UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

APRIL 2022

South-South Integration and the SDGs: Enhancing Structural Transformation in Key Partner Countries of the Belt and Road Initiative

UNCTAD/BRI PROJECT/PB 06

Debt Sustainability and the China Pakistan Economic Corridor

Safdar Sohail

National School of Public Policy

sohailsafdar@gmail.com

Abstract

In 2013, the establishment of the China-Pakistan Economic Corridor (CPEC) was announced, an initiative that groups several infrastructure projects including transportation networks, energy projects, and industrial parks. This paper assesses the reasons for Pakistan embarking on the CPEC and whether the project original promises have been fulfilled. In particular, the paper sheds light on Pakistan's interest in improving electricity supply and spurring domestic growth. Secondly, in light of debt sustainability issues, the paper discusses the macro-economic effects of the CPEC on the Pakistani economy. It concludes that, contrary to the popular discussions about Pakistan facing unsustainable debt due to CPEC, Pakistan's debt issues have other origins. The author concludes with reasons for the slowdown in progress of the CPEC.

Key words: China-Pakistan Economic Corridor, debt sustainability

UNITED NATIONS

The findings, interpretations, and conclusions expressed herein are those of the author(s) and do not necessarily reflect the views of the United Nations or its officials Member States. The designations employed and the presentation of material on any map in this work do not imply the expression of any opinion whatsoever on the part of the United Nations concerning the legal status of any country, territory, city, or area or of its authorities, or concerning the delimitation of its frontiers and boundaries.

This paper represents the personal views of the author(s) only, not the views of the UNCTAD secretariat or member States. The author(s) accept sole responsibility for any errors. Any citation should refer to the author(s) and not the publisher. This paper has not been formally edited.

© 2022 United Nations

Contents

Acknowledgements

This paper has been prepared under the project South-South Integration and The SDGs: Enhancing Structural Transformation in Key Partner Countries of the Belt and Road Initiative, funded by UNPDF Sub-Fund for SDGs. The author would like to thank UNCTAD staff for comments on an earlier draft. Any remaining errors and omissions are the responsibility of the author.

1. Background

Pakistan has been holding parliamentary elections every five year since 2008. In the lead up to each election year (2008, 2013 and 2018), the country witnessed macroeconomic instability, marked by depleting forex reserves, significant depreciation of the rupee on the back of widening current account and trade deficits, culminating in a knock at the doors of IMF. The 'boom and bust' cycles in Pakistan are marked by increasing and accelerating growth of imports, with successive governments supporting the overvalued rupee steady.

The supply of electricity and the allied problems has been one of major challenge for all the previous governments. Pakistan has been experiencing severe shortages of electricity as well as spiraling circular debt for the last two decades as the new power brought by the (Independent Power Producers) IPPs has been expensive and the governments would prefer to subsidize rather than increase the tariff for the ordinary consumer. The non-payment of obligations and wastage and shrinkage have also remained high, with old transmission system resulting in significant distribution losses.

Pakistan has also been facing chronic budget deficits due to the massive provision of subsidies to inefficient public sector enterprises. The tax-to-GDP ratio has been historically very low in the country. At the same time, the government has been expanding its public sector expenditure, albeit with falling public sector expenditure efficiency. The public sector expenditure has typically increased significantly in the fourth and fifth years of the election cycle. In the election years, the fiscal deficit ballooned as the governments would try shield voters from power price rises and would try to keep the rupee-dollar exchange rate steady.

After some significant FDI coming to the services sector, particularly in the Banking and Telecom sectors after liberalization in early 2000s, Pakistan did not see much FDI coming to the country, neither in the power sector nor in the manufacturing. Higher growth rates have fueled consumption, and consequently imports, as Pakistan's manufacturing sector has been shrinking over the past 20 years. Due to little FDI in manufacturing, partly due to the security issues linked with the war on terror and low socio-economic indicators like health and education, the productivity in Pakistan has been stagnant. The poor track record of public private partnership (PPP) in Pakistan, poor project selection of public sector development plans and the inefficiencies in the public sector project implementation, the public investment has failed to crowd-in private sector investment and create the kind of structural development momentum, which the public sector investment, with deficit financing should ideally produce.

The effectiveness of the public sector expenditure has been worse in the provinces, which now, enjoy a lion's share of the federal consolidated fund after the 18th Amendment i.e., more than 58 per cent . As a result, the under-developed regions like Baluchistan, KPK, Gilgit-Baltistan and AJK have continued to fall behind the relatively more developed regions of the country, particularly in Sindh and Punjab. All these structural problems, combine to give Pakistan anemic growth rates with deep poverty and mounting inequality.

2. China-Pakistan Economic Corridor (CPEC) as a Game Changer for Pakistan

Announced in May 2013 during the visit of the Chinese Premier Li Keqiang to Pakistan in May 2013, CPEC was warmly welcomed in Pakistan as it promised to end the debilitating load shedding in the country, fill the infrastructure gaps, establish industrial parks and open up the possibilities of transit trade to China through an ungraded Gwadar Port with the help of new roads, mostly passing through the less developed regions of Pakistan. The touted investment of $ 43 Billion worth of Early Harvest Projects (EHP) in an FDI-starved country lifted spirits and expectations, with both governments duly contributing to the hype, reaching a high point with President's Xi's visit to Pakistan in April 2015.

Both the countries worked actively to establish the list of priority projects in the Energy Sector and identify the key connectivity and Gwadar Projects, which were to be implemented during the EHP. The EHP was designed mainly to address the urgent issues, especially power shortages and those connectivity projects which would improve the quality of physical infrastructure for transportation between the two countries.

In the intervening period between Premier Li's visit in May 2013 and President Xi's Pakistan's visit to Pakistan, the Chinese Vision of CPEC was articulated more clearly and vigorously under the Belt and Road Initiative. In order to make CPEC a Flagship of Belt and Road Initiative, it was decided to present CPEC as a new development model of regional development and shared prosperity primarily through a new vision of Spatial Development; not a handful of energy and road construction projects. The very first major MOU signed during the visit of Premier Nawaz Sharif to China in July 2013, as follow up of Premier Li's visit of May 2013, promised to quickly give a long term orientation to CPEC in the very first paragraph of the MOU, with due importance to Corridor Construction and Industrial Parks.

The 5th July MOU also provided for a governance template to steer the CPEC ambition by creating the Joint Coordination Committee (JCC) to be headed by the Federal Minister Planning and Development on the Pakistan side and by a Vice Chairman of NDRC on the Chinese side, to which the CPEC Joint Working Groups would submit the CPEC Projects for approval. The first Joint Working Group to be established to implement the resolution was Planning. Both the countries decided to ask the China Development Bank (CDB) to propose the Outline of CPE Long Term Plan. CDB proposed the Outline MOU, which was approved by both sides on 8th November 2014. The Outline MOU had the following stated as the Vision of China and Pakistan respectively:

2.1Vision of China for the Region with OBOR

- Improve the International and regional integration in the global economy
- Form new International Logistics networks and industrial layout
- Promote regional economic development through steady growth of trade & investment
- Establish new benchmark for deepening economic cooperation in the new situation

2.2 Vision of China for CPEC

- Share with Pakistan, China's advantage of funds, technology, production, engineering and operational capability for mutual development
- Promote long-term social stability in Pakistan and prolonged political stability in Xinjiang
- Accelerate the implementation of the Silk Road Economic Belt and Western Development Strategy

2.3 Vision of Pakistan for CPEC

- Modernize infrastructure and break critical bottlenecks in infrastructure which constrain long-term growth and development
- Connect major economic regions of Pakistan with a view to reduce regional economic development gaps through the emergence of Node Cities as engines of growth
- Up-grade the level of development, with the help of Chinese aid and investment
- Upscale investment relations with China to promote exports of goods and services to China, grow the industry and employment; strengthen and form industry clusters

The Outline MOU identified the following as the constituent Plans of CPEC LTP (perhaps put this in paragraph form – there are a lot of bullets above):

1. Spatial Development Plan
2. Industrial Parks Plan
3. Information and Communication Technology Plan
4. Agriculture Plan
5. Water Resources management Plan
6. Coastal Tourism Plan
7. Financing Plan

The Outline MOU was hailed by the Government of Pakistan as a high-quality document with the stated visions, the roadmap and prioritization of regional development by creating new economic geographies very clearly. From the Pakistan perspective, the inclusion of Agriculture, Water and Tourism - all provincial subjects - embodied the focus on equitable development required by Pakistan, in addition to the mutually beneficial closer trade and investment integration between the two countries.

3. A Long-Term Plan for CPEC as a Flagship embodying BRI promise

While approving the Outline of LTP MOU, both countries again desired CDB to prepare CPEC Long Term Plan. CDB by that time had prepared 18 similar Plans . CDB involved NDRC research organizations heavily in preparing its Report. A CDB Delegation also visited Pakistan for consultation and to collect stakeholders' input in early 2015. CDB presented the 236 pages long LTP to NDRC in June 2015, which was shared with Pakistan after the approval of NDRC and translation in English in August 2015. Realizing that the CDB team did not have any representation from Pakistan side and their team during their visit only collected information and data, the Government of Pakistan decided that the vision and plan presented in the LTP by the Chinese side needed to be taken to the Pakistani stakeholders and the Plan should be finalized after the consultations. Pakistan side did give some initial inputs in October 2015 and some new elements were added to it by from the CPEC Monographic Study on Transport, which was adopted by the two countries in November 2015. With some additions, NDRC shared a final version from their side with the government of Pakistan in February 2016.

The Pakistan side accepted the Plan in its thrust and basics and shared their perspectives on some aspects of the CDB Report for making it more responsive to Pakistan's structural problems in July 2016. The two sides met face-to-face for the first time on the subject in in August 2016 in Beijing and after a difficult start on the financing of LTP, it was finally decided that the CDB Report and Pakistan Perspectives would be merged and a new shorter version would be prepared, after taking out the research and analytical details, which were no longer needed to be present in the final CPEC LTP as both the countries agreed on the Vision and Conceptualization of the Corridor Construction from 2015 to 2030. The new Plan was therefore expected to provide a Vision, Framework of Principles guiding the Corridor Construction and the Strategy to meet the qualitative and quantitative targets by 2030. The responsibility of preparing this Plan was given to the Pakistan side.

The CPEC LTP was presented by the Pakistan side to the Chinese side after approval by the Government of Pakistan in October and was rejected by the Chinese Government in December 2016, notwithstanding all the years and effort taken by both sides to develop a Long-Term Plan. According to the original understanding arrived in July 2013, the work of CPEC LTP was to be completed within one year so that the Long-Term Plan could start from 2015 with a 15 year timeframe. The discussions to arrive at a substantive agreement, particularly on the financing of the CPEC LTP broke down during the 6th JCC in Beijing in December 2016. The Chinese replaced the CPEC LTP it had approved in June 2015 and the CPEC LTP proposed by the Pakistan side in October 2016 with a small document of 25 pages, containing generalities and aspirational statements as the final 'CPEC LTP', without any sectoral or general financing plan and funds, with no sectoral performance targets and no central strategy or Implementation arrangements for the CPEC LTP as an integrated Corridor Construction Pan, emanating from BRI discourse. The adoption of the new Plan by both sides in November 2017 effectively meant the continuity of the Early Harvest Projects format which was project focused and incremental in nature, without a unifying framework of reference in terms of Spatial Development, the key promise of CPEC/BRI.

No new Projects have yet been started under the CPEC LTP for the last five years and all the quantitative goals given for the CPEC LTP 2020 remain unrealized.

4. CPEC and Pakistan's Debt Burden

CPEC has surely fallen short on its promises. Has this failure contributed to the macro-economic instability experienced by Pakistan during the election year of 2018?

In 2018, in Pakistan, familiar structural problems kicked in, with the public debt soaring up to Rs. 30 Trillion (from Rs. 6.8 Trillion a mere ten years before). As the forex depletion and yawning trade deficit became very pronounced, debt sustainability became an important issue, with some accusing CPEC directly responsible for the Debt Burden as if Pakistan was a fit case of Debt Diplomacy of China (Chellaney, 2017).

This is true that for the first time in Pakistan, the debt servicing requirement was more than the federal government's share of the anticipated revenues in the 2019-20 budget and all other expenditure of the government - be it Public Sector Development Expenditure or Subsidies or Government Administration expenditure - had to be financed by the fresh debt. But to what extent and in which way is this assertion by the researchers of the Centre for Global Development, on Debt Diplomacy of China correct in case of CPEC (Hurley, J. et al 2019):

> "Through CPEC, Pakistan currently serves as a centre piece for BRI. The total value of CPEC projects is currently estimated at $62 billion, with at least $33 billion of this amount expected to be invested in energy projects. China will reportedly finance roughly 80 per cent of that amount. Yet, despite this ambition, there have already been cancelled projects, most recently three major road projects at the end of 2017. Adding to Pakistan's risk of debt distress are the relatively high interest rates being charged by China. Unlike the 2–2.5 per cent "concessional rate" given to some China Exim Bank customers, reports indicate that some of Pakistan's loans reflect rates as high as 5 per cent. The IMF notes that adverse shocks could lead to public debt ratios well above 70 per cent. As a country that has requested six debt treatments from the Paris Club, Pakistan's massive amount of borrowing from China raises concerns that it will need to return a seventh time."

I elaborate further on this below.

4.1 Pakistan as a Centre piece of BRI

With the CPEC Long Term Plan projects pipeline drying up with little chance of an early revival, Pakistan is no more the centre-piece of BRI through CPEC. The role of the Chinese state funding in CPEC Projects in the loan mode is highly exaggerated as insinuated in the above-mentioned article as if 80 per cent of the $ 62 Billion is going to be a fresh debt to be incurred by the government of Pakistan directly or indirectly. The above-mentioned figure is not a part of any financing plan of CPEC Projects. The estimated costs of a list of projects under consideration at different levels is actually a figure which keeps on changing as some projects are added and some others are taken out. In the case of energy for example, the estimated cost of the list of Energy Projects established in 2015 was $ 34 Billion.

4.2 The case of CPEC Energy Projects

The bulk of the projects completed to date are not financed through loans, but represent equity holdings of foreign investments in the energy sector in the IPP. This can have an indirect impact on Pakistan's public finances. It has been well understood that the investments in power generation by Chinese investors, attracted by relatively higher returns on equity, would generate outward capital flows but the additional megawatts would avoid GDP loss associated with prolonged spells of load shedding. It is self-evident that IPP investment by a third country puts pressure on the capital outflows, which could create forex problems in a country with a chronic trade deficit. However, one may also say that the supply of uninterrupted power would lift the exports also and attract fresh investment into manufacturing offsetting the imbalance augmented by the Chinese investments in the IPP Sector. Most of the projects in the original list have now been dropped with very few new additions. The realized actual investment in energy projects by the Chinese companies to date is less than one-third of total projected investment of 2015. Again, it needs to be highlighted that it is not an ordinary FDI.

It is an investment in the IPP mode. As this is not a loan, it would not generate a foreign debt sustainability issue directly, but instead ongoing outflows on the external account.

4.3 Foreign Loans to finance CPEC Connectivity

As far as the infrastructure development projects are concerned, the original estimated cost of the two Road Projects i.e., Sukkar-Multan Motorway and KKH was around \$ 8 Billion, however, the realized loan is around \$ 6 Billion. The long-term interest rates on the two Road Construction projects with very long repayment periods is around 2 per cent. What remains out of the original \$43 Billion is about \$ 900 Million for projects in Gwadar. These Projects have been slow to take off but mostly these are in Grant mode.

In case of Sukkar-Multan Motorway, which was always a commercially feasible project, proved by its success after its opening last year, it may have been better to build the road through a PPP, instead of taking a loan. There have been serious objections on the accumulation of costs during the project construction, a common affliction of Pakistan's infrastructure development projects.

As far as the repair and upgrading of Karakoram Highway is concerned, again this road is a very important road both from commercial and security perspective and the expenditure appears justified as this road is not very feasible commercially given very high costs involved in repairing and upgrading a road in a difficult terrain.

4.4 Look elsewhere than to CPEC for unsustainable debt

This is true that the debt-to-GDP ratio has gone well above 70 per cent, recently exceeding 80 per cent. But this has to do more with the sticky structural problems of Pakistan, than CPEC as such. Even if we take the alarmist IMF projections of peak stress of CPEC related peak outflows of around \$ 6 Billion, the peak would come in 2022-23. The bill of imported coal on account of CPEC Coal-based power projects is growing but if we take it as a part of the larger picture, the trade deficit in Pakistan has lately narrowed down and Pakistan's export sector is doing better despite Covid.

The current level of forex reserves is currently not of concern although traditionally, Pakistan has been facing forex problems almost on a continuous basis due to the high trade deficit and outflows including capital flight. Chinese investors into IPPs have actually helped stabilize the forex situation by placing significant reserves at the Central Bank of Pakistan. The suggestion that Pakistan has borrowed massively from China is an exaggeration. Though the share of China in Pakistan's foreign debt has grown steadily, it is represents a relative low of 15 per cent of the total foreign debt and most of this debt is long term debt.

References

Chellaney, B. 2017. China's Debt-Trap Diplomacy. *Project Syndicate*. 23 January. Available at https://www.project-syndicate.org/commentary/china-one-belt-one-road-loans-debt-by-brahma-chellaney-2017-01

Hurley, J., S. Morris, and G. Portelance. 2018 *Examining the Debt Implications of the Belt and Road Initiative from a Policy Perspective*. CGD Policy Paper 121. March.