Testimony before the U.S.-China Economic and Security Review Commission

China's response to U.S. withdrawal from Afghanistan and China's engagement with Pakistan

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1. How does China view its relationship and engagement with Pakistan, beyond the catchphrase "all-weather friend?" What are the real extents and limits of the Chinese-Pakistan relationship and how does China view those in terms of its broader engagement in South Asia?

China and Pakistan have had a close relationship since the 1960s, and China views Pakistan as an 'all-weather strategic partner' (USIP, 2020). Relations between both countries have broadened and deepened over time from a historically narrow base focusing on the security dimension to include economic and political. This is especially true after the launch of the multi-billion dollar China Pakistan Economic Corridor (CPEC) in 2015. The CPEC has been described as an important pilot project of the Belt & Road Initiative (BRI) (Safdar, 2021). Originally valued at US$ 46 billion, CPEC is one of the earliest and largest BRI projects (BBC, 2015). This increase in Chinese military, economic and diplomatic support has coincided with a decline in the U.S. engagement with Pakistan (USIP, 2020).

Key takeaways from this section:

- The Pakistan-China security relationship is particularly close and has a long history. Non-traditional security threats are testing this partnership in Pakistan.
- Despite tensions, China has expanded its links with different political actors. Learning from their experience, China has developed institutional modes of engagement with a diverse set of political actors.
- Since the launch of the CPEC in 2015, economic cooperation in trade and investment has grown. Productive capacity issues limit Pakistan's ability to take advantage of improved access to Chinese markets.
- China holds a substantial portion of Pakistan's debt, but evidence of "debt-trap diplomacy" is limited. Rather, the Chinese government's recent reticence to reissue US$ 4 billion in loans signals a limit to the partnership.

The Security Dimension

The relationship has its roots in a shared concern regarding India. Pakistan and India have had fractious relations since 1947, especially over Kashmir, while China and India fought a bitter border war in 1962. More recently, beginning in May 2020, tensions between China and India have been high with violent border skirmishes in Ladakh (Santora, 2020). Given these historical roots, the bedrock of the relationship between Pakistan and China is in the security realm informed by a mutual conflict with India. China has been one of the main elements in Pakistan's strategic posture with India (USIP, 2020).

Given their continuing mutual interests, defense relations between Pakistan and China remain especially strong. From cooperation in the nuclear sphere to joint aircraft development, supply of military hardware including warplanes, missiles, submarines, and ships to frequent military-military exchanges. The relationship between the militaries of both countries continues to deepen. In 2002, the countries began Defense Dialogues on military cooperation, defense industry collaboration, and strategic issues. China has been the main supplier of conventional military hardware to Pakistan. Chinese technical cooperation has also been essential for developing the JF-17 thunder jetfighter by the Pakistan Air Force. In 2016, China sold eight submarines to the Pakistan Navy (Malik 2016). Most recently, in 2022, China sold J-10CE fighter jets to the Pakistan Air Force (Xuanzun, 2022). Despite the strength of the conventional military relationship between both countries, non-traditional threats such as continuing attacks on Chinese citizens and interests in Pakistan are worrying for Beijing. Continued attacks and perception by the Chinese of inaction from the Pakistani establishment could negatively affect these close relations.

Some analysts have tied China's engagement with Pakistan to long-term geostrategic interests other than serving as a counterweight to India. In particular, some see China's attempt to build an overland corridor connecting western China and the Indian Ocean through CPEC to secure energy supplies to escape the 'Malacca Dilemma' (Myers 2021). Coined by President Hu Jintao in 2003, the "Malacca Dilemma" refers to China's dependence on the narrow Malacca strait to supply crucial natural resources and especially oil from the Middle East. Without the naval capacity to force open the Malacca strait and supply oil to the mainland during a conflict, the Chinese economy and military could be brought to a standstill. A fully operational pipeline for crude oil and other natural resources through Pakistan would reduce this risk. This could help explain the Chinese interest in Gwadar. Currently, there is limited physical progress on these plans because of the high cost of building such infrastructure. The geography of the area and the difficult terrain means that the cost of building the transportation infrastructure is currently prohibitively high.

The Political Dimension

Relations in the civilian realm have historically been the weakest link between China and Pakistan. Given the India-centric basis of the relationship between both countries, the military has been the constant in the relationship. As the Chinese relationship with Pakistan has broadened, so have its links with political actors across Pakistan.

Boni (2019) noted that the CPEC's launch during the Pakistan Muslim League-Nawaz's (PML-N) tenure represented a period when civilian authority asserted itself. The civilian leadership played an important role in decision-making regarding the CPEC projects. At times, the vision of political actors regarding the CPEC came into direct conflict with that of the military, exacerbating the civilian-military tensions that are an inherent part of Pakistan's political structure. It is important to note that Chinese state and corporate actors (state-owned enterprises) had a strong working relationship with the PML-N in the center and Punjab, the country's largest province by population.

The relationship between the Chinese and the Pakistan Tehreek-e-Insaf government was much less cordial. There were multiple reasons for the tension. In opposition, the PTI had been highly critical of agreements under CPEC negotiated by the previous government. Statements made by ministers and high-level officials further complicated the relationship between the two sides. Political instability and other issues have meant that China has pared down its expectations from CPEC, focusing once again on the military dimensions of the relationship (Small, 2020).

While CPEC has run into certain issues, it has provided the foundations for a deeper relationship, including in the political realm (Markey, 2020). This can be witnessed by looking at the developing relationship with political parties across the political spectrum, from the religious right to large national-level political parties like the Pakistan Muslim League-Nawaz (PML-N), the Pakistan People's Party (PPP) and the Pakistan Tehreek-e-Insaf (PTI). China has learnt from the criticism of CPEC projects and developed institutional mechanisms to engage with local political parties across the political spectrum. A Joint Consultative Mechanism (JCM) was launched in 2019 in Beijing, bringing together representatives from nine Pakistani political parties[1], as well as officials from government departments and elite leaders and representatives from the Chinese Communist Party (CCP) (Safdar 2021).

[1] These parties include the three largest national parties, the Pakistan Tehreek-e-Insaf (PTI), PML-N, Pakistan People's Party (PPP), religious parties including the Jamat-e-Islami (JI), Jamiat-e-Ulma-e-Islam-Fazal (JUI-F) and regional parties from Balochistan and Khyber Pakhtunkhwa province like Awami National Party (ANP),

The Economic Dimension

Trade

Economic ties between China and Pakistan have steadily become deeper. China is already Pakistan's largest trading partner, though the relationship is heavily skewed towards China. Pakistan has a persistent and large trade deficit with China. In 2021, imports from China accounted for more than 30 per cent of Pakistan's total imports. In response to persistent criticisms regarding the lack of access for exporters from Pakistan to the Chinese market, in 2020, both countries implemented the second phase of the China-Pakistan Free Trade Agreement (CPFTA-II). Under the terms of CPFTA-II, Pakistani goods are given preferential access to the Chinese market. Since its implementation, Pakistani exports to China have increased substantially from US$ 1 billion to US$ 3 billion in 2021 (UN COMTRADE, n.d.). Figure-1 shows changes in the trade relationship between both countries. Despite the increase in exports from Pakistan to China, the ability of Pakistani exporters to take advantage of the market access is severely constrained by productive capacity issues across different sectors resulting from persistent under-investment.

Figure 1: Pakistan's Trade with China

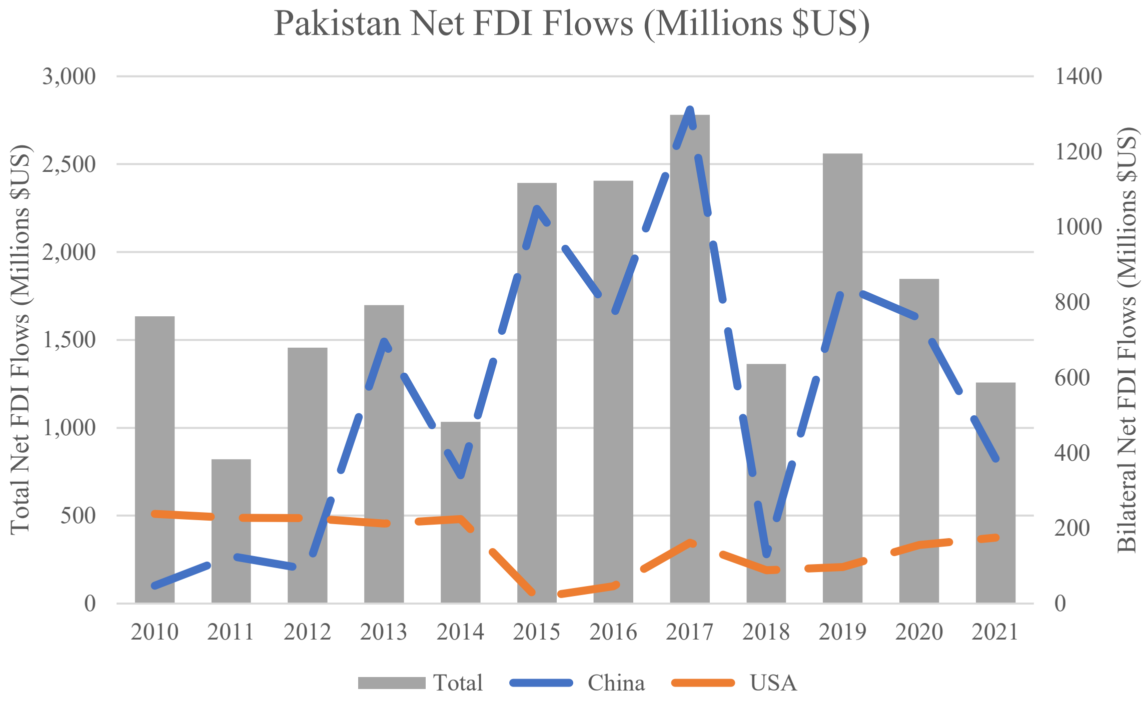
Source: Author's own based on UNCOMTRADE Data, available at: https://comtrade.un.org/data/

Investment

Since the CPEC's launch in 2015, China has consistently been the largest source of foreign direct investment in Pakistan. China overtook the United States in 2014 as the largest investor in Pakistan (Figure-2). Much of the Chinese investment in Pakistan has been in the power sector rather than in manufacturing. The lack of investment in manufacturing is a function of different variables, including security concerns among Chinese firms, opposition from large businesses in Pakistan and lack of progress on Special Economic Zones (SEZs).

National Party, Pakhtunkhwa Milli Awami Party (PkMAP), Balochistan Awami Party (BAP) and the Balochistan National Party (Mengal) (BNP-M) (Safdar, 2021)

Figure 2: Net FDI to Pakistan and a comparison of U.S. and Chinese FDI



Source: Author's own based on Board of Investment, Pakistan data, available at: https://invest.gov.pk/statistics

Debt

Apart from trade and investment, China has also emerged as an important source of debt. China is one of the most important lenders to Pakistan. According to the International Monetary Fund estimates, China holds almost 27 per cent of Pakistan's debt (IMF, 2022). While there are limits to the debt-trap argument, Pakistan faces challenges in paying back Chinese loans (Younas, 2021). Given Pakistan's economic challenges, China has also provided balance of payments and budgetary support. In March 2022, China agreed to roll over US$ 2.5 billion in commercial loans. Given the ongoing vulnerabilities in Pakistan's external sector, the Chinese agreed to roll over a total of US$ 4.5 billion in loans (Haider, 2022). There are, however, limits to Chinese monetary support to Pakistan. Despite assurances of Chinese debt rollovers, it has yet to honor the pledge to reissue loans with a total value of US$ 4 billion that Pakistan repaid at the end of March (The News International, 2022).

2. Please describe the Pakistani and Chinese motivations for China-Pakistan economic cooperation. What does each country hope to achieve from economic initiatives such as the China-Pakistan Economic Corridor?

China and Pakistan's Economic cooperation: motivation

The economic ties between Pakistan and China have deepened further, especially after the China-Pakistan Economic Corridor's (CPEC) launch. The China Pakistan Economic Corridor refers to plans to connect Kashgar in the Xinjiang Autonomous Region to the port of Gwadar, located in Southwest Pakistan in the province of Balochistan. These multimodal connections include roads, pipelines, and railways. Apart from physical connectivity through infrastructure projects, there are plans to build special economic zones, power plants, agriculture, communication infrastructure and other allied infrastructure along the physical corridor.

Work on CPEC was divided into the following three phases:

- Early Harvest (2015–2020): Focus on dealing with supply-side infrastructure bottlenecks in energy supply and transport infrastructure (Cultivation Phase);
- Medium Term (2020–2025): Industrial cooperation with investment, especially by Chinese firms in Special Economic Zones (SEZs; Development Phase); and
- Long-Term/Maturity Phase (2025–2030): Improving regional connectivity and integration and connection between Gwadar and Kashgar (Maturity Phase).

Cooperation between the two countries is based on a 1 + 4 model, with CPEC as a long-term development vision at the core and four functional areas of cooperation, including Gwadar port, energy, communication infrastructure, and industrial development. Multiple projects are to be undertaken in each functional area (Shulin, 2014). In the first phase, the bulk of the funding has gone towards projects in the power sector, with the rest allocated for projects to build the transport infrastructure, including roads and railways, and the Gwadar port (McCartney, 2020).

The key takeaways from this section are:

- Expansion in China-Pakistan economic corridor is driven by the motivations of diverse actors across the state and private sectors. While some of these objectives are strategic, commercial interests play a significant role.
- Investment in Pakistan's power sector was driven by congruence in the interests of diverse Pakistani and Chinese actors. Commercial returns were important drivers of investments by Chinese state-owned enterprises (SOEs) and large Pakistani conglomerates.
- In infrastructure, the expansion in the relationship between both countries represents both commercial and long-term strategic interests.
- In transport, the commercial interests of Chinese SOEs aligned with the development priorities of local politicians.
- Cooperation has also extended to emerging technologies. While these technologies can improve people's livelihoods, there is a danger that these tools can also be used for repression.
- Cooperation in the manufacturing sector is more limited but expanding. Pakistani firms increasingly look towards China as a source of technology, capital, and products.

Roots of deeper economic engagement

The Power Sector

During CPEC's first stage, most funding has gone toward the power sector. Unlike transport infrastructure, where projects are financed through government-to-government loans, projects in the energy sector represent the CPEC's foreign investment component. The CPEC's Long Term Plan calls for cooperation across the electricity value chain (MPD&R, 2017); however, initial cooperation has focused on augmenting the country's generation capacity (Safdar, 2021).

The focus on the energy sector during the CPEC's first phase was driven by congruence in the interests of diverse stakeholders, including Pakistani politicians, the military establishment, large local firms, Chinese policymakers, and Chinese State-Owned Enterprises. Chinese SOEs agreed to invest in Pakistan's power sector as the government urgently sought to deal with power shortages.[2]

For Pakistani politicians, Chinese investment in the power sector represented perhaps the only opportunity to confront the country's chronic power shortages within a short period. It also provided an opportunity to delay structural reforms in the power sector, which were likely to be unpopular. Furthermore, for politicians, the success of Chinese SOE investment in the power sector could act as a powerful signal to other potential investors from China and other countries that Pakistan was open to business and therefore spur economic growth.[3]

For other domestic actors like the military establishment, dealing with the power crisis was essential to maintain internal security. Frequent protests across major urban areas raised severe internal security challenges. For the establishment, investment in the power sector was also significant from an economic perspective. They believed that dealing with the power sector woes could lead to greater economic activity in the country and enhance resources available to the defence establishment.

Under the CPEC framework that guides energy sector cooperation between both countries, local firms, especially conglomerates with experience in Pakistan's energy sector, have partnered with Chinese State-Owned Enterprises (SOEs). The incentive of local firms to work with Chinese SOEs is commercial. Local firms have been able to deal with the primary constraint hindering investment in the energy sector through these partnerships – access to capital. Working with Chinese firms, they have been able to invest in projects where other external actors were unwilling to invest due to environmental, political, and economic sustainability concerns (Safdar, 2021).

Despite risks, for Chinese SOEs[4], investment in Pakistan's power sector provided an opportunity to enhance their presence in foreign markets as part of the go-global strategy. The search for more profitable avenues of capital accumulation gained urgency after the Belt & Road Initiative's launch in 2013. Investment in Pakistan's power sector presented Chinese SOEs with an opportunity to make higher returns. The 2015 power policy guarantees a dollar-indexed return on equity (ROE) ranging from 17 – 20 per cent over the project's lifetime.[5] For upstream Chinese industries, projects in the power sector under CPEC helped ameliorate overcapacity problems. It also provides a chance to internationalize Chinese standards in different industries.

The Chinese state viewed investment in Pakistan's power sector as an opportunity to showcase the development impact of the Belt & Road Initiative. Along with North Korea, Pakistan is the closest example of an ally that Beijing has. The close relationship would mean that the implementation of individual projects would not face challenges. Furthermore, the successful implementation of the power projects could signal other countries regarding the efficacy of the Chinese development model. Therefore, as a pilot project, investment in Pakistan's power sector could have long-run benefits for China and the BRI despite the risks involved. Therefore,

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[2] Interview with a senior politician in Islamabad (2018) and an interview with a Lahore-based businessman working in the manufacturing sector (2019)

[3] Interview with a senior politician in Islamabad (2018)

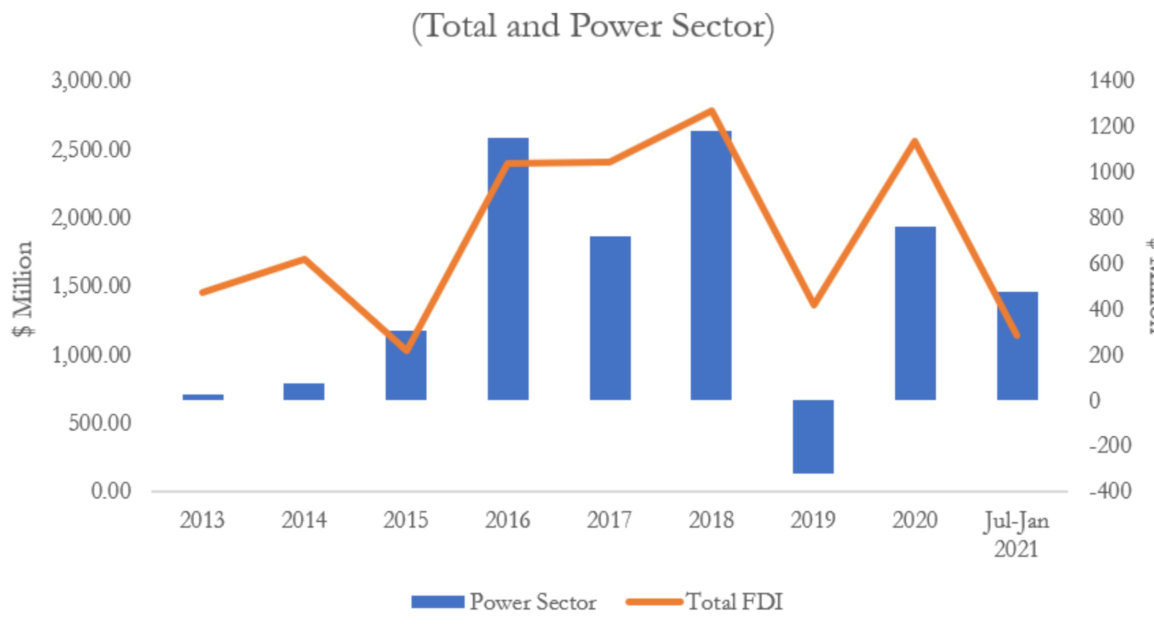
[4] There are structural problems facing Pakistan's power sector. The most pressing issue facing the sector is that of circular debt. Circular debt describes the amount of payments held back by an entity which is facing cash flow problems from suppliers and creditors so that it can push its cash flow problems down to other segments of the supply chain. At its core, the problem of circular debt in the sector occurs when there is a chronic shortfall between inflows and outflows in the power sector.

[5] Salman (2018). Consultative session: Determination of rate of return. Islamabad: National Electric Power Regulatory Authority, Government of Pakistan.

the power sector represented a true ‘win-win’ situation for both parties as their incentives aligned.

The figure below shows overall foreign-direct investment in Pakistan and the share of the power sector in FDI since 2013:

Figure 3: Net FDI in Pakistan and Investment in the Power Sector



Source: Safdar (2021)

Multiple power plants planned under the CPEC are already operational, and there has been substantial progress in dealing with persistent energy shortages. The share of the CPEC projects in electricity generation is likely to go up as more power plants begin commercial operations. There was a reduction in power shortages because of the addition of this capacity to the national grid. During the last five years, Chinese firms have invested almost US$ 10 billion in building power plants and transmission lines. They have added more than 5000 MW to the national grid. The CPEC power plants accounted for almost 33 per cent of the country’s power generation in 2020. While much of the initial investment went towards commissioning plants based on imported coal, more recently, power plants that have started production or are under construction are based on renewable energy (including hydropower) or use indigenous fuel (local coal). Efforts to develop local fuel sources are in sync with the Pakistan government’s focus on optimizing the country’s power mix by reducing dependence on imported fuel.

The table below shows the increase in installed generation capacity.

Table – 1: Installed Generation Capacity by Type (MW)

Fuel Type	Installed Capacity (MW)	
	2013	2019
Hydel	6,947	9,761
Thermal	15,941	25,670
Nuclear	787	1,467
Renewables	50	2,247
Total Capacity	23,725	39,145

Source: Author's own based on NEPRA, State of the Industry Report, various years

The increase in installed capacity is primarily due to a rapid rise in thermal generation. The share of thermal generation has increased due to the commissioning of the CPEC projects and the addition of RLNG based power plants. While many of the earlier power plants used furnace oil or High-Speed Diesel (HSD), the share of electricity generated using coal has increased. The power mix has become more balanced, as the addition of coal and hydel power plants has reduced the overall generation cost.

The table shows changes in actual power generation by fuel type:

Table 2: Total Electricity generation by fuel type

<table>
<tr><th colspan="2" rowspan="2">Fuel Type</th><th colspan="2">Total Generation (GWh)</th></tr>
<tr><th>2012 - 13</th><th>2018 – 19</th></tr>
<tr><td colspan="2">Hydel</td><td>30,524</td><td>33,096</td></tr>
<tr><td rowspan="5">Thermal</td><td>Natural Gas</td><td>28,191</td><td>28,010</td></tr>
<tr><td>Re-liquified Natural Gas (RLNG)</td><td>-</td><td>30,813</td></tr>
<tr><td>RFO</td><td rowspan="2">35,804</td><td>13,826</td></tr>
<tr><td>HSD</td><td>28</td></tr>
<tr><td>Coal</td><td>40</td><td>16,725</td></tr>
<tr><td colspan="2">Nuclear</td><td>4,181</td><td>9,136</td></tr>
<tr><td colspan="2">Renewable Energy</td><td>32</td><td>4,918</td></tr>
<tr><td colspan="2">Imports</td><td>375</td><td>487</td></tr>
<tr><td colspan="2">Total</td><td>99,147</td><td>137,039</td></tr>
</table>

Source: NEPRA, State of the Industry Report, Various years

Infrastructure Development

The Chinese have expended substantial resources on infrastructure development in Pakistan. While some of the funding has gone towards traditional areas like building ports, roads and mass transit projects, China has also financed improvements in Pakistan's digital infrastructure. Unlike the power sector, though, infrastructure projects are based on government-to-government loans and represent the explicit debt component of the CPEC. Loans for infrastructure projects are typically long-term with a grace period and interest rates ranging between 2 - 3 per cent. While the terms of these loans are usually not discussed, evidence suggests that in Pakistan's case, the debt instruments are blended with most of the value of the loan at below-market interest rates but a significant minority (12 – 13 per cent) of the value of the loan at near market rates (5 – 6 per cent) (Safdar, forthcoming). Unlike the power sector, where the rationale was commercial, the motivation of Chinese spending on infrastructure development represents a mixture of long-run strategic interests mixed with commercial interests. These motivations are couched in the language of win-win cooperation.

Projects to improve the transport sector have funded motorways and a mass-transit light rail system in Lahore. Constructing a transport corridor between China and Pakistan has not been a priority for the Chinese, given the high material costs and challenging geography (Garlick, 2018). China's motivation for financing transportation projects is driven partly by local factors, especially the over-capacity that exists in different sectors of the economy.

Infrastructure spending is also a function of the commercial incentives of large Chinese SOEs like China State Construction Engineering Corporation (CSCEC), which lobbied the central government to fund the construction of the Multan-Sukkur motorway. Spending on improving the transport infrastructure is also in response to the demands of local policymakers. The Pakistan Muslim League-Nawaz (PML-N) prides itself as the party which builds infrastructure while in power. The motorway projects and the light-rail mass transit project in Lahore were pet projects of the PML-N leadership. Evidence suggests that the Chinese were inclined to spend on improving the country's railway infrastructure during the CPEC's first phase; however, road projects were fast-tracked because of the demands of the local politicians.

Several infrastructure projects are in various stages of completion in Gwadar. Unlike infrastructure projects in the rest of the country, funding for projects in Gwadar is primarily in the form of grants which shows the importance given by the Chinese to Gwadar port. The Chinese are financing and building the New Gwadar International Airport, which on completion, will be the largest commercial airport in the country. There are big plans for Gwadar, which currently has less than 150,000 people. The literature highlights the dual-use potential of Gwadar port as an important variable to explain the Chinese interest in the port (Kardon et al., 2020). It also provides the Chinese access to the Indian Ocean. In the Chinese strategic thinking, Gwadar is a gateway project connecting China with the Indian Ocean (Brewster et al., 2017). Given the evolving situation in the South China Sea, Gwadar could also provide an alternative route to the Strait of Malacca for moving goods and energy supplies. While the cost of such a project is prohibitively high (Garlick, 2018), geopolitical tensions and improvements in technology could provide the rationale for investment in this infrastructure. For Pakistan, Gwadar port provides a hedging strategy against India. Both Karachi and Port Qasim are located relatively close to each other. In the case of a conflict with India, they can be blockaded. Gwadar provides more strategic depth to Pakistan, given its location. It could also help Pakistan develop closer trade linkages with land-locked Central Asian states as a trans-shipment location. However, the success of this venture is dependent on peace in Afghanistan. Pakistani policymakers also hope to attract Chinese investment in the Gwadar free zone being developed by China Overseas Port Holding Company (COPHC) which operates Gwadar port.

Pakistan is also part of the digital silk road. Karachi is one of the landing stations for the high-speed submarine PEACE cable, which connects countries in Europe, sub-Saharan Africa, and South Asia. Originating in Karachi, the PEACE cable embodies the emerging geostrategic competition between China and the United States in the technology sphere. Given the strategic location of the landing stations, the PEACE Cable is about more than just commercial returns (Blaubach, 2022). It is a theatre for great power competition. For Pakistan, the PEACE cable provides greater data security because of the involvement of Indian firms operating the existing submarine cable.

The PEACE cable landing station is in addition to other initiatives in the digital areas, including the China Pakistan Optic Fibre Project and Smart city projects across the country. There are both economic as well as strategic motivations behind these projects. From an economic perspective, improved access to information technologies and the internet can positively impact people's lives through innovative uses in education, health, agriculture, etc. It can also contribute to a better interface between the state and the citizenry by augmenting e-governance services in developing countries like Pakistan. Given the quasi-military nature of the regime in Pakistan after 2018 (Rahman and Shurong, 2021), links between China and Pakistan in the digital arena can also provide the tools to clamp down on dissent and further reduce individual freedom.

Cooperation in the Manufacturing sector

The CPEC's second phase focuses on fostering industrial cooperation through investment by Chinese firms in Special Economic Zones (SEZs). Policymakers in Pakistan have expressed their hopes of attracting labour-intensive manufacturing, which was relocating from China to other countries because of rising labour costs and other geopolitical challenges.

According to the CPEC Long-Term Plan, cooperation in the industrial sector would help generate local employment while reducing regional inequalities in Pakistan (MPD&R, 2017). Through CPEC and investment in the SEZs, Pakistan aims to enhance local industrial development by not only upgrading the textile sector but also promoting value addition in other industrial sectors by progressively upgrading capabilities from simple assembly operations to local value addition, both for the local market as well as exports (ibid.). Local policymakers see industrial development as a means of dealing with the chronic trade deficit affecting Pakistan by enhancing exports. The theory of change is where the initial investment in removing supply-side bottlenecks in the power and transport sector can help generate demand-side growth through increased economic and industrial activity.

Representatives of the Chinese state and Chinese SOEs operating in Pakistan highlight the importance of industrialization in contributing to sustainable economic growth and development in Pakistan.[6] They observe that infrastructure improvement is unlikely to contribute to growth without enhancing industrial competitiveness and the share of manufacturing in the country's GDP. They highlight the manufacturing sector's important role in China's development[7] and stress the importance of Pakistan learning from the Chinese experience, especially the role played by special economic zones (SEZs). The statements by Chinese officials and businesses highlight the importance of industrialization for Pakistan's development. The motivation for different Chinese actors to invest in industrial cooperation is much less strong in short to medium term than the motivations in the power sector. Because of

[6] Interview with Chinese Diplomat in Islamabad (2019) and with managers of Chinese SOEs in Lahore (2019)
[7] Interview with a large Chinese firm in Lahore (2021)

its location, Pakistan could be a bridgehead for Chinese firms expanding to Africa and the Middle East. Despite the advantageous location, multiple risks face Chinese manufacturers investing in the country, including political instability, lack of policy coherence, threats of violent terrorism and high costs.

While the evidence is anecdotal, Chinese FDI in the manufacturing sector is far more limited than investment in the power sector. Many Chinese firms that have invested in the manufacturing sector seek to take advantage of the domestic market rather than produce for the export market. Furthermore, Chinese firms' preferred entry mode is through licence agreements with Pakistani firms or joint ventures, given the market risks. A small but growing group of domestic firms have actively developed linkages with Chinese firms, especially those manufacturing consumer durables. Over the last decade, these linkages have contributed to the emergence of a capitalist class closely aligned with China and look toward Chinese firms as sources of capital, technology, and products instead of the Western world. Some of the most significant linkages have emerged in the automobile sector and consumer electronics.

In the automotive sector, local firms have developed joint ventures and technical/licence agreements with leading Chinese firms, including Changan, FAW and BAIC. A local firm has also signed a production licence agreement with Geely. These Chinese linked firms in the automotive sector initially began by introducing and assembling commercial vehicles for the domestic market. However, they are now expanding their presence in the passenger vehicle category. While these firms produce vehicles for the domestic market, some firms, like Changan, could use the local operation as an export hub (Hussain, 2020).

Chinese manufacturers have also gained a substantial market share in consumer electronics. As with the automotive sector, Chinese firms like Haier, TCL, Gree and Changhong are active in the domestic market. Haier began operating in Pakistan in 2006 as a joint venture with a local company. Haier has emerged as the market leader across consumer electronic categories. Haier became the first company to assemble laptops for the domestic market within the country. Since the tie-up with Haier, Ruba has gained significant prominence. Both companies launched the country's first privately owned and operated special economic zone (SEZ) in Lahore (Business Recorder, 2014). The importance accorded to the venture can be gauged from the fact that the SEZ was inaugurated in 2006 by President Hu Jintao (Bräutigam & Xiaoyang, 2014) while the Chinese Vice President Wang Qishan visited the economic zone during his trip to Pakistan in 2019. This was the first overseas Chinese SEZ.

The Ruba Group is emblematic of the emerging domestic firms looking toward China. Over the last decade, the company has developed partnerships with many Chinese firms in diverse sectors, including automotive (J.V. with Foton, a subsidiary of BAIC); glass (J.V. with Deli Glass Company Limited) and is actively seeking to expand the relationship with other Chinese firms. Whether these commercial relationships grow and expand remains open to speculation. However, what is certain is that the shift of local businesses towards Chinese firms and China is increasingly discernible. Others like Service Industries Limited, a local firm, entered a joint venture with Chaoyang Long March Tyre Co. Ltd. to manufacture steel-belted tyres for export. The venture began operations in Karachi in 2021 (Ahmed, 2021).

The lack of investment in manufacturing is also due to slow progress from the Pakistani side on the much-trumpeted special economic zones (SEZs). While the first SEZ was supposed to begin operations at the beginning of the second phase in 2020, development work has faced multiple delays. The impact of the Covid pandemic can partly explain the slow pace of work. Problems have been exacerbated by a lack of policy focus from the state. Estimates suggest that the first SEZ located in Rashakai in KPK province will begin operations in 2024 – 4 years after the initial plans. Other prioritized SEZs in the urban centres of Punjab and Sindh are likely to begin operations in subsequent years.

3. What concerns exist in Pakistan about economic engagement with China among different sectors of society (such as policymakers, religious leaders, business owners, or workers) or in different regions of the country? How have Pakistan's goals in economic engagement with China changed in recent years, and how could current political trends in Pakistan affect future engagement with China? How has China changed its engagement with Pakistan to respond to changing political conditions in Pakistan?

As Pakistan remains in the depth of ongoing economic challenges—that have been exacerbated by exogenous factors such as the rise in global commodity prices, geopolitical tensions, and internal security challenges—there are different concerns/hopes among stakeholders regarding the multifaceted Chinese economic engagement in Pakistan. The section below highlights the concerns among different stakeholders.

Key takeaways from this section are:

- Chinese financed projects face structural problems associated with Pakistan's power sector. Despite efforts by the Pakistanis, the Chinese have shown an unwillingness to re-negotiate the terms and conditions governing these investments.
- China has given preferential market access to Pakistani products; however, it maintains a consistently high trade surplus. The high surplus is a function of the lack of local productive capabilities in industry and agriculture.
- Large businesses are concerned with competition from Chinese firms in the planned SEZs.
- As an autonomous economic actor, the Pakistani military has played a relatively small but growing role in direct cooperation on CPEC projects that generate economic rents.
- Peripheral regions like Balochistan feel that they have been ignored in the CPEC negotiations process and wealth creation, prompting unrest.
- The major change in Pakistan's goals in economic engagement with China came with the election of Imran Khan and the PTI in 2018. The CPEC was directed away from mega-project infrastructure investment and toward socio-economic development.
- Recent political changes in Pakistan could boost CPEC; however, many uncertainties remain on the political front.

The Power Sector

One of the major concerns for policymakers in the outgoing PTI government was the increase in circular debt in the power sector and the Chinese reticence to re-negotiate some of the terms and conditions governing the power purchase agreements (PPAs). These concerns will likely remain a formidable challenge for the incoming government, grappling with the rising international cost of commodities like oil, coal and liquified natural gas (LNG). As a natural resource deficient country, Pakistan is dependent on imports to meet its energy needs.

Evidence suggests that the rising capacity payments drive a significant portion of the increase in circular debt in the power sector. As more Chinese-financed power plants begin commercial generation, these capacity payments will increase (Ghumman, 2022). There are already substantial stresses in the relationship as Chinese-financed independent power producers face greater exposure to the problems of circular debt. Latest estimates show that the receivables of ten Chinese financed IPPs have increased to Rs 300 billion (US$ 1.6 billion), and almost 37 per cent of capacity is offline (Shahbaz Rana, 2022a).

Problems in the power sector are further exacerbated by the frequent devaluations of the Pakistan Rupee (PKR). Various tariff components are indexed with foreign currencies to adjust for exchange rate variations. Every time there is a devaluation of the Pakistan Rupee, there is a corresponding increase in the cost of electricity. While the tariffs shield investors from exchange rate variations, the frequent devaluation contributes to rising landed costs of electricity which has important welfare implications in a lower-middle-income country like Pakistan, for ordinary Pakistanis. It is difficult for civilian and military governments to pass on the full cost of electricity, increasing circular debt. On the other hand, an increase in the cost of electricity also acts as an incentive for power theft.

The lack of economic activity and less than forecasted demand growth have raised further management challenges in the power sector. As the spectre of circular debt continues to haunt Pakistan's power sector, the issue of capacity payments will gain increasing importance for policymakers as they deal with the twin challenges of dealing with the circular debt while trying to ensure that the country meets its obligations under the long-term Power Purchase Agreements (PPAs). The increase in international commodity prices further compounds problems in the power sector. The increase in commodity prices has a direct impact on the cost of electricity generation

The Covid pandemic further contributed to the challenges facing policymakers in the power sector. In 2020, the PTI government began re-negotiating PPAs with different IPPs. Through these renegotiations, the government reached an agreement with a consortium of 47 independent-power producers established under the power policies of 1994 & 2002. The government also wanted to re-negotiate the contracts with Chinese-financed power plants built under the CPEC framework, but the response of the Chinese side to these requests has not been positive. At the 10th meeting of the Joint Cooperation Commission, the highest forum for joint decision making under the CPEC, Pakistan agreed to keep the tariff and tax regime intact (Rana, 2021). Despite these assurances, Pakistani policymakers once again raised the issue of renegotiation with Chinese policymakers during former Prime Minister Imran Khan's visit to Beijing in February 2022. They unsuccessfully tried to convince the Chinese to re-negotiate two aspects of the existing PPAs:

- The existing contracts are front-loaded, which means that the debt will be paid off in ten years. As several CPEC projects have come online quickly and demand increase has lagged supply because of the economic slowdown in 2018 and the effects of the Covid pandemic, policymakers wanted to extend the loan payment tenor to 20 years. Doing so would reduce the capacity payments due on these projects.
- The Return on Equity per-annum for different CPEC projects ranges from 17 – 20 per cent (IRR-based). As noted earlier, the ROE is indexed to the U.S. Dollar.[8] Through renegotiations, the government wanted to reduce the ROE to reduce the cost of electricity.

Trade & Investment

Trade relations between China and Pakistan have developed over time, but, as noted earlier, China runs a substantial trade surplus. The size of the trade surplus has grown over time, especially after the two sides signed the first Free Trade Agreement in 2006. The agreement

[8] It is important to note here that this indexation is not a special allowance for Chinese investors. Indexation to the US$ is a common feature across all power policies announced in Pakistan to 'attract' private sector investment since 1994

eventually took effect in 2007. From 2007 to 2018, bilateral trade grew by more than 240 per cent. The growth in bilateral trade was six times greater than Pakistan's trade with the rest of the world. A study by the Consortium for Development Policy Research shows that while Pakistan's exports to China increased by almost 200 per cent, imports increased by almost 250 per cent, increasing from US$ 4.2 billion in 2007 to US$ 14.5 billion in 2018 (Afraz and Mukhtar, 2020).

Organizations like the Pakistan Business Council, a collective organization representing large businesses in Pakistan, were highly critical of the impact of CPFTA-I on Pakistan's manufacturing sector. A major critique of CPFTA-I was that the agreement was one-sided because it gave access to Chinese imports to Pakistan, but reciprocal access to the Chinese market for Pakistani imports was missing. The increase in Chinese imports to Pakistan contributed to premature de-industrialization in Pakistan. Attributing de-industrialization in Pakistan entirely to Chinese imports and the CPFTA is problematic, given the policy framework and incentive structure which incentivized investment in speculative areas of the economy, especially the stock market and real estate, while being at odds with the interest of industry (Naseemullah, 2016).

Pakistan and China began renegotiations on the FTA in 2012, and negotiations concluded successfully in 2019. The CPFTA-II covers the period from 2019 to 24. The terms of the re-negotiated FTA are a marked improvement to CPFTA-I and improve Pakistani exporters' access to the Chinese market. Afraz and Mukhtar (2020) observe that 80 per cent of the product lines that China imports from exporters from Pakistan face tariffs that are lower than or equivalent to China's main trading partner. Under CPFTA-II, China eliminated tariffs on 313 priority tariff lines for products that Pakistan exports. These include a diverse basket of goods including textile and garments, seafood, meat products, chemical plastics, footwear, and engineering goods including tractors, auto parts, home appliances and machinery etc. The effects of CPFTA-II on Pakistan's exports have been positive, and in Financial Year 2021which runs from July 2020 to June 2021, Pakistan's exports to China grew year-on-year by 38 per cent to US$ 2.355 billion.[9] The relationship between the two countries remains heavily skewed towards China, and imports from the country increased by 13 per cent during the financial year.

Chinese officials in Pakistan have highlighted the problems associated with China's high trade surplus (Alam, 2022). While China has offered duty-free access to many different tariff lines, the ability to take advantage of these opportunities is constrained by the productive capabilities of local agriculture and industries. The lack of focus on industrial development by subsequent governments means that the capacity of Pakistani businesses to take advantage of the opportunities presented by CPFTA-II is limited.

Businesses

As noted earlier, large businesses that have entered the power sector have largely supported Chinese investment. Other business interests have been critical of the higher cost of electricity relative to Pakistan's neighbours. They are also wary of the impact of the planned special economic zones on their interests, given the substantial incentives offered to Chinese investors within the SEZs (Small, 2020). While opposition from local businesses could be part of the reason for the delay in establishing SEZs, problems were exacerbated by the lack of focus from the provincial and federal governments. Furthermore, recent work by McCartney (2021) has raised questions regarding the perception that industrial relocation in the SEZs will positively impact Pakistan's economic development in the absence of an active industrial policy. The

[9] Data with the UNComtrade puts the figure at US$ 3.03 billion

Pakistani state's ability to develop and implement a coherent industrial policy is highly questionable.

The Military Establishment

The bedrock of the relationship between China and Pakistan is the security dimension. The military establishment remains the most important actor in the relationship with the Chinese. After a brief interlude when civilians played an important role after CPEC's launch in 2015, the military re-emerged as the main actor in the relationship after the PTI government came into power in 2018. During the CPEC's initial years, civilian-military relations became increasingly acerbic, leading to Prime Minister Nawaz Sharif being dismissed on corruption charges. Given the military's oversize role in Pakistan's history, their lack of oversight over CPEC emerged as a bone of contention between the two sides. It raised broader questions related to the future of civil-military relations in the country.

There was also an economic dimension to these concerns, which had to do with China's increasing economic presence in Pakistan. These concerns, it was feared, could negatively affect public support for bilateral security cooperation (Small, 2020). There is little discussion in the existing literature regarding another important aspect of the economic dimension—economic rents. Contracts of multi-billion-dollar Chinese financed infrastructure projects were awarded solely to Chinese state-owned enterprises despite provisions in the framework agreement to form joint ventures (AGP, 2019). For large military-operated and controlled firms, this meant that they had no access to the substantial economic rents that these projects generated, contributing to further questions regarding the benefits of CPEC. There has been some progress in finding an accommodation between Chinese SOEs and military-run organizations like the Frontier Works Organization. In 2020 a Power China and FWO joint-venture was awarded a Rs 442 billion (US$ 2.9 billion) contract for the first phase of the Diamer-Bhasha Dam. Power China holds the majority (70%) share in the joint-venture, with FWO holding the rest. While the Diamer Bhasha dam is not part of CPEC, the joint venture could provide a template for large CPEC projects in the future, further cementing military-linked firms' role in infrastructure construction (Safdar, forthcoming).

Changes in the geopolitical environment further exacerbated the military's concerns. Despite the close relationship between the two sides, Pakistan's military does not want to be caught in the middle of the emerging great power competition between the U.S. and China. Exclusive dependence on China reduced the room for manoeuvre with other partners, including the United States (Small, 2020). Recent changes in the regional geopolitical environment, including India's increasingly privileged position in U.S. strategic thinking as a counterweight to China in the region and beyond, have strengthened the close military–military relations between the two sides. This can be evidenced by burgeoning arms sales to Pakistan.

Centralization and the case of Balochistan

Soon after CPEC's launch in 2015, controversy erupted regarding the route followed by the physical corridor. Stakeholder conflict over fund allocations for different CPEC projects also began. The PTI levelled accusations that there was an over-allocation of funds for projects in Punjab province (Hussain, 2019). To deal with the concerns, the PML-N organized an All-Parties Conference to deal with the concerns of different provinces. Despite these efforts, the period was marked by concerns from regional actors regarding the continued dominance of Punjab in CPEC (Ahmed, 2019).

Despite the challenges, recent work by Ahmed (2019) observes that the post-2015 discussion on the CPEC and efforts to build a broad-based consensus provided an opportunity to revitalize centre-province relations within the country through dialogue and compromise. These efforts could help deal with some of the deep-rooted ethnic divisions in the country (Ahmed, 2019). There is limited evidence that such a dialogue process has started. Centralizing decision-making regarding the CPEC has increased over the last two years (Adeney and Boni, 2020). Nowhere are the effects of this centralization felt stronger in Pakistan than in Balochistan.

Balochistan's political leaders expressed their reservations regarding Punjab's domination of CPEC (Ahmed, 2019). Despite the strategic importance of Balochistan, locals feel that the province has been ignored in CPEC's first phase. A study by the provincial Planning & Development Department highlighted that Balochistan received only 7 per cent of the total spending under CPEC. The study also highlighted the lack of progress on road infrastructure projects in the province under CPEC. In late 2018, the Balochistan provincial assembly adopted a resolution against the province's meagre share in CPEC projects (Shah, 2018).

Problems are further compounded by the tenuous relationship between Balochistan and the center. Nationalist political leaders highlight the history of resource extraction from the province and the lack of meaningful development. The example of natural gas—which was discovered in the province in Sui in the 1950s—is frequently cited. While Balochistan produces a substantial portion of the country's natural gas, only 6 per cent of the province has access to natural gas. Furthermore, limited financial benefits accrued to the provincial government are limited (Samad, 2014).

Given that Balochistan is Pakistan's largest province by area but has the lowest share in population, Baloch leaders fear that the economic opportunities generated by the CPEC will lead to a massive influx of labour from other parts of the country. This influx could further marginalize the local population and eventually make them a minority in their homeland (Ahmed, 2019). While part of the problem is related to the low population of the Baloch, the other issue is the lack of public sector spending on areas like health and education, which constrains human capital growth in the province.

The sense of deprivation is perhaps substantially deeper in Gwadar. Gwadar port has privileged importance in CPEC and China's strategic thinking. However, six years after CPEC's announcement and almost two decades after work on the port began, there has been minimal improvement in people's lives. There has been some improvement in the transportation links between Gwadar and other parts of the country through the Makran Coastal Highway; however, development in other areas remains limited. Gwadar still imports electricity from Iran as there have been delays in finalizing the modalities of the coal-fired power plant.

Furthermore, access to water remains a chronic problem in an arid area. Despite promises, the Federal government has been unable to construct the promised desalination plants to help alleviate the problem. There have also been concerns regarding the impact of the port on people's livelihoods. A substantial portion of Gwadar's total population is engaged in fishing. Their livelihoods have been affected by fishing from deep-sea trawlers from China and neighboring provinces like Sindh (Notezai, 2022). Plans to build a fence around Gwadar port and many security checkpoints in the city further stoked local disaffection (Aamir, 2020). In response to the multiple issues facing people in the region, there were massive protests in Gwadar in 2021 (Dawn, 2021). Many of the problems raised by the protestors are linked to development issues, such as the lack of access to basic facilities like electricity, drinking water, health, and education facilities (ibid.).

Changes in Pakistan's Goals

The realignment in Pakistan's position regarding CPEC began in 2017 when the country faced a record trade deficit. Before the election of the PTI in 2018, there were signs that CPEC was slowing down. The PTI's election further contributed to a shift in the CPEC's strategic focus from infrastructure to socio-economic development. Former Prime Minister Imran Khan frequently highlighted the importance of learning from the Chinese poverty alleviation strategies. The changes have meant a substantial change in the scale of projects under the CPEC (Small, 2020). Under the PTI government, new joint-working groups on third-party cooperation, socio-economic development and agriculture were formed. In both cases, discussions focus on a more toned-down version of the CPEC with limited scope for largescale investments. While SEZs remain a part of the CPEC, progress on providing utilities and physical work on zone development remains slow.

Impact of Political Changes on the relationship

The PTI's historical relationship with the Chinese has been tense. Before CPEC's launch in 2014, Asad Umer, who served initially as the finance minister and then as the Minister of Planning, filed a petition with the electricity regulator regarding the higher than market returns offered to Chinese investors (NEPRA, 2014).

In 2018, the former advisor on Commerce, Abdul Razzaq Dawood, caused significant concern in Beijing. In an interview with the Financial Times, Dawood observed that the Chinese investors were given incentives, much to the detriment of local investors (Andrelini et al., 2018). Dawood also called for a renegotiation of some of the CPEC contracts. The interview was published during Foreign Minister Wang Yi's visit to Pakistan and was viewed as a slight by the Chinese, who sent a sharp rebuke (Small, 2020). Others, like the new minister of railways, Sheikh Rashid Ahmed, bemoaned the substantial loan burden of the ML-1 project and its effect on the country's financial sustainability (Siddiqui, 2018). The statements need to be seen in totality in the context of Pakistan's political dispensation at the time and the hybrid nature of Imran Khan's regime.

Further controversies followed. In 2019, Murad Saeed, the Minister of Communication in the PTI government and one of Imran Khan's closest confidantes made accusations against a large Chinese SOE of corruption. He alleged that the firm offered kickbacks to ministers in the PML-N government. He accused the former Planning Minister Ahsan Iqbal of being the prime beneficiary of cost escalations allowed to China State Construction Engineering Corporation (CSCEC)—a leading Chinese SOE under the management of the central State-owned Assets and Administration Commission of the State Council (SASAC)—in the construction of the Multan-Sukkur motorway. The accusations contributed to further tensions between the Chinese and the PTI government. The Chinese SOE issued a strongly worded statement against the minister's charges, which is uncharacteristic for Chinese firms (Khan, 2019). The relationship between the PTI government and the Chinese improved in 2019 when Imran Khan visited Beijing with the Chief of Army Staff for a second time (Small, 2020). The JCC meeting, which followed the trip, signaled progress in some areas, including socio-economic cooperation (a priority for Imran Khan) and establishing three prioritized SEZs in Faisalabad, Rashakai and Thatta, as well as the ML-1 railway line project.

Despite these improvements, tensions persisted. In 2020, a report on the power sector commissioned by the government to audit the power sector observed that one of the Chinese projects under CPEC, the Shandong Ruyi (Pak) Energy power plant, would receive US$ 2 billion in excess ROE during the project's lifetime due to misrepresentations by the sponsor (Committee for Power Sector Audit, Circular Debt & Future Roadmap, 2020). The Chinese expressed their frustration with these periodic statements against Chinese interests and the negative perceptions they generated.[10] The tensions in the relationship with the civilian government meant that over the last three years, the Chinese have increasingly looked to the

[10] Interview with Chinese Diplomat in Islamabad (2019)

military as the ‘principal interlocutor’ (Small, 2020: 6) and have relied on it to deal with political and economic challenges previously managed in the civilian domain.

These contracts were negotiated and implemented during the tenure of the Pakistan Muslim League-Nawaz (PML-N) government. Small (2020) noted that during the 2018 elections, Beijing hoped for political continuity as the PML-N had played an effective role in pushing CPEC forward during the first phase. A second term for the PML-N would help continue progress and strengthen Beijing’s position in Pakistan. With the recent political changes in Pakistan, relations with the Chinese could likely improve. This is especially true for Shahbaz Sharif, the younger brother of PML-N supremo Nawaz Sharif, who came into power after a no-trust vote against the Imran Khan-led PTI government. The incoming Prime Minister has historically had a good working relationship with the Chinese. Under his government, the Sahiwal coal-fired power plant was constructed and began operations within 22 months. He is viewed as an able administrator; during his tenure as Chief Minister of Punjab, the Chinese dubbed his ability to ensure rapid project implementation ‘Punjab Speed,’ akin to China’s famed ‘Shenzhen Speed’ (Rehman, 2016). Depending on the incoming government’s handling of the China-Pakistan relationship, the Chinese could exhibit greater flexibility to enter some form of negotiations to support Pakistan’s fledgling economy, especially as uncertainty grips the global economy. If the past provides some indication, the Chinese will be more comfortable working with the PML-N led coalition government in Islamabad. Despite Beijing’s willingness to work with the new government, Pakistan’s ongoing political instability is likely to remain a pressing concern for Chinese policymakers.

The PML-N led coalition government has also signaled a change in the organizational structure of CPEC. Soon after coming into power, Ahsan Iqbal, the Minister of Planning when the CPEC was launched, declared that the CPEC Authority—a decision-making body with strong military influence—would be shut down. The establishment of a parallel CPEC Authority, which gave an explicit role to the military leadership, was a major point of conflict in the relationship between the PML-N and the Army. The news that the CPEC Authority is now being liquidated raises questions about whether the military will be willing to take a less frontline role in CPEC and the relationship with the Chinese. It is too early to tell, and the situation will likely become clearer only after a new Chief of Army Staff takes over in 2022. Furthermore, national elections are likely to be held in 2023 and could provide further clarity on civilian-military dynamics.

4. How have security concerns affected China’s willingness and ability to engage economically with Pakistan? How has the return of Taliban rule affected China’s engagement with Pakistan?

There are substantial security challenges that will continue to affect the economic relationship between Pakistan and China. There has been a steady increase in attacks on Chinese targets in Pakistan as China’s economic footprint has grown. These attacks come from many actors, including Baloch nationalists and the Pakistani Taliban, highlighting the growing security dilemmas that the Chinese face in Pakistan (Basit and Pantucci, 2021).

Key takeaways from this section are:

- Attacks on Chinese nationals and interests are increasing from a range of insurgents. These attacks raise significant challenges for Chinese economic engagement in Pakistan.
- The costs of securing the CPEC have increased. These costs are likely to increase further, given the evolving threat matrix.

- China has engaged with the Taliban in Afghanistan and is interested in expanding CPEC to include the country. China's efforts are likely to be negatively affected by tensions between the Pakistan military and the Taliban.

The Baloch insurgency

There has been an ongoing insurgency in Balochistan since 2004. The insurgency gained greater traction after the killing of Nawab Akbar Bugti in 2006. The insurgency is the latest in a series of uprisings in the restive province since Pakistan gained independence in 1947. While terrorist attacks in Pakistan have declined in recent years, there have been high profile attacks on Chinese interests in Pakistan by Baloch militants.

Most of these attacks have taken place on high visibility targets in Balochistan. What is perhaps more worrying is that apart from Balochistan, most of the recent high-profile attacks on Chinese interests have taken place in Karachi, Pakistan's economic hub. In 2020, militants from the BLA's Majeed Brigade also claimed the attack on the Karachi Stock Exchange (KSE). In 2017, a consortium of Chinese firms acquired a 40 per cent stake in the Pakistan Stock Exchange for US$ 85 million (Washiyama, 2020). The attack could be seen as signs of an emerging tactical alliance between Baloch and Sindhi separatist groups against Chinese economic interests in Pakistan (Basit, 2020). The BLA also carried out other high-profile attacks on Chinese interests in the country, including the 2019 attack on the Pearl Continental hotel in Gwadar and the 2018 attack on the Chinese consulate in Karachi.

In the latest such attack, a female suicide bomber from the Majeed Brigade of the Baloch Liberation Army (BLA) targeted a van carrying Chinese and Pakistani staff members working at the Karachi University's Confucius Institute. Three Chinese nationals died in the attack, leading to swift condemnation from Beijing. What is important to note concerning this attack is that it is the first known instance in the Balochistan conflict where a woman carried out the attack. Secondly, the attacker was well-educated and came from a well-off Baloch family. The attack serves as another reminder of the threats facing Chinese targets in Pakistan. It also signals a different and worrying dimension of the Balochistan conflict for Pakistani security analysts (Rana, 2022).

The Tehreek-e-Taliban Pakistan

Baloch militants are not the only threat to Chinese interests in Pakistan, including in Balochistan. The Tehreek-e-Taliban Pakistan (TTP) has also been accused of spearheading attacks against Chinese nationals. The militant group targeted the Chinese ambassador during a visit to Quetta. The Chinese ambassador narrowly escaped the attack at the upscale Serena Hotel in the city. The attack left five people dead and injured seventeen. Analysts saw the attack as a signal that the militants viewed China as an opponent because it supported the Pakistani state (Aamir, 2021).

In July 2021, nine Chinese were killed in an attack on a bus carrying Chinese and Pakistani workers engaged in constructing the Dasu dam project in Pakistan's Northern region. After initially suggesting that the incident was due to a technical fault in the vehicle, the government admitted that militants of the banned TTP were to blame (Rana, 2022). More worryingly, Chinese sources accused the East Turkestan Islamic Movement (ETIM) of working with the TTP in carrying out the attack (Basit and Pantucci, 2021). The Chinese reaction to the attack was strong. China canceled the Joint Coordination Committee meeting, which was supposed to meet after a hiatus of almost two years. The Chinese firm also stopped working on the project as China demanded that the Government of Pakistan improve security.

Mounting security costs

Pakistan has expended substantial resources to protect Chinese nationals and CPEC projects. In 2016, the Government of Pakistan raised a Special Security Division tasked mainly with protecting Chinese interests in the country. The SSD comprises two light infantry divisions with 15,000 soldiers each. The SSD is supported by 32,000 other security personnel from para-military forces like the Frontier Constabulary, Rangers, and the police. The cost of providing security to the Chinese is high. Recent reports suggest that the Chinese contribute to security costs (Rana, 2022). The high-security cost is already affecting large infrastructure projects like the ML-1 railway project, where the cost of providing security to Chinese nationals working on the project is a staggering Rs 36 billion (around US$ 200 million) (Shahbaz Rana, 2022b). Given the precarious economic condition facing Pakistan, the high cost of security poses another challenge for policymakers in Islamabad.

In the face of the evolving threats faced by Chinese interests in Pakistan, Beijing is likely to increase pressure on the Pakistani establishment to improve the security of Chinese businesses and nationals. This will increase the security costs of CPEC putting further pressure on Pakistan's economy.

Prospects for Chinese investment

As China's economic footprint in Pakistan continues to evolve and expand, the threat matrix faced by Chinese interests is likely to evolve. These threats will contribute to a rethinking of the Chinese position in the country. More importantly, it will further deter private Chinese firms from investing in the country from Pakistan's perspective. Investing in the country is already risky; as the chronic political instability and problems large Chinese SOEs face in the power sector have shown, the additional risk posed by violence is likely to further deter private Chinese investors from relocating to Pakistan. This is especially true because other regions of the world, like Southeast Asia, are far less risky for industrial relocation.

It is doubtful that Chinese investment in the much-vaunted SEZs will grow substantially in short to medium. The lack of foreign investment in Pakistan's productive sectors means that the country faces the boom-bust cycle that has characterized Pakistan's growth over the last five decades. A large infusion of Chinese capital and firms in the planned SEZs will be accompanied by an increase in Chinese nationals coming to the country, raising the spectre of more attacks. While the incoming Pakistani government has repeatedly stated that they will improve the security of Chinese citizens working on different projects in Pakistan, the recent spate of high-visibility attacks is unlikely to give the Chinese much confidence. Basit (2018) has taken a different view regarding counter-insurgency cooperation between the two countries. After the early 2000s, Basit (ibid.) argues that both sides are trying to develop a holistic security strategy that involves multiple security actors, including the military, para-military, and private security firms. Despite these efforts, the recent attacks show a need to move beyond conventional security measures (Rana, 2022).

One of the ways in which the Chinese could play a positive role in Pakistan to safeguard their interests is by prodding the Pakistani establishment to open lines of communication with Baloch nationalists and insurgents. The Chinese could also push for some accommodation on issues that contribute to popular discontent against the Pakistani state in Balochistan. One such area is that of missing persons. There are frequent accusations that the Pakistani security forces act with impunity, and there are cases of enforced disappearances in the province (Samad, 2014).

Afghanistan after the Taliban takeover

During the U.S. war in Afghanistan, Miao and Xie (2021) have argued that China engaged in a policy of 'minimal intervention,' meaning that it avoided security issues other than serving as a meeting place between the Afghan government and the Taliban. China also sought economic cooperation with Afghanistan within the framework of the BRI and particularly the CPEC. Overall, China had low-level involvement in the security field but significant economic investments due to China's growing demand for energy and incentives for foreign energy investment in Afghanistan (Miao and Xie 2021). China had temporarily withdrawn from Afghanistan following the uncertainty of the Taliban victory (Chen, 2021). China has sought to mediate the relationship between Afghanistan and Pakistan to ensure the safety of its economic investment and long-term strategic goals in the CPEC. Since the Taliban takeover in Afghanistan, there have been multiple high-level visits between the two countries. The Chinese Foreign Minister Wang Yi attended the Organisation of Islamic Countries' foreign ministers' meeting held in Islamabad in March 2022, after which he proceeded on a surprise visit to Kabul. Wang's visit to Afghanistan presents the clearest signal that China wants to engage with the Taliban as a 'normal government' (Gannon, 2022).

To minimize the risk of conflict along Pakistan's Western border, China has also begun to consider incorporating Afghanistan into the CPEC, potentially at links between Kabul, Peshawar, Kandahar, and Quetta (Chen 2021). Recently, Pakistani officials have also publicly discussed building connections between Afghanistan and Pakistan. China has reiterated the desire to extend CPEC to Afghanistan, highlighting the positive spillovers for the country's economy (Jun and Daye, 2021). Given its geographic location, Afghanistan could gain substantially from increasing transit trade from Central Asia to Pakistan's Gwadar port.

While fostering connectivity and improving transportation links between the two countries is one of the ways in which the CPEC can be extended to Afghanistan, other more innovative means of providing support to Afghanistan and Pakistan are also under consideration. Given the problems associated with circular debt, which are crippling Pakistan's power sector and negatively affecting the Chinese-financed power plants, one of the options is for Pakistan to export power to Afghanistan. Rather than the Afghans paying for the electricity, the Chinese can buy the electricity from Pakistan as part of their development assistance to Afghanistan through long term contracts (thirty years) (Ghumman, 2022). While authorities have mooted the plan in Pakistan, there has been no official response from China or Afghanistan. Currently, Afghanistan receives electricity from Central Asian states like Turkmenistan and Tajikistan.

Pakistan has been largely supportive of China's overtures to the Taliban. Given that Pakistan is one of the Taliban's closest supporters and has been a vocal advocate of the international community accepting the Taliban as the legitimate government in Kabul, this support is not surprising. While the Government of Pakistan frequently accused the US-backed government in Kabul of turning a blind eye to the activities of the TTP, the situation does not seem to have changed under the Taliban. The TTP seems to be enjoying the patronage of the Taliban government, and little action appears to have been taken against Baloch insurgents (Rana, 2022). The inability or lack of interest in dealing with the TTP has contributed to a marked decline in relations between the Afghan Taliban and the Pakistani establishment. Over the last few months, there has been a significant increase in attacks on Pakistan's security forces (Hussain, 2022). The clearest sign of the fast-deteriorating relations between the two countries was the announcement that Pakistan carried out air raids on alleged TTP sanctuaries in Afghanistan's eastern provinces of Khost and Kunar in April this year (Aljazeera, 2022). The air raids come on the heels of earlier incidents in which Taliban soldiers blocked an ongoing project to fence the porous border. The air raids represent a severe escalation in violence along the border. Given the volatile situation, China's options in the region are limited. Despite China's overtures to the Aghan Taliban, the continuing activity of the TTP and the group's access to weapons left behind by the U.S. is likely to raise concerns in Beijing, given that it wants to maintain peace in the region and protect its economic as well as domestic interests.

5. How does China's economic relationship with Pakistan affect U.S. interests? To what extent has it affected the willingness or ability of the United States and other development partners to work with Pakistan? How have concerns over Pakistan's debt, including the potential for undisclosed debt to China, affected Pakistan's relationship with multilateral institutions such as the IMF?

The United States has long-standing relations, and strategic interests in South Asia as the region is home to two nuclear-armed neighbors. Maintaining stability and open lines of communication between India and Pakistan aligns with U.S. regional interests. Furthermore, ensuring cooperation in counterterrorism operations will likely remain important. To support these long-term interests in the region, the U.S. should support Pakistan's nascent democratic transition and the civilian government. Investment—whether by China, the U.S., or other partners—that promotes sustainable economic growth and development will help maintain political stability in Pakistan and, thus, the broader region.

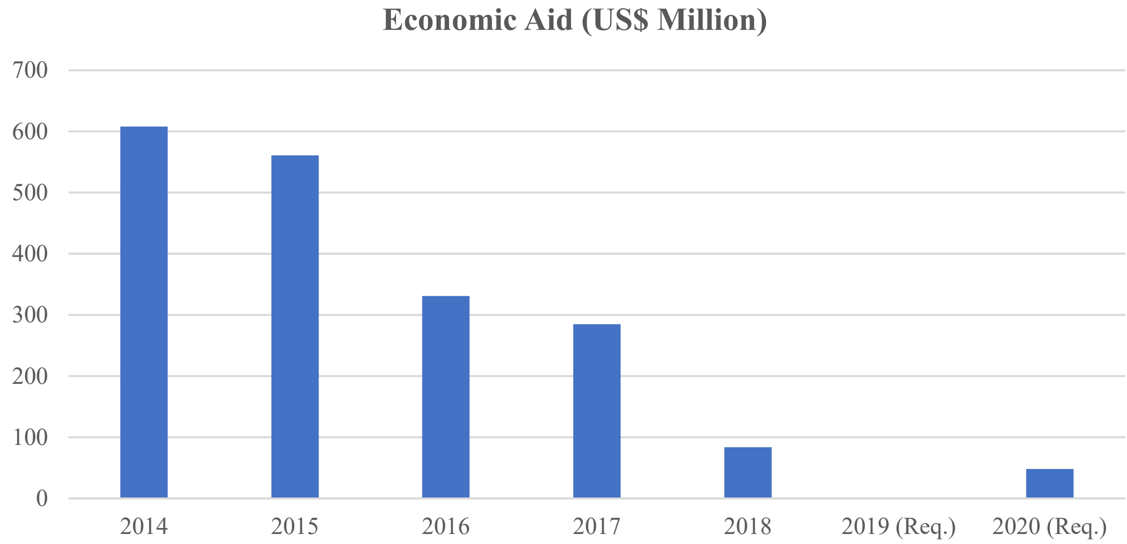
Key takeaways from this section:

- Chinese investment that promotes sustainable economic development converges with U.S. interests in safeguarding stability in Pakistan. Unsustainable debt-based growth threatens to destabilize the fragile Pakistani economy and its political system.
- China's exporting of emerging technologies, especially for surveillance and censorship, may also create dependencies and erode civil liberties to the detriment of U.S. interests.
- Third-party bilateral and multilateral development partners remain engaged with Pakistan.
- Pakistan's debt, including undisclosed debt to China, has been less of a factor in the relationship with the IMF than structural problems in the Pakistani economy.

Geopolitical changes and Pakistan

Given the geopolitical changes taking place globally, especially with the U.S. withdrawal from Afghanistan, policymakers in Pakistan realize that the U.S. interests in the region have changed. The U.S. will likely reduce its engagement in the region, at least in the short term (Kugelman, 2016). Policymakers in Islamabad have their grievances regarding the U.S. and its increasingly lopsided regional engagement, which has skewed heavily towards India in the recent past. They also point out that while the U.S. has periodically abandoned Pakistan, China has remained a steadfast ally. For policymakers in Islamabad, the decline in U.S. involvement in Pakistan is evidenced by the reduction in financial and military support for the country. In January 2018, the United States suspended security assistance to Pakistan. In the economic realm as well, the U.S. has significantly pared back economic assistance to Pakistan with a constant reduction in U.S. aid during the period from 2014 to 2020, as the figure below shows:

Figure 4: U.S. Economic Aid to Pakistan



Source: Author's own based on Kronstadt and Epstein (n.d.)

Along with the reduction in economic assistance, FDI from the U.S. has also witnessed a decline. While the United States has historically been the largest source of FDI to Pakistan, since 2013, investment by the U.S. in Pakistan has been eclipsed by Chinese investment in the country. China has consistently been the largest source of FDI to Pakistan since the announcement of the CPEC in 2015.

The declining economic role of the United States in Pakistan may limit its ability to safeguard its interests in Pakistan on regional issues and problems like counterterrorism (Sacks, 2021). China's expanding economic linkages with Pakistan should not be seen as damaging to long-term U.S. interests in the country, however. To the extent that the development of Pakistan's economy will reduce the appeal of radical ideologies, Chinese investment may align with U.S. interests in Pakistan in promoting political stability and counterterrorism partnership.

Areas of Convergence

Infrastructure Development & Industrialization

There are many areas of convergence where China's economic engagement with Pakistan can positively impact the U.S.'s long-run strategic goals. For one, CPEC brought much-needed investment in Pakistan's power sector, contributing to economic activity in the country. The subsequent problems facing Chinese investments, especially in the power sector, underscore the limits of quick-fix solutions for Pakistan's economy and the importance of undertaking structural reforms. The U.S. has been engaged in providing policy support, especially in capacity building, to help Pakistan deal with some of these structural issues in the power sector. This support needs to be enhanced while keeping in view some of the political economy constraints facing political actors in Pakistan. Politicians in Pakistan have periodically highlighted the importance of engaging with the U.S. in the realm of ideas while depending on China for hardware like machinery.

Similarly, improvements in physical infrastructure can contribute to sustainable economic growth through direct and indirect linkages. At the micro level, it can open avenues of income generation for local people and weaken existing patronage networks. Similar is the case with mass transit projects. The Orange line urban mass-transit project in Lahore has been criticized for the lack of economic sustainability and the continued dependence on subsidies. Given Pakistan's economic position, taking on more debt for the project is problematic; however, state subsidies are important for operating large public transport networks.

Structural change in Pakistan's economy could play an important role in dealing with the frequent boom-bust cycles that plague the Pakistani economy, thereby reducing dependence on multilateral institutions like the IMF. Chinese efforts to spur industrial development in Pakistan could align with U.S. interests by promoting economic stability in the country. Investment in infrastructure is likely to positively impact Pakistan's economic development if it contributes to augmenting the productive capabilities within society.

Areas of Divergence

Debt-fueled growth

Pakistan provides a cautionary tale to the debt-fueled growth model. While Pakistan's economic turmoil is structural, these problems have been exacerbated by Chinese lending for infrastructure projects and the lack of local linkages that these projects generate. In the power sector, Chinese financed projects have added capacity. However, they have also contributed to a substantial increase in capacity payments, thereby putting further pressure on Pakistan to meet the payment obligations. The debt-based growth model negatively affects Pakistan's economic and political stability and thus negatively affects U.S. interests.

Emerging Technologies

Information technologies have an important role in the economy in developing countries like Pakistan. They can provide access to information and have positive spillovers in health, education and income generation. Evidence, however, shows that they can also be deployed as tools of repression. The evolving relationship between China and Pakistan in emerging technologies can help the Pakistani state control the media and political opponents, stifling democracy. Cooperation between the two countries can also lead to more control over the online space based on learnings from the Chinese experience. Similarly, Safe City surveillance technologies that have been used in different cities in Pakistan can be used to clamp down on political dissent. The danger of using these technologies to stifle debate and strengthen central control is problematic for the long-term U.S. interests.

Development Partnerships with the U.S. and Others

Multilateral organizations and bilateral partners are still working with Pakistan on development projects. For its part, Pakistan continues to exhibit a willingness to work with other development actors, including the United States. Pakistani policymakers frequently express their desire to extend the CPEC and include other countries and partners (APP, 2022). The Chinese have also encouraged Pakistan to promote third party participation in the CPEC. Both sides established a Joint Working Group on Third-Party participation in CPEC projects. This multilateral approach is already visible in some existing CPEC projects. For example, the International Finance Corporation has invested in two Chinese-financed hydropower projects currently under construction in Pakistan (Safdar, 2021). The United Kingdom's Department for International Development (DFID), in partnership with the Asian Development Bank, has funded the construction of sections of the motorway network in Pakistan, forming part of the road network linking China and Pakistan (ICAI, 2018). Pakistan is a part of regional connectivity programmes like the Central Asian Regional Economic Cooperation project. It is also a party to the Turkmenistan-Afghanistan-Pakistan-India gas pipeline project and the World Bank-sponsored Central Asia South Asia Electricity Transmission and Trade Project (CASA-1000).

Pakistan and the IMF

Pakistan's boom-bust economic cycle means that the country frequently requires balance of payments support. Since the late 1980s, Pakistan has been to the IMF more than 12 times. In 2019, Pakistan entered a US$ 6 billion Extended Fund Facility (EFF) programme with the IMF. One of the main concerns of the IMF and the United States was the lack of transparency in Pakistan's relationship with the Chinese and the opacity of contracts.

Given Pakistan's chronic financing needs and dependence on the IMF programme to access other avenues of financing, the government has shared details of Chinese financing with the Fund. Moreover, overall, ambiguity regarding the terms of Chinese funding has not been a significant challenge in Pakistan's current relationship with the Fund. In the Article IV negotiations discussions between the IMF and Pakistan, debt rescheduling with Chinese lenders is expressly mentioned as one of the means through which Pakistan will bridge its financing needs (IMF, 2022). Differences have been more acute in other areas like controlling the fiscal deficit. Removing costly fuel subsidies remains a central sticking point between both sides. Furthermore, while the government has increased electricity tariffs, the Fund is pushing for the implementation of structural reforms to help sustainably resolve the circular debt problem.

6. The Commission is mandated to make policy recommendations to Congress based on its hearings and other research. What are your recommendations for Congressional action related to your testimony?

Key recommendations based on the testimony are as follows:

- There is a need for sustained engagement by the U.S. with Pakistan, especially with the civilian government. Rather than being seen as transactional, the U.S. should be seen as a dependable partner in Pakistan.
- Simplistic arguments like debt-trap diplomacy fail to capture the factors that make developing countries like Pakistan willing partners with China in the Belt & Road Initiative. While China holds a significant share of Pakistani debt, it is unlikely to result in the loss of Pakistan's sovereignty, infrastructure, or industry.
- Chinese and Pakistani actors have multiple motives for engaging with each other. While some of these motives are strategic, there is an explicit commercial rationale for the burgeoning economic relations. China's economic engagement is driven by many decentralized commercial actors that act semi-autonomously from the Central Government's direction.
- Rather than competing with the Chinese in infrastructure construction, the U.S. can play an important role by contributing to the software of development through ideas and training human capital. These are areas where the U.S. enjoys a substantial competitive advantage.
- The U.S. can play a positive role in South Asia by promoting dialogue between India and Pakistan. Pakistan has already expressed the desire to engage with India on bilateral issues. Given the close evolving relationship between Washington and New Delhi, the U.S. can prod India to start a dialogue.
- There is substantial evidence that meagre access to technology does not improve productive capabilities. Significant learning risks are associated with technology adoption in late industrializers like Pakistan. The U.S. can help reduce these learning risks for Pakistani firms by augmenting technical cooperation. U.S. technical expertise

can play a vital role in assisting local firms in upgrading their productive capabilities. While the emphasis on small and medium enterprises is important, such technical support needs to also focus on large firms that are much more likely to adopt new technology.

- Both the U.S. and China have long-run interests in promoting stability in Pakistan, and there is a need to build on these areas of mutual interests. The United States should engage constructively with China in Pakistan and Afghanistan.

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