

CPEC 2.0

THE PROMISE & THE PERIL





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Report

CPEC 2.0

The Promise and The Peril

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Where We Stand

Today, the China Pakistan Economic Corridor (CPEC) is one of the largest bilateral investment projects underway anywhere in the world. Early harvest projects worth \$18.9 billion have already been allocated to Pakistan in its first leg, while the government in Islamabad points to much higher flows in the near-term. As the country navigates change in regional alignments as well as global and economic pressures on its economy, the choices it has seem limited. With an opportunity-pipeline estimated at over \$62 billion¹ in investments in infrastructure, energy, communications and industry, CPEC clearly stands for more than just an investment platform. It is not a resource-channel Pakistan can afford to miss.

The scale of the promise is so large that it invites anxiety as well as awe in its sweep. While some of the Pakistani concerns pivot around transparency, repayment terms and capacities, none of them question the intention of the embrace. Federal units that have powers of taxation and governance are often heard voicing complaints, but they either do so because of Islamabad's growing institutional opacity, or simply because they want more of the pie. This is not where the challenge ends. External players attack it as China's pie-in-the-sky for Pakistan, yet continue to cross-hair CPEC in a lens that has moved from economic competition to a dangerous new model of strategic global containment. As the China-US trade war tangles all continents and currencies, new pressure points in the Middle East, such as the threat of American war with Iran, bring Pakistan with its old "all-weather friend", China into the mix. The target of big American ire is Beijing, and Islamabad makes the cut.

In its framing by Beijing as a crucial pivot of China's larger trillion-dollar Belt and Road Initiative (BRI), CPEC's footprint embeds in a larger web of supply chain initiatives that connects Europe to Asia, and actually makes China a two-ocean power. For Islamabad the dream appears tangible given Beijing's modus operandum in Pakistan. Remarkable for its scale and bandwidth that cuts across Pakistan's internal political faultlines, the Chinese are now in the process of building on decades of goodwill with Islamabad to focus on both public outreach and the meticulous construction of political capital in provincial capitals and with political parties that bargain power.

While many view CPEC as a conduit for Pakistan entering the New Economic Global Order.² The challenge of its geo-political sweep and sheer "connectography"³ of such an ambition is lost on no one. Its premise is based on surging Asian capital, not

¹ CPEC Quarterly. Autumn Issue 2017. Centre of Excellence for CPEC Publication

<http://cpec.gov.pk/brain/public/uploads/documents/CPEC-Quarterly-Magazine-reduced.pdf>

²Cheema, Zafar Iqbal. "CPEC: A Precursor to Regional Economic Growth and Stability". 2019. Strategic Vision Institute. Page 134

³ Khanna, Parag. "Connectography: Mapping the Future of Global Civilization". April 19, 2016. Random House

traditional sources of economic leverage, and its engine is the Chinese plan to export surplus, while accumulating global power in traditional soft power trajectories.

As with all such big platforms, CPEC's challenges are legion. Many of these can be situated within the growing vortex of strategic anxieties emerging across the globe from China's unprecedented rise over the past decade. The unavoidable imminence of the Asian growth momentum led by China, which Pakistan will miss without CPEC, has suddenly become a news-cycle reality. Washington, which once dominated Islamabad's maximum attentions-span, has now become the ally that was, period. Although a recurring crisis in public finances, and compliance protocols with multilateral regimes such as FATF, prompts co-engagement with the western powers, and the US in particular, Islamabad's reliance on the latter for growth models and strategic umbrellas has changed dramatically over the last ten years. This in itself is a huge and rapid geopolitical shift that poses new challenges to all movers and shakers in traditional international power circles while simultaneously representing a new arc of global growth and muscle.

Equally significant are the domestic, often structural challenges posed by this large investment belt in countries whose economies have traditionally lacked absorption capacity. Questions about Pakistan's ability to make the management transition from a loosely coordinated, unwieldy bureaucracy at the federal level to an integrated federal decision-maker sharpening its creaky joints for utilizing assistance and low-interest loans are well taken. Any credible planning portfolio that does not build in a compass to negotiate the web of permissions needed after allocations and financial closure for projects, is at risk of being reduced to a power-point presentation on old data files. The real and present danger to big and small-ticket projects green-lighted in the CPEC Phase 2 menu are Pakistan's structural gaps in transparency, coordination, human resource efficiency and project management.

This report seeks to examine both external and internal challenges facing CPEC in Pakistan. It provides a set of recommendations for the government and policy makers to reach a level of optimisation of the opportunities presented by CPEC investments.

PART I

Red Reach: Situating CPEC in the Wider Region

The Storm Outside

Regional and global stormwinds have picked up momentum. To understand the external challenges to CPEC, this potentially transformational project has to be conceptually embedded in the larger BRI and China's dramatic growth over the past three decades. On its main level, the BRI seeks to build new routes for trade in commodities, services and energy. Investments connecting East Asia with Central Asia, the Middle East and extending through Eurasia are in the process of channelizing a dormant landmass culminating in a new arc of connectivity comprising Russia, Turkey, Iran, Pakistan, China and the Central Asian countries.

Often referred to as the New Silk Road, this phrase is used by both the Chinese authorities and observers alike to suggest the multiple dimensions that BRI invokes for China and the rest of the world. Similar to the ancient network of trade routes, according to Beijing, the BRI will not simply be a means for the exchange of commodities between nations but also for the exchange of information, culture and technology – a form of exchange that can be vital for future diplomacy across the world. But more importantly, it capitalizes on the memory of the Silk Road which harkens back to a history of 'open' connected empires rather than disconnected isolated civilizations.⁴ With connectivity playing a crucial role in how world politics is perceived, this model has effectively made Central Eurasia the political center for imperial rivalry rather than being just the 'middlemen of an interconnected world history.' Unfortunately, none of this projection of Chinese soft power welding with the Eurasian is taken as benign by global powers who are in the throes of measuring options of decoupling supply chain economies from China.

But nothing in the "Cold War Lite" universe is as simple as it seems. China is now a global superpower, but unlike the old European imperial order or the United States led Bretton Woods system, it offers multi-polarity as an alternative international model. Pivoted on vital trade links between the Europe and Asia, the Chinese model is helping create three economic power centers in the world. Europe, America and Asia now represent the changing map of the economic globe with capital and human flows self-adjusting to a new reality. China's model of economic interdependence runs counter to the new protectionism emerging in the muscular tariff regimes of the United States and other countries. China, under the BRI offers connectivity, economic and trade linkages that includes 30 per cent of world GDP, 62 per cent of the world's

⁴ Chin, Tamara. "The Invention of the Silk Road, 1877." *Critical Inquiry*. Vol.40. No.1 (Autumn 2013). pp 194-219. The University of Chicago Press.

population and 75 per cent of known energy reserves. Over 125 countries and 40 international organisations are now signed on.

The BRI is investing large sums of capital accumulated by the Chinese government and banks over the past three decades of phenomenal growth⁵. But as China's productivity and growth faces a slowdown, with Beijing's economy posting some of its lowest growth figures of 6.6 per cent in the past 28 years⁶, the BRI is envisioned by Xi Jinping as an economic project that will open new markets for Chinese goods and help sustain China's growth while extending their strategic interests across the globe in keeping with their new status as a world power. Of the one trillion dollars allocated to BRI, nearly \$65-72 billion is now envisaged for the China Pakistan Economic Corridor (CPEC). It is therefore unsurprising that CPEC has borne the brunt of both regional competition as well as global anxieties about China's growing footprint across the Eurasian landmass.

China as Strategic Competitor

For CPEC, external challenges are closely linked with suspicion of Chinese expansionism. Indian suspicion of CPEC is neither couched in diplomatic gloves nor is it hidden. It is seen as a potential challenge to New Delhi's strategic dominance of South Asia⁷ and the Indian Ocean⁸ region, both in terms of supply chain valuations and broader plans of naval dominance. New Delhi has made no secret of its animus by formally declaring its hostility to CPEC. It has based its opposition to CPEC on declaring the joint project as virtually illegal for passing through Pakistan's northern areas, which it claims as disputed in the sense that it sees the erstwhile State of Jammu and Kashmir as its own territory, and has repeatedly tried to embed CPEC in inter-state controversy. It has obviously not succeeded. China is India's other historic rival, and the creation of stronger economic and strategic bonds between China and Pakistan is a visible worry to New Delhi. Pakistan and China's close collaboration in

⁵ "Where is the Funding for a \$26 trillion initiative coming from?" CNBC.

<https://www.cnbc.com/advertorial/2018/03/06/where-is-the-funding-for-a-26-trillion-initiative-coming-from.html>

⁶ Yao, Kevin; Chen, Yawen. "China's 2018 growth slows to a 28 year low, more stimulus seen". 21 January 2019. Reuters Beijing. <https://www.reuters.com/article/us-china-economy-gdp/chinas-2018-growth-slows-to-28-year-low-more-stimulus-seen-idUSKCN1PF04A>

⁷ Pant, Harsh V. "China's Clout Grows in South Asia, but can India raise it's Game?" 19 January, 2019. China Morning Post. <https://www.scmp.com/comment/insight-opinion/article/2129480/chinas-clout-grows-south-asia-can-india-raise-its-game>

⁸ "China's Growing Presence in Indian Ocean a Challenge for Indian Navy: Navy Chief Lamba". 14 March, 2019. The Economic Times. Times of India. <https://economictimes.indiatimes.com/news/defence/chinas-growing-presence-in-indian-ocean-a-challenge-for-india-navy-chief-lanba/articleshow/68409545.cms>

defence⁹, economy and diplomacy all the way to support at the United Nations is viewed as the foremost threat by New Delhi to its resurgent strategic doctrine of Indo-American dominance of the region. Bolstering Chahbahar Port in Iran as a counterweight to Gwadar, as well as to Afghan transit through Pakistan, is an obvious challenge. The recently released US South Asia policy report¹⁰ by the Pentagon which signals a full-blown containment of China and US's strengthening strategic partnership with India has significant implications for Pakistan's foreign policy and national security. This push towards arming India and intensifying economic pressure on China means that Pakistan must focus on recalibrating its policies in line with the future. (Indo-Pacific Strategy Report: Preparedness, Partnerships, and Promoting a Networked Region 2019)

Yet as counterpoint to this rival-based model of strategic power there is a growing view in the region that this bend in history needs to be treated as a geo-economic complementarity rather than a strategic threat. While American suspicion of CPEC is more complex, it is also based on similar evaluations of hegemon-challenge responses with China. The Thucydides-trap analyses animate many debates, where a rising power goes to war with the status quo hegemon. But these are unhelpful tools in managing geopolitical tensions or trade winds. In Pakistan's view China is not visibly seeking replacement dynamics. It is looking for multiple benefits and recognition of its soft power arm, which is BRI. Trade, economic, military considerations all factor into the broader equation of traditional Western evaluations of structural changes in global trends, marked largely by China's leadership role in what is clearly an Asian Century. In this century maintaining the value, security and integrity of supply chains will matter as much as investments in military hard power.

South China Sea power-play aside, Pakistan's offer of Gwadar as a major trans-shipment facility has created new dynamics across the Pacific region. The Pentagon has repeatedly raised concerns that China may establish a permanent naval base at Gwadar¹¹. It has literally positioned China to expand its reach from a Pacific bandwidth to new options on the Indian Ocean Region map. There's a keen awareness in strategic circles that by using Gwadar as a bridgehead, China for the first time acquired the ability to bypass its traditional Malacca sea-lane choke-point, while also setting roots in a strategic perch that links access to Central Asia and Iran, with military as well as trade implications. This awareness is sharpened by the growing oil power-play in which China is the largest net importer of oil globally, while Iran, Libya

⁹ Dutta, Anushree. "The India Factor in China-Pakistan Defence Ties". 19 December, 2017. Indian Defence Review. <http://www.indiandefencereview.com/spotlights/the-india-factor-in-china-pakistan-defence-ties/>

¹⁰ "Indo-Pacific Strategy Report: Preparedness, Partnerships, and Promoting a Networked Region" The Department of Defense. United States of America. 1 June, 2019.

¹¹ "China to Increase Overseas Military Bases" 3 May, 2019. Al-Jazeera. <https://www.aljazeera.com/news/2019/05/china-increase-overseas-military-bases-pentagon-report-190503065146243.html>

and Venezuela's ability to export has been critically hit by American actions or sanctions related to the three. Given CPEC's value to China, in terms of new leverage from 2013 onwards when the port was included as part of the China-run platform, the crucially located Strait of Hormuz has become even more critical as a possible inflection point in any global crises impacting the movement of oil, goods or warfare.ⁱ To American analysts such as Robert Kaplan studying the impact of proximity to the Gulf of Oman amid the Iran-US standoff, a made-in-Beijing container port at Gwador means that China is already in the Middle East.¹²

Finally, the suspicion of Chinese expansionism through CPEC, and largely through BRI, is also grounded in the rise of information warfare in the 21st Century. With BRI pivoting on connectivity as one of its overarching goals, it would be naïve to presume that this would only be a brick-and-mortar pathway. Originally referred to as the Information Silk Road by the Chinese, the aim of this digital infrastructure project is to strengthen the internet skeleton, scale up cooperation across space, and to enable common technology standards.¹³ This could possibly be done through enhancing the current infrastructure for telecommunications and satellites, developing smart cities and advancing e-commerce.

Pakistan's geo-strategic location is of tremendous importance to China for this digital corridor; the fibre-optic cables that are being laid in Pakistan all the way from Khunjerab to Gwadar do not only bring advanced internet technology to Pakistan but also comprise of a larger network of connections across the globe. Once the project is completed in 2020, a 6299 km long underwater line will extend from the Gwadar port stretching all the way across the Indian Ocean to Djibouti connecting Asia with Africa. This web of digital connections fosters an exclusive space for communication between Africa and the Arab world with China preventing any external disruptions. However, China will be controlling the reins of this network and all countries participating in the BRI will have to rely upon Beijing for their internet freedom and face the risk of being surveilled. The recent ban on Huawei, a Chinese telecom company in the US through an executive order is just another indicator of the threat that the West feels of being potentially disempowered and cyber-invaded by China's increasing global presence in the telecommunication industry.

This network is not only limited to the physical infrastructure that China is laying on the ground and through deep-sea cables. Improving the space-based navigation system is another aspect of BRI that has often been a cause of panic when it comes to information privacy. The BeiDou Navigation Satellite System (BDS) is aiming to replace the current American Global Positioning System (GPS) by 2020 by offering

¹² Kaplan, Robert. "This Isn't About Iran. It's About China." 28 June, 2019. The New York Times

¹³ Hao, Chan Jia. "China's Digital Silk Road: A Game Changer for Asian Economies" 30 April, 2019. The Diplomat.

<https://thediplomat.com/2019/04/chinas-digital-silk-road-a-game-changer-for-asian-economies/>

improved accuracy. Already having deployed 40 satellites with the promise of deploying 8 more in the next couple of years, the BDS has already outdone the 31 satellites of the American GPS with claims to be 100 times more accurate once it is fully functional across the globe. Again, the role of BRI countries in this process has been of extreme significance for BDS. The very first base station for BeiDou around the globe was established in Karachi in 2017 making Pakistan one of the earliest members of this space-based information system. Ever since, 30 other BRI countries have also already been linked up with others promised ramp-through by 2020.

The western fear of Chinese expansionism is rooted in the suspicion that this digital silk road will introduce a new digital regime to the world where global information flows will be dominantly regulated by the Chinese. Even though this digital technology is useful and essential to the development of BRI partner countries, the US views this as a long-term surveillance strategy and is in the fight for blocking China from getting control of this global telecom infrastructure.¹⁴

With the steady expansion of Chinese undersea cables and satellite networks such as BeiDou, it is likely that China will become one of the most important players for communications in the world within the next two decades. Even though China's innovation dominance can position them to become an information hegemon by wielding power over data like Silicon Valley giants, the availability of high-quality, low-cost data networks will potentially accrue significant benefits to BRI partner countries.

Debt Diplomacy

Riding this global trend, articulated not just as a symptom of Western anxiety, is the repeated riff of CPEC and BRI playing out as bloated, unplanned and predatory initiatives. The specter of swamping Chinese indebtedness is cited by Western powers as a critical neo-imperial gambit that cannibalizes developing, weaker economies, while ignoring their own debt profiles and serial lending to countries like Pakistan. This growing global public conversation naturally stokes real fears in Pakistan, where the opacity of Chinese contracts with government are cited as troubling for good governance and debt-ratio metrics.

Irrespective of intent, facts do matter. The facts state that 90 percent of developing country debt, including Pakistan's is owed to Western countries or institutions. Servicing this debt consumes about 30 percent of hard currency outflows from these developing countries, notwithstanding examples of Sri Lanka or Malaysia. At the Second BRI Summit in April 2019, China sought to realign its investments in large

¹⁴ Siddiqui, Sabena. "BRI, BeiDou and the Digital Silk Road 9 April 2019. Asia Times." <https://www.asiatimes.com/2019/04/opinion/bri-beidou-and-the-digital-silk-road/>

scale projects by addressing concerns of exclusivity, sustainability and standards¹⁵. The launch of the new Debt Sustainability Framework under the Chinese Ministry of Finance, coupled with the Multilateral Cooperation Center for Development Financing¹⁶ are meant to address concerns of debt sustainability, and build multilateral cooperation mechanisms to help share financing for infrastructure projects, largely restricted to policy banks such as the China Development Bank, EXIM Bank of China and other state-owned banks.

As Pakistan enters the second phase of CPEC, it is important to understand the measures and projections surrounding the arguments over debt risk to inform policy behaviour. One of the main concerns is that CPEC is adding on to Pakistan's already ballooning public debt. This is not entirely true. According to official Chinese statements, early harvest projects are worth \$ 18.9 billion in investments which is made up of \$6 billion in government loans with a 2% interest rate and private investments in the form of equity worth \$3 billion and \$9.8 billion in commercial loans with a 5% interest rate¹⁷. So far, the government of Pakistan only needs to repay \$ 6 billion over the span of 20-25 years. It is important to note that although commercial loans figure in the country's total external debt and liabilities, it is in fact not guaranteed by the government. This is proven by the State Bank's official figures that do not show any guaranteed private-sector external debt¹⁸. CPEC makes up for 6% of Pakistan's total external debt worth \$105.84 billion whereas other multilateral loans run about 4-5 times more, dwarfing CPEC loans in comparison.

Aside from the debt question, worries about the risk of asset seizure in case Pakistan fails to repay its Chinese loans also resonate in the debates on the subject, even in Pakistan's parliament. Sri Lanka is regularly cited as a cautionary tale. However, the circumstances that led to Sri Lanka leasing its port to China point to a more pervasive balance of payment crisis that goes well and beyond its Chinese loans.ⁱⁱ The Rhodium Group, in a recent study, looked at 40 cases of Chinese debt renegotiations. Their findings revealed that asset seizure is indeed a very rare occurrence¹⁹. In fact, deferment, change of loan terms and deadlines, refinancing or even write-offs or debt forgiveness are more common outcomes. The refinancing and renegotiation given to Angola, Ecuador, Ethiopia, Mongolia and Ukraine support this claim. Altogether,

¹⁵Parameswaran, Prashanth. "What is China's New Belt and Road Recalibration?" 7 May 2019. The Diplomat. <https://thediplomat.com/2019/05/whats-in-chinas-new-belt-and-road-recalibration/>

¹⁶ Alex; Malkin. "China Tweaks its Belt and Road Initiative to Avoid Further Backlash". 6 May 2019. The Hill. <https://thehill.com/opinion/finance/442306-china-tweaks-its-belt-and-road-initiative-to-avoid-backlash>

¹⁷Statement from Chinese Embassy. December 29, 2018.

<http://pk.chineseembassy.org/eng/zbqx/t1625941.htm>

¹⁸Summary of Pakistan's External Debt Servicing (Principal + Interest). FY19

http://www.sbp.org.pk/ecodata/pakdebtsvr_summary.pdf

¹⁹Agatha Kratz, Allen Feng, and Logan Wright. "New Data on the "Debt Trap" Question. April 29, 2019. <https://rhg.com/research/new-data-on-the-debt-trap-question/>

China has renegotiated around \$50 billion worth of debt. With the country's ballooning external debt, questions surrounding the country's capability to repay its loans without risking the country's assets are not unfounded. The real risk lies in Pakistan's ability to stabilize its balance of payments.

Trade Balance

For Pakistan, the trade imbalance with China is not new. In financial year 2018, Pakistan's trade deficit with its largest trading partner stood at \$9.7 billion, accounting for 30 per cent of the entire trade deficit²⁰. At the moment, Pakistan's exports to China still hover around \$1.7 billion. Part of the problem lay in the 2006 FTA, after which Pakistan's nascent light manufacturing industry disappeared off the map, as it was unable to compete with Chinese machine tools, many of which were assembled or produced in small outfits along Punjab province's Grand Trunk Road. Significantly, Pakistan's tariff concessions under Phase I of the FTA were the same as those given by China to ASEAN countries in export products where Pakistan had competitive advantage²¹. This meant that while imports from China grew exponentially over the last decade, ranging from electronics to machinery, Pakistan was able to exploit only a marginal proportion of the estimated \$ 6 billion export potential to China²².

With the new Phase II of the FTA in 2019, some of these deficiencies have been addressed. Leveraging the new FTA will be helpful as China has extended duty free access to 313 new product categories from Pakistan, including surgical instruments, furniture, chemicals etc. Export diversification from Islamabad will be needed to avail the new terms. If Pakistan boosts exports, earnings could go up by as much as \$500 million in the next 18 months. Alongside this, ease of doing business too needs to improve. With Yuan based trading on the rise, the need for opening of more banking facilities across borders will help in shoring up the low uptake of currency swap facilities.²³

²⁰ Iqbal, Shahid. "Trade Gap with China Rises to \$9.7 billion in FY18". 29 July, 2018. DAWN. <https://www.dawn.com/news/1423551>

²¹ "Preliminary Study on Pakistan and China Trade Partnership Post-FTA." 2013. Pakistan Business Council. https://www.pbc.org.pk/wp-content/uploads/21-Oct_Pakistan_China_Trade_Study_2013.pdf

²² Ibid.

²³Cheema, ZafarIqbal. "CPEC: A Precursor to Regional Economic Growth and Stability". Page 144

Security Pivot

With over 30,000 Chinese nationals now working in Pakistan in remote and inaccessible areas on CPEC projects²⁴, the safety and security of Chinese workers and investments has become a growing concern. Over the last year, the expansion in both the scale and frequency of attacks against Chinese interests in Pakistan speaks to a change in operational capability and resources of the various terrorist groups targeting CPEC. The most visible of these groups are Baloch insurgent groups such as the BLA, BLF and BRA that have been responsible for the vast majority of attacks against Chinese interests in Pakistan, claiming that Chinese investments are resource extractive and detrimental to Baloch interests. However, Baloch groups alone aren't the only ones who have been involved in such attacks. In 2017, ISIS claimed to have killed a Chinese couple kidnapped from Quetta²⁵. Subsequent raids against ISIS cells in the province killed nearly 30 militants tied to the terror organization. As ISIS loses space in Syria and Iraq, its operational investments in the Afghanistan-Pakistan border region have grown. So have their links with Islamist militants from IMU and ETIM, creating common cause against Chinese interests in Pakistan²⁶.

The first major attack against the Chinese took place as far back as 2004, when three Chinese engineers were killed in a bomb attack at the Gwadar port.²⁷ Since then, instances of targeting the Chinese have increased. In the last year alone, high profile attacks such as the suicide bombing of a bus carrying Chinese workers in Dalbadin²⁸, a raid and bomb attack on the Chinese consulate in Karachi, and the daring raid on Pearl Continental Hotel Gwadar, are worrying signs of an upsurge in CPEC related attacks.

On its part, Pakistan's government had raised a Special Security Division comprising of 9,000 army and 6,000 paramilitary soldiers²⁹. This is in addition to provincial security forces such as the Punjab Special Protection Unit and the 4,200 strong Khyber Pakhtunkhwa CPEC security force³⁰. In 2017-18 the federal government alone

²⁴Wu, Wendy. "Beijing condemns suicide attack on bus carrying Chinese engineers in Pakistan". August 11 2018. South China Morning Post. <https://www.scmp.com/news/china/diplomacy-defence/article/2159291/bus-carrying-chinese-engineers-targeted-pakistan>

²⁵Aamir, Adnan. "ISIS Threatens China-Pakistan Economic Corridor". August 17, 2018. China US Focus. <https://www.chinausfocus.com/peace-security/isis-threatens-china-pakistan-economic-corridor>

²⁶ Ibid.

²⁷Baloch, Kiyya. "Chinese Operations in Balochistan Again Targeted by Militants". March 27 2015. The Diplomat. <https://thediplomat.com/2015/03/chinese-operations-in-balochistan-again-targeted-by-militants/>

²⁸Wu, Wendy. "Beijing condemns suicide attack on bus carrying Chinese engineers in Pakistan".

²⁹Rehman, Abdur. "How CPEC Security Will Test the 'All-Weather Friendship' of China and Pakistan". June 24 2017. The Diplomat. <https://thediplomat.com/2017/06/how-cpec-security-will-test-the-all-weather-friendship-of-china-and-pakistan/>

³⁰ Bureau Report. "KP to form force to protect CPEC projects in its area". April 6 2017. Dawn. <https://www.dawn.com/news/1325210>

allocated Rs 1.8 billion for CPEC security. The new Khyber Pakhtunkhwa security force was estimated to cost another Rs 1.2 billion. With the recent spate of terror violence, Pakistan's military has announced to redouble its effort on security for Chinese workers and projects in the country. After the deadly attack on PC Gwadar, the military has announced raising a second full division of 9,000 soldiers for CPEC security, assuring the Chinese that such threats were being addressed³¹.

Pakistan's difficulties in securing investments under CPEC have also been perpetuated by a worsening regional security situation. All indications point to, at a minimum, freedom of movement and operations for Baloch and ISIS militants targeting Pakistan and Chinese interests. At worse, several strands of information highlight some form of support in both arms and training being provided to such groups by state actors along Pakistan's western border. The terror mastermind of the attack on the Chinese consulate, Aslam Baloch, was killed in a bomb blast in Kandahar, Afghanistan, while he was meeting a group of insurgents in a well-to-do locality of the city. The arrest of serving Indian Naval Commander Kalbushan Jadhav while operating under a false identity in Balochistan has also shed light on Indian intelligence operations influencing Baloch militants and targeting CPEC.

An equally worrying development for the safety and security of CPEC investments along the coast of Pakistan, including the Gwadar port, are rising tensions in the Persian Gulf. Situated just a 120 km from the Iranian border, the security and viability of the port are likely to face serious repercussions in the event of another war in the Gulf. Attacks on oil facilities and ships from the Gulf of Oman to the Strait of Hormuz have given rise to maritime insecurity in the Arabian Sea. Pakistan is unlikely to remain unaffected in the event of another war next door.

³¹ NNI. "Pakistan to deploy another division for CPEC security". May 19 2019. The News. <https://www.thenews.com.pk/print/473155-pakistan-to-deploy-another-division-for-cpec-security>

PART II

Pakistan's Governance Gaps

China's record of pulling 800 million people out of poverty in four decades presents a compelling model for Pakistan. After the onset of CPEC investments, the government insists that Pakistan's growth has already nudged forward by 1-2 per cent.³² Given new budgetary challenges, and a tough series of IMF-induced measures for stabilization, growth seems to have slowed down even more. With the precipitous slide of an overvalued rupee, and public finances straining at crippling deficits, predictions of Chinese-led investment growth is the only balm to a rattled government. In future estimates, it is believed that Chinese investment can potentially stimulate an 8-10 per cent increase in Pakistan's GDP by 2030, but that may well be too ambitious a calculation given Islamabad's current rulers' inability to operationalize promised reform.

These gains, however, cannot simply be understood through the country's economic indicators; these economic reforms can also usher in a new form of knowledge. The economic reforms that CPEC has brought to Pakistan, provides a roadmap to the country that instructs how economic modernization can be operationalized for the 21st century. To leapfrog development, Pakistan must ensure that this transfer of knowledge trickles down effectively from Shanghai to Gwadar and branches out to other provinces.

Even though there have been no fundamental disagreements over Pakistan's new economic policy focusⁱⁱⁱ, the goals that it espouses have remained blurry and unaligned with parliamentary and public reporting. It is precisely this ambivalence that has hampered the transfer of knowledge and caused the failure in connecting nodes at the downstream institutional level.

Understanding that the real challenges to realizing the maximum potential from CPEC are internal is a crucial step towards successfully benefitting from it. These are embedded in three "Cs": Capacity, Coordination and Consensus. Pakistan, undeniably, has to scale up its capacity and coordination while building consensus and clarity in identifying policy frameworks for the opportunity this platform offers.

Consensus

One of the foremost roadblocks in effective consensus building on CPEC has been the divergence in processes between a centralised Chinese communist party government and Pakistan's nascent democratic parties and governance structures. With CPEC envisioned as a cross-Pakistan project that involves all of Pakistan's four provinces,

³²"CPEC increases Pakistan GDP by 2%: Report". *The Times of Islamabad*, December 19, 2018. <https://timesofislamabad.com/19-Dec-2018/cpec-increases-pakistan-gdp-by-2-report>

navigating Pakistan's multi-party provincial structures and building bridges with all political parties has been a challenge³³. However, China has sought to overcome the Pakistani government's own inability to build consensus and manage the political centre-field by engaging directly with several political parties at the provincial and federal level to cultivate a better understanding of CPEC vision and priorities. This process has culminated in the establishment of a CPEC Political Parties Joint Consultation Mechanism, which has seen the Community Party of China engage with a broad spectrum of Pakistan's political parties³⁴.

Since CPEC is not a parochial one-party or one province ambition, it requires strategic levels of consensus building to ensure each province's stake in the project is protected and that Pakistan's government moves forward collaboratively. Given the clear multi-party buy-in and commitment to CPEC, building consensus between Pakistan's political parties should not be as arduous of a project as it seems. However, the federal government's attempts for building political consensus between political parties has been poor because of the lack of transparency about CPEC between the different wings of government. The parliament is not brought into the fold by the federal government and has also consistently lacked an appreciation of the need to build consistent stakes in parliamentary leadership at the highest level – a failure that has led to political instability hampering the path to consensus and in ensuring that CPEC is implemented at optimum capacity. The federal government is often seen as absent or dismissive of this incredibly crucial process of political-coalition building.

Capacity

Another major challenge to Pakistan has been the government's capacity deficit to absorb concessionary loans and grants which has been only worsened by their inability to plan how these will be absorbed in the future.³⁵ Given the multiplicity of project designs under CPEC, both in the government and the private sector, it is clear that the Planning Commission, in which CPEC is nested, is both under-resourced and under-powered.

The way forward would have been less arduous if a one-window autonomous CPEC Authority had been set-up by the government the way that it had been envisioned by the Senate Special Committee. The incumbent government, however, has recently introduced the CPEC authority through an ordinance that not only lacks any clear Terms of Reference (ToR), but also undermines the parliament which is counter-

³³ Shah, AbdurRehman. "China's Trouble with Pakistan's Turbulent Democracy." *The Diplomat*, 7 January, 2017. <https://thediplomat.com/2017/01/chinas-trouble-with-pakistans-turbulent-democracy/>

³⁴ Ali, Shafqat. "Pak Political Parties, China Adopt Declaration on BRI, CPEC". *The Nation*, 20 March 2019. <https://nation.com.pk/20-Mar-2019/pak-political-parties-china-adopt-declaration-on-bri-cpec>

³⁵ Rafiq, Arif. "The China-Pakistan Economic Corridor: The Lure Of Easy Financing And The Perils Of Poor Planning". *Asian Affairs*. 10 May 2019.

productive to the goal of improving coordination across provinces. This CPEC authority was envisioned to manage the internal challenges of planning and financing through coordinating between institutions, provinces and agencies to build momentum on speedy outcomes but the shape it has taken now might only further discord across these stakeholders. In the Senate Special Committee on CPEC, we discussed the rationalization of tax regimes; ensuring of infrastructure and energy provision; transparency of contracts to avoid controversy; sovereign guarantees to provinces along with flexible financing for private joint ventures; along with structural reforms that would all be managed by this autonomous CPEC Authority. Unfortunately, the unwillingness of the government to consult its own parliament and ruling through ordinances, along with lack of TORs, has meant that this newly formed CPEC Authority can either have unbridled powers or be completely superfluous, or anywhere in between.

In terms of business reforms, most of the improvements have come at the provincial level from the provinces of Punjab and Sindh, limiting the development only to Karachi and Lahore. Even though these efforts are commendable they are insufficient for the country in the longer run as they give off the impression that the government is only fixing what can be measured. It is the responsibility of the federal government to effectively disseminate information about the economic impact of CPEC that provides a blue-print to the rest of the provinces to implement business reforms that can equip them with the right tools that can prepare them to benefit from CPEC. Therefore, reforms must be extended to all provinces including Balochistan and KP which can be achieved only through the strengthening of institutions and robust impartial policy-making.

The Chinese ambassador to Pakistan, Yao Jing, has repeatedly asserted that Pakistan has the potential to attract huge Chinese investments only if they can develop better trade policies, offer tax incentives and foster an investment friendly climate.³⁶ Currently, investors are required to get multiple No Objection Certificates (NOCs) before investments can begin. Hence, while SEZs in other countries like China, UAE, Thailand and Georgia offer a one-stop-service for all regulatory matters, in Pakistan, the Board of Investment (BOI) serves that purpose, which, due to lack of a tailor-made framework for SEZs, leads to unnecessary bureaucratic red tape. Reforms should be aimed at empowering the provincial governments to process the application of SEZs to save time and money instead of being dependent on Islamabad. Amending the SEZs Act of 2012 to ensure reform is currently being debated in parliament but any reform must ensure that SEZs provide Chinese and other companies at a minimum that same incentives that other South East Asian and African SEZs are currently providing. In addition, to deter rent seeking and to guarantee that industries are market driven, SEZs must ensure devolved decision making that takes the private

³⁶ <http://www.cpecinfo.com/news/tax-incentives-and-business-friendly-environment-can-attract-huge-chinese-investments-chinese-ambassador/NjUyMw==>

sector on board. With the majority of SEZ companies expected to be from the private sector, ensuring the market dynamics determine SEZ policies will be essential for long term viability of SEZ companies³⁷. A clear 'rules of engagement' agreed upon by both China and Pakistan would also prove beneficial in terms of expected outcomes.³⁸

Another significant hurdle in Pakistan's ability to generate employability under CPEC initiatives has been a weak human resource skill-base. While Pakistan boasts the ninth largest labour force, lack of investments in technical and vocational training have seriously affected labour skills. As a result, while infrastructure projects under CPEC continue to employ over 90 per cent domestic labour, the percentages shrink dramatically in technical projects such as energy and digital connectivity. Presently, several Chinese companies are undertaking specific on-the-job training programs for semi-skilled workers, both in China and in partnership with dedicated short training courses in collaboration with universities in Pakistan³⁹. Pakistan's reorientation in vocational training and higher education, to meet market demand, is essential for CPEC employment uptake. SEZs are also instrumental in achieving structural transformation through skill development and knowledge transfer.⁴⁰

Moreover, estimates suggest that CPEC has the potential to generate anywhere from 800,000 to 1,500,000 jobs till 2030⁴¹. For Pakistan, investments like CPEC are valuable for their spillover impact on local firms and labour in terms of transferring technology, boosting skills, and improving the quality and quantity of employment. The availability of productive, skilled, and reasonably priced labour is an important determinant of the location decision for foreign investment. For Pakistan's demographic structure, with a burgeoning young labour force, the opportunity to generate high-value jobs from CPEC investments is not one that Pakistan can afford to miss.

CPEC has so far created nearly 68,382 direct jobs.⁴² The question of how Pakistan can further seize the CPEC opportunity remains an important one. A more sustainable approach to this predicament of underinvestment in labour is to aide firms that train and use local labour.^{iv} There are several tools for this such as part-funding the training cost incurred by private businesses. Additionally, tax incentives can be conditioned on training labour and tax breaks can be conditioned on sourcing components from local firms, which also translates, albeit more indirectly, into local employment gains.

³⁷Mehmood, Zafar. "Unlocking Pakistan's Economic Potential." Chapter 8: Special Economic Zones. *CPEC: A Precursor to Regional Economic Growth and Stability*. China Studies and Information Center. Strategic Vision Institute. Islamabad, 2019.

³⁸Cheema, Zafar Iqbal. *CPEC: A Precursor to Regional Economic Growth and Stability*, 169

³⁹Zia, Muhammad Muzzamil. "Job Creation Under CPEC". 25 April 2019. *CPEC Center of Excellence. Planning Commission of Pakistan*. <https://cpec-centre.pk/job-creation-under-cpec-a-reality/>

⁴⁰Cheema, Zafar Iqbal. *CPEC: A Precursor to Regional Economic Growth and Stability*, 161

⁴¹ Ibid.

⁴² China-Pakistan Economic Corridor Committee Meeting. *Ministry of Planning, Development and Reform*. 13th June 2019.

In a bizarre and rather sharp contrast to this, the current services sales tax regime imposes a tax on business trainings, thereby increasing the costs of private training. However, business friendly measures can directly address the market failure that plagues the labour market: By compensating firms that invest in labour, the government can plug in the gap between private and social benefits. (Special Section 1: The Importance of Human Capital in the Context of CPEC 2019)

Coordination

Coordination and communication is critical to connecting institutional dots. Effective communication is the overarching element of power in the 21st Century, and CPEC's scale and ambition must best be addressed with clarity. Provinces have to be given the confidence that CPEC will be transparent and equitable. Unfortunately, to this day, little is known about the government contracts signed under CPEC.

The government should make sustained efforts to separate myth from reality and set clear goals for inclusive planning at the federal, provincial and grassroots levels. As a diverse country comprising of multiple languages and ethnicities, where information is disseminated through a variety of mediums such as the radio, television, social media, even minor inconsistencies between the information that is made available about CPEC by different wings of the government can create severe cascades of backlash at all tiers of governance.^v An institutionally clear roadmap for project planning is an alternative that can very easily do away with these inconsistencies. Additionally, a higher commitment to transparency, pertaining to coordination and contracts will assist CPEC advocates in Pakistan to identify gaps in both planning and investment roadmaps, whether it be between provinces within Pakistan, or between federal ministries or private sector joint venture projects that need support.

In addition, when it comes to a discussion of provincial stakes, it is fair to start with Balochistan – the home of Gwadar, which is the centerpiece of the CPEC maritime Silk Road linkage. It goes without saying that the province has several deprived regions that need development and connectivity. The people of Balochistan and their public representatives have their hopes pinned on CPEC as much as the rest of Pakistan, if not more. For years the mineral-rich province has provided resources like natural gas. At home it has witnessed scarcity of resource and even gas at multiple levels. Its only consolation has come in the form of the 18th Amendment which ensures them ownership of their own resources through the National Finance Commission award.

It has already been indicated that the Balochistan government has repeatedly displayed confusion about the lack of progress on the Western route. They have also raised questions about the province's share in the multi-billion project remaining at a meagre 2-3 per cent. In the absence of transparency and provincial coordination, several voices suggest that the provinces aligning the Eastern route will be the larger

beneficiaries of CPEC investments. In parliamentary committee meetings, members from both Balochistan and Khyber Pakhtunkhwa have protested against the lack of groundwork on CPEC in their respective provinces. Additionally, lack of water infrastructure is a major roadblock to development in Gwadar as well as other parts. These are areas that beg the government's attention but little of substance has been communicated during Senate Special Committee meetings to date.⁴³

Nonetheless, the main political parties of Balochistan have been on the record to offer their full support to the central government as have other political and opposition parties from Sindh, KP and Punjab, on all CPEC projects.

Now, as CPEC drives into the next phase, the flow of substantive informational exchanges between various provincial and central departments as well as the private and public sector should not remain ambiguous anymore. There are fault lines in communication as various members of the Senate CPEC Committee, who are also representatives of their provinces, have raised questions about timelines and priorities. The federal government will have to demystify the details and for that, it needs to make use of the parliament.

It is clear that in order to be functional, the most effective means of communicating across the federation would be to use parliamentary committees^{vi} to ensure transparency and build a narrative that has a buy-in from all parties and provinces. The fact remains that as representatives of their communities, all parliamentarians and political parties do see the benefits of CPEC and the potential for their own communities once clear timelines and execution of projects is visible.

⁴³ First Interim Report. Special Committee On The Project Of Pak-China Economic Corridor. *Senate of Pakistan*. 17th July, 2018 – 15th March, 2019.

Recommendations

BRI shows that the breadth of possibilities in planning and coordinating a new regional economic system is real. At the second Belt and Road Forum in Beijing, China has demonstrated flexibility and inclusiveness. Realising the scale of their own ambition and the need to build multiple interests in BRI investments, the Chinese leadership has engaged multilateral institutions, including the World Bank and the Asian Development Bank in building broad based consensus. Similarly, China's head-on engagement with questions around debt sustainability and environmental sustainability are positive markers of flexibility in approach and a willingness to learn.

The external pressures emanating on China's transformative BRI, and by extension CPEC, are symptomatic of strategic anxieties couched amidst questions around sustainability. Despite its doubters, the fact remains that the BRI constitutes the single largest effort to transform the infrastructure and development potential of middle- and low-income economies around the world in the past century.

In Pakistan, the growth potential from CPEC can be immense, but the federation's ability to transform opportunities into tangible gains has remained hostage to inefficiencies and shortcomings in both governance and capacity. The 'Three C Strategy' outlined above provides some salient recommendations for grappling with the internal challenges that CPEC has presented over the last five years. CPEC is not Beijing's dream alone and the task ahead for Pakistan is enormous and unprecedented.

Firstly, to ensure that there is consensus between the different political parties of Pakistan, the government needs to utilize existing committee structures in parliament to build multi-party consensus and address any grievances by provinces or political parties. Additionally, they need to create frameworks for managing the politics of stakeholder inclusion, including at the grassroots level in provinces, or at big-tent political party level in Islamabad.

The second major internal challenge to CPEC is building enough capacity to fully absorb the potential that it promises. This capacity needs to be built at the federal and provincial level in project planning, management and monitoring. This can be done through including the private sector in SEZ policy planning and management to ensure market driven competitive industrialization. Rationalizing SEZ incentives to match incentive structures being offered by SEZs in South East Asia, Gulf and Africa is another technique that can increase the country's capacity to absorb the projects under CPEC. Furthermore, a comprehensive investment policy must be put in place and built into future Foreign Trade Agreements with China so that these governance policies do not have to be retroactively fitted.

Capacity can also be built through incentivising the private sector towards vocational and skills training to quickly build human resource capacity. This policy

recommendation can manifest itself on the ground through reorienting both public sector vocational training and higher education curricula to align with market demand for skilled and semi-skilled labour.

Finally, the third major C of Coordination can help resolve the remaining internal challenges that CPEC has posed for the country. The challenge of Coordination can be resolved through ensuring transparency in communication and coordination between the federation and the provinces on CPEC projects, timelines and investment contracts. This can be done through establishing an autonomous CPEC Authority to ensure coordination between various government ministries, departments and agencies, as well as provincial level coordination.

Given Pakistan's history, governance structure and internal political and economic challenges, taking ownership of CPEC will require painstaking systemic reforms. There is a need to focus on Pakistan's development outcomes, without which the country will inevitably see a disproportionately high economic growth in enclaves, while poor human development and crumbling infrastructure slows down investor options in others. CPEC provides a chance to focus sustained and inclusive growth if it is made as a pre-requisite as the country moves forward, not an afterthought.

ⁱ For America, oil prices matter not just to gain market share but also to support a price that makes drilling economical. American oil is not economically feasible until the price rises above \$70 as drilling costs are high. To replace Iranian oil, America has proposed deals to India, China, South Korea, and Germany to provide its oil on better terms. This will provide them both control of energy as well as the geopolitical advantage of pressuring Iran and keeping China in a trade loop. However, the creation of Special Purpose Vehicles to counter oil sanctions on Iran, especially with China, Russia, Turkey, and the EU may be as useful as barter trade and currency swap regimes. At the same time China also remains America's banker, emphasizing that nothing is zero-sum in the new web of changing global dynamics.

ⁱⁱ Sri Lanka's decision to hand over Hambantota Port to China for 99 years, and China Merchant Port Holdings' acquisition of 70% of the port's operating company, is often cited as a warning for Chinese debt trap. However, the circumstances that lead to this, point to a much pervasive balance of payment crisis that goes well and beyond its Chinese loans. At that time, Chinese loans which were mostly concessionary, only accounted for 10% of Sri Lanka's foreign debt whereas 39% were sovereign bonds with short payback period despite weak exports. This, along with structural weaknesses and poor government revenue made debt management extremely difficult for the Sri Lankan government and thus contributed heavily to Sri Lanka's decision to lease Hambantota Port.

ⁱⁱⁱ This new focus includes revamping the following: Trade and Market Access; Industrial Development and Global Value Chains; Socio-Economic Development and Poverty Alleviation; Agricultural Modernization and Marketing; Gwadar Oil City and the Blue Economy; Regional Connectivity and Third-Party Participation.

^{iv} Pakistan has been the first recipient country of newly formed Chinese aid agency, Chinese International Development Cooperation Agency (CIDCA) under which China would provide grant of \$1 billion (Rs151 billion) for various projects of socio-economic uplift of Pakistan. This help received from CIDCA can also be crucial in the development of human capital for the country.

^vCommunity level politics is critical to navigating trade union tensions in Gwadar, for instance, where the local fishermen have not been consulted in the building process of terminals and jetties that displace their livelihoods and boats.

^{vi} The CPEC Committees are fully functional in the Senate, which is the House of Parliament that guarantees the rights and voice of each province in equal measure.

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