



A Perspective on FDI from China

PAKISTAN BUSINESS COUNCIL

A Perspective on Foreign Direct Investment from China

Background

Whilst significant investment by the Chinese public and private sector has resulted from the CPEC initiative, most of it so far has been confined to infrastructure - power, roads, railways etc. The Chinese private sector has been shy to invest in Pakistan. There is therefore a need to identify the reasons and explore the sectors where Chinese investment would both be feasible for investors and more important, desirable for Pakistan. This is the Pakistan Business Council (PBC) brief perspective on attracting private sector investment from China. PBC believes that without an ideal investment climate, neither foreign nor local investment will materialize. As investment climate is a sub-set of the general socio-economic conditions, it is not possible to create a positive investment climate without addressing the fundamental issues that confront Pakistan's economy and impede its socio-economic growth. It is with this objective that the PBC published in November 2020 a Charter of Economy to bring all stakeholders to a common platform to deal with the challenges and address the opportunities. This perspective on FDI from China should be read in the broader context outlined in PBC's Charter of Economy <https://www.pbc.org.pk/wp-content/uploads/PBCs-charter-of-economy.pdf>.

Pakistan's FDI Experience to Date

Pakistan has for long had a liberal and undifferentiated foreign direct investment (FDI) policy. It has been open to investment virtually from any source, including offshore centres, and into almost all sectors of the economy. The policy allows 100% ownership and full remittance of profit and capital. Foreign exchange laws provide for royalty and technical fee payment. However, other than recent infrastructure investment from China, the kind of FDI the country has attracted has mainly been in the quick (and high) pay-back, low-technology, FMCG sectors. This market-seeking investment pursues the demographic dividend from a growing and consumption-driven middle class and leverages off the rapid rate of urbanization, leading to switch from loose to packaged products. As a result of an open, undifferentiated and undirected policy, many categories of FMCG are today in the hands of, mainly western, MNCs. These MNCs have been growing at rates faster than their parents and have over the long run enjoyed returns far superior than their global average. Whilst a detailed economic analysis of this investment has not been performed, the impact on the external account is negative

RECENT EXAMPLES OF FDI



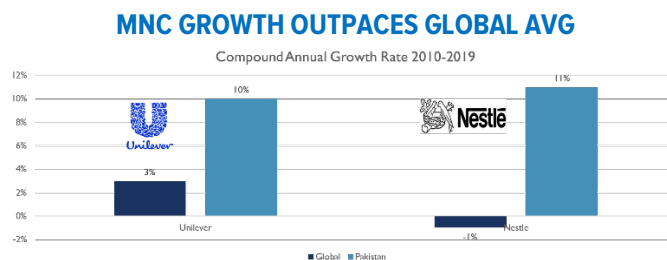
MANY CATEGORIES ARE DOMINATED BY MNCs

Sector	Packed Dairy	Home & Personal Care	Ice Cream	Bottled Water	Mobile Telephony
MNC Share %	80%	75%	80%	70%	100%
Operators	 	 	 	 	

MNC's ENJOY HIGH RETURNS ON EQUITY

HIGH RETURN ON AVERAGE EQUITY FOR MOST MNCs	
MNC	AVG ROE% (6 Yrs 2014-2019)
Unilever Pakistan	207
Nestlé	183
Pakistan Tobacco	72
Abbott	23
GSK	19
Sanofi-Aventis	14
SIMPLE/UNWEIGHTED AVERAGE ROE OF ABOVE	86

from the high reliance on imported raw and packaging materials, absence of exports from the country and from the remittance of profit, royalties and technical fee. On a strong positive, this type of FDI has improved the quality of products and talent, promoted higher standards of ethics and governance and helped develop robust domestic supply chains.

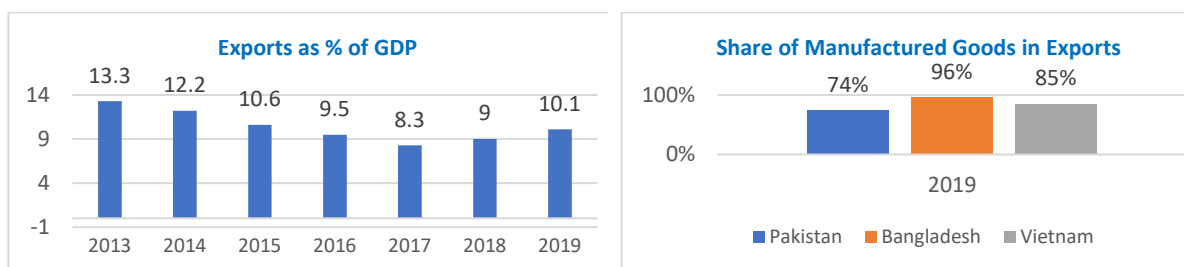


PBC's Perspective on the FDI Policy

Whatever may have been the historic rationale of an open, undifferentiated and undirected FDI policy which resulted primarily in attracting large investment in the FMCG sector, the PBC advocates that Pakistan now adopts a more differentiated policy to attract investment according to its long term needs rather than short term infusion of foreign exchange. Pakistan's primary needs are:

- Jobs for our youth and the un-employed and the under-employed,
- value-added exports, not just export of commodities
- import substitution in a competitive and sustainable manner,
- technology/knowhow of the type not already available and
- capital for riskier investment into sectors such as oil & gas exploration and mining,
- investment that benefits both the large rural and the growing urban populations.

Exports as a % of GDP have been declining as is the share of manufactured goods in exports relative to Bangladesh and Vietnam.



PBC also advocates that the new FDI policy should allow 100% foreign ownership only to those fresh investors who meet the aforementioned criterion. Other new investors not meeting the aforementioned conditions may be required to enter JVs or seek stock-market listing. They should also be required to gradually increase their exports and/or support import substitution, up to a prescribed threshold.

In its interactions with the Board of Investment, the PBC reminds it of its role to promote **all** investment, not just FDI. It is encouraged by the BOI's new strategy to target specific sectors in which jobs, exports and import substitution can be promoted. PBC is also encouraging the media to start reporting inward FDI in the context of the potential to create jobs, generate exports and impact import substitution rather merely mentioning the size of the incoming investment. Put simply, as short pay-back market-seeking investments lead, in the medium term to a drain on the country's external account. Celebrating inward FDI in dollars without the longer-term context of jobs and impact on the external account is short-sighted.

Priority Sectors for FDI

The sectors in which Pakistan would benefit from FDI, not necessarily from China, under the framework proposed by the PBC are:

	Exports/Forex Earnings	Import Substitution	Job Creation	Technology and Know-how
Agriculture				
Horticulture				
Livestock				
Tourism				
IT/IT-enabled incl. 4 G Towers				
Textiles				
Auto parts				
Mining				
Oil & Gas Expl.				
Health Services				
Fisheries/Sea-food				
Footwear				
Light Engineering				
Food Processing/branding				
Construction materials				

We recommend a vertical FDI policy which targets specific sectors where the opportunity to create economic impact is greatest for the country. Investors benefiting from this policy can anchor their returns on the country's specific competitive advantage. The importance of various sectors in the GDP are as follows:

Sector	% of GDP	Main Sub-sectors	% GDP
Agriculture, Livestock etc	19.3%	Crops	6.4%
		Livestock	12%
		Others incl fishing, forestry	1.6%
Industry	19.3%	Textiles	4.2%
		Minerals	2.5%
		Food, Beverages & Tobacco	2.5%
		Construction	2.5%
		Electricity Generations	2%
		Coke & Petroleum	1.1%
		Pharmaceuticals & Chemicals	1.1%
		Iron & Steel	1.1%
		Slaughtering	1%
		Autos	0.9%
		Electric appliances	0.4%
Services	61.4%	Wholesale and Retail	18.2%
		Transport, storage & communication	12.3%
		Finance & insurance	3.6%
		Housing services	7%
		Government services	8.6%
		Others	11.8%

The common factors that dictate the choice of sectors for potential investment v=by the Chinese private sector are:

- Size and importance of the sectors in the GDP
- Sectors already identified as priority sectors for Chinese investment in SEZs
- Pakistan's labour cost advantage and its relevance
- Sectors with some level of skills availability with potential to develop further in the short term

- Raw material/mineral reserves availability with scope to add value
- Non energy-intensive sectors
- Those that would benefit from global reach of Chinese investors, such as textiles

Using the above criteria, the template of potential sectoral investment for Chinese FDI is prioritized as follows:

	Size in GDP	Identified for SEZs	Labour Cost	Skills	RM Availability	Low Energy Intensity	Global Reach of Chinese
Agriculture	Green	Green	Green	Yellow	Green	Green	White
Horticulture	Green	White	Green	Yellow	Green	Green	White
Livestock	Green	White	Green	Yellow	Green	Green	White
Tourism	Yellow	White	Green	Yellow	Green	Green	White
IT/IT-enabled incl. 4 G Towers	Yellow	Green	Green	Green	Green	Green	White
Textiles	Green	Green	Green	Yellow	Green	Green	Green
Auto parts	Yellow	Green	Green	Yellow	White	Green	Green
Mining	Green	Green	Green	Yellow	Green	Green	Yellow
Oil & Gas Exploration	White	Green	Green	Yellow	Green	Green	White
Fisheries/Sea-food	White	White	Green	Yellow	Green	Green	White
Footwear	White	Green	Green	Yellow	Yellow	Green	Green
Light Engineering	Yellow	Green	Green	Yellow	White	Green	Green
Food Processing/branding	Green	Green	Green	Yellow	Green	Green	Yellow
Construction materials	Yellow	Green	Green	Yellow	Yellow	Green	Green

Key Constraints to Investment

The key constraints to investment in Pakistan which impact local and foreign investors are broadly similar:

- Poor productivity due to low investment in human capital, technology and skill development
- High energy costs: whilst the five export sectors are provided energy at regionally competitive rate, the rest of industry suffers at least 25% higher costs
- Unreliable, unsafe and costly goods and passenger transportation
- Paucity of affordable land close to centres of population with adequate infrastructure. No SEZ is operating yet.
- Colonial-era over-regulation, administered by a bloated bureaucracy lacking specialist knowledge, focusing its attention mainly on the formal sector
- High tariffs on imported inputs (though this is changing due to cascading tariffs)
- Minimum tax on turnover at 1.5% even in tax holiday periods and on ventures to be located in SEZs
- Unlevel playing field vs a large informal sector. Misuse of the Afghan Transit Treaty, smuggling, under-invoicing, misdeclaration of imports, IPR infringement and adulteration.
- Weak support by the provinces to check illicit trade as they are not beneficiaries of federal levies
- High rate of GST for an undocumented economy leading to rampant evasion
- An under-resourced FBR chasing unrealistic tax targets by pursuing existing tax payers for more
- Poor regional/global connectivity given the relations with India, sanctions on Iran and war in Afghanistan
- Dwindling supply of cotton, the main input for textiles, which in turn is the main export
- Low agriculture yields and high waste, especially of horticulture
- The government crowding out the private sector from bank credit
- Absence of proper development finance institutions that can take long term credit and equity risk
- Reluctance of banks to take risk by lending to the SMEs
- Poor standards and certification systems
- Narrow export basket and over-reliance on USA, UK, EU as destinations.

The Potential for Chinese Private Sector Investment

This section responds to Pakistan's critical needs for jobs, exports, import substitution and infrastructure rather than merely the potential for Chinese investors to profit from investment by catering to Pakistan's large domestic market. As mentioned earlier, PBC believes it should be Pakistan's needs that should drive FDI.

Agriculture, Horticulture, Livestock and Food Processing

Agriculture represents 24% of the economy and provides inputs to industries that account for 59% of manufacturing output. It also has backward linkages to fertilizers, chemicals and tractors and forward linkages to retail, wholesale and transportation. Agriculture employs 40% of labour and directly and indirectly supports nearly 75% of exports. Thus, its total contribution to the economy at 40% makes it the country's primary sector. Sadly however, in none of the five major crops does Pakistan's per acre yield exceed 50% of the global best.

Output Tons/Hectare	Pakistan	Best in the world	Pakistan as % of Best
Wheat	3.1	8.1 (France)	38%
Cotton	2.5	4.8 (China)	52%
Sugar Cane	63.4	125.1 (Egypt)	51%
Maize	4.6	11.1 (France)	41%
Rice	2.7	9.2 (USA)	29%

Cotton which is a primary input into Pakistan's main exports of textile products has seen a steady decline:

Cotton Production	2004 Mn 480 lb bales	2020 Mn 480 Lb bales	Change %
India	19	28	+50%
Pakistan	11.1	6.3	-56%

Output is marred by fragmentation of land holdings; forced reliance on exploitative middle-men; gaps in affordability and availability of mechanization/ modern techniques, including land levelling, precision application of seeds, fertilizers and insecticides; poor seed quality especially of cotton; wasteful use of water; outdated harvesting techniques; and weak cold chain and logistics resulting in high waste. There is therefore significant scope to introduce modern, water-conservation knowhow and co-operative mechanization that the Chinese are known to have expertise in. However, there are several issues that need to be carefully evaluated in pursuing a strategy to meet the growing needs for food in China:

- **First is to preserve Pakistan's dwindling water resources.** China is reportedly looking to switch to imports of water-intensive crops, including vegetables and fruits. As Pakistan too is water stressed, it must evaluate its options carefully before committing to a course which is heavily water reliant. We can learn from the experience of promoting cultivation of sugar cane. However, of particular interest to Pakistan would be leveraging the Chinese experience of cultivating cotton in the arid conditions in Western China. Baluchistan could provide ideal conditions.
- **The second aspect is to secure land ownership.** Long-term leases on a shared return basis, with protection of farm employment could be a way forward.

- **Before refocusing Pakistan's agricultural resources to serve China's large market, we need to secure our own food needs, especially of the staples.** We also need to ensure that there is a robust inventory and forecasting system to prevent surges in cost.

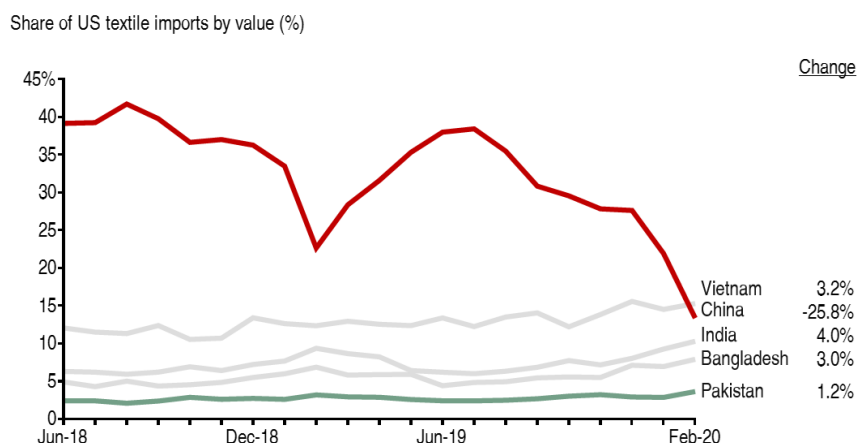
As agriculture is a provincial subject, getting the provinces on board on future collaboration with the Chinese is a prerequisite. Investment is also required in logistics, including the cold chain and in capability building to comply with phytosanitary standards.

Livestock is the largest component of agriculture. However, animals are primarily kept for subsistence and as an appendage to cultivating crops. Neither dairy nor meat are pursued on professional basis. Hence there is significant scope for investment and optimization.

Rice is Pakistan's second largest export. However, bulk of this is not in a branded form. Branded rice is sold globally at a price which is 15 times that of unbranded rice. Packaging plays a role in this and Chinese investment would help promote branded exports.

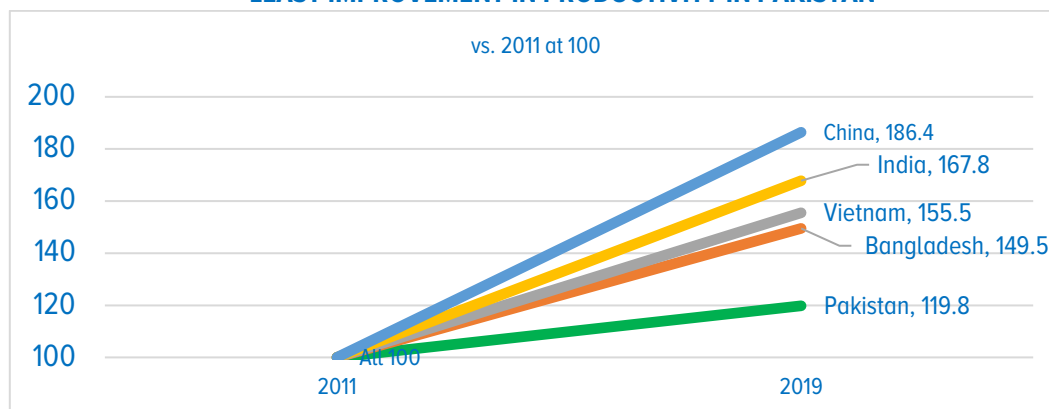
Apparel, Footwear, Luggage and other Labour-Intensive Sectors

Following US tariffs on China, the larger beneficiaries of the shift in share of textile imports into the USA have been India (4%), Vietnam (3.4%) and Bangladesh (3%). Pakistan has gained the least (1.2%).



China the world's largest manufacturer and exporter of textile products. Chinese companies dominate the global textile supply chain which is not confined to production in China. They have significant influence in sourcing from multiple Chinese owned or JV operations in countries like Vietnam, Cambodia, Laos, Bangladesh and Ethiopia. Some of the share gain by these countries into USA is a result of diversification of supplies from China to Chinese controlled plants located elsewhere. Despite close relations with China, Pakistan has yet to benefit from this kind of re-location. The tension in US/China trade may subside under a Biden administration. However, pressure is likely to remain on diversification of sourcing. Hence Pakistan should pitch to partner Chinese companies through local production. There are however, several impediments that need to be addressed, not least Pakistan's poor productivity.

LEAST IMPROVEMENT IN PRODUCTIVITY IN PAKISTAN



Security issues, mainly in the past, poor labour skills and low productivity, high cost of logistics, time and energy-sapping bureaucracy, high energy costs, unaffordable land, coupled with inadequate infrastructure, all contribute to a negative perception about Pakistan as an investment destination, relative to alternative locations that provide “plug and play” facilities.

The PBC has been advocating the following key aspects to be addressed in developing Special Economic Zones:

- Primary aim should be to industrialize. Export & import substitution can be a focus of SEZs, but not need not be a prerequisite;
- SEZs should be open to all investors, without any min. or max. % shareholding or country of origin conditions;
- Speedy resolution of disputes be ensured through tribunals, bypassing the slow legal system;
- Provide land on long-leases **for industrial use only**, through “plug & play, one-window facilities. **DO NOT SELL LAND;**
- Create clusters to promote supply chain integration and expertise
- Locate near centres of population, ports and road networks. Remote SEZs offer no incentive to industry
- There should be no minimum tax, whether turnover-based or otherwise, during the tax holiday period
- 10-year tax holiday be offered to those generating 80% of revenue from exports, subject to 25% of profit reinvestment into expansion
- Specific relief for import substitution projects to be agreed at the start, subject to 25% profit reinvestment
- Duty- and sales tax-free import of plant and machinery for all SEZ units at the start and up to 10 years thereafter
- Expatriate management and workers be allowed on a gradually reducing level

Apparel exports from Pakistan cover the bottom 20% of the global universe of apparel, leaving 80% of demand unaddressed. This is where countries like Vietnam and Bangladesh have moved with speed. Bulk of Pakistan’s exports are 100% cotton based, whilst global demand is shifting to man-made fibres, which are also ideal for the emerging technical textiles. The per unit price commanded by Pakistan apparel exports is between 11-50% of Vietnam’s and 20-33% of Bangladesh’s. Hence there is significant scope to change the cotton/man-made fibre mix and to go up the value chain. The main onus of this is on the current large players who need to invest in capacity and capability, including skills. Teaming up with Chinese textile companies should expedite the process. Secondly, anti-dumping duty should not be levied on imports required as input (for example fabric for man-made fibre) for exports and the bonding facility rules should apply, as for other

imported inputs. Skills for value-addition aside, the marketing network of Chinese textile companies will prove to be useful for Pakistan.

IT, IT-enabled Services and Internet Penetration/Band-width

Pakistan's large number of software developers and its young population offer an opportunity for Chinese IT companies and BPO/Call Centres to collaborate in developing an IT supply chain. Due to tension between China and the West, it is likely that China's reliance on western software will subside and it will increasingly focus on developing home-grown solutions. Talent from Pakistan can provide beneficial partnership. China's ageing population also offers Pakistan's youth with IT skills an opportunity to work there or as part of remote teams. Developing linguistic skills would be vital for this. The Pakistan government needs to prioritize locally developed software for the digitalization process of government. That would amount to import substitution. Whilst the export of goods attracts rebates and duty refunds, export of services, including IT does not. A level playing field between export of goods and services would attract further investment into the latter.

According to the Economist Intelligence Unit Pakistan ranks 76 out of 100 in Internet Inclusiveness Index and stands almost at the bottom in Asia. Outside the big cities in Punjab and Sindh, there is little or no internet coverage. 35% of the country lacks the much-needed internet infrastructure. This includes connections to optical fiber and poor coverage by telecom towers. 60% of Baluchistan is not covered by internet. Similar numbers can be expected in Gilgit-Baltistan and the former F.A.T.A areas. While some areas have some coverage, internet speeds in such districts are lower than the national average of 6.2 Mbps (cellular only). In some areas, the download speed was recorded at less than 1 Mbps. Telecommunication in general and broadband specifically is expensive on account of taxes and the presumptive manner in which these are levied. Internet inclusivity is vital for equitable development of the country. With the right policy, this could be an area for Chinese investment that would meet the critical need to position Pakistan in the knowledge economy.

Alibaba and Ant Financial have already invested in e-Commerce and digital platforms in Pakistan. Formalization of the economy will be further facilitated by use of QR codes. Transactions using QR codes have replaced cash and cards in China. Tencents WeChat Pay and Alibaba Alipay dominate this space. Facial and fingerprint recognition systems are being explored in China. Pakistan's economy could benefit enormously through documentation and formalization using similar systems. The smartphone penetration is likely to grow with local assembly and can provide the basis of moving away from cash and card settlement.

Domestic Appliances, Cell Phones, EVs, Solar Panels, Light Engineering

With tension between Washington and Beijing, US companies are moving to separate their global sourcing away from China-based supply chains, leaving in China just what is necessary to meet domestic demand. An example of this is Apple which henceforth, will confine its production in China to meet local demand, whilst relocating its global sourcing to countries like Indonesia and India. This can also offer opportunity for Pakistan as an alternative production location to meet both local demand as well as for exports. Pakistan's new policies for cell phone assembly and EVs, though belated, would support it. Foremost, Pakistan needs investment in auto parts, component manufacturing for domestic appliances and in light engineering. The investment by the Chinese so far has been limited to basic assembly of components imported from China. Gradually this needs to evolve.

Mining and Oil & Gas Exploration

Mining and Oil & Gas exploration are capital and risk intensive and require know-how and technology. Approximately a third of Chinese FDI is in the Mining and Oil & Gas sectors. JVs with Chinese investors, ideally for local smelting and refining of minerals and the retention of rare earth and other precious metals, would be

worth pursuing. When conditions permit in Afghanistan, its iron-ore deposits could provide input to steel-making in Pakistan.

Fisheries and Sea-food

Pakistan's location on the Arabian Sea and its access to a variety of sea-food makes fisheries an ideal export sector for investment. Factors limiting this sector have been sanitary standards and a poor cold chain. Collaboration with Chinese investors would help address both as well as develop Gwadar as a staging point for air-freight of sea food. Besides China, this would also promote exports to the Middle East, Japan and the EU.

Logistics

Pakistan fares poorly at 122nd amongst 160 countries ranked by the World Bank's Logistics Performance Index (LPI). By comparison, India, Bangladesh and Vietnam stood at 44, 100, and 39 respectively. Pakistan suffers from an ageing trucking fleet, a poor road-safety record and high cost of logistics. Whilst the ML1 investment should see bulk of the north-south freight movement through rail, carriage by road elsewhere and especially to Central Asia, via China or when security conditions permit, through Afghanistan, could be scope for the Chinese to invest. The entry of Chinese investors in road transportation would help break the collusive pricing practices and improve fleet maintenance, warehousing, cold chain etc. There are only a handful of Pakistani transportation companies that are TIR licensed and without further investment, the potential to feed Central Asia through road would remain limited.

Energy Transmission and Distribution

Whilst Pakistan's power generation needs have been met or exceeded, the country loses up to 25% on account of grid inefficiency and theft. Significant investment is required in transmission and distribution. However, the experience of Shanghai Electric in acquiring K-Electric to date does not bode well to attract further Chinese interest in this sector. There may be scope for manufacturers of insulated cables and electronic meters to team up with Chinese investors. This could help control theft and address inefficiencies to bring the cost of power to a globally competitive basis.

Construction Materials

Given the government's focus on low-cost housing, there is potential for Chinese investors to enter the field of prefabricated construction which would address speed and cost, as also enhance the potential for vertical construction on smaller land holdings. Besides, there is also scope for knobs, fittings, light fixtures, locks etc.

ABOUT THE PBC

The PBC is a private sector business policy advocacy forum composed of Pakistan's largest businesses / groups including multinationals that have a significant investment in and a long-term commitment to the growth of Pakistan. Members turnover represents every ninth Rupee of Pakistan's GDP and together the members contribute 25% of tax revenues and 40% of exports. More information about the PBC, its members and its activities can be found on our website www.pbc.org.pk







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