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Pakistan needs to look beyond China for FDI

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The China–Pakistan Economic Corridor (CPEC) is widely considered to be a game changer not only for Pakistan, but for the Asian region. CPEC is a major stimulus for Pakistan, ensuring rapid economic growth with massive infrastructure development and flows of foreign direct investment (FDI). CPEC aims to connect Gwadar Port in Pakistan to China's northwestern region of Xinjiang via a network of highways, railways and pipelines. Connectivity with Central Asia, the Middle East and Africa under CPEC will shape the entire region's economic agenda.

The estimated investment under this project is US$46 billion. The expected investment will transform Pakistan into a regional economic hub. It is projected that CPEC will directly create 700,000 jobs between 2015–2030 and boost annual growth by 2 to 2.5 percentage points.

The CPEC project has two components. One component aims to develop a new trade and transport route from Kashgar in China to Gwadar Port. This includes US$33.8 billion for energy projects, US$5.9 billion for roads and US$3.7 billion for railways. CPEC energy projects will serve as the backbone of the energy strategy to overcome Pakistan's power crisis.

CPEC's other component envisages developing special economic zones along the route, including power projects.

CPEC will be a confidence booster for investors. The project is viewed by many as a business magnet, attracting investment beyond China, from Europe and other regions. Much more than China's initial US$46 billion investment is expected from other parts of the world through government-to-government and business-to-government collaboration.

But to what extent does Pakistan succeed in attracting FDI from countries other than China? Recently, the State Bank of Pakistan revealed that net FDI flows have increased to US$1281.1 million in the 2016 fiscal year, compared to US$922.9 million in the previous fiscal year. That's a growth rate of 38.8 per cent. These statistics paint a very promising picture of Pakistan's FDI future and are aligned with the government's Pakistan Vision 2025 plan and projected CPEC achievements.

But there is a flipside to this picture. If we look at FDI by country, it is notable that the net increase in FDI from China was US$337.1 million during that same period. This is almost equal to the entire net increase of overall FDI. China contributed almost half the total FDI that Pakistan received in the last fiscal year and has increased its FDI as part of CPEC.

Looking at the growth pattern of other major contributing countries, we find the opposite story. There is no significant growth in FDI excluding that from China. By country, China was followed by Norway, the UAE, Hong Kong and Italy as the largest contributors to FDI in the fiscal year 2015–16. FDI flows have declined from US$218.8 million to US$164.2 million from the UAE, from US$169.6 million to US$79.8 million from the United Kingdom, from US$208.9 million to US$65.5 million from the United States and from US$115.3 million to US$103.5 million from Italy over the same period. The United States has traditionally been a big source of FDI, but that trend is now changing.

Why has Pakistan failed to attract FDI from the rest of world despite the launch of CPEC? To reap the potential FDI benefits from CPEC, Pakistan needs to look at the performance of its prerequisite indicators.

FDI inflows are constrained by three major factors: business environment, regulatory framework and physical infrastructure. All these factors are linked to maintaining security and political stability, ensuring transparency and good governance. But developing physical infrastructure, as proposed in CPEC, may not be enough to attract FDI from the rest of world.

Major reforms are essential to attract FDI to Pakistan. The reform agenda should focus on two components: economic and institutional reform.

Macro-stability along with high economic growth is a prerequisite to boost FDI. The government should ensure macro-stability to enhance investor confidence. This also attracts investment in long-term projects including infrastructure development. At least 6–7 per cent GDP growth per annum is required for this purpose.

Growth should be inclusive to ensure equal distribution of resources. On the macro-stability front, though significant progress has been made by keeping inflation and interest rates low, the government should seek to maintain stability over a longer period of time. These measures not only induce FDI but also promote private sector-led growth in the economy. Pakistan's government has recognised the primacy of the private sector as a key instrument for accelerating growth.

CPEC's success is also linked to institutional reform. The country faces formidable security and governance challenges. Performance in key institutional indicators, including rule of law, political stability, control of corruption and regulatory quality is comparatively very poor. According to the World Bank's *Worldwide Governance Indicators*, Pakistan is in the third percentile for political stability and absence of violence or terrorism, where 0 is the least desirable and 100 the most desirable rank. South Asia as a region ranked in the 33rd percentile and Europe and Central Asia (ECA) ranked in the 64th.

In control of corruption indicators, Pakistan ranked in the 22nd percentile while South Asia and ECA are in the 39th and 64th percentiles respectively. The situation is similar for rule of law and regulatory quality indicators.

Pakistan needs to invest in reforming these institutions to attract FDI, as improved governance will allow higher returns on investment. Institutional reform may require restructuring and improving legal frameworks, adopting a carrot-and-stick approach in order to ensure accountability and transparency, implementing rule of law and ensuring political stability. Without the implementation of an integrated institutional framework in which governments can develop and enforce their own regulations, the fruits of CPEC may never materialise.

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