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CPEC and Pakistan's Economy: A Way Forward

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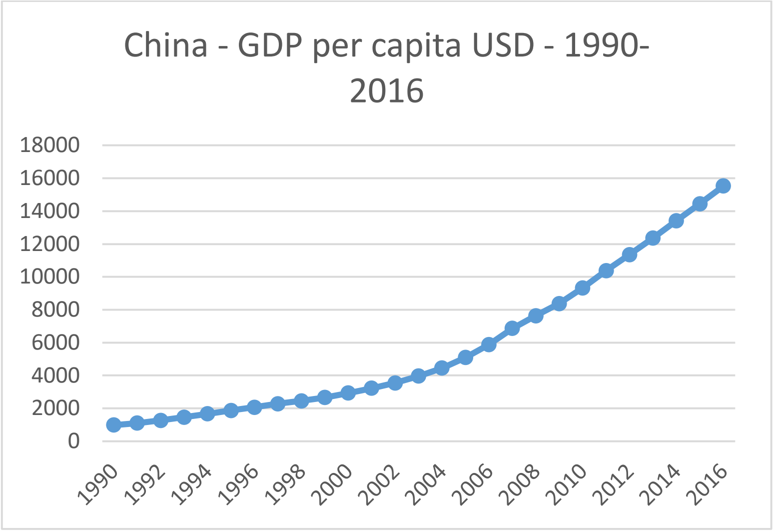
1. CPEC should be considered in the large context of (a) the Chinese development model that has brought about an economic miracle, (b) the Belt and Road Initiative, and (c) China's stellar comparative advantage in infrastructure construction.

2. China's development model that has lifted more than 700 million people out of poverty in a short period of twenty-five years has bewildered the whole world, particularly development scholars, and practitioners. The progress achieved in less than a generation in transforming from a poor country with per capita income of $300 to become the second largest economy in the world, and top exporting nation in the globe has puzzled almost everyone. How was it able to achieve this rapid and successful transformation? It seems that China has found a mid-way ground by combining an efficient market mechanism, with an effective and functioning government to accelerate economic growth and significantly reduce poverty. By combining the visible hand of the government with the invisible hand of the market, it has struck an equilibrium in which the asset holders favored by the market create wealth and jobs, while the government, by providing infrastructure and social services, helps in redistributing the gains of growth among those who are unable to derive any benefits from the market mechanism.



Source: World Bank data, China

The Soviet economy collapsed because the State took care of the citizens' needs from the cradle to the grave but was a big stumbling block in the creation and accumulation of wealth. As the ever-growing demand of the population exceeded the supply of financial resources, it was inevitable that the economy would collapse.

In the capitalist system, only those who have capital or skills can make enormous returns and incomes, while the hands-off and non-interventionist policy of the State results in the less endowed population to fall below the poverty line. Before Obama Care was introduced, as many as 45 million Americans (approx. 14% of the population) did not have any kind of health insurance, and one sixth of the population was living below the poverty line, in the Citadel of Capitalism.

The populism and backlash exhibited in the 2016 elections by the U.S., the Brexit and the rise of nationalist political parties in Europe are a manifestation of the deep-rooted frustration and disaffection by the segments of population that have been by-passed by this capitalist system. Pakistan has to seriously ponder if the Chinese development model can be adapted, modified and applied to suit our peculiar conditions. In a multiethnic society, wider diffusion of benefits to the large majority of the population, particularly the deprived regions of the country, should take precedence in the interests of social cohesion and national integration.

3. The scope of China-Pakistan economic relations should not remain limited to CPEC but also broadened to include Trade, bilateral investment, financial services and Transfer of Technology. The Free Trade Agreement (FTA) with China should be renegotiated and the terms allowed to ASEAN countries made applicable to Pakistan also. Pakistani exports should be allowed less than equal reciprocity access. As the world's largest exporting nation, the penetration of Pakistani goods and products provides an attractive means for boosting employment and growth in Pakistan. In financial services, currency swaps between Yuan and Pak Rupee, expansion of Chinese bank branches in Pakistan and allowing Pakistani banks to open branches in China and availability of credit lines for cross border trade would reduce the transaction costs of doing business for both the countries, the second order effects of CPEC projects would be further spread as trade and financial cooperation are intensified. China has become a powerhouse in emerging technologies with applications to health, agriculture and industry that include clean energy, genetics, biotechnology and ICT. Pakistan should seek assistance of the Chinese scientists in training and collaborating in research with our scientists by establishing laboratories and regular exchange programs. This would solidify the Research and Development base of Pakistan and this trained manpower, in turn, would adapt and diffuse these technologies for increasing productivity in our various sectors.

4.The Belt and Road Initiative (BRI) involves $3 trillion investment over the next 30 years, in nearly 60 countries, covering 60% of the population, and 33% of the global GDP. The goals of BRI are Policy Coordination, Connectivity, Unimpeded Trade, Financial Integration, and People to People Bonds. Six major economic corridors linking China with the rest of the world are developed – four land routes and two maritime corridors. In this region, the other noteworthy Corridor is Bangladesh – China – India –Myanmar.

It must be realized that while the threats to globalization and financial integration are emanating from its proponents such as the U.S. - the country which is making an attempt to preserve and relay the impulses of globalization, and thus help bring about prosperity to large segments of population is China. President Xi Jinping made a highly persuasive and eloquent case for preserving and promoting globalization in his speech at Davos in January 2017. BRI is by no means an altruistic endeavor - it is aimed to maintain and augment China's comparative advantage in international trade by opening new markets for Chinese goods. It would also help China in securing alternate trade and energy routes and generate new opportunities for investment in emerging markets by Chinese enterprises. In return, if the partner countries are able to derive maximum benefits through this connectivity, the end result would be a win-win situation

China has the financial capacity to undertake this quantum of investment. If the BRI enables China to arrest its slow rate of economic growth, then this capacity would be further strengthened and enhanced.

According to an article by Wang Yiwei in China Daily, China has signed 101 cooperative agreements with 86 countries and international organizations, carried out regular capacity cooperation with more than 30 countries, built 75 economic and trade zones with 24 countries along the routes, and made a cumulative investment of $50 billion in involved countries, creating nearly 200,000 jobs since Belt and Road Initiative was first raised.

Given that China enjoys huge advantages in infrastructure construction, the advancement of BRI will surely boost connectivity between China and the rest of the world. The growing economic and political power of China which would get a further boost through the connectivity with 60 countries under the BRI has begun to raise serious concerns among the Western powers who are likely to lose their hegemony. Attempts are being made through media, think tanks, and social media to raise suspicions and doubts in the minds of the intelligentsia and opinion makers in developing countries about the efficacy of these projects. A recent study by the Washington based Center for Global Development has already pronounced the judgment that eight developing countries including Pakistan are entrapped by the heavy burden of the Chinese debt. The highly respected magazine, The Economist in its cover story of March 3, 2018 has challenged the West "It is a time for serious thinking about how to balance China more effectively, with a united front and without losing sight of the strength of democratic, accountable government, a free press and independent courts. Instead the West feels tired, timid and tetchy. From Washington to capitals of Europe, the air is filled with call for more aggressive screening of investments to proposals to deny Chinese academic visas." The struggle between the rising power of China and the eroding influence of the West would have unintended adverse consequences for the developing countries. Pakistan's expanding ties with China and the US's with India in this struggle would play a major role in systematic efforts to discredit CPEC in the eyes of Pakistani opinion makers, op ed writers, talk show and seminar participants. This does not mean that genuine criticism and shortcomings of CPEC projects should be swept away and ignored. A sense of blind faith should not prevail among the negotiators or policy makers and maximization of the national interests of Pakistan should be the sole criterion for buildup of the portfolio under the CPEC.

5. CPEC is only one component of the Belt and Road Initiative (BRI) of China. CPEC offer great advantage to China as it gains physical access to the Indian ocean and closer proximity to the Middle Eastern oil resources. It would reduce its dependence on Strait of Malacca through which 85% of its oil imports travel through. Savings in the cost of transportation for Chinese exports and imports from the Western China would help boost the economy of this backward region. There is no doubt that reduced transaction costs and turnaround time through this network would serve China's economic interests and particularly its Western provinces. But it would not come at the cost of any damage to Pakistan's economic interests. It is the concentrated efforts of the Government and the private sector of Pakistan, which would determine if the

benefits are shared equally or disproportionately. A confrontational, adversarial and non-cooperative approach within Pakistan where the provinces blame the Federal government, the Government complains about the lack of capacity in the provinces, the private sector believes it is being ignored and by-passed or a level playing field is not available to them, would definitely end up in diminished benefits to the country. CPEC should not also be considered as a substitute for relations with other powers in the region or the world but as a first step towards using the country's strategic location for economic advantage rather than for geo political purposes which has only brought us infamy in the world and huge losses in financial and social capital domestically. If the CPEC is successfully implemented there is no reason as to why we should not develop the East West Corridor connecting South Asia with Afghanistan, Central Asia and China and also Gwadar-Iran land, rail and sea links.

6. How is Pakistan going to derive maximum gains from CPEC or is at all for China's own interest? To begin with, a more collaborative, synergetic and constructive approach followed by all the stakeholders, is quite critical. In my view, the present cynical and suspicious atmosphere propagated by certain sections of the media and intellectuals in Pakistan, is not all conducive, and may in fact be a self-fulfilling prophecy with disastrous results. Unfortunately, both the champions and detractors of CPEC have done a great disservice. The impact of CPEC on Pakistani economy has been highly exaggerated by its proponents and champions while it has been vastly understated by its detractors, and some of them have created unfounded fears and apprehensions.

7. We must first spell out what it is likely to happen over the next 15 years. To trace the economic consequences, we need to identify those components that have been approved, have been completed or are under active implementation such as Early Harvest projects. It is not advisable to indulge in speculative analysis of the projects that are still under planning stage or are included in the Long term Plan for preparing feasibility studies first. This article, however, proposes later on some safeguards and

guidelines for those projects also as part of the action plan of policy reforms and institutional restructuring. Out of the originally approved CPEC allocations of USD 45 billion for the period 2015-30 as much as USD 35 billion are earmarked for Energy projects including Generation and Transmission. The priority of CPEC is thus very much responsive to meet the immediate economic needs of Pakistan. Under the Early Harvest program and Short term projects to be completed between 2015-2020, projects worth $ 23-26 billion are to be undertaken for the three components: Energy, Infrastructure and Gwadar. While Energy projects are investment by the Chinese companies in the IPP mode under the established policy of the Government of Pakistan, the infrastructure projects are financed through Government to Government loans at a concessional rate of 2.4 percent average with an extended repayment period and most of the Gwadar projects are based on grants. Missing from these amounts is the ML1 Railway project costing over $ 8 billion for upgrading the track from Karachi to Torkham. This project is still under study and the terms have not yet been finalized. It may be clarified that most of the Western Route projects are being financed by the Government of Pakistan out of its own resources under the Public Sector Development Program and these are not reflected in the above allocations. . Although Special Economic zones (SEZs) for industries are mentioned in the approved program very little work except identification of 9 zones has taken place.

8. As mentioned earlier, bulk of the allocation $ 35 billion out of 46 billion would be utilized for adding generation capacity of 11,000 MW by 2020 to ease the crippling shortages of power. Fuel sources would be diversified and LNG, Coal, wind, Solar and Hydropower replacing Furnace oil, so far, projects generating about 3720 MW have been commissioned or are expected to be commissioned in the next few months. 70 percent feeders in the national grid system are at present free from load shedding. The real test would be whether supply and demand for power during the peak hours in the coming summer are in equilibrium. This would be the most tangible achievement of CPEC that can speak for itself. Infrastructure projects that span the

Western Route, Central Route and Eastern Route are at various stages of contracting, construction and completion.

9. The overall possible contribution of CPEC to Pakistan's economy has been highly exaggerated in some quarters as if the country did not achieve anything before or is unlikely to do better in future in absence of CPEC. Pakistan's current annual investment outlay by the public, private and foreign sectors amounts to USD 45-50 billion. CPEC's annual average investment of USD 3 billion would account for around 6 percent of the total and therefore any claims that it is going to be the only game in town are not substantiated by this empirical data. Over time, as the country's economy grows even by 5 percent annually and investment rises correspondingly the share of CPEC projects would keep on declining to less than 3 percent of the total investment by 2030. What it would do, however, is to change the perception of Pakistan among other foreign countries as an attractive destination for investment. It would help in easing the power shortages, building Gwadar port and city, upgrading the quality of railway network, connecting the backward districts of Balochistan and southern KP with the national markets through the Western route and proposed Railway link connecting Gwadar with Jacobabad. CPEC is the first major initiative that could play a pioneering role in taking advantage of Pakistan's strategic location. Following this other corridors connecting the East-west and Pakistan-Iran and Pakistan- Afghanistan –Central Asian states can be established. What it is not going to do is to industrialize Pakistan overnight as even the planning for industrial zones has not yet begun or take care of the our youth employment problem in any significant way (at best only 400,000 new jobs are to be created by CPEC projects during this entire period while 1 million youth enter the labor force every year) or bring about extraordinary prosperity and transform the country economically into another Korea or Vietnam. These are unrealistic expectations that need to be tampered and those proponents of CPEC who are making such claims do not realize that they are in fact doing a great disservice.

10. The detractors of CPEC are also blatantly wrong when they assert that Pakistan would not be able to service the loans and repatriate the profits to Chinese investors, due to declining exports, depleting foreign exchange reserves, an unsustainable current account and a heavy debt servicing burden. The country would be trapped in serious debt obligations to China which would provide the latter a leverage to take over all assets including Gwadar. A cool and dispassionate analysis would reveal that the crux of all these problems lies in the energy crisis that brought Pakistani exports down from USD 25 billion to 21 billion (see the Chart below for both goods and services). Export orders could not be fulfilled as the exporters did not have reliable and uninterrupted power and gas supply. Had the energy constraint been absent, a growth rate of 10 percent annually would have been achieved in the last four years (During 2002-08 export growth rate was 14 percent and in the first eight months of FY 18 exports have risen by 11 percent as the load shedding has eased) . In that case, Pakistan's exports would have reached USD 36 billion in FY 18. Current account deficit with the unchanged volume of imports would have been lower by at least USD 15 billion and the need for short term commercial borrowing would not have arisen. Foreign exchange reserves would have been healthy and debt servicing burden manageable. Debt and Debt servicing projections prepared by the Ministry of Finance for the period 2018/19 to 2022/23 show declining debt servicing ratios . The additional burden of CPEC debt as well as repatriation of profits on investment would not create any stress and is quite manageable. IMF has estimated that at its peak the repayments on both debt and investment account would be between 2.5 to 3 billion annually. This amount can be easily absorbed by increased exports, savings in imports of fuel, transit fees etc. Thus the fear of Debt entrapment does not stand the test of empirical validity.

Source: World Bank Data, Pakistan

11. Going forward, the key to Pakistan's economic stability and revival does not lie in the CPEC but in improving the competitiveness of our exports, by (a) removing the problems of their liquidity and paying their refunds promptly, (b) reducing the cost of doing business, (c) minimizing the hassle caused by government functionaries and (d) providing the exporters access to gas and power at affordable prices. A country where domestic consumers are subsidized at the expense of the exporters has its priorities completely wrong. Along with this upsurge in exports, an acceleration in the economic growth rate by 1.5 to 2 percent arising from assured energy supply, reduced costs of logistics and savings in imported fuels would strengthen Pakistan's repayment capacity well beyond the USD 2.5 to 3 billion – the amount that we have to pay annually on account of debt servicing and return on equity for the CPEC projects. However, it must be once again reiterated that the realization of these benefits is not automatic and without concerted efforts on many fronts.

12. The focus of this article is therefore to outline the **policy reforms** and **institutional arrangements** that should enable Pakistan to **derive maximum benefits for the economy**, for **a large segment of the population**, and **minimize risks**. The proposed action plan should contain the following measures:

- As generation projects are completed and become fully operational, the Circular Debt quantum is likely to rise creating stress on public finances unless the **Transmission and Distribution losses** are **brought down** and electricity dues are fully recovered. This can only be done either by restructuring the DISCOs or privatizing them and introducing competition. Upfront tariffs and guaranteed Take or Pay and return on equity arrangements for generation plants should be replaced with auctions and multi buyers and multi seller competitive market model as soon as possible. Some of the existing contracts can be bought out. Consumers particularly industries would get relief from the existing high tariff structures.
- Western route connecting Gwadar to KKH should be given priority, as it would open up the backward districts of Balochistan and integrate the population with the national market for goods and exchange. Educational, health, drinking water, vocational training and credit facilities should be made available to the communities living along the Western Corridor to improve their economic and social conditions. Careful planning should be done so that the local population benefits in the form of employment, contractual services, rural roads and transport services, agriculture development in the districts where industrial zones are built. The proposed rail link connecting Gwadar to Jacobabad should also be taken up for implementation on a priority basis to increase the effective movement of inbound and outbound freight from the port reducing the cost of goods exchanged between Balochistan and the rest of the country.
- To facilitate effective Coordination between the Federal, Provincial and local government on one hand, and the private sector on the other hand, a highly empowered agency should be established to take timely decisions, review the progress and resolve implementation problems. The present system of obtaining clearances, NOCs by multiple agencies in a sequence is time consuming and costly and should be revamped.

- The present reported cost estimate of the cost per kilometer of the up-gradation of Main Railway line between Karachi to Peshawar appears quite high in relation to other similar double tracking projects. Including the complementary investments in locomotives and wagons the economic viability of this project may require future recurring subsidies from the state, Different design features should be applied to bring down the costs and make it feasible. Physical up gradation must be accompanied by building of capacity within the Railway organization to operate, manage and maintain the system in an efficient and commercially viable manner.
- As the labor costs in China are on a gradual incline, some of the labor intensive export industries are no longer competitive there. Joint ventures between the Chinese and Pakistani companies ought to be given preference for location in the industrial zones in which technical know-how, design, connection with the buyers in international markets and supply chain management functions would be carried out by the Chinese with Pakistani partners providing low cost fabrication facilities.
- An autonomous governing board and fully empowered but accountable management should run the affairs of the Special Economic Zones (SEZs) where all the infrastructure, utilities, land acquisition and development and facilities are established before handing over the possession to the industrial units. In case the sponsors are unable to complete the project within the stipulated time, the allotment of land should be cancelled and no secondary sales allowed to curb land speculation. Once these bodies are functioning, and the Zones become operational, the role of Provincial Economic Zones Companies should not extend to these nine zones.
- The guidelines for investment in the Special Economic Zones should be widely disseminated. The principle of level playing field to every investor whether Chinese, Pakistani or foreigner should be strictly adhered to. All concessions, tax exemptions, subsidies preferences, Credit etc. should be made available to all the

investors in a transparent manner. Regular consultations with the private sector in the planning of the zones should be held to keep them apprised but also seek their feedback and views as they are going to play a critical role in populating these zones., Board of Investment should take active measures to attract non-Chinese foreign private investment in these zones as well in addition to Pakistani and Chinese.

- Preference should be given to (a) local residents in employment contracts, and service provision in the SEZs, (b) industries that are export oriented, (c) employ 80% of the Pakistani workers – skilled, semi-skilled and unskilled, and (d) those sub-contracting with the small and medium industries, and using local raw materials such as Horticulture, Livestock, Fisheries, mineral resources . Various types of clusters should be set up in these SEZs. Domestically manufactured goods should be brought at par with the Chinese manufactures, in the treatment of taxes. Dumping of Chinese goods at prices lower than the international benchmarks should not be allowed.
- Attention should be paid to job creation, skill up-gradation and professional training of Pakistanis working with the Chinese on these projects. One of the competitive advantages of the Chinese companies is to complete the projects on time and deploy cutting edge technologies. The training of Pakistani engineers working on CPEC projects in China along with the accompanying transfer of knowledge and project management would enhance the highly skilled manpower inventory of Pakistan and prove a major boon to Pakistan economy in the long run and must remain on the top of our agenda.
- Backward and forward linkages of CPEC projects to the Pakistani economy should be appraised systemically and materialized. Cement, Steel, Automobile, Cable and electrical goods, and Trucking industries are likely to benefit largely from these linkages. Complete information about the timing, phasing and quantum should be made available so that Pakistani businesses can prepare themselves for supplying goods and services required for all the CPEC projects—ongoing or

future Additional demand estimates should be firmed up for the entire portfolio and disseminated widely.

- There is no room for complacency about Gwadar's future as a deep sea port and hub in view of intense competition from Salalah, Jebel Ali, Bandar Abbas and Charbahar. Commercial promotion and presentations about this new port's benefits to the businesses such as a vast hinterland should remain a continuous activity. To attract talent, the living conditions and habitat in Gwadar should be upgraded. Gwadar's development as an urban center, particularly in providing potable drinking water supply, electricity and roads should not lose sight of the requirements of the population of the district, and the adjoining areas in Makran division. Local population of the district and adjoining areas should be trained, employed and given all possible opportunities to fully participate in Gwadar's development. Potable drinking water remains a serious problem for the residents of Gwadar and expeditious arrangements should be made to meet this pressing need. Fisheries Industry in Gwadar which provides sustenance and livelihoods to a large section of population should be taken up for modernization.
- Pakistani businesses should be made aware of the working mode and practices of the Chinese companies. At the same time, the Board of Investment BOI of the Federal and provincial governments must play a proactive role in identifying opportunities for joint ventures, sub-contracting, and supply chain participation for Pakistani businesses. Facilitation Centers should be established in each SEZ.
- Environmental Protection and Green Technologies should be prime considerations in the selection of the projects in the SEZs. Coal-based energy projects should remain limited to the Thar area where coal deposits are plentiful, but imported coal based energy projects out to be disallowed. Renewables such as Hydropower, Wind and Solar offer much better return on investment, have lower tariffs, and are also clean. New investment must be allowed only in these sub-sectors, saving foreign exchange on import of fossil fuels. Industrial effluent plants must be made an integral part of the infrastructure facilities of each Zone.

- Business schools should organize collaborative short term Executive Development programs in which both the Chinese and Pakistani businesses can interact with each other.