be assuaged with explicit norms on sustainability.

The Chinese presence in Pakistan is small but visible. Large-scale projects entail influx of personnel and upheaval of communities. Support for social transition includes schools, training centres, and health, water and sanitation facilities. Foreign companies provide such services as part of corporate social responsibility. Such activity can be scaled up through public-private-civic partnerships. The integration of Chinese in Pakistan will contribute to a more diversified society and vibrant economy, the benefits of which can be fostered under the banner of cultural cooperation.

## **5. Conclusion**

Overall, the impact of Chinese investment on the Pakistan economy will be positive, and could even be substantial. At a minimum, the energy projects will reduce the crippling power shortage. The special economic zones will stimulate industry. The transport corridor will earn transit revenue and establish Pakistan as a regional services hub for multimodal trade. At a maximum, Chinese investment could infuse a growth momentum that would set Pakistan on a path to becoming an upper middle-income country by 2030.

In the best scenario, Chinese investment can accelerate economic growth in four ways. First, capital inflows ease the balance of payments. Second, improved infrastructure will catalyse key productive sectors. Third, vibrant economic activity would attract investment from other countries. Fourth, the ensuing cross-border flows will deepen integration in the global economy.

These growth drivers will take time to gather momentum. The economic zones typically take 5 years to come into full operation; even then, the stimulus of a handful of zones must permeate the larger industrial structure (the development of Gwadar into a port city may take 15 years, Iftikhar, *et. al.*, 2019). Domestic economic activity must germinate before foreign investment follows. Enterprises must gain competitiveness before they can export. Skilling a new labour force may take a generation. However, proactive industrial and vocational policies can shorten the lead times. There is a particular need for a “big push” on investment and exports, led by industry. Domestic private investment needs to double to meet the minimum threshold for dynamic growth.

There are also hurdles to overcome. An enlarged external exposure places pressure on the balance of payments. Already, the trade balance has widened greatly as imports have risen faster than exports. Financing the deficit is draining reserves and accumulating debt. Even as exports catch up with imports, new pressures will surface as capital outflows balloon in the medium-term with an expected repatriation of profits, dividends and interest payments. Issues of Chinese project delivery, financing, trade imbalances and economic, social and environmental impact should be monitored and addressed within the bilateral cooperation framework of CPEC. However, it is the accepted responsibility of Pakistan “to sustain economic growth momentum” (CPEC, p. 7).

Maximizing the impact of Chinese investment will therefore entail strenuous effort within Pakistan. Consumers and producers need to absorb the cost of improved energy and infrastructure services, which need to be efficiently supplied by public utilities. Domestic enterprises need to invest to realize productivity gains and extract value added from linkages with foreign enterprises. Exports need a rapid boost led by traditional goods, and progressively supplemented by new products in new sectors. Public investment should enlarge absorptive capacity, particularly for human development in the least advantaged localities. There is need for continued capital inflows, to be met increasingly through non-debt incurring foreign direct investment from all countries.<sup>17</sup>

In this respect, the latest IMF stabilization program is a welcome development.<sup>18</sup> The US\$6 billion extended funding arrangement provides a macroeconomic framework for the piecemeal actions of government. It also purports to release US\$38 billion from international partners over the 39-month program period. Hopefully, the brunt of the downward adjustment in fiscal, monetary and exchange rate policies will fall not on investment but on consumption, which comprises two-thirds of aggregate demand. Nevertheless, economic growth will drop significantly. A new driver of growth is needed

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<sup>17</sup> Total foreign investment was US\$5.7 billion in fiscal year 2017-2018 but in the following fiscal year 2018-2019 it was reduced to only US\$250 million, as gross FDI inflows of US\$3.1 billion were negated by outflows of US\$2.8 billion on direct and portfolio investment and the servicing of government debt securities.

<sup>18</sup> IMF, “Pakistan Request for an Extended Arrangement under the Extended Fund Facility,” IMF Country Report No. 19/212, July 2019.

and Chinese investments “can provide a stimulus for Pakistan’s much-needed growth recovery in the post-stabilisation IMF program period” (Hamid & Khawar, 2019).

The policy prescription for moving the Pakistan economy forward predates CPEC (Amjad and Burki, 2013).<sup>19</sup> For some years the economy has been mired in a low middle-income trap, with growth spurts largely reliant on external factors rather than endogenous drivers (Amjad, 2014). There is general agreement on the need to revive domestic private investment, raise exports, improve public services, and prioritize education. The policy choices are clear but entail reforms that are hard to make. CPEC is a spur for advancing that broader policy agenda. In the absence of vigorous domestic effort, Chinese investment will still create a transport corridor but the full benefits for Pakistan of a vibrant economic corridor would fall short of expectations.

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