POLICY BRIEF

Global insights with national implications: AidData's policy engagements on the China-Pakistan Economic Corridor

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March 22nd, 2022

Summary

The China-Pakistan Economic Corridor (CPEC) blurs the line between public and private debt, using loans and export credits from China to build public-private infrastructure projects, especially roads and power plants, that are intended to kickstart private industry, open market access in special economic zones, and catalyze export-led growth.

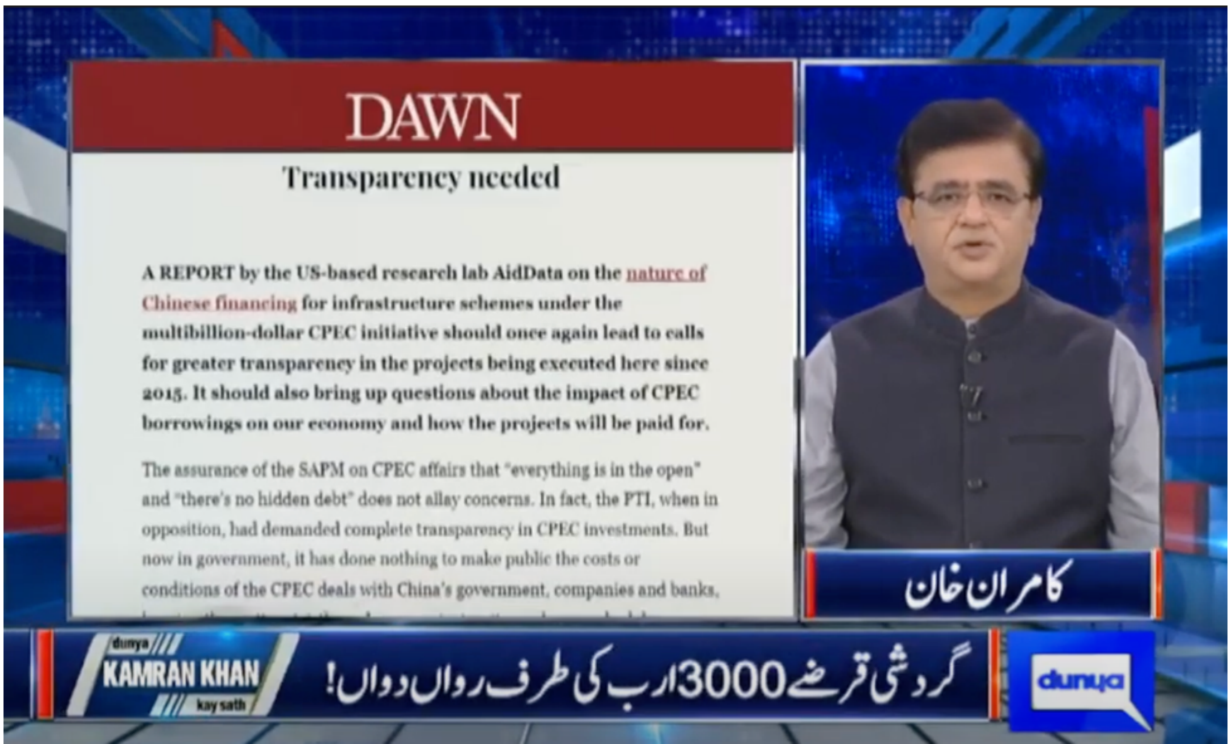
Although Chinese financing has helped Pakistan improve its national highway system and overcome crippling blackouts, the jury is still out on whether the CPEC will be considered a long-run success for the country's economic transformation. Loan repayments on a nearly $20-billion energy portfolio—and Pakistani government-guaranteed dollarized returns on equity to Chinese and local investors (worth 17% and 34%)—could create major public financial management challenges, particularly as the country faces increasing political uncertainty this year and beyond. Every devaluation of the Pakistani Rupee against the US Dollar, such as the nearly 40% drop since August 2018, results in a ballooning of the country's repayment obligations.

As of February 2022, the Pakistani government has enlisted over a dozen Chinese companies interested in major multi-billion-dollar investments in Pakistan's special economic zones (SEZs). Moving forward, this will require local knowledge spillovers into empowered and well-resourced local institutions. To make good on these "spatial bets," Pakistani planners need to create a clear vision, empower local governments, and pay more attention to the overall business climate.

Background: The local implication of global insights

On September 29, 2021, AidData released a landmark report, *[Banking on the Belt and Road](#)*, that carefully documents the full extent of China's overseas development finance program. Among its most striking findings was that 42 low- and middle-income countries (LMICs) have public debt exposure to Chinese state-owned lenders worth at least 10% of their GDP. The report also revealed that many LMIC governments are underreporting their Chinese debts to multilateral institutions, such as the World Bank.. AidData estimated that the average LMIC government is underreporting its repayment obligations to China by an amount that is equivalent to 5.8% of its GDP. Altogether, these underreported debts are worth approximately $385 billion.

In Pakistan, a hard-hitting editorial by leading English daily *Dawn* titled "Transparency needed" raised alarm over the government's refusal "to make public the costs or conditions of the CPEC deals." The newspaper deplored the fact that Pakistanis "get information on Chinese investments from foreign sources [AidData] rather than their own government."



On October 1, 2021, leading Pakistani journalist Kamran Khan of Dunya News featured AidData research on his primetime news program "Dunya Kamran Khan Kay Saath." Source: https://tinyurl.com/y9ww46s7

Fueled by the fresh evidence produced by AidData, leading news anchors (here, here, and here) questioned why Chinese companies were awarded all CPEC contracts without competitive bidding; how project financing structures had blurred the lines between public and private debt; and whether debts from energy projects, with guaranteed dollarized returns and a devaluing local currency, were on a sustainable trajectory. They also lamented the current administration's decision not to publish CPEC loan contracts, despite having a history of being severely critical of the previous administration for doing the same.

Sensitive to negative press coverage on CPEC, within days of AidData's report the Ministers responsible for Planning and Development and CPEC Affairs responded with a press conference broadcast live and several national television appearances (here and here). While acknowledging that Pakistan's debt-to-GDP ratio was reaching unsustainable levels, the Minister of Planning proclaimed that "we do not have a China debt problem." Criticizing the local media for reporting on public policy issues "without due verification and understanding," he claimed that CPEC projects were operating under "parliamentary oversight" and that there are no secrets in Pakistan's dealings with Chinese state-owned financiers and contractors.

CPEC theory of change: Public infrastructure, private investment, prosperity

There is near universal agreement in Islamabad that, following the U.S. withdrawal from Afghanistan, Pakistan's geoeconomic fate is highly dependent on China. Given that CPEC is the BRI's largest and earliest flagship undertaking, the stakes are incredibly high for both sides to make every possible effort to implement their shared vision. But some observers are calling for a more balanced approach, in which Western countries would supplement Chinese hardware financing by continuing to build human capital—for example, through initiatives like the Fulbright scholarship program for graduate studies.

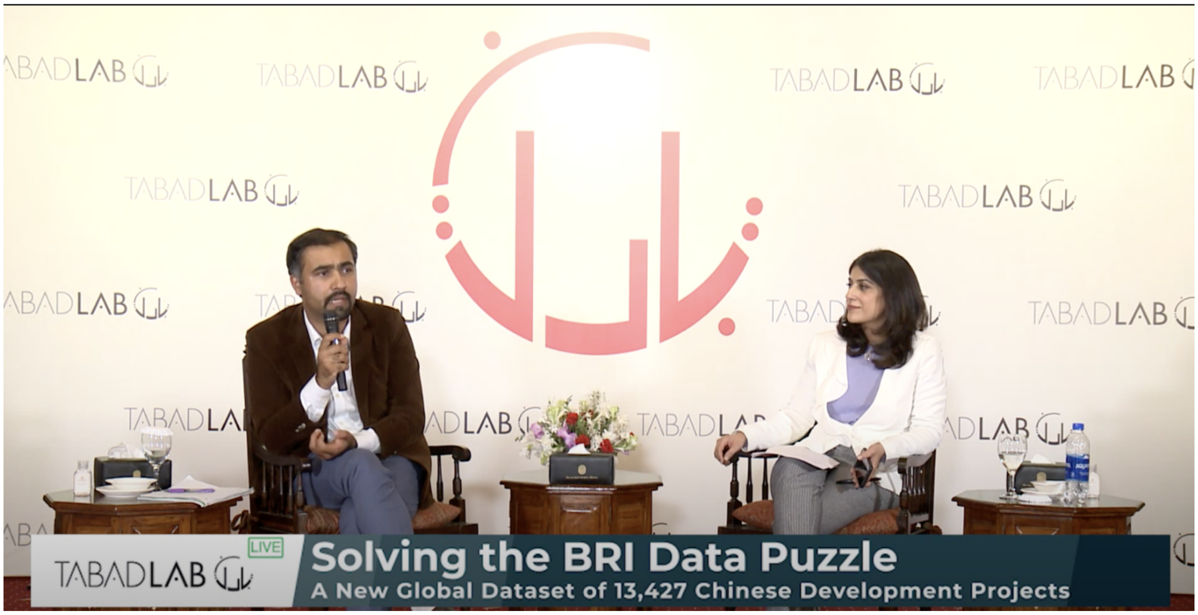
After years of crippling power outages (8-15 hours per day) that darkened bustling cities and dampened economic activity, there is a palpable sense that Chinese financing for the construction of power plants has resolved Pakistan's power crisis. Similarly, Chinese-financed improvements in the quality and coverage of the national highway system have reduced driving times between major markets, increased connectivity to hinterland regions, reduced the likelihood of dangerous car accidents, and reduced upcountry freight costs from the southern seaport of Karachi.

Author's illustration of the CPEC theory of change, based on the jointly released Long Term Plan for China-Pakistan Economic Corridor (2017-2030) and elaboration during meetings with key stakeholders. Source: https://www.pc.gov.pk/uploads/cpec/LTP.pdf

CPEC's theory of change—as elaborated in the official "long term plan"—was a simple three-step framework to transform the country's long-term economic trajectory. At the same time, its implementation has faced challenges, including project implementation delays, terrorist attacks, and public health restrictions during the Covid-19 pandemic. There are also serious structural problems in crucial markets like energy, where the government's power purchasing monopoly has created large line losses (electricity lost during its transmission and distribution across the grid) and mismanagement has resulted in payment delays to Chinese and other independent power producers.

1. **Phase I, Public Infrastructure:** Resolving Pakistan's crippling infrastructure shortcomings, particularly energy shortages and poor ground transportation connectivity, are first-order problems that will help lay the foundation for economic growth.

2. **Phase II, Private Industrialization:** Having improved market access through Phase I, through a network of 19 SEZs scattered throughout the country, Pakistan will become a preferred destination for Chinese industries looking to relocate abroad to counteract rising labor costs at home. This would be accelerated by the government's timely and efficient provisioning of "plug and play" facilities for firms investing in the SEZs including cheap land parcels, utilities like gas and electricity, and "one-stop-shop" registration services for greater ease of doing business.
3. **Phase III, Societal Prosperity:** Once a plethora of Chinese industries set up major manufacturing facilities in Pakistan, making use of cheaper market access to major markets in the Middle East, Europe and the Americas, the country's export competitiveness will improve dramatically, leading to large-scale job creation and consequently, widely shared prosperity among the Pakistani people.



On November 8, 2021, Dr. Ammar A. Malik, senior research scientist at AidData, was hosted by Islamabad-based think tank Tabadlab for a policy dialogue. The event was attended by senators, Western diplomats, and senior Pakistani government officials from the Ministries of Planning, Foreign Affairs and Energy, all interested in discussing findings from AidData's latest publication. Source: https://tinyurl.com/ya8ob6qy

However, several challenges have dampened enthusiasm, particularly on the Chinese side. First, China has expressed concern about Pakistan's sluggish efforts to identify and ready the SEZs, which have led to a two-year delay in transitioning from Phase I to II. Second, given a spate of terrorist attacks in summer 2021 targeting Chinese nationals working on CPEC, including a suicide bombing that killed nine Chinese workers near the project site for the Diamer Bhasha hydropower plant, the security situation has deteriorated. Consider, for example, the long delay in reaching agreement on the $6.8 billion Mainline-1 railway project, which would be the single largest transport infrastructure project in the country's history. This 1,733-km railway line from Karachi to Peshawar was originally conceived as part of Phase I of CPEC, but negotiations with Chinese lenders stalled in part because Beijing's state-owned insurance provider (Sinosure) has not agreed to underwrite the project.

Loan repayments on a nearly $20-billion energy portfolio—and Pakistani government-guaranteed dollarized returns on equity to Chinese and local investors (worth 17% and 34%)—could cause serious public financial management challenges. The government is the sole purchaser (in US dollars) from power producers and the sole reseller (in Pakistani rupees) to consumers of electricity in Pakistan. Thus, every devaluation of the local currency, such as the nearly 40% fall since August 2018, results in a ballooning of the country's repayment obligations. In an economic environment where real per capita incomes are falling and the government faces reelection next year, increasing power tariffs to offset these effects is simply not a viable political option. While this is not necessarily a CPEC-induced problem, it is certainly one that threatens the viability of future foreign investments in the energy sector and could derail progress on CPEC itself.

CPEC Phase II: Cautionary notes from international experiences

Following Prime Minister Imran Khan's recently concluded visit to Beijing, where he held a series of meetings with China's political and business leadership, the Pakistani authorities have claimed that continued interest among Chinese firms in making large-scale investments in Pakistan's SEZs signals the arrival of CPEC's second phase. While no investment agreements were signed in Beijing, the government has enlisted the support of more than a dozen Chinese companies interested in major multi-billion-dollar investments in Pakistan's SEZs.

To make a strong business case for Chinese companies to invest in Pakistan, the CPEC Authority presented a "pitchbook" to Chinese political and business leaders for the first time. While not available in the public realm, it reportedly highlights Pakistan's geostrategic location; low freight and labor costs; youthful population; tax exemptions, including duty-free machinery importsy; and the existence of a facilitation center at CPEC Authority charged with troubleshooting administrative bottlenecks for investors. Based on sector-specific and regional competitive analysis, it identified seven priority sectors—textile, pharmaceutical, automotive, information technology, footwear, furniture, and agriculture—where it offers advantages that could benefit Chinese investors.

But beyond providing land and utilities, kickstarting SEZs requires carefully identifying the unique policy complementarities that each site requires, such as combining hardware like highways with software like workforce development. At their heart, SEZs are "spatial bets" made by the Pakistani government on a given site's ability to deliver a return on public investment. The desired economic transformation, in the form of economic productivity enhancements, is facilitated by greater FDI inflows, but it ultimately requires local knowledge spillovers into strong local institutions. Given that only two out of nine SEZs under CPEC are in proximity to major cities or existing industrial clusters, Pakistan is prioritizing lagging regions where infrastructure provision is arguably more expensive.

In the case of the Rashakai Special Economic Zone in Khyber Pakhtunkhwa for example, 56% of the province's urban population in theory lives within commuting distance to upcoming industries, but enabling the movement of workers from homes to workplaces will require transportation infrastructure investments well-coordinated across multiple jurisdictions within the province and beyond.

The agglomeration of economic activities, particularly in specialized industrial clusters, accelerates knowledge spillovers by helping to integrate local small- and medium-sized enterprises (SMEs) into global supply-chains. When firms collocate in areas with intense economic interactions, they experience sizable reductions in the costs of hiring and retaining workers, particularly those with specialized skill sets. On the government side, closely following the SEZ playbook could lead to prioritization for centralized, one-size-fits-all policies, regardless of that site's unique natural endowments. This is where the presence of empowered and well-resourced local institutions, holding capacity to understand their needs and deliver solutions at the local level, becomes incredibly useful. My analysis of international experiences with SEZs offers several takeaways for governments aiming to launch their own.

1. **Create a clear vision:** Articulate each SEZ's unique competitive advantage, fully communicate a vision for its future, and coordinate action plans across all levels of government. Governments must explain why a location has been selected, what enabling measures will make it competitive, what success will look like, and which agencies are responsible for implementing which part of the SEZ action plan.
2. **Empower local governments:** Local authorities in SEZ catchment districts, even if they fall outside the official SEZ boundaries, must be preemptively empowered to generate their own revenues. They should be allowed to build new capacity to deliver public services and provide high quality public amenities to newly relocating workers and firms.
3. **Do not underestimate business climate factors:** Firms respond more positively to sites offering affordable and accessible connectivity than to tax incentives, which are temporary and carry a high public cost to administer. Firms also favor digitization and minimizing the time, cost, and procedural complexity of business registration.

The jury is still out on whether the SEZs identified under CPEC will be successful in the absence of large-scale government subsidization and improved multilevel governance. However, AidData will continue to monitor the situation on the ground. In the coming months, several of our teams working on China's growing global influence in the region are also planning to organize policy research engagements in Pakistan.