Consortium for Development Policy Research

International Growth Centre

How Chinese FDI can accelerate Pakistan's economic growth

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This brief is based on the paper "Can Chinese FDI Accelerate Pakistan's Growth?" written by Dr. Shahid Yusuf (Chief Economist, The Growth Dialogue, George Washington University, U.S.A.).

In brief

- The share of Foreign Direct Investment (FDI) in Pakistan has been minimal in key export sectors, such as textiles and medium tech industries
- Chinese FDI is more advantageous for Pakistan than investment from other sources
- China's share of FDI to Pakistan has begun rising and Pakistan must take advantage of this in several ways to boost its exports sector

FDI and Pakistan

The East Asian (among other regional experiences) have shown that Foreign Direct Investment boosts local resources, can prompt local producers to improve quality of their products, increases links with global value chains as well as access to foreign markets, and promotes technology transfer. Thus, following in the footsteps of successful East Asian economies, Pakistan can diversify its tradable goods and services and derive productivity gains from advances in technology by taking steps that could enlarge the flow of FDI

In 2000, the net FDI in Pakistan was $308 million. Since then the flow of FDI has varied significantly- from a peak of $5.59 billion in 2007 it fell to $859 million in 2012 before rising to a little under $1.2 billion in 2015-16. In recent years, the biggest investors in Pakistan have been China, Norway, the UAE, Hong Kong, and Italy while investment from the United States and Germany has tended to decline. Most of FDI has been focused in six sectors, which, in order of importance, are: communications, power generation, finance, oil and gas, petroleum refining, beverages, and trade. The key export-oriented subsectors such as textiles, leather goods, food processing, and metal products have received very little FDI. In addition, foreign investors have also neglected medium-tech industries such as auto-parts, with good export potential.

The case for Chinese investment

China's share of FDI in Pakistan has inched upwards because of the Investments associated with the China Pakistan Economic Corridor (CPEC) program. In 2015-2016 it amounted to almost $600 million much of it in the power sector. However, recent and past investment from China has also flowed to telecommunications, transport infrastructure and mining. There is some investment in tradable activities as well. China's FDI to other countries is increasingly swiftly and attracting more of this to Pakistan would be beneficial, particularly if Chinese FDI boosts the garments industry and other exportable manufacturing activities.

Chinese FDI is more advantageous for Pakistan than investment from other sources for three reasons:

- China is one of the principal drivers of global growth with a rapidly expanding domestic market that is generating increased demand for imports
- It has capital to invest and some of its firms are looking to move their production bases abroad as domestic wage costs rise
- China is moving up the value chain and is likely to

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exit from some low value-adding activities, thereby creating opportunities for Pakistan

China's remarkable economic performance over the past three decades offers Pakistan two useful lessons:

- The ability to assimilate new technologies is vital. It enables a country to diversify its industry, raise productivity, and possibly seed industrial clusters in major cities that can be a source of agglomeration economies
- Building industrial and technological capabilities facilitates penetration of global markets and progress up the value chain

What Pakistan must do

In order to enhance FDI and technology transfer from China, Pakistan needs to move on a number of fronts including:

- Tightening its trade relations with China and enhancing its access to the Chinese market
- Enter into joint arrangements with Chinese to develop Pakistan's mineral resources such as copper, coal, iron ore, and benefit from China's technical expertise in exploration, mining and environmental protection
- Capture a larger share of industrial activities that China is seeking to transfer abroad by increasing the attractiveness of Pakistan's business environment. This will require policy initiatives on part of the government and the readiness of Pakistani firms to be entrepreneurial.

International and Pakistan's own experience indicates that the vertical and horizontal spillovers from FDI will be greater if Pakistan focuses private and public efforts in five areas:

- **Technological Advancement**: Modernization of equipment to improve quality and productivity, and the ability to meet quality standards and tight delivery schedules
- **Skills training**: Improving the formal and on-the-job training of workers, supervisory staff and management, with increasing emphasis on the use of information and communications technology as well as modern automated equipment
- **Research and Development (R&D)**: Increase basic research in selected areas and applied research in products and processes that raise productivity, lead to product diversification, improve quality, and introduce green technologies. R&D would also benefit the agricultural sector by upgrading the quality of cotton varieties grown in Pakistan
- **Marketing and branding**: Investing efforts in marketing and branding to raise profitability
- **Compliance**: Giving greater attention to compliance with labour and environmental standards and to the adoption of clean methods of manufacturing

Policy actions on the above stated areas could increase gains from FDI and increase inflows. The latter requires a relaxing of constraints that are more political than economic. For example, powerful and established industrialists seek and support trade protection policies that guarantee them generous profits and weaken the incentive to diversify, innovate and compete in international markets; inability of the government that has been captured by interest groups to undertake the required policy reforms; and conflicts on Pakistan's border and that impact on internal security. Collectively these have rendered the business environment unattractive for all, especially foreign investors and importers of Pakistan's products. Pakistan is in the dire need to overcome these political hindrances and it is vital that the government commits itself to a long-term strategy for growth. Otherwise very little FDI will flow in from China and other economies, which will not allow Pakistan to realize its export potential and realize its developmental objectives.

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