CPEC: The Dynamics of Economy and Finance

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This paper[1] would attempt to set the ball rolling for subsequent discussion by the panelists at this and subsequent sessions by addressing five oft-asked questions about the CPEC:

1. What is the total size committed by China, what are the different components of CPEC, and how is the phasing of the program?
2. Where do we stand? What has the CPEC achieved so far and what should we expect in the future?
3. What net benefits are likely to accrue to the Pakistan economy and the society at large?
4. How much financing burden the CPEC projects would impose on Pakistan's external account?
5. What are the possible risks to the economy that should be avoided?

1. Size, components and Phasing:

In 2015, China committed a total amount of $46 billion for investment and financing of CPEC program over a period of 15 years. The portfolio consists of 4 projects of which 22 are under implementation. Additions and deletions have taken place since then, but it is advisable to stick to this Commitment.

The four major Components of the program are:

i)	Energy	USD 34 billion
ii)	Infrastructure	USD 11 billion
iii)	Gwadar	USD 0.8 billion
iv)	Industrial Zones	

[1] Chairman's remarks at the opening Session on the CPEC Summit organized at Karachi on April 23, 2018 by DAWN and Ministry of Planning and Development

It may be seen that except for Gwadar Free Zone, no allocations have been made for Industrial Zones as the studies for these Zones are still under preparation and discussion.

The phasing of the program is as follows:

A) Early Harvest Projects up to 2019
B) Short term Projects up to 2022
C) Medium term Projects up to 2025
D) Long term Projects 2030 and beyond

We should remember that the Long Term Plan has been announced only a few months ago and is still on the drawing board. The confusion arises mainly when we lump together Early Harvest Projects which are under implementation, with the Medium Term Projects, for which financing has not yet been indicated, and Long Term projects, which have not been conceptualized. Most of the misunderstandings about the CPEC arise because of this mix up between firm ongoing projects and those which have not yet been agreed upon and require a lot of preparatory work including feasibility studies. Those who complain about the lack of information refer to the elusive projects which are not yet on the drawing board. However, it is fortuitous in case of Industrial zones that these zones are still at initial stages of planning and design as the authorities can benefit from the active involvement of the private sector and nurturing their ownership . After all, the success of these zones would not depend upon the hardware created in the zones by the Government but by the investment decisions made by the Pakistani , Chinese and non Chinese investors. Their fears and apprehensions and concerns can be allayed when they themselves feel assured that the government policies are investor neutral, non discriminatory and a level playing field would become available to all the players.

2. Current Status and Achievements

Since 2015, the priority has been given to Energy projects. These projects are at different stages of implementation. Quaid-e-Azam Solar, Sahiwal Coal, Port Qasim Coal, Hydrochina Dawood Wind, Sachal Wind, have been completed and added to the Grid, while another three to four would be completed by the end of 2018. These projects together would add about 7,620MW to the National Grid.

The projects that have been approved and are at different levels of implementation, consist of 4 Wind, 3 Coal mining, 7 Coal fired, 3 Hydro and 1 Solar while there are two transmission projects. Once all these projects are completed the total addition to the country's generation capacity would be more than 13000 MW i.e. almost 60 percent more than what the country had in 2015.

Under Infrastructure, at least six ongoing projects are expected to be completed by the end of 2018, and cross border Optical Fiber Cable that has attained about 60% Target would also be laid by end of 2018. It should be clarified that although the entire Western route is included in the CPEC umbrella some sections are being financed exclusively by the Government of Pakistan out of its Public sector Development program and this financing is over and above the $ 11 billion allocated by the Chinese for infrastructure.

The Investments made on these projects so far have been approximately $ 23-25 billion.

Looking forward, most of the coal mining, Thar coal fired, Hydel and renewable projects , fibre optic cable network and several roads would be completed more or less around their completion dates .However, it must be alerted that the ML1 railway project would suffer delays as the present cost estimate, according to the Pakistani authorities, are high and the scope and specifications need to be revised to make it economically viable.

3. Net Benefits to the Economy

Pakistan's exports recorded a serious decline from about $ 25 billion in 2012/13 to $20 billion in 2016/17, mainly due to energy crisis. Had the exporters not faced power shortages, Pakistani exports would have reached $40 billion by 2017/18 assuming 10% annual growth rate. Even at a more modest growth rate of 5%, the exports would have touched $32 billion by 2017/18, shrinking our Current Account deficit from projected $16 billion to $ 5 billion only, easing the pressure on external payments, and reducing the borrowing requirements.

As energy supply has rested to normalcy, exports have shown a growth rate of 12% during the first nine months of the current fiscal year. It is estimated that the Current Account would gradually decline over next year as exceptional imports for Power Generating machinery and equipment slow down and exports pick up speed.

The demonstration effect of large Chinese investment in Pakistan has been positive as it has aroused the interest of investors from other countries which are thinking of CPEC as a door opener for them.

The Fuel mix of power generation and efficiency level of Plans are likely to improve when CPEC projects become operational. Furnace oil would lose its share from 38 percent to 14 percent while renewables, hydro, Coal and LNG would gain. The unit costs by closing low efficiency plants (operating at 20% factor) which are generating about 3,000MW at present would decline by 22 percent (Rs. 10.08 to Rs. 8.3 per KWh).

The transit fees for using the Western ,Central and Eastern Corridors by the Chinese traders can amount to $4-6 billion annually, assuming that only 4 percent of the total Chinese export and import trade of $ 4 trillion passes through these Corridors, i.e. flow of $160 billion only.

The losses incurred during the Energy crisis have diminished GDP growth by 2 percentage points (pps) annually. The availability of normal supplies and additional generation should restore the growth rate and raise it by 2 pps with positive consequences for employment and living standards.

In my view, the most positive outcome of the CPEC would be the integration of the backward districts of Balochistan and Southern KP into the national market. The goods produced in these areas—fisheries, horticulture, mining etc would be able to reach the larger consuming centers of the country on time with reduced transportation costs enhancing the incomes of the poor population of these backward districts. This endeavor would not be automatic but has to be carefully planned through construction of feeder roads connecting to the main highways, technical and financial assistance, skill development programs etc.

4. Financing Burden:

It must be clarified that there is a mix of different financing structures that pin the CPEC projects:

a) IPP mode in which the investors are granted an upfront tariff based on debt-equity structure. Chinese investors are getting most of the financing from Chinese EX-IM, Chinese Development Bank or ICBC. They would be entitled to a 17 percent Return on Equity in US dollar terms (excepting coal and renewables where the rate is much higher), which they can repatriate as profits to their home countries. The terms of financing are agreed between the Chinese companies and their lenders. Govt. of Pakistan does not bear any debt servicing obligation on these loans.

b) Government-to-Government loans for Infrastructure projects. These are Concessional long term loans with average rate of interest of 2 percent, and repayment period stretching over 20-25 years.
c) Grants from the Chinese Government mainly for development of Gwadar
d) Private direct investment in form of Joint Ventures with Pakistani Companies in which the obligation for Pakistan is to permit repatriation of profits and dividends in foreign exchange if these ventures are profitable.

Our estimates and those of Sakib Sherani show that the average annual outflows to the Chinese investors and government would lie in the range of $ 2.5 – 3 billion. IMF has estimated that the peak outflows would reach $3.5 – 4.5 billion by 2024/25, or 1.2-1.6% of GDP, and then gradually decline. If our exports attain a level of $ 40 billion by then (assuming a Conservative growth rate of 5% p.a.) then this would not cause any stress on balance of payments and can be easily absorbed.

5.Risks to the Economy

The main risk arises from the current mindset and the model of doing Business as usual. If we continue the practices of bickering, blame game, point scoring, narrow parochial and personal considerations, red tape, hesitation and delays in solving problems and removing bottlenecks then the country would find itself entrapped in heavy financial burden. The projects would not be completed on time or would be hit by constant overruns diminishing the net benefits and therefore our repayment capacity.

The other risk is that as we expand the power generating capacity without repairing the distribution companies, the Circular debt burden would keep on rising, causing serious problem for public finances. Low recovery rates, electricity theft, leakages, inefficiencies, and line losses would create further wedge between the purchase price and sales revenues.

The restructuring and reform of Distribution companies has been overdue for quite some time, but the risk would be amplified when we move from 20,000MW generation to 30,000MW capacity. A competitive power market with multiple buyers and multiple sellers is needed to overcome this highly problematic issue.

Another risk is that the quality of our machinery should conform to international standards. The toxic combination of purchasing second hand machinery and over-invoicing of imports has proved lethal to both the productivity of our industry as well as to our external payments regime.

International inspection companies of repute should be engaged for certifying the machinery and equipment that would be brought to CPEC industrial zones.

CONCLUSION

To sum up, the above analysis shows that CPEC projects are most likely to bring positive net economic and social benefits to Pakistan provided we strengthen our response and absorptive capacity in terms of business model, institutions and policies. Those who think that CPEC would be a game changer should wait to make such bold claims until we are able to design and implement export led investment in manufacturing sector in the nine industrial zones to be built under CPEC. At present the annual average annual investment of $ 3-4 billion under the CPEC amount to only 6 to 8 percent of our annual investment spending of $ 45 -50 billion. Similarly, those who are propagating unnecessary fear and despair by arguing that Pakistan would become so entrapped in debt burden that it would lose its economic sovereignty and forced to cede its territory i.e Gwadar port to China are sadly mistaken. The analysis above clearly shows that Pakistan can easily absorb even the peak payments from its own foreign exchange earnings but it would require concerted efforts to keep the export growth rate above 10 percent annually. This is not such a difficult goal to achieve as we have done so in the past and under the new energy supply scenario which pushed our exports down the curve it is possible to get back on that path.

Appendix

Pakistan's Export Revenues

Simulation and Projections (USD billion)

2012/13 - 2017/18

	Actual	**If these Exports had grown at:**	
		10% p.a.	5% p.a.
2012/13	24.8	-	-
2013/14	25.0	27.3	26.0
2014/15	24.0	30.0	27.3
2015/16	21.9	33.0	28.7
2016/17	21.9	36.3	3.4
2017/18 (estimated)		39.9	31.6

2018/19 - 2024/25

	Assuming 5% export growth rate	**Assuming 10% export growth rate**
2018/19	25.5	26.7
2019/20	26.8	29.4
2020/21	28.1	32.3
2021/22	29.5	35.4
2022/23	31.0	39.1
2023/24	32.5	43.0
2024/25		