

# The China-Pakistan Economic Corridor and the New Regional Geopolitics



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# Executive Summary

The China-Pakistan Economic Corridor (CPEC) brings a dimensional shift in China-Pakistan relations at a time of significant geopolitical change. The project is a nodal part of China's ambitious Belt & Road Initiative that envisages connecting China to Europe, the Middle East and Africa. The promised investment of billions of dollars in infrastructure and power sector development is welcomed in a country that desperately needs foreign investment to boost its fledgling economic growth. The addition of an expected 10,000 MW of electricity to the national grid by end 2018 will help overcome energy shortages and give a major boost to the economy. Similarly, the development of roads and other transport infrastructure will also improve connectivity inside the country as well with other neighboring countries in the future. The connectivity part of the project could actually become a game changer for Pakistan.

However, there may be some unintended, adverse consequences for public finances if Pakistan does not put its policies right. The Chinese money may be coming with a cost that many believe could have serious long-term implications for Pakistan's balance of payments. Although China has an extremely positive image among Pakistanis, the lack of transparency on the terms of various CPEC projects has generated a growing skepticism in Pakistan's civil society and business circles. For instance, there is a strong apprehension that the concessions granted to Chinese firms could adversely affect domestic industries. There are also questions about Chinese firms bringing their own labor to work on the projects, thus depriving Pakistanis of important employment opportunities.

In other words, a major challenge for Pakistan is to negotiate better terms with the Chinese firms so as to reap maximum benefit from their investments. The underlying issue for Pakistan's leadership is how to implement the CPEC program in a way that removes structural imbalances and puts the economy on a sustainable growth trajectory. The CPEC can also become a source of regional economic integration provided efforts are made to reduce inter-provincial disparities and focus more on the country's economically backward areas. Despite disagreement over the distribution of CPEC projects, there is complete consensus among the provinces and political parties on the long-term economic benefits that the Chinese investments could bring for the country. The notion that economic growth will bring political stability is also largely shared.

Finally, the growing China–Pakistan axis reflects Asia’s emerging geopolitics and realignment of forces. Pakistan’s estrangement with the United States and heightening tension with India has led Islamabad to increase its reliance on China, its “all weather friend”. The burgeoning relation between the United States and India is also a factor that is further consolidating the China-Pakistan axis. Meanwhile, the CPEC has raised hope of greater connectivity and economic cooperation among the regional countries. Once the projects are implemented, Pakistan’s geostrategic location should make it a potential nexus for the Eurasian “Silk Road Economic Belt” and a Southeast Asian “Maritime Silk Road”. The CPEC could then not only serve as a game changer for Pakistan, but also for the entire region.

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# Introduction

“This will be my first visit to Pakistan, but I feel as if I am going to visit the home of my own brother,” Xi Jinping, the Chinese President, wrote in an editorial on 19 April 2015, on the eve of his first State visit to Islamabad.<sup>1</sup> The following day, the two countries formalized a historic agreement to begin work on a record \$46 billion project, designated as the China-Pakistan Economic Corridor (CPEC). Under this mega-initiative, China has started investing in various transport infrastructure and energy development projects, deemed critical to stimulating Pakistan’s connectivity and economic growth. Eventually the project will provide China a land route connecting its landlocked Xinjiang province to the Indian Ocean through the Pakistani port of Gwadar, also giving it an access to the Persian Gulf.

As US experts Daniel Markey and James West noted in 2016, this multibillion-dollar investment program underscores “an intensified and expanded bilateral cooperation at a time of rising Chinese geopolitical ambition and persistent concerns about Pakistan’s security and development”.<sup>2</sup> Indeed, the CPEC cannot be looked at in isolation, as it is an important part of a much more ambitious Chinese plan, the One Belt One Road (OBOR) initiative, now renamed the Belt and Road Initiative (BRI). Launched by President Xi Jinping in 2013, the OBOR/BRI vision proposes to push economic integration and connectivity across the three continents of Asia, Africa and Europe, through the construction of new land and maritime transport infrastructures and the development of pipelines and information networks. This grand vision envisages an overland “Silk Road Economic Belt” across the Eurasian continent and a “Maritime Silk Road” across Southeast Asia and the Indian Ocean. Given its geostrategic position, Pakistan is ideally poised to serve as an interconnection between the two routes, which is the reason why the Chinese leadership has identified CPEC as a “flagship project” in the whole scheme of OBOR/BRI.<sup>3</sup>

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1. H.E. Xi Jinping, President of the People's Republic of China, “Pak-China Dosti Zindabad”, *Daily Times*, 19 April 2015. Available at: <http://issi.org.pk>. See also : S. Javed Burki, “A Corridor out of Isolation”, *Newsline*, March 2017.

2. D. S. Markey and J. West, *Behind China's Gambit in Pakistan*, Council on Foreign Relations, 12 May 2016.

3. *Ibid.*

As for Pakistani leaders, Prime Minister Nawaz Sharif above all, they have described the CPEC as a game-changer for the country's economic development and security, as well as for the larger neighborhood.<sup>4</sup> The CPEC has thus added a new dimension to the "all weather" friendship between Pakistan and China. From a purely strategic and security cooperation spanning over more than five decades, the relationship has now evolved into a dynamic economic and commercial partnership as well. More generally, the CPEC is also a reflection of the new regional geopolitics shaping the larger region. In order to analyze the multidimensional underpinnings of the CPEC, this paper first underlines the uniqueness of the Sino-Pakistan relationship, which results from more than 50 years of close security cooperation. In a second section, it highlights the fault-lines that have emerged in the partnership since the 1990s, showing in a third section that to a large extent, the CPEC initiative aims at addressing these difficulties. The last section raises some of the main question marks that hang over the future of the CPEC.

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4. "CPEC 'Game-Changer' for Pakistan, 'Fate-Changer' for Region: PM", *The Nation*, 29 August 2016.



### THE CHINA-PAKISTAN ECONOMIC CORRIDOR: HIGHWAY AND ENERGY PROJECTS



# The Enemy of my Enemy Is my Friend

## The China-Pakistan axis of the Cold War

The story of China–Pakistan relations began in 1950. Pakistan was among the first countries to recognize the People’s Republic of China, but it took more than one decade for bilateral ties to develop into a close and supportive relationship. It was the Indo-Chinese war in 1962 that opened the doors for what subsequently became a strategic relationship. India’s long-drawn conflict with Pakistan over Kashmir pushed Pakistan into forming an axis with China. Although Pakistan was still a member of the US-led anti-communist defense pacts, it did not create any obstacle in bringing the two nations into an alliance against their common Indian threat. The 1965 war between India and Pakistan brought them even closer. Another factor pushing Pakistan into China’s embrace was Washington’s refusal to come to Islamabad’s aid in the 1965 war and subsequent imposition of an arms embargo. Pakistan looked towards China as the US arms supplies dried up.<sup>5</sup>

While Chinese military assistance to Pakistan began in 1966, the two countries entered into strategic entente after Pakistan’s humiliating defeat in the 1971 war with India. China never got militarily involved on behalf of Pakistan though; it even proved to be quite helpless during the 1971 war that led to the dismemberment of Pakistan. Nevertheless, China’s role was critical in that it helped build Pakistan’s military-industrial infrastructure and maintained continuous supplies of military hardware when virtually all options were cut off.<sup>6</sup> That helped build the kind of trust that Pakistan did not have with any other country, not even with its long-term ally, the United States.

Although the two countries never entered into a formal defense pact, China was seen as the most reliable ally to stand by Pakistan in times of conflict with India. As the bond between them grew stronger, Pakistan served as China’s window to the outside world. It not only became the main

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5. L. Sunawar and T. Coutto, “U.S. Pakistan Relations during the Cold War”, *Journal of International Relations, Peace Studies and Development*, Vol. 1, 2015.

6. A. Small, *The China Pakistan Axis*, London, Hurst, 2015, p. 29.

bridge between Beijing and the Muslim world, but also played a key role in bridging the communication gap between China and the United States. The historic visit of US president Richard Nixon to China in 1972 was the result of that opening up.<sup>7</sup> The establishment of diplomatic relations between Beijing and Washington not only changed the global balance of power, but was also a defining moment in China-Pakistan relations.

Pakistan's decision to develop a nuclear weapons capability in response to India's nuclear test in 1974 was also, to some extent, intertwined with its strengthening strategic relationship and consequent military cooperation with China.<sup>8</sup> Pakistan's nuclear ambition primarily resulted from its sense of insecurity vis-à-vis India's superior conventional military power. It also reflected a feeling among Pakistani leaders that the relationship with the United States was deceitful and that they could not rely on Washington in the event of an Indian aggression. Moreover, the Indian test of 1974 decisively tilted the balance of power in South Asia in favor of India and increased Beijing's own apprehensions, thus providing a reason for China to back Pakistan's nuclear program. Interestingly, the nuclear cooperation between the two countries was not one sided. Although Pakistan may have benefitted more, China received Islamabad's help in developing its own uranium-based centrifuge technology. China also used Pakistan to get access to Western technology for reverse engineering, which significantly helped its own nuclear program.<sup>9</sup>

A number of other geopolitical factors also contributed to strengthening the China-Pakistan strategic partnership. For example, the Soviet occupation of Afghanistan in 1979 made Pakistan a frontline state of the Cold War and led to a new alignment of forces supporting the Afghan resistance. Its own security concerns compelled China to join Pakistan and the West in supporting the Afghan resistance. Pakistan's military spy agency, the Inter Services Intelligence (ISI), and the American CIA jointly conducted the biggest covert operation in the history that eventually forced the Soviet Union to leave Afghanistan in 1989. As for China, its support was limited to the supply of arms to Afghan Mujahedeen, through Pakistan.

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7. D. Ignatius, "Nixon's Great Decision on China, 40 Years Later", *Washington Post*, 10 February 2012.

8. A. Small, *The China Pakistan Nexus*, op. cit., p. 30.

9. *Ibid.*

## Pakistan's increased dependence on China since the 1990s

The end of the Cold War and emergence of a unipolar world order didn't affect the mutually beneficial strategic relationship between Beijing and Islamabad. A close identity of views and mutual interests remained the center-point of the bilateral ties. At the same time, the 1990s saw a diminishing US interest in the region. From the most trusted ally, Pakistan became a problem child for the West because of its nuclear weapon program. Moreover, the West walked out of Afghanistan, leaving it in the middle of a bloody civil war, and Pakistan was left to bear the brunt of the legacy of the "anti-Soviet Jihad" in the form of Islamic militancy.

As Pakistan lost its utility for the West, Washington would not look the other way on Pakistan's nuclear program anymore. Under the Pressler Amendment that was originally passed in 1985, the United States decided in 1990 to suspend all military assistance and any new economic aid amidst concerns that Pakistan was attempting to develop a nuclear weapon. The nuclear-related sanction caused relations between the two countries to hit a new low, especially as Washington cancelled the transfer of 28 F-16 fighter aircraft that Pakistan had paid for.<sup>10</sup>

Meanwhile, the period following the dissolution of the Soviet Union marked a realignment of forces in the region with the United States tilting towards India, which until then was considered part of the Soviet bloc despite New Delhi's claim of nonalignment. Pakistani civil and military leadership felt betrayed by this US policy turnaround. With the US civil and military aid drying up, Pakistan increased its dependence on China. An expanding relation with China was seen in Islamabad as a means to fill the gap arising from waning US support. The primarily geopolitical alliance between the two nations thus evolved into military and economic cooperation after 1990.

At the same time, collaboration between Pakistan and China on their nuclear programs continued during the 1990s. Ignoring the US sanctions on Islamabad, China supplied 34 short-range ballistic M-11 missiles in 1992. Over the course of the decade, China continued to provide technological support for the expanded production of Pakistan's ballistic missiles, including the 750-km-range Shaheen-1 ballistic missile. China even tested a nuclear warhead on behalf of Pakistan on its territory before

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10. C. Christine Fair, "The U.S.-Pakistan F-16 Fiasco", *Foreign Policy*, 3 February 2011.

Islamabad formally conducted test explosions in Chagai in 1998 in response to India's tests.<sup>11</sup>

May 1998 saw the dawn of a new nuclear era with India conducting a series of nuclear tests followed by Pakistan. The underground tests on 28 May in Chagai district in western Baluchistan province heralded Pakistan's emergence as the seventh overt nuclear power. The two South Asian countries becoming nuclear weapon states changed the regional security dynamics. It triggered a dangerous nuclear arms race between them and turned the region into a new nuclear flashpoint, as illustrated by the two serious crises of 1999 and 2002. While on the diplomatic front, China tried to moderate Pakistan's brinkmanship, calling on Islamabad and New Delhi for restraint during the crises of 1999 and 2002, on the military front, it further enhanced its cooperation with Pakistan.

Since the late 1990s, China has been involved in several projects to enhance Pakistan's military and weaponry systems. These projects have included the joint development of the JF-17 Thunder/FC-1 Xiaolong fighter aircraft and of the K-8 Karakorum advance training and light attack aircraft (a tailor-made training aircraft for the Pakistan Air Force based on the Chinese domestic Hongdu JL-8). Other projects involve space technology, AWACS systems and Al-Khalid tanks, for which China has granted license production and tailor-made modifications based on the initial Chinese Type 90 and/or MBT-2000. In other words, the Chinese have designed tailor-made advanced weapons for Pakistan, making it a strong military power in the Asian region with the wherewithal to challenge India's rise to power.<sup>12</sup>

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11. A. Small, *The China Pakistan Nexus*, op. cit., p. 30.

12. L. Curtis and D. Scissors, "The Limits of the Pakistan-China Alliance", *Reuters*, 20 January 2012.

# Emerging Fault-Lines in the China-Pakistan Partnership

## Lagging economic ties

With China's accelerated growth from the 1980s on, economic cooperation between the two countries has expanded manifold and led to the conclusion of a China-Pakistan Free Trade Agreement (CPFTA). The CPFTA on trade in goods was signed on 24 November 2006 and implemented on 7 July 2007. The FTA on trade in services was signed on 21 February 2009 and has been operational since 10 October 2009. The bilateral trade volume, which amounted to \$4 billion in 2006-07, reached an all-time high at \$12 billion in 2014-2015. Pakistan's exports jumped to \$2.1 billion in 2014-2015 from \$575 million in 2006-2007. Correspondingly, China's exports to Pakistan increased to \$10.1 billion in 2014-2015 from \$3.5 billion in 2006-2007.<sup>13</sup>

However compared to other countries, the growth of Sino-Pakistani bilateral trade has remained slower. Not only is the trade relationship small, it is imbalanced. Pakistan has been unable to fully tap and utilize the concessions granted by China under the CPFTA and has only used 3.3 percent of the total tariff lines. Pakistan could only export in 253 tariff lines out of the total 7,550, where average export value was 500 dollars.<sup>14</sup> Its export basket has mainly included raw materials and intermediate products such as cotton yarn, woven fabric and grey fabric, while value-added products have been completely missing. This is why Pakistan has not benefitted from the CPFTA, despite the fact that some of the value-added products like garments are included in the concessionary regime.

In contrast, China's trade relationship with India has increased at a relatively fast pace. Sino-Indian trade rose from around \$5 billion in 2002 to more than \$60 billion in 2010. Now it has gone up to \$100 billion annually, which is about eight to ten times the volume of trade between Pakistan and China. Despite their persisting border tensions and India's closeness with the United States, the trade between the two countries has

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13. P. Muhammad, "Pakistan Has Failed When it Comes to Trade with China", *The Express Tribune*, 26 June 2016.

14. *Ibid.*

not been affected. That has been one of the reasons for Beijing's efforts to balance its ties with India and Pakistan.<sup>15</sup>

## Rising concerns about terrorism

Notwithstanding their growing strategic cooperation, Chinese authorities have grown concerned about the existence of terrorist sanctuaries in Pakistan since the mid-2000s. A major source of tension has been the issue of Uighur separatists receiving training in the militant camps in Pakistan's lawless tribal territories bordering Afghanistan. The restive Chinese province of Xinjiang is home to about eight million Uighur Muslims. Frustrated by the growing economic and political domination of Han Chinese, some of them have joined the movement for an independent "East Turkestan". The movement is believed to have developed strong ties with some Pakistani militant groups and global Jihadi groups like Al Qaeda.<sup>16</sup>

Under Chinese pressure, Pakistan cracked down on the members of the East Turkestan Islamic Movement (ETIM) and closed down religious seminaries allegedly training Uighur separatists. Islamabad also extradited to China about 10 ETIM militants who were suspected to have been involved in plotting terrorist activities in Xinjiang. The action was taken after Chinese authorities publically pointed to Pakistani radical influence as a factor contributing to the bloody riots that shook Urumqi, the capital of Xinjiang in July 2009 and that caused the death of more than 195 people.

New attacks in Xinjiang, this time in the city of Kashgar, in late July 2011 led the Chinese to chastise Pakistan for failing to take more effective action against the Uighur militants based in the tribal areas. These accusations were first raised locally, with Xinjiang's authorities stating that the militant responsible for the attack had trained in Pakistan, before being conveyed at the national level by the China Daily newspaper.<sup>17</sup> More importantly, Beijing established a direct link between the growing bellicosity of the Uighur separatists in Xinjiang and the rise in terrorist militancy in Pakistan. It became apparent that any terrorist attack similar to the one in Kashgar, i.e. with a Pakistani connection, would have serious implications for China-Pakistan ties.

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15. L. Curtis and D. Scissors, "The Limits of the Pakistan-China Alliance", *op. cit.*

16. "China Urges Pakistan to Expel Uighur Islamic Militants", *BBC*, 31 May 2012.

17. P. Bhattacharji, "Uighurs and China's Xinjiang Region", *Council on Foreign Relations*, 29 May 2012.



Attacks by Islamic militants on Chinese workers in Pakistan also became a growing matter of concern for Chinese authorities. These attacks, which reportedly started in 2004, reached a peak in 2007. In the summer of that year, the followers of a militant cleric who had established a parallel Islamic Sharia court in Islamabad, kidnapped several Chinese citizens after waging a raid on a massage center, which they accused of being run as a brothel. That incident provoked strong Chinese reaction that ultimately forced the then military-led government of General Pervez Musharraf to launch a military operation at the Red Mosque where the Chinese women were detained. Around the same time, in July 2007, three Chinese officials were killed in the Charsadda district of Khyber Pakhtunkhwa in an attack by militants avenging the execution of a Uighur separatist leader. Days later, a suicide bomber targeted a group of ten Chinese engineers in Baluchistan. The situation became so serious that it compelled senior Chinese leaders, including President Hu Jintao, to threaten to suspend some Chinese projects in Pakistan if the lives of Chinese workers were not better protected.<sup>18</sup>

Beijing was also particularly perturbed by the rise of the Pakistani Taliban Movement of the TTP (Tehrik-i-Taliban Pakistan) from 2007 on. The TTP expanded its control over Pakistani tribal regions and part of northwestern Khyber Pakhtunkhwa province. After taking over the control of Swat district, the militant group advanced to just 60 miles from Islamabad Capital Territory in 2009. The insurgents even threatened to cut off the Karakoram Highway, the principal land artery between Pakistan and China. Islamabad had to deploy a full division of army troops to protect the critical route.

In this context, Beijing stepped up pressure on Pakistan to pursue a more effective counterterrorism strategy. It sent a strong signal to Islamabad in December 2008 when it dropped its resistance at the UN and other international forums to declaring Jamaat-ud-Dawa (JuD) a terrorist group.<sup>19</sup> The JuD was (and still is) a front organization for the Lashkar-i-Taiba, a banned group responsible for the 2008 terrorist attack in Bombay, which had long been patronized by Pakistani military intelligence. The persistent Chinese pressure was also one of the many factors that eventually prompted Pakistan to launch a long-delayed military operation in North Waziristan in June 2014. Codenamed Zarb-e-Azb, the operation took on local and international extremist militants, including ETIM members. In this respect, the Pakistani government has taken the Chinese

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18. L. Curtis and D. Scissor, "The Limits of the Pakistan-China Alliance", *op. cit.*

19. *Ibid.*



criticism far more seriously than the US call to do more to rein in Afghan insurgents who also find sanctuary in Pakistan.

For the same reasons, the renewed influence of the Taliban in Afghanistan has raised Chinese concern. But instead of arm-twisting Pakistan to fight the Taliban insurgency in Afghanistan, the Chinese leadership has adopted a more nuanced approach on the issue. While supporting the US-backed Kabul administration, Beijing has maintained close contacts with the Afghan insurgents, though Pakistan. This approach has been in keeping with China's past policies. When the Taliban established the Islamic Emirate of Afghanistan (1996-2001), Chinese authorities reached agreements with them to prevent Uighur separatists from using the Afghan territory as a training ground. Those contacts continued after the overthrow of the Taliban regime by American forces in late 2001. That was, perhaps, one of the reasons why China would not provide any military support to the NATO mission in Afghanistan.

# The Changing Geopolitics and Economic Security behind CPEC

## Promoting connectivity across Pakistan

The existence of some fault-lines in their partnership has not prevented China and Pakistan to come closer to each other. The changing regional geopolitics and consequent realignment of forces have been the driving factors of their strengthened relationship. As far as Pakistan is concerned, the cooling of its relations with the United States and rising tension with arch rival India have given further impetus for leaning on China. As for China, it has seen its growing support to Pakistan as the best answer to the strategic rapprochement between the US and India. To a large extent, the CPEC proposal is the product of these larger geopolitical trends.

The CPEC is intended to promote connectivity across Pakistan with infrastructure development projects and power plants needed to boost Pakistan's economic growth. The total value of the power and infrastructure deals concluded under CPEC has increased from the \$46 billion investment plan originally announced in 2015 to an estimated \$57 billion. This rise in costs has resulted from the inclusion of Chinese financing for Pakistan Railways and for rail-based mass-transit projects in Karachi, the greater Peshawar region and Quetta, the respective provincial capitals of Sindh, Khyber-Pakhtunkhwa and Baluchistan. While Beijing will provide funding for the larger part of the CPEC plan through commercial loans, soft loans, grants and private equity investment, Pakistan is also required to bring in funds for transport projects.<sup>20</sup>

Almost \$28 billion of the proposed investment plan has been earmarked for early harvest projects, with \$18 billion allocated for power projects and \$10 billion for transport infrastructure.<sup>21</sup> The rest of the investment plan should be released by 2030 and beyond. As explained by journalist Nasir Jamal, "Power plants are being funded through foreign

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20. N. Jamal, "The Cost of CPEC", *Dawn*, 12 March 2017.

21. CPEC will extend over a 15-year period, in four phases, i.e. Early Harvest Projects (EHPs) in 2018, short-term projects in 2020, medium-term projects by 2025 and long-term projects by 2030.

direct investment by Chinese firms and commercial loans at the rate of six to seven percent from Chinese banks. The financing for the transport sector is provided by the Chinese government and the respective state-owned Chinese banks mostly as concessional loans have been taken at 2 to 2.4 percent mark-up.”<sup>22</sup>

The final objective of CPEC is to open a 3,200-km trade and energy route between the Chinese city of Kashgar in Xinjiang and the Pakistani port of Gwadar in Southern Baluchistan, thus directly connecting Western China to the Arabian Sea. Regional connectivity remains high on Pakistan’s growth policy as its geo-strategic location offers a unique opportunity to connect South, West and Central Asia. Regional connectivity has actually been on the Sino-Pakistani cooperation agenda for decades. Although the CPEC agreement was formally signed during the visit to Islamabad of the Chinese President Xi Jinping in 2015, the thinking and the discussion on the project spanned many years under both the military and civilian administrations of Pakistan. The construction of the more than 1,100-kilometer long Karakoram Highway back in the 1960s was a milestone strengthening the connectivity between the two countries. The Highway reflected a vision that ultimately led to the CPEC. Similarly the Gwadar deep-sea port, a pivot around which the entire CPEC project is built, was constructed in early 2000. While still a work in progress, its control was handed over to the China Overseas Port Holding Company in 2012 by the previous government of President Asif Ali Zardari.

## Pakistan’s expectations

As noted by journalist Nasir Jamal, “ever since President Xi Jinping showed up in Islamabad in April 2015 to sign the investment deals around the trade route, the corridor project has created huge expectations about future growth among the common people, businesspersons and the government in Pakistan”.<sup>23</sup> Moreover, there has been a complete unanimity between Pakistan’s civilian and military leadership on the economic, political, and security opportunities that the CPEC offers. In Pakistan, the Ministry of Planning, Reform, and Development has been the nodal agency in charge of managing CPEC projects. Its counterpart on the Chinese side has been the National Development and Reform Commission (NDRC), which also has a central role in the larger BRI scheme. The two sides have set up a Joint Cooperation Committee of CPEC to periodically review the projects’ progress, as well as working groups focused on Planning, Energy,

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22. N. Jamal, “The Cost of CPEC”, *op. cit.*

23. *Ibid.*

Transport infrastructure, Gwadar, Industrial Parks and Economic Zones, and finally on Long Term Plan.<sup>24</sup>

Pakistan desperately needs foreign investment to push its sluggish economic growth. For nearly one decade, Pakistan's average annual economic growth rate has not been more than 3 percent. Rising militant violence and perpetual political instability have made it difficult for the country to get foreign direct investments (FDI). In the last three years, FDI has stayed below the one billion-dollar mark. Lack of foreign investment has also affected domestic investments, stunting Pakistan's economic growth. Against this background, CPEC aims at developing the basic infrastructure required for rapid growth in Pakistan. China's investment plan represents more than the double of all FDI in Pakistan since 2008.<sup>25</sup> China's financial commitment has already prompted an acceleration of Pakistan's GDP growth rate from 3.7 to around 5 percent. Pakistan was also ranked as the best-performing stock market in Asia by Bloomberg in 2016. Even Western companies are taking a new look at the investment opportunities in the country.<sup>26</sup>

Under CPEC, China is to earmark a major part of its investment – about \$35 billion – to energy projects in the form of power plants, a dam, a solar power park, and a pipeline.<sup>27</sup> Pakistan's energy sector, which is in a critical state indeed, is in dire need of investment. Supply shortfalls and transmission and distribution losses are estimated to cost more than 2 percent GDP growth a year. The problem is further compounded by Pakistan's demographic growth. With an increase of 2 percent per year, the population expansion has created serious economic and social problems in the country, especially as low economic growth is unable to absorb the annual supply of labor.

Against this background, CPEC has made it a priority to enhance Pakistan's power generation capacity. Twenty-one new projects have already been elaborated, with a view to adding about 17,000 megawatts of generation capacity and nearly double Pakistan's installed capacity.<sup>28</sup> Fourteen out of those 21 projects are to be completed on a fast-track basis and generate an expected additional capacity of 10,400 megawatts to the national grid by the end of 2018.<sup>29</sup> In the vicinity of the power generation

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24. Official website of the China-Pakistan Economic Corridor: <http://cpec.gov.pk/index>.

25. "Is China-Pakistan 'Silk Road' a Game-Changer?", *BBC*, 22 April 2015.

26. M. Akram, "Double Happiness", *Dawn*, 2 April 2017.

27. Of this 35 billion-investment plan, about 11 billion will go each to Khyber Pakhtunkhwa and Sindh, while Baluchistan and Punjab will receive around 7 billion each. See Z.T. Ibrahim, "China-Pakistan Economic Corridor: A Boon for the Economy, a Bane for Locals", *Dawn*, 12 May 2016.

28. D. S. Markey and J. West, *Behind China's Gambit in Pakistan*, *op. cit.*

29. *Ibid.* See also: <http://pakchina.pk>.

sites, Pakistan's government plans to develop industrial parks and special economic zones that shall provide jobs to the local communities and attract local investment.

## China's interests in CPEC

CPEC is perhaps even more important for China. It is the first concrete project to take shape under the mega Belt and Road Initiative, which is to involve more than sixty countries across Eurasia. Because it stands as a pilot exercise for the larger BRI scheme, CPEC has been the first project to benefit from China's Silk Road Fund. Established in late 2014 with a \$40 billion pledge from the Chinese state institutions, the Silk Road Fund is an investment fund dedicated to supporting infrastructure, resources and energy development in countries and regions involved in BRI. This Chinese initiative is meant to ensure medium and long-term financial sustainability and reasonable returns on investment.<sup>30</sup> Moreover, CPEC will not only contribute to Pakistan's economic stability, but also allow for the most productive use of China's abundant financial reserves as well as for the export of its over-capacity in various sectors.<sup>31</sup>

Another significant advantage for China is that CPEC will open a new, shorter route to Europe, the Middle East and Central Asian markets, as well as to the energy sources of the Persian Gulf. With this direct overland connection to the Arabian Sea, China will be able to import its energy sources from West Asia, through Pakistan, thus bypassing the Strait of Malacca, through which roughly than three quarters of its oil imports are currently shipped.<sup>32</sup> China has traditionally seen its dependence on the shipping route that passes through the Indian Ocean and Malacca Strait as a strategic vulnerability, because of the US predominance over these maritime expanses. An overland shortcut that can pipe energy from the Persian Gulf through Pakistan would thus substantially improve China's energy security.

China's security concerns, especially those stemming from its restive western region of Xinjiang and the Islamic militancy threatening Pakistan's stability, have also been a factor in Beijing's decision to launch CPEC. In fact, China is deploying in Pakistan the same strategy it has pursued for

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30. Pakistan-China Institute CPEC Portal. The Fund has invested \$1.65 billion in the Karot hydropower project and other hydropower projects in the region.

31. M Akram, "Double Happiness", *op. cit.*

32. A. B. Kennedy, "China's Petroleum Predicament: Challenges and Opportunities in Beijing's Search for Energy Security", in: J. Golley and L. Song (eds.), *Rising China: Global Challenges and Opportunities*, Canberra and Beijing, Australian National University and Social Sciences Academic Press, 2011, p. 121-136.

years in Xinjiang, whose core concept consists in promoting economic development with a view to achieving security. In this respect, Daniel Markey and James West insightfully note that, “The CPEC represents an international extension of China’s effort to deliver security through economic development.”<sup>33</sup> In other words, China’s response to the threat of jihadist militancy and terrorist networks in Pakistan is to bring in massive investments in the hope that they will boost the economy, create jobs and opportunities locally and, thus, have a trickle-down effect resulting in improved social stability. Ultimately, in strengthening Pakistan’s security, China hopes to buy security for its own Western territory of Xinjiang.

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33. D S. Markey and J. West, *Behind China’s Gambit in Pakistan*, *op. cit.*

# The Question Marks over the Future of CPEC

## Opportunity and cost

According to Chinese authorities, there has been rapid progress in many CPEC projects. Within two years of signing the CPEC agreement, the Chinese government and companies would have spent about \$14 billion on power and transport infrastructure projects in Pakistan. But there are questions in Pakistan about the cost and benefits of the Chinese investments. The closed bidding process and the general lack of openness related to the financing of CPEC projects and the manner of their execution have sparked a public debate on the various costs, including the hidden ones, of the deals.<sup>34</sup> A major concern shaping this public debate is that the many deals concluded with China will eventually weigh heavily on the national budget and, thus, on the people, particularly as Pakistan has not clearly focused on the economic viability of the projects.

The upward revision in the bills of various projects has led many in Pakistan to worry about the high costs of the infrastructure projects contracted to Chinese companies. Questions are also raised on the agreement that allegedly binds the Pakistani government to award all CPEC-related projects to Chinese contractors at whatever price they quote in their bids, and with no consideration on whether they enter partnerships with local firms or not, or on whether they will procure material from local providers or not. Pakistani businessmen and construction firms complain that the multi-billion-dollar CPEC initiative appears to be a boon for Beijing, since the contracts for CPEC projects are awarded to Chinese contractors and the chunk of CPEC investments flows back to China for equipment, machinery, materials and even manpower.<sup>35</sup> A widespread perception has developed, according to which CPEC investment will eventually carry greater dividends for China than Pakistan.<sup>36</sup>

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34. N. Jamal, "The Cost of CPEC", *op. cit.*

35. *Ibid.*

36. S. Rana, "Govt Green-Lights Three CPEC Projects at 23% Higher Cost", *The Express Tribune*, 15 December 2015.

Moreover, Pakistan has granted substantial tax concessions to the Chinese companies managing the Gwadar port and special economic zone as well as to the Chinese contractors engaged in the construction of major transport infrastructures such as the Lahore Metro and various sections of the Karachi-Peshawar Motorway and of the Karakoram Highway. Tax concessions are also to be given to the Chinese companies that will settle in the more than one dozen industrial zones that will be established under the CPEC. Pakistani businessmen and industrialists, particularly officials of the Pakistan Business Council (PBC) and Lahore Chamber of Commerce and Industry (LCCI), have been demanding that the same incentives be given to them and that they be provided an even playing field. They also demand that Pakistani companies be allowed to compete for the CPEC contracts.<sup>37</sup>

As for power projects, the government of Prime Minister Nawaz Sharif has gone the extra mile to mollify Chinese investors. In many instances, it has agreed to increase the tariffs originally negotiated with the Chinese contractors. It has also agreed to create a special mechanism to guarantee regular payment to Chinese power plants, in the form of a revolving account matching 22 percent of their estimated monthly invoices. The account will be funded by Pakistani power purchasers and backed by sovereign guarantees issued by the Ministry of Finance.<sup>38</sup> With such a mechanism, Chinese power-producers should be protected from the structural cash-flow problems that affects Pakistan's energy sector, including power purchaser firms.<sup>39</sup> This special protection was originally granted to coal-fired power plants, before being extended to all CPEC energy projects in early 2016. However, Pakistani companies have complained that no such benefits have been proposed to them.

The IMF has echoed some of the questions raised in Pakistan. Although it viewed the CPEC project as an opportunity for Pakistan, the Fund warned about its immediate and long-term impact on the economy, especially the country's fragile balance of payments position. "During the investment phase, Pakistan will see a surge in FDI and other external inflows. A concomitant increase in import of machinery, industrial raw materials and services will likely offset a significant share of these inflows, such that the current account deficit would widen, with manageable net inflows into the balance of payments," the IMF notes in its final staff review of its \$7.6 billion loan in September 2016.<sup>40</sup>

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37. N. Jamal, "The Cost of CPEC", *op. cit.*

38. D. S. Markey and J. West, *Behind China's Gambit in Pakistan*, *op. cit.*

39. The Pakistani government will cover any defaults on payment by Pakistani power purchasers and directly pay 22 per cent of the bills of Chinese power producers.

40. International Monetary Fund, *Pakistan*, IMF Country Report No. 16/325, October 2016.



The Fund also warned that once the Chinese power generation companies start operating, the profit repatriation and interest would begin to rise in the subsequent years. Repayment obligations to CPEC-related government borrowings, including amortisation and interest payments, would then rise after 2020-21 due to the concessional terms of these loans. Combined, these CPEC-related outflows could reach about 0.4 percent of GDP per year over the longer term. The Fund noted that CPEC had the potential to boost higher private investment and exports, which would help cover the CPEC-related outflows that are expected over the long term, but it also cautioned, “reaping the full potential benefits of CPEC will require forceful pro-growth and export-supporting reforms. These include improvements in business climate and strengthening security and governance.”<sup>41</sup>

Pakistan is expected to only earn \$3 billion in transit fees once the corridor becomes fully operational. But some experts fear that this amount will be nothing compared with what Pakistan may be required to pay back to China. For instance, one estimate by Topline Securities, a brokerage house in Pakistan, stirred much controversy and anxiety as it predicted that the country would have to pay back as much as \$90 billion to China in return for the \$55 billion CPEC investment plan.<sup>42</sup> A growing number of stakeholders in Pakistan also maintain that, in order to take advantage of the CPEC project, Islamabad must review the deals negotiated with Chinese investors and contractors. An opposition lawmaker, Senator Tahir Mashhadi, chairman of the Senate Standing Committee on Planning and Development, even warned in October 2016 that CPEC could prove to be another “East India Company”<sup>43</sup> if the special incentives given to Chinese firms are not withdrawn.<sup>44</sup> While provocative, this statement reflects the emerging view that Pakistan cannot fully benefit from CPEC if its local businesses and investors are not provided equal opportunities and if local manpower is not employed.

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41. N. Jamal, “The Cost of CPEC”, *op. cit.*

42. K. Husain, “CPEC: Is There Cause for Alarm?”, *Dawn*, 25 April 2017. Most estimates, however, put the figure of \$3 billion per year as repayment obligations.

43. The East India Company (EIC), also known as the British East India Company was formed in the 17th century to pursue trade with East Indies, but ended up ruling India in the beginnings of the British Empire.

44. S. Irfan Raza, “CPEC Could Become Another East India Company”, *Express Tribune*, 18 October 2016.

## Challenges to CPEC

Security still remains a major concern for CPEC's full implementation despite the creation of a dedicated force of ten thousand. With the projects widely distributed across the country, more troops will be required, particularly as some of the road networks are planned to run through the territories of northwest Pakistan where militant groups are active. A major troubled spot is the western province of Baluchistan, where a number of important projects, including the nodal Gwadar port project, are located. The province has been at the center of a low intensity insurgency for over ten years and Chinese workers have been targeted there in the past. In order to protect Chinese workers and CPEC projects in the country, Pakistan has pledged to deploy a Special Security Division of 15,000, which is to include 9,000 regular Army soldiers in addition to 6,000 more paramilitary personnel.<sup>45</sup> The provinces have also been asked to raise extra paramilitary and police force for the security of the Chinese working on the project on their territories.

The CPEC has also sparked a great deal of domestic political rivalries in Pakistan, with the provinces and the central government bickering over the repartition of the Chinese investments. The suspicion of preferential treatment to Punjab – the country's richest province and the political stronghold of the Pakistan Muslim League (N), the ruling party led by Prime Minister Nawaz Sharif – has provoked criticism from the other three smaller provinces of Sindh, Khyber Pakhtunkhwa and Baluchistan. Opposition parties like the Pakistan Peoples' Party (PPP) and Pakistan Tehrik-i-Insaf (PTI), which respectively rule Sindh and Khyber Pakhtunkhwa, have repeatedly complained that the allocation of services, industrial parks, and special economic zones mostly benefits Punjab and deprives the other provinces of equal access to investment opportunities. The opacity surrounding the negotiated deals has reinforced the view that CPEC may increase the regional disparity in the country.

Then there are also some concerns in Baluchistan province that the expected influx of labor and technical manpower from other regions to Gwadar port and industrial park could reduce the local population into a minority. The province, which is the largest in terms of landmass, has a very low population density.<sup>46</sup> What is adding to the problem is that the local population does not possess the necessary skill sets and diversity of occupational requirements essential to sustain a mega enterprise as

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45. I. Price, "Is the US Trying to Sabotage the China-Pakistan Economic Corridor?", *The Diplomat*, 29 September 2016.

46. N. Ahmed, "CPEC's territorial impact", *Dawn*, 22 November 2016.

demanding as CPEC. This fear of being further marginalized is thus aggravating the alienation of the population already unhappy with the central government. A major challenge for the government is to alleviate the apprehension of the local population and to address the grievances of the province. Regional stability is crucial for completion of CPEC projects. In theory, a stable Baloch middle class and growth of local entrepreneurs could change the entire social and economic landscape of the country's poorest and most backward province.<sup>47</sup> But it is not going to be easy to initiate this change, given the alienation of the local population from the central government.

On the external front, China's growing geopolitical assertiveness and massive investments in Pakistan have caused huge worry to India. One of the Indian concerns is that China could use Gwadar as a naval base for its expanded blue water fleet and operations throughout the Indian Ocean.<sup>48</sup> New Delhi has also objected to the CPEC running through the disputed territory of Gilgit Baltistan claimed by India as part of the Kashmir dispute. In return, Islamabad has often accused India of conducting covert operations and helping the Pakistani Taliban and Baloch separatist groups in order to obstruct the CPEC projects. There is a risk that CPEC may become another point of contention between the two South Asian nuclear powers. In June 2015, barely two months after Chinese President Xi Jinping announced plans to invest \$46 billion in CPEC, India's Prime Minister Narendra Modi told China that it was "unacceptable".<sup>49</sup>

Washington has its own concerns about the CPEC helping China to expand access to, and likely influence within, Eurasia. The US administration is also concerned about the new geopolitical nexus between Pakistan and China and the loss of any leverage over its long-term South Asian ally. Pakistan's growing closeness to China may also push Washington to compete for influence in Islamabad.<sup>50</sup> That also poses a serious challenge to Pakistani policymakers on how to balance relations between Beijing and Washington. Islamabad is worried, indeed, about falling out with Washington, but at the same time, it hopes to get more out of Beijing.

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47. *Ibid.*

48. M.K. Bhadrakumar, "Chinese Naval Ships at Gwadar Port Call for a Rethink of India's Regional Policy", *Dawn*, 28 November 2016.

49. F. Shah, "Does the China-Pakistan Economic Corridor Worry India?", *Al Jazeera*, 23 February 2017.

50. D. S. Markey and J. West, *Behind China's Gambit in Pakistan*, *op. cit.*

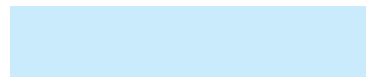
## Conclusion

The CPEC brings a dimensional shift in China-Pakistan relations at a time of significant geopolitical change. The project is a nodal part of China's ambitious Belt & Road Initiative that envisages connecting China to Europe, the Middle East and Africa. The promised investment of billions of dollars in infrastructure and power sector development is welcomed in a country that desperately needs foreign investment to boost its fledgling economic growth. The addition of an expected 10,000 MW of electricity to the national grid by end 2018 will help overcome energy shortages and give a huge boost to the economy. Similarly, the development of roads and other transport infrastructure will also improve connectivity inside the country as well with other neighboring countries in the future. The connectivity part of the project could actually become a game changer for Pakistan.

However there may be some unintended adverse consequences for public finances if Pakistan does not put its policies right. The Chinese money may be coming with a cost that many believe may have serious long-term implications for Pakistan's balance of payment. Although China has an extremely positive image among Pakistanis, the lack of openness on the terms of various CPEC projects has generated a growing skepticism in Pakistan's civil society and business circles. For instance, there is a strong apprehension that the concessions granted to Chinese firms could adversely affect domestic industries. There are also questions about Chinese firms bringing their own laborers to work on the projects, thus depriving the Pakistanis of important employment opportunities.

In other words, a major challenge for Pakistan is to negotiate better terms with the Chinese firms so as to reap maximum benefit from their investments. The underlying issue for Pakistan's leadership is how to implement the CPEC program to remove structural imbalances and put the economy on a sustainable growth trajectory. The CPEC can also become a source of regional economic integration provided efforts are made to reduce inter-provincial disparities and focus more on the country's economically backward areas. Despite disagreement over the distribution of CPEC projects, there is complete consensus among the provinces and political parties on the long-term economic benefits that the Chinese investments could bring for the country. The notion that economic growth will bring political stability is also largely shared.

Finally, the growing China–Pakistan axis reflects Asia’s emerging geopolitics and realignment of forces. Pakistan’s estrangement with the United States and heightening tension with India has led Islamabad to increase its reliance on its “all weather friend”, China. The burgeoning relationship between the United States and India is also a factor further consolidating the China-Pakistan axis. Meanwhile, the CPEC has raised hope of greater connectivity and economic cooperation among the regional countries. Once the projects are implemented, Pakistan’s geostrategic location should make it a potential nexus for the Eurasian “Silk Road Economic Belt” and a Southeast Asian “Maritime Silk Road”. The CPEC could then not only serve as a game changer for Pakistan, but also for the entire region.



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