



**CHINA PAK ECONOMIC CORRIDOR (CPEC)  
IS PAKISTAN READY TO SURF THE TIDE?**

**INFONALYSIS**

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*The gateway to economic prosperity...*

## Executive Summary

The China Pakistan Economic Corridor (CPEC) is envisioned to expedite regional economic integration and transform Pakistan into a Central and South Asian economic hub. It offers Pakistan with a once in a life time opportunity to make itself count amongst developed nations of the world. It is being viewed as a transcontinental project linking more than 64 countries, the reason why CARs, Afghanistan, Turkey, Saudi Arabia, Iran and reportedly UK and France are vying to become a part of the project.

Costing over \$ 54Bn, CPEC encompasses a ~3,000km long road corridor from Gwadar in Pakistan to Kashgar in China and a host of energy and infrastructure projects. CPEC strives to eliminate Pakistan's power shortages plaguing its economy for the past many years, develop Gwadar as a port of international standard and importance, upgrade Pakistan's industrial and human resource base, and reduce travel time and costs to its ports in the south.

From China's perspective, CPEC is a strategic part of its ambitious One Belt, One Road (OBOR) project that attempts to provide regional connectivity facilitating potential trade with 4.4Bn people through a network of roads. It is expected to save \$ 2Bn annually on its oil supplies from the gulf countries while for non-oil trade, CPEC would be providing a cost saving trade route from China's western and central regions to its export markets in the Middle East and North Africa (MENA).

Of primary importance in the CPEC plan is China's Xinjiang province in Pakistan's immediate neighborhood. Xinjiang is China's top cotton growing area, producing ~60% of China's cotton production. Previously under-developed, the province is undergoing rapid industrialization under China's plan of developing it into a major textile exporting hub. It is putting in \$ 27Bn investment in Xinjiang's transport infrastructure for better regional connectivity in 2017 alone, while a \$2.8Bn fund is being utilized for investment in standard garment factory constructions. By 2020, Xinjiang is expected to produce about 500Mn garments annually.

Here is where CPEC becomes an important strategic proposition for China; it provides a cost and time effective route for its heavy textile exports from Xinjiang to markets in the MENA region. But how does it bode for Pakistan? Pakistan's exports are already facing a decline in the global markets owing to a host of factors, two of which are high production costs and lack of govt. incentives in the sector. Although a \$1.7Bn textile package has recently been announced by the govt., it is no match with the incentives provided to textile exporters in Xinjiang. Augment this with China's high production technology and levels of value addition, and it becomes evident that Pakistan would simply not be able to compete with its Chinese counterparts in competitive markets.

It is therefore inevitable for Pakistan to not only improve on the competitiveness and breadth of textile production but also diversify its exports in other sectors even if it is to sustain the current levels of exports. Capitalizing on the humungous opportunity presented by CPEC entails a marked improvement in national production capability and business environment. Infrastructural

improvement will encourage greenfield industrial setups, but it is the focus on high tech and value additive industries that will provide the real platform for competitive trade in the global economy.

Pakistani markets are already awash with hordes of low cost Chinese products; items produced in Pakistan as well, but at higher costs. Add to this the decades long smuggling and dumping problem which Pakistan has been facing due to Pak-Afghan transit trade and the likelihood increases that Pakistan would be experiencing a similar influx of goods under China's transit trade, and that the Pakistan market would be made a dumping ground for Chinese products, effectively kicking local Pakistan producers further out of competition.

Further to this, the government's unabated efforts to raise tax revenues by imposing further taxes and doing away with exemptions wherever possible has further squeezed manufacturers' capacity to face the intense global competition not only in the export market but even in their home ground.

China has times and again proved to be a better negotiator of the terms its agreements with Pakistan, as observed in the case of the FTA put in place in FY07. Since then, trade deficit with China has continued to widen further year after year. Under CPEC, Pakistan faces yet higher risk of broadening its trade deficit with China, unless new investments in manufacturing increase levels of domestic productivity.

Proposed joint ventures with the Chinese in Special Economic Zones (SEZ) under the CPEC umbrella bode well for domestic industrialization, yet such incentivized investments pose threat of crowding out the already struggling mainstream export industry.

Financing structures for CPEC differ on the basis of sectors and projects. Almost all of the power projects have debt to equity ratio of 80:20, which signifies that the inflows into the country represent debt financing rather than equity investments. The markup on debt and return on equity would not only imply a higher electricity rate for the next many years, but profit and principal repayments in dollars - expected to jack up after 2021- would inevitably be putting incessant pressure on the PKR and forex reserves in the years to come.

Power projects having total capacity of 10,400 MW are expected to be completed by 2018. Pakistan currently faces a shortfall of 5,000MW, implying surplus power generation of 5,400 MW from 2018. While this may not seem bad at the moment, it is the long term electricity purchase contracts which are problematic. Sovereign guarantees have reportedly been issued to power sector investors for electricity purchase meaning that end-consumers will have to pay for the excess electricity whether it is utilized or not. However, not all is lost and we may still have time to negotiate some of our power purchase agreements to allow enough incentives for rapid commercial operation commencement, yet provide cost compatibility with our regional competitors.

All being said, CPEC has already seen the first trade convoy from China dispatching goods via Gwadar port to onward destinations in Sri Lanka and the MENA region. Important questions that arise here are how much Pakistan would gain in terms of transit fee from the project and who is to bear the

security cost of the project? Whether it will be made part of the CPEC account, or the tax payer is to eventually bear it? Here Pakistan's foremost priority should be to smartly negotiate and exploit CPEC to achieve maximum economic strategic depth for Pakistan, and to make all transactions transparent to the hilt. Transit fee with China and all partnering countries needs to be prudently negotiated as such a fee would be a major earning source for paying off CPEC related debt and other associated costs.

Long term continuity of CPEC-related policies is essential to the success of the project keeping in view the fact that only a year remains in the next general elections. Pakistan's Chambers of Commerce provide the ideal platform for stakeholder participation as regards industrial development in SEZs and hence should be included in core decision making.

The emerging shift in regional trade patterns in the wake of CPEC and other corridors has made it critical for Pakistan to promote and protect its own industries. Chinese investments in Pakistan, while boosting its economy will also be fuelling dependency on China in all respects. It remains to be seen how Pakistan utilizes China's propositions and its growth story for its own advantage while maintaining diversity in its relationships with other world powers.

CPEC is widely being publicized as a game changer in the region; Pakistan can only be successful if it remains an active part of this game.

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## CPEC: Is Pakistan ready to surf the tide?

The China Pakistan Economic Corridor (CPEC) project has become the talk of town and is widely being touted as a major game changer for Pakistan. Hopes are high for the multi-dimensional project as under it almost all quarters are expecting wide ranging economic benefits for the country and the region. The project anticipates high levels of job creation, fresh investment inflows and increased tax collections, thus resolving to a large extent the major economic issues Pakistan currently faces. CPEC is expected to serve as a catalyst for the development of sectors such as cement, steel, retail, tourism, transport, hospitality and expansion of these industries could have significant positive impact on various downstream sectors with multiple benefits accruing to the larger population. The initial sections of this report cast a glance on what CPEC offers as a package of projects and what value it stores for both Pakistan and China. The later sections delve briefly upon the challenges faced by Pakistan during and in the aftermath of the project and the final part recommends the required course of action to be taken by Pakistan.

### What does CPEC offer?

CPEC is envisaged to form a conduit between China, South Asia and Central Asia, home to nearly half of the globe's population!!

CPEC is an over \$ 54Bn project encompassing a ~3,000km long road corridor from Gwadar in Pakistan to Kashgar in China and a host of energy and infrastructure projects. From a bird's eye view, CPEC is envisaged to form a conduit between China, South Asia and Central Asia, home to nearly half of the globe's population!! It is envisioned to expedite regional economic integration and in the process transform Pakistan into a Central and South Asian economic hub.

Amounting to about 19% of the national GDP, the whole corridor is expected to create some 2Mn direct and indirect jobs during the period 2016 – 2030.

About 64 projects are planned in the energy, transport and infrastructure sectors. Of these, 30 projects including power stations, highways and projects related to Gwadar Port have been classified as “early harvest” or short term projects, and are at various stages of completion (*See Annexure for complete list*). Early harvest energy projects, based on coal, solar and wind sources are to be completed by 2018. Likewise, medium-term projects are to be completed by 2025, while the long-term projects would be completed by 2030. Amounting to about 19% of the national GDP, the whole corridor is expected to create some 2Mn direct and indirect jobs during the period 2016 – 2030.

#### Road and Rail Projects under CPEC

The CPEC route starts from Xinjiang province in China and enters Pakistan from Khunjareb in Gilgit Baltistan, moving onwards through Abbotabad, and

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Haripur in KPK and Hasanabdal and Burhan in Punjab. It connects to Islamabad – Peshawar Motorway from where there are three main routes to reach Gwadar i.e. the Western, Central and Eastern Routes.

As part of infrastructure projects worth ~\$ 11Bn a 1,100km motorway is to be built between Karachi and Lahore; however, only the Sukkur-Multan section of the road is part of CPEC.

- **Western Route:** (2,674 km) starts from Attock in Punjab, runs through Dera Ismail Khan in KPK then enters Baluchistan passing through Zhob, Qila Saif Ullah and Quetta. The route reaches Gwadar going through Sorab and Panjgur.
- **Central Route:** (2,756 km) passes through Dera Ismail Khan and reaches Gwadar via passing through Bhakkar, Muzaffargarh, Layyah, Rajanpur, Sukkur and Khuzdar.
- **Eastern Route:** (2,781 km) consists of M2 (Lahore – Islamabad Motorway), M3 (Lahore – Faisalabad Motorway), M5 (Lahore – Karachi Motorway) passing through cities of Lahore, Multan, Sukkur, Hyderabad, Karachi. Makran Coastal Highway connects Karachi and Gwadar Port in Pakistan.

About 62% of the CPEC investment will be allocated to energy projects as 23 projects on energy costing \$ 33.7Bn aim to increase power production by 16,700 MW in the country.

As part of infrastructure projects worth ~\$ 11Bn a 1,100km motorway is to be built between Karachi and Lahore; however, only the Sukkur-Multan section of the road is part of CPEC. The Karachi-Hyderabad section (M9) is to be built by a third party on BOT (Build-Operate-Transfer) basis while other portions are to be built either through BOT or PSDP funding. The Karachi – Peshawar main railway line will also be upgraded to allow for speeds up to 160Km/hour.

### Energy Projects under CPEC

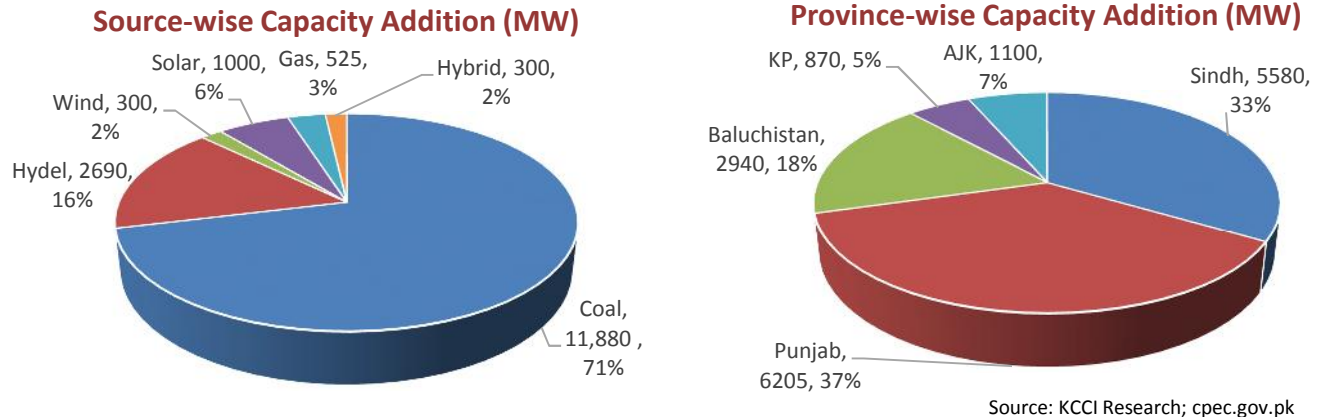
About 62% of the CPEC investment will be allocated to energy projects as 23 projects costing \$ 33.7Bn aim to increase power production by 16,695 MW in the country. Of these, 15 priority projects costing \$ 21.6Bn will be able to provide up to 10,350 MW of electricity by mid-2018, while 8 projects costing \$ 12Bn will jack power production capacity by 6,345MW at a later stage. The projects would provide a reliable growth platform for domestic economic activities and exports by mitigating Pakistan's long standing electricity problem estimated to be have been costing the nation 7% of its GDP annually.

At Gwadar, container, bulk and dirty cargo storage areas are under construction in addition to RLNG terminals.

### Development of Gwadar Port and City

Being an integral part of CPEC, the deep-sea port at Gwadar is being constructed at a fast pace. Three berths having the capacity to host large vessels are already operational while container, bulk and dirty cargo storage, and RLNG terminals are also under construction; as is the Gwadar airport, Gwadar city and Gwadar Free Zone.

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### Karachi / Sindh Projects under CPEC

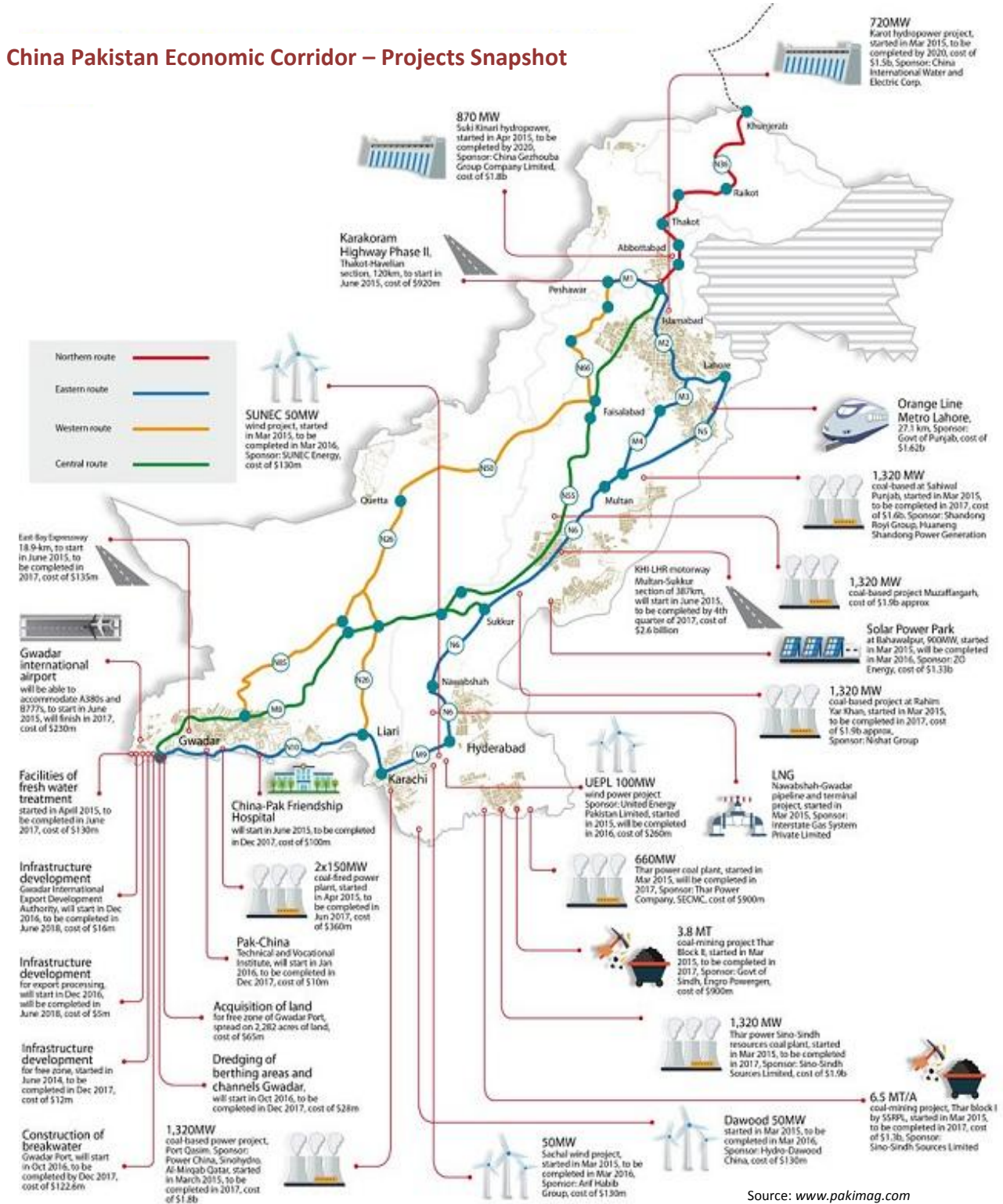
Karachi and Sindh based projects that have specifically been incorporated in CPEC include:

- The long pending Karachi Circular Railway project: the \$ 2.5Bn project was initially supposed to be developed with support from Japan International Cooperation Agency (JICA); now becomes part of CPEC.
- Development of a port at Keti Bandar near Thatta in Sindh: the port, while providing a platform for future exports, also serves as an ideal location for setting up the 10,000MW Thar Coal based Power Park.
- Development of Dhabeji Special Economic Zone (SEZ), located 55Km near Karachi: the Sindh govt. had initially finalized 3 SEZs - Khairpur, Bin Qasim and Korangi to be put with the CPEC ambit, but only Dhabeji was able to get the final nod.
- Development of Industrial Park on Pakistan Steel Mills Land at Port Qasim near Karachi.

Karachi and Sindh based projects that have been incorporated in CPEC include Karachi Circular Railway, Development of Keti Bandar, Dhabeji SEZ, and Industrial Park at Port Qasim.



China Pakistan Economic Corridor – Projects Snapshot



Source: www.pakimag.com

CPEC, if sensibly utilized, provides Pakistan with an exceptional opportunity to make itself count as a developed nation.

Power shortages plaguing the economy for the past many years are to be eliminated resulting in high productivity and reduced production costs.

Better connectivity would also allow Pakistan to offer its perishable good quality agricultural products in the global markets, which hitherto were not being exported due to high air-freight costs.

### CPEC to bolster Pakistan's economic potential manifolds

CPEC has high potential to jump start Pakistan's economy and leap-frog it many places in front of its competitors. In fact, if sensibly utilized, it provides Pakistan with an exceptional opportunity to make itself count as a developed nation.

We look at a number of ways how CPEC is to favorably affect Pakistan:

- Power shortages plaguing the economy for the past many years are to be eliminated resulting in high productivity and reduced production costs. The 7% estimated GDP loss attributed to power outages would now be catered to.
- Travel time and costs of exportable goods from up-country to ports will be greatly reduced. Current transportation structure amplifies already high cost of production, thus contributing to the uncompetitiveness of Pakistani goods abroad.
- Better connectivity would also allow Pakistan to offer its perishable good quality agricultural products in the global markets, hitherto not being exported due to high air-freight costs.
- The huge trade volume to be generated through CPEC would significantly add to diverse economic activities, including clearing, shipping services and other allied services.
- Direct job creation in almost all sectors of the economy, including transport, construction and power. Construction of SEZs and manufacturing setups therein would ignite secondary and tertiary rounds of employment generation.
- Cargo movement on roads trigger lots of economic activity through vehicle maintenance shops and road-side restaurants, estimated to be PKR 50Bn annually.
- CPEC would allow small scale production to be outsourced to suppliers having access to cheap labor in remote areas.

## CPEC: Is Pakistan ready to surf the tide?

Shanghai Electric's buying of K-Electric for a record \$ 1.67Bn has made headlines across the investment world and global companies in diverse sectors are fast choosing Pakistan as an investment destination.

CPEC is a strategic part of China's ambitious One Belt, One Road (OBOR) project that attempts to connect it with 60 countries facilitating potential trade with 4.4Bn people through a network of roads.

OBOR has the potential of boosting China's GDP by an estimated 25% as these economic corridors facilitate business and distribution networks linked with production clusters and economic zones.

- CPEC will immensely help the country's real estate sector running along the trade corridor.
- CPEC will bring better trade integration with China.
- CPEC will link Pakistan to the One-Belt-One-Road (OBOR) project and provide direct access to the markets of Central Asia and Europe.
- About 97% of the \$ 10Bn Pak- China trade occurs through the sea route. Trade through CPEC would undoubtedly lead to a shift towards road transportation and a substantial increase in bilateral trade.
- CPEC is garnering attention of many a foreign firms in the country. Shanghai Electric's buying of K-Electric for a record \$ 1.67Bn has made headlines across the investment world and global companies in diverse sectors from Automotive (Renault, KIA, Hyundai), Cement (Anhui Conch of China, Asian Precious Minerals of UK), Dairy (Friesland Campina buying Engro Foods) to Electronics (Turkey's Arcellic \$ 258Mn buyout of Dawlance) are fast choosing Pakistan as an investment destination.

### What does CPEC have for China?

CPEC is a strategic part of China's ambitious One Belt, One Road (OBOR) project that attempts to connect it with more than 60 countries (including Eurasian economies) facilitating potential trade with 4.4Bn people through a network of roads.

#### One Belt, One Road – OBOR Initiative

OBOR involves investment of \$ 900Bn in huge infrastructure projects designed to facilitate China's trade through developing six corridors under two roads:

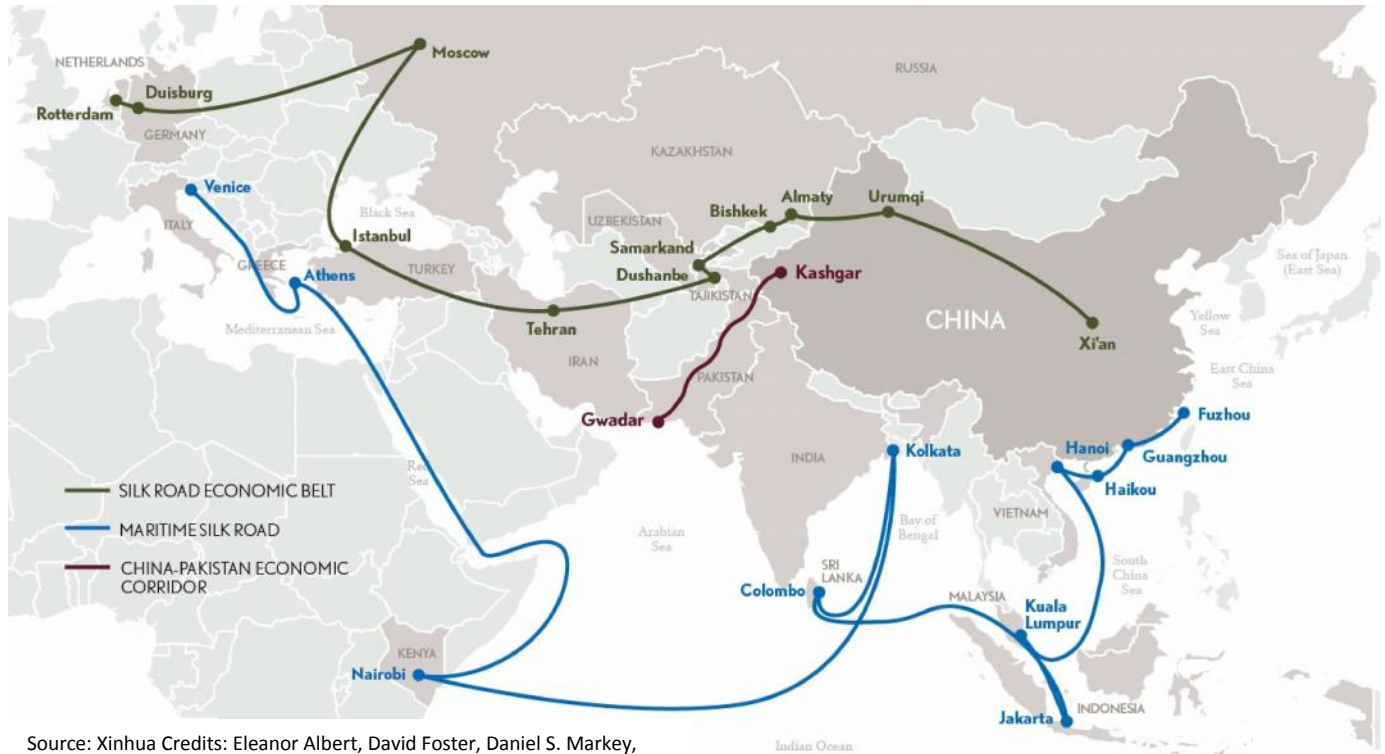
- The New Silk Road Economic Belt running west toward Europe through Russia and Central Asia, and
- The 21<sup>st</sup> Century Maritime Road to Europe through ports in South Asia and Southwest Africa.

Other corridors planned by China aim to connect China to the Middle East, giving direct access to the energy-rich Persian Gulf markets. OBOR has the potential of boosting China's GDP by an estimated 25% as these economic

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corridors facilitate business and distribution networks linked with production clusters and economic zones.

### China's Proposed New Silk Roads



### Reduction of time and cost in oil supplies

In case of oil supplies, China is expected to be saving an estimated \$ 2Bn annually through CPEC as 60-80% of its oil supplies come from Gulf countries that are in close proximity to Gwadar, through the Strait of Malacca to Shanghai, taking more than 25 days and a minimum of 11,000km to reach Shanghai port in the east. With Gwadar becoming operational, the distance would reduce to less than 5,000 km where it will serve as a strategic gateway for Middle Eastern oil shipments to be transported overland to Kashgar via CPEC's planned oil pipelines and onwards to Shanghai.

### An attempt to push towards the western regions

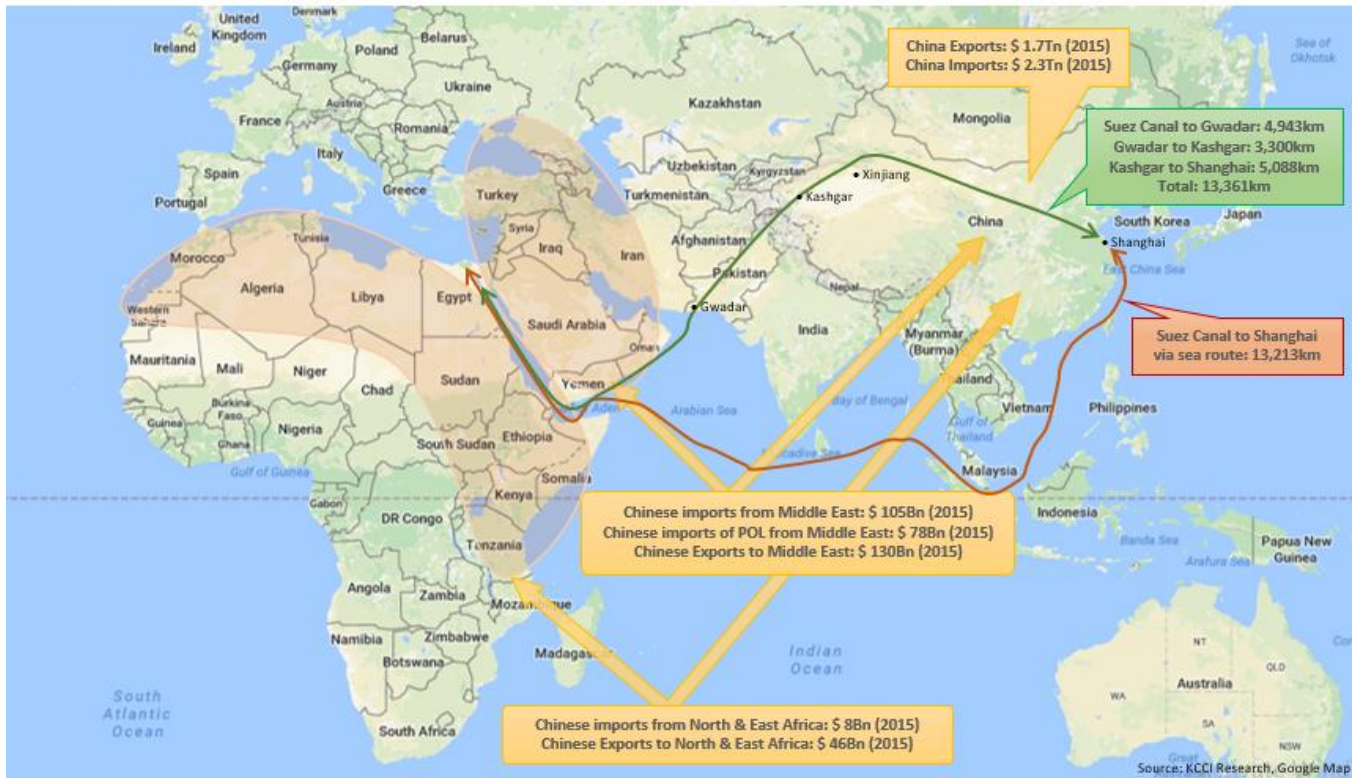
A close analysis of the distance map from the Middle East and North Africa (MENA) to different parts of China reveals that in case of non-oil trade, CPEC would add little benefit to the eastern side of China, yet it would provide an important access route particularly to China's western and central regions.

China is expected to be saving an estimated \$ 2Bn annually through CPEC as 60-80% of its oil supplies come from Gulf countries.

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The distance from the Suez Canal to Shanghai is almost the same (~ 13,000km) whether the CPEC route is utilized or not. However, if we focus on the western and central regions of China, the distance for shipment of goods to MENA via CPEC is greatly reduced by ~ 10,000km!! (18,449Km from Suez to Kashgar via Shanghai, as compared to 8,243Km direct distance from Suez to Kashgar via CPEC)

**China Trade with Middle East, North and East Africa and Distance Map**



The analysis becomes more interesting if China's population distribution is also taken into account. The Aihui–Tengchong Line on the map below shows that 94% of China's population (~1,302Mn in 2015) occupies only 43% of the area towards the eastern side while 6% population (~83Mn) occupies 57% of the area, mostly in the west.

94% of China's population occupies only 43% of the area towards the eastern side while 6% population occupies 57% of the area, mostly in the west.

Of primary importance in the CPEC equation is the Xinjiang province in the North West; it has a population of only 22Mn spread over 1.67Mn km<sup>2</sup> while by comparison, Pakistan has population of ~195Mn in 0.76Mn km<sup>2</sup>. Xinjiang, the largest of China's regions and provinces, borders Russia, Mongolia, Kyrgyzstan, Pakistan, Tajikistan, Afghanistan, and Kazakhstan, and has 45% of its population as Muslim ethnic Uyghurs. Xinjiang's is rich in petroleum and

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natural gas while its heavy industries include iron and steel works and a cement factory at Ürümqi.

### Map of provinces and population distribution in China



### Enhanced market access to Xinjiang's forthcoming textile base

What is significant from Pakistan's perspective is that China is fast developing Xinjiang into a major textile exporting hub. Xinjiang is China's top cotton growing area, producing between 3 to 4 Mn tons (~60%) of China's ~7Mn tons of cotton. Rapid industrialization is taking place in the province, and in 2017 China is to spend a huge amount of 183Bn Yuan (~ \$ 27Bn) on its transport infrastructure alone.

A fund of 20Bn Yuan (~ \$ 3Bn) has been created through which the govt. is investing and encouraging private capital investment in standard garment factory constructions. Factories are to have minimum capacity of 50,000 spindles; as the onus of this textile base is on creation of high tech and high capacity industries, installation of outdated manufactured equipment is strictly prohibited. Investment in R&D is to exceed 1% of total investments,

Xinjiang is China's top cotton growing area producing about 3-4 million tons (~60%) of China's ~7Mn tons of cotton.

## CPEC: Is Pakistan ready to surf the tide?

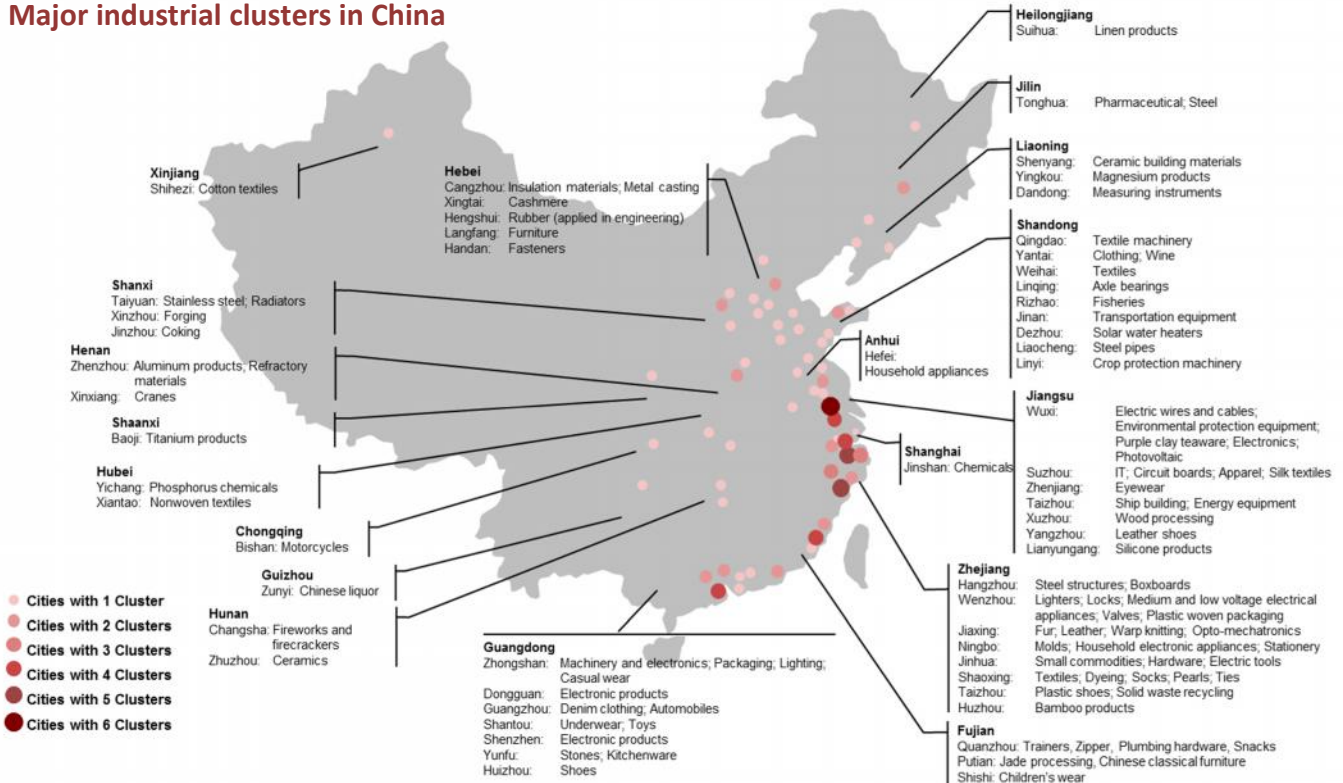
A fund of 20Bn Yuan (~ \$ 2.8Bn) has been created through which the govt. is investing and encouraging private capital investment in standard garment factory construction in Xinjiang.

By 2020, Xinjiang is expected to produce about 500Mn garments annually

while factories are being rented out to enterprises virtually rent-free. Sustainability of the project has been ensured by mandating the reinvestment of value added taxes in the development of the industrial zone. By 2020, Xinjiang is expected to produce about 500Mn garments annually, and create more than 600,000 jobs.

Total investment in Xinjiang's textile sector reached nearly 65Bn Yuan (~ \$ 9.4Bn) in 2016. Exports of textiles and garments from Xinjiang reached 43Bn Yuan (~\$ 6.2Bn) during the Jan.-Oct. 2016 period, up 49% from the same period last year. Annual cotton spinning capacity has risen to 15Mn spindles, up 150% year on year (Pakistan's total installed capacity is 13.27Mn spindles). Yarn production is 15-20% cheaper in the region as compared to other areas in China.

### Major industrial clusters in China



Source: Li & Fung Research Centre; The Beijing Axis Analysis

CPEC is to provide Xinjiang better access for its exports to markets in the MENA region and thus can be essentially considered China's push to industrialize and populate its western and central regions. How will such rapid and heavily

CPEC is to provide Xinjiang better access for its exports to markets in the MENA region and thus can be essentially considered China's push to industrialize and populate its western and central regions.

With the establishment of Textile Park in Xinjiang, the textile exports of China are envisaged to be increased manifolds, giving tough competition to Pakistan.

Chances are high that Pakistan would be experiencing a similar influx of goods under China's transit trade, and that the Pakistan market would be made a dumping ground for Chinese products, effectively kicking local Pakistan producers further out of competition.

subsidized development in Xinjiang affect Pakistan's textile industry? We will elaborate in the next sections.

### Challenges to Pakistan on CPEC

CPEC will be bringing a paradigm shift in trade dynamics of the region. But how well is Pakistan prepared to cope with the challenges of trade integration that this rapid development of corridors is to bring about. Following are some of the challenges which needs to be dealt with on war footings.

#### **Xinxiang's textile push to render Pakistan uncompetitive**

China is already Pakistan's major competitor in global trade, particularly in the textile and garment segments, and with the establishment of textile park in Xinjiang, its textile exports are anticipated to increase manifolds. Pakistan lamentably has heavy dependence on its textile exports (~60% of total exports) with much of it being low value added.

Setting up of the textile park at Xinjiang will be a heavy blow for Pakistani textile exports. Already being high value added and low in cost due to high technology, superior production efficiency, govt. subsidized manufacturing and cheap labor, China's textile-ware from Xinjiang passing through CPEC to the MENA region would experience a further reduction in costs, that of transportation.

Comparatively, Pakistan's exports are already facing a decline in the global markets owing to a host of factors, two of which are high production costs and lack of govt. incentives in the sector. Although a ~ \$1.7Bn textile package has recently been announced by the govt., it is no match with the incentives provided to textile exporters in Xinjiang by China, and Pakistan would simply not be able to compete with the Chinese exporters.

#### **Low cost Chinese products to further burgeon their way into Pakistan**

Pakistani markets are already awash with hordes of low cost Chinese products; those produced in Pakistan as well, but at higher costs. Added to this is the decades long smuggling and dumping problem which Pakistan has been facing due to Pak-Afghan transit trade, whereby smuggled goods find their way into the local markets under the garb of APTTA. Chances are high that Pakistan would be experiencing a similar influx of goods under China's transit trade, and that the Pakistan market would be made a dumping ground for Chinese products, effectively kicking local Pakistan producers further out of competition.



### Pakistan already at the losing end of its FTA with China

Under CPEC, Pakistan faces yet higher risk of broadening its trade deficit, unless new investments in manufacturing increase levels of domestic productivity.

China has times and again proved to be a better negotiator in terms of its agreements with Pakistan, as observed in the case of the Free Trade Agreement (FTA) put in place between the two in 2006-07. Local manufacturing faced tough competition amid heavy influx of low cost Chinese items. In the immediate aftermath of the FTA, Pakistan's China imports jumped by \$ 794Mn while exports increased only by \$ 135Mn. Pakistan, owing to lesser levels of industrialization and value addition, has a much smaller export base as compared to China and has minimal surplus of competitive exportable of China's interest.

Further to this, the government's unabated efforts to raise tax revenues by imposing further taxes and doing away with exemptions wherever possible has further squeezed manufacturers' capacity to face the intense global competition not only in the export market but even in their home ground. At the same time Pakistan's government has also lost billions of rupees in tax revenues due to its PTAs and FTAs with various countries particularly China.

The government's unabated efforts to raise tax revenues by imposing further taxes and doing away with exemptions wherever possible has further squeezed manufacturers' capacity to face the intense global competition not only in the export market but even in their home ground.

Trade deficit with China has continued to widen further year after year. Under CPEC, Pakistan faces yet higher risk of broadening its trade deficit, unless new investments in manufacturing increase levels of domestic productivity. Discussion on the 2<sup>nd</sup> phase of this FTA is still lingering, with Pakistan now making concerted efforts to make up for lost ground.

### CPEC to add mountain of debt

Financing structures for CPEC differ on the basis of sectors and projects. In the logistics sector, financing will mainly be provided by China and its state-owned banks as concessional loans with 2% interest rate for the next 20-25 years; smaller infrastructure projects are expected to be financed through a mix of concessional loans and grants.

Power plant projects worth \$ 35.4Bn will mostly be funded through FDI from Chinese companies, and loans from Chinese banks to Chinese investors in Pakistan.

In the energy sector, power plant projects worth \$ 35.4Bn will mostly be funded through FDI from Chinese companies, and loans from Chinese banks (Exim Bank of China - Port Qasim power project, Industrial and Commercial Bank of China - Sahiwal power project) to Chinese investors in Pakistan. The power projects are to be financed at an interest rate of 4.95% (Libor 0.5% + spread of 4.50%) along with guaranteed rate of return on equity varying from 27% p.a. to 30.65% p.a., all repayable in dollars. <sup>1</sup>

<sup>1</sup> Daily Times: CPEC – An Objective Analysis

Power sector companies, operating as Independent Power Producers (IPPs), have their electricity sales and tariffs guaranteed through pre-negotiated agreements.

Almost all of the power projects have debt to equity ratio of 80:20, which signifies that the inflows into the country represent debt financing rather than equity investments.

Pakistan will have excessive power generation capacity of 5,400 MW and the govt. will have to pay for this electricity even if it is not utilized as the govt. has issued sovereign guarantees to purchase electricity for thirty years under the CPEC projects.

Almost all of the power projects have debt to equity ratio of 80:20, which signifies that the inflows into the country represent debt financing rather than equity investments. Repayment of these loans and profits to the investors (included in the tariff) are liable to be paid right from the onset. The firms, operating as Independent Power Producers (IPPs), have their electricity sales and tariffs guaranteed through pre-negotiated agreements.

The markup on debt and return on equity would not only imply a higher electricity rate for the next many years, but profit and principal repayments in dollars (expected to jack up after 2021) would inevitably be putting incessant pressure on the rupee and Pakistan's forex reserves, resulting in Pakistan piling up more debt from other resources in the years to come. Incidentally, the govt. plans to seek financing for setting up industrial zones on the CPEC route at the same time.

The IMF too has stated that there will be significant investment flows in the initial phase of the project; however, a parallel surge in import of machinery, industrial raw material, and services will likely offset a significant share of these inflows.

### **Case of power generation – consumers to pay for excess supply**

Energy projects having capacity of 10,400 MW are expected to be completed by 2018 under the early harvest program. Pakistan, already deficient in its electricity requirements by 5,000MW, direly requires the projects to start producing as per schedule. However, Pakistan will have excessive power generation (5,400 MW) and the consumers will have to pay for this electricity even if it is not utilized as the govt. has issued sovereign guarantees to purchase electricity for thirty years under the CPEC projects.

Another important issue facing the govt. is the import requirement of the fuel of 10,000MW power projects. \$3.5Bn are reportedly needed as fuel import cost of the CPEC power projects every year which in all probability will not be financed through CPEC funding, rather to be arranged by the govt. on its own.

### **Perils of Chinese investments in proposed SEZs**

Incentivized investments in the proposed SEZs contain inherent perils of crowding out the already struggling mainstream export industry. The SEZs also run the danger of functioning as duty-free ware housing hubs of Chinese products for tariffed exports to other areas of Pakistan. This would give them an unfair advantage over locally manufactured goods which are being taxed at every node of the value chain.

SEZs would give Chinese investors an unfair advantage over locally manufactured goods which are taxed at every node of the value chain.

Important questions that arises here are how much Pakistan would gain in terms of transit fee from the project. Further, who is to bear the security cost of the project? Whether it will be made part of the CPEC account, or the tax payer is to pay it through rise in taxes?

Pakistan's foremost priority should be to smartly negotiate and exploit CPEC to achieve maximum economic strategic depth for Pakistan, and to make all transactions transparent to the hilt.

### Strategize to capitalize on this once in a life time opportunity

Development of CPEC is a once in a life time opportunity for Pakistan, yet it needs to keep its interest on the fore when deciding on the different aspects of the project.

#### Transit Trade via CPEC – big bucks opportunity

CPEC has already seen the first trade convoy from China passing through its western route and dispatching goods via Gwadar port to onward destinations in Sri Lanka and the MENA region. An important question that arises here is how much Pakistan would gain in terms of transit fee from the project. The fact of the matter is that such details have not been publically disclosed yet there are strong vibes that some sort of transit fee is to be effectively collected on Chinese cargo routed through CPEC.

CPEC should be viewed as a boon not only for China and Pakistan, but for the entire region as better inter-connectivity would allow more trade amongst Iran, Afghanistan, Central Asian states as well as India. It should be viewed as a transcontinental project linking more than 64 countries; precisely the reason why CARs, Afghanistan, Turkey, Saudi Arabia and reportedly even some European countries including UK and France are vying to become a part of the project. Iran, too, has shown its interest to be a part of the corridor, as it realizes that CPEC could become a major world channel for petro-chemical trade in the region, providing the shortest and safest available route through Gwadar to CAR and energy hungry China.

But who is to bear the security cost of the project? Whether it will be made part of the CPEC account, or the tax payer is to pay it through rise in taxes?

#### Negotiations to determine the outcome

Pakistan's foremost priority should be to smartly negotiate and exploit CPEC to achieve maximum economic strategic depth for Pakistan, and to make all transactions transparent to the hilt. Transit fee with China and all partnering countries needs to be prudently negotiated as such a fee would be a major earning source for paying off CPEC related debt and other associated costs.

Likewise, we may still have time to negotiate some of our power purchase agreements in such a way that allow enough incentives for rapid commercial operation commencement, yet have cost compatibility with our regional competitors.

It is the focus on high tech and value additive industries that will provide the real platform for competitive trade in the global economy.

It needs to be ensured that CPEC projects and policies will continue irrespective of which party is at the helm of affairs at the center.

Care should be taken that all stakeholders including Pakistan's Chambers of Commerce should be included in all aspects of development and planning.

### **High value addition – the only way forward**

Importantly, the anticipated glut of textiles and garments from the Xinjiang textile park in the export as well as domestic markets of Pakistan poses a serious threat to Pakistan's textile sector already struggling to remain afloat. It is therefore inevitable for Pakistan to not only improve on the competitiveness and breadth of textile production but also diversify its exports in other sectors even if it is to sustain the current levels of exports, let alone grow it.

Capitalizing on the humungous opportunity presented by CPEC entails a marked improvement in national production capability and business environment. Infrastructural improvement will encourage greenfield industrial setups, but it is the focus on high tech and value additive industries that will provide the real platform for competitive trade in the global economy.

### **Continuity of policies remains critical**

A core issue is the continuation of CPEC-related policies in the longer term. With the govt. already being bogged down in domestic politicking, and only a year remaining in the general elections, it needs to be ensured that CPEC projects and policies will continue irrespective of which party is at the helm of affairs at the center. Long-term developments in a country like ours often become subjected to the whims of political leaders resulting in incomplete projects on which debt money has been futilely used.

### **Vital to rake-in the local stakeholders**

As CPEC also incorporates setting up a host of SEZs in different areas of the country, care should be taken that all stakeholders including Pakistan's Chambers of Commerce should be included in all aspects of development and planning. Chinese private investment in the form of joint ventures, both in labor and capital intensive industries, needs to be attracted in the long term for both capacity and skill development. Trends in China's manufacturing reflect its push upwards on the value chain, while relocating its low value industries to other regional countries. Pakistan could attract such industries in its SEZ's to utilize Chinese global linkages and production mastery. Local skilled and unskilled labor and SMEs need to be sufficiently involved in all projects as well.

### Pakistan first!!

The emerging shift in regional trade patterns in the wake of CPEC and other corridors has made it critical for Pakistan to promote and protect its own industries. Pakistan needs to be savvy enough in putting its own business interests to the fore, and take sufficient care that not every business opportunity is lost to China.

Chinese investments in Pakistan, while boosting its economy will also be fuelling dependency on China in all respects. Besides infrastructural and economic linkages, China aims for geo-political and strategic advantage in the region, and Pakistan will undoubtedly be expected to align its policy with China, both within the region and outside.

It remains to be seen how Pakistan utilizes China's propositions and its growth story for its own advantage while maintaining diversity in its relationships with other world powers. CPEC is widely being publicized as a game changer in the region; Pakistan can only be successful if it remains an active part of this game.

## Annexures

CPEC-Energy Priority Projects			
#	Project Name	MW	Estimated Cost (US\$ M)
1	Port Qasim Electric Company Coal Fired, 2x660, Sindh	1320	1,980
2	Sahiwal 2x660MW Coal-fired Power Plant, Punjab	1320	1,600
3	Engro thar 4x330MW Coal-fired, Thar, Sindh	1320	2,000
	Surface mine in Block II of Thar Coal field, 6.5 metric ton per annum (mtpa), Thar Sindh		1,470
4	Gwadar Coal /LNG / Oil Power Project, Gwadar	300	600
5	HUBCO coal power plant 1X660 MW, Hub Balochistan	660	970
6	Rahimyar Khan Coal Power Project, Punjab	1320	1,600
7	SSRL Thar Coal Block 1 - 6.5 metric ton per annum(mtpa) Thar, Sindh	N/A	1,300
	SSRL 2x660 MW Mine Mouth Power Plant,Sindh	1320	2,000
8	Quaid-e-Azam 1000MW Solar Park, Bahawalpur, Punjab	1000	1,350
9	Dawood 50MW wind Farm, Bhambore, Sindh	50	125
10	UEP 100MW wind Farm, Jhampir, Sindh	100	250
11	Sachal 50MW Wind Farm, Jhampir, Sindh	50	134
12	Suki Kinari Hydro power Station, KPK	870	1,802
13	Karot Hydropower Station, AJK & Punjab	720	1,420
14	Matiari to Lahore Transmission line	N/A	1,500
15	Matiari to Faisalabad Transmission line	N/A	1,500

CPEC-Energy Actively Promoted Projects			
#	Project Name	MW	Estimated Cost (US\$ M)
16	Gaddani Power Park Project (2x660MW)	1320	3,960
	Gaddani Power Park Project (Jetty + Infrastructure)		1,200
17	HUBCO coal power plant 1X660 MW, Hub Balochistan	660	970
18	Kohala Hydel Project, AJK	1100	2,397
19	Pakistan Wind Farm II 2X50 MW(Jhampir, Thatta, Sindh)	100	150
20	Thar mine mouth oracle, Thar Sindh	1320	1,300
21	Muzaffargarh Coal Power Project, Punjab	1320	1,600
22	Gas Power Plant 525 MW, Chichoki Malian, Punjab	525	550
23	Development of hydro projects along the north Indus River	N/A	N/A

CPEC Infrastructure Projects			
#	Project Name	Length (Km)	Estimated Cost (US \$ Mn)
<b>Road</b>			
1	KKH Phase II (Thakot -Havelian Section)	118	1,305
2	Peshawar-Karachi Motorway (Multan-Sukkur Section)	392	2,846

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3	Khuzdar-Basima Road N-30 (110 km)	110	N/A
4	Upgradation of D.I.Khan - Zhob, N-50 Phase-I (210 km)	210	N/A
5	KKH Thakot-Raikot N35 remaining portion (136 Km)	136	N/A
<b>Rail Sector Projects</b>			
6	Expansion and reconstruction of existing Line ML-1	1736	3,650
7	Havelian Dry port (450 M. Twenty-Foot Equivalent Units)	N/A	40
8	Capacity Development of Pakistan Railways	N/A	N/A

<b>CPEC Gwadar Projects</b>		
#	Project Name	Estimated Cost(US\$ M)
1	East-Bay Expressway	140.6
2	Gwadar International Airport	230
3	Construction of Breakwaters	123
4	Dredging of berthing areas & channels	27
5	Development of Free Zone	32
6	Necessary facilities of fresh water treatment, water supply and distribution	130
7	Pak China Friendship Hospital	100
8	Technical and Vocational Institute at Gwadar	10
9	Gwadar Smart Port City Master Plan	N/A
10	Bao Steel Park, petrochemicals, stainless steel and other industries in Gwadar	N/A
11	Development of Gwadar University (Social Sector Development)	N/A
12	Upgradation and development of fishing, boat making and maintenance services to protect and promote livelihoods of local population	

<b>CPEC Others Projects</b>		
#	Project Name	Estimated Cost(US\$ M)
1	Cross Border Optical Fiber Cable	44
2	Digital Terrestrial Multimedia Broadcast (DTMB)	

<b>CPEC Rail Based Mass Transit Projects</b>	
#	Project Name
1	Karachi Circular Railway
2	Greater Peshawar Region Mass Transit
3	Quetta Mass Transit
4	Orange Line – Lahore

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CPEC New Provincial Projects	
#	Project Name
1	Keti Bunder Sea Port Development Project
2	Naukundi-Mashkhel-Panjgur Road Project connecting with M-8 & N-85
3	Chitral CPEC link road from Gilgit, Shandor, Chitral to Chakdara
4	Mirpur – Muzaffarabad - Mansehra Road Construction for connectivity with CPEC route
5	Quetta Water Supply Scheme from Pat feeder Canal, Balochistan
6	Iron Ore Mining, Processing & Steel Mills complex at Chiniot, Punjab

CPEC Special Economic Zones (SEZs)	
#	Project Name
1	Rashakai Economic Zone on M-1
2	Special Economic Zone Dhabeji
3	Bostan Industrial Zone
4	Punjab - China Economic Zone, M-2 District Sheikhpura
5	ICT Model Industrial Zone, Islamabad
6	Development of Industrial Park on Pakistan Steel Mills Land at Port Qasim near Karachi
7	Bhimber Industrial Zone
8	Mohmand Marble City
9	Moqpondass SEZ Gilgit-Baltistan

Source: KCCI Research; [cpec.gov.pk](http://cpec.gov.pk)



## CPEC: Is Pakistan ready to surf the tide?

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