

**The Incentives for Chinese Investments in Pakistan:
An Analysis from the Perspective of the Belt and the Road**

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ABSTRACT

The increasing Chinese investment in Pakistan in the recent years has brought a high curiosity on the motives attached to this keen interest to Pakistan. Through the strong trading partnership between the two countries, supported by attractive fiscal policies and the improvement of business conditions, Pakistani authorities found the means to assist Chinese firms in their investment choices.

The paper aims to examine the increasing trend of Chinese investments in Pakistan in the past years and uses a historical analysis based on data collected from articles, official reports and literature to analyze the motives of this trend in the quantum of Chinese investments in Pakistan since the beginning of the Belt and Road Initiative (B&R) introduced in 2013 by the Chinese government.

The analysis suggests that the improved and adjusted friendly investment climate offered to Chinese firms in Pakistan under the China-Pakistan Economic Corridor (CPEC) along with the openness of Chinese cooperation in the region supported by the B&R initiative have constituted a whole package that have triggered the flow of Chinese foreign investments in Pakistan. This paper fulfills the need to examine the early effects of the B&R and the CPEC on the expansion of Chinese overseas investments especially in Pakistan. As the initiative and the corridor are on-going, more investments and business opportunities are expected to keep flowing in the future between the two countries.

Keywords: China-Pakistan Investments, Belt and Road Initiative (B&R), China-Pakistan Economic Corridor (CPEC).

1. INTRODUCTION

On a recent visit to Hong Kong, the Pakistani Prime Minister Nawaz Sharif presented Pakistan as a business destination that *“no-one can afford to miss”*. Certainly, China and many other countries have cautioned this statement and envisaged to offshore their capital in Pakistan.

In a span of three years, the increasing Chinese investment in Pakistan has stirred up diverse opinions on the real motives of such particular attention to Pakistan. Actually, many factors have motivated this strategic decision from the Chinese side. Besides the strong ties of friendship that bind up the two trade partners, China and

Pakistan have established in the past a solid bilateral cooperation now fostered by the Belt and Road Initiative (B&R) introduced by the Chinese government in 2013. The implementation of the initiative's projects is highly regarded by the two parties, especially through the construction of the China-Pakistan Economic Corridor (CPEC). Meanwhile, in order to be more attractive and to favor the successful progress of the CPEC related projects, Pakistan has also set up a bunch of investment measures that offer excellent conditions for Chinese companies to offshore their capital over there.

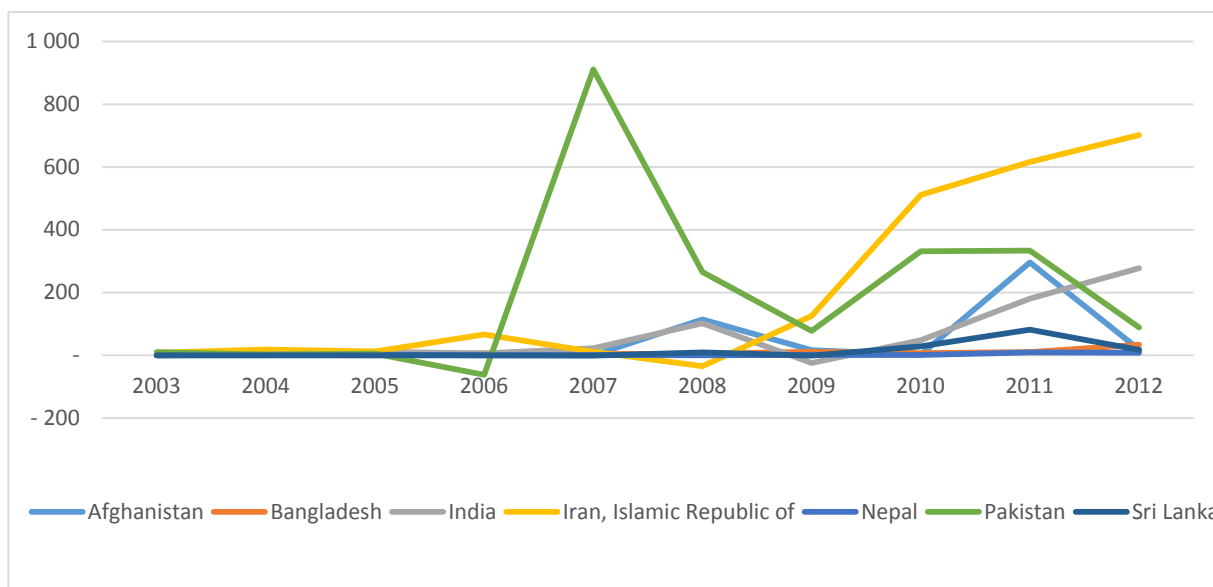
The relevance of this paper stands behind the examination of the increasing trend of Chinese investments in Pakistan in the past years. The paper intends to meet this objective by understanding the motives of the high flow of Chinese investments in Pakistan by using a historical analysis based on data collected from articles, official reports and literature. The study is conducted for a period prior and after the introduction of the B&R initiative. Although limited due to the chosen research approach, the paper brings some insights on the incentives behind this keen interest for Pakistan and suggests that the B&R, the CPEC associated with the Pakistan demand for new investments have all surely motivated such important Chinese investments flows in Pakistan. These suggestions also imply the early effects of the B&R initiative and the CPEC on Chinese overseas investments in Pakistan. Mainly, the B&R initiative strengthened with the CPEC have contributed to expand the quantum of Chinese investments in Pakistan in the past recent years.

2. AN OVERVIEW OF CHINESE INVESTMENTS IN PAKISTAN

With gradual liberalization of their international trade and business policies, Chinese overseas investment has increased worldwide. Hong Kong has been for long among the favored destinations of Chinese foreign investments as well as African, European and American countries that have experienced greater volume of Chinese investments during the last decade. For Jafar and Anum (2014), the social and economic relations between China and Pakistan are qualified as a "model" of friendship. Yet, though having great and strong friendly relationship, the two nations did not achieve impressive foreign investments exchange compared to others. Pakistan biggest investors have been the U.S., the UK, Netherlands, the UAE, and Switzerland (Shahid Yusuf, 2013) while China's outward foreign direct investment (FDI) portion in Pakistan was quasi insignificant. However, considering their strategic geopolitical position, their potentials for business and the benefits that they could gain from tightening their trade relationships, China and Pakistan decided to join efforts to create better conditions to enlarge their business ties. Trade agreements have been reviewed and strengthened followed by a bunch of tax policies adjustments that have eased bilateral trade and boosted Chinese investments in Pakistan.

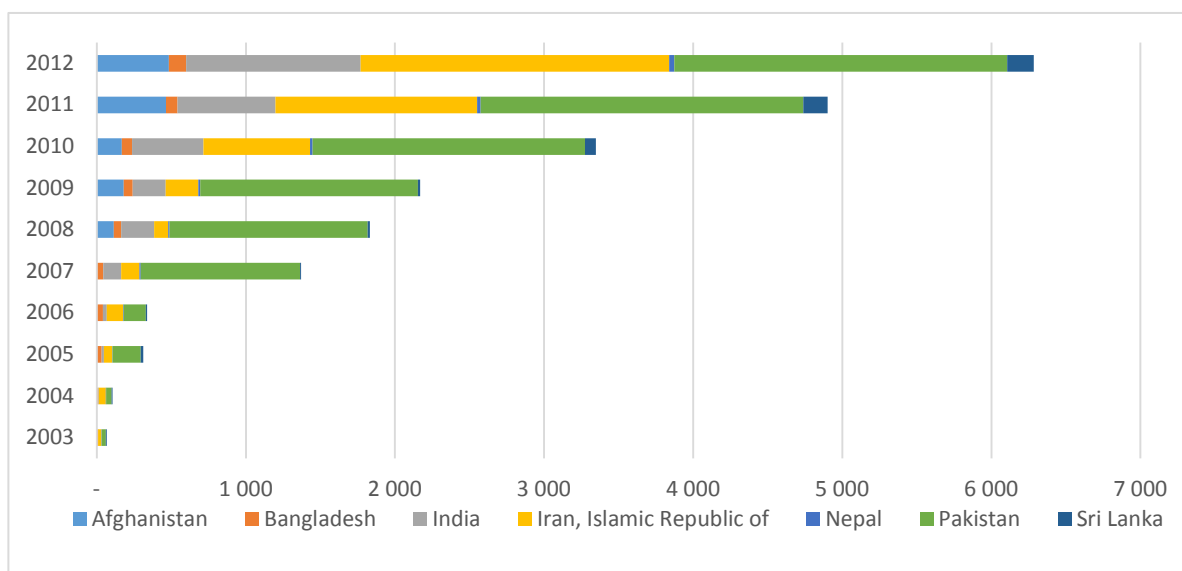
Prior to 2013, Chinese investments in Pakistan, though not insignificant considering the Chinese total overseas FDI, were considerably important in the South Asian region. The United Nations Conference on Trade and Development (UNCTAD) FDI statistics report that Pakistan has been among the preferred destinations of China FDI outflows (Figure 1) and out-stock from 2003 to 2012 in South Asia (Figure 2)

Figure 1: China FDI Outflows in South Asia (Millions of US\$)



Source: UNCTAD FDI/TNC database

Figure 2: China FDI Out-stock in South Asia (Millions of US\$)

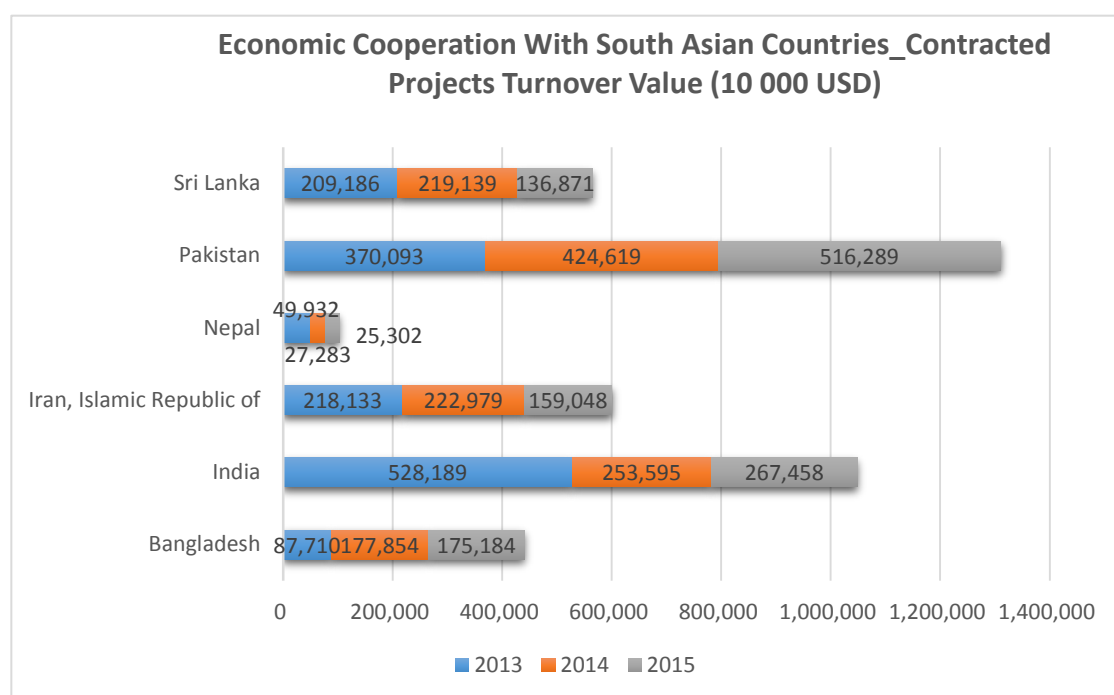


Source: UNCTAD FDI/TNC database

China foreign investments in South Asia, whether measured in outflows or out-stock were mainly directed to Pakistan and Iran in the period prior the B&R and CPEC respectively introduced in 2013 and 2014.

After the introduction of the B&R and the settlement of the CPEC infrastructures projects, Chinese economic cooperation in Southern Asian countries remained tight with Pakistan and India. The figure below shows that in 2015, China has contracted projects worth more than 5 billion USD in Pakistan against some of 2 billion USD in India (Figure 3). This data witnesses the importance of Chinese cooperation with Pakistan in the region after the implementation of the B&R and CPEC.

Figure 3: China Economic Cooperation With South Asian Countries

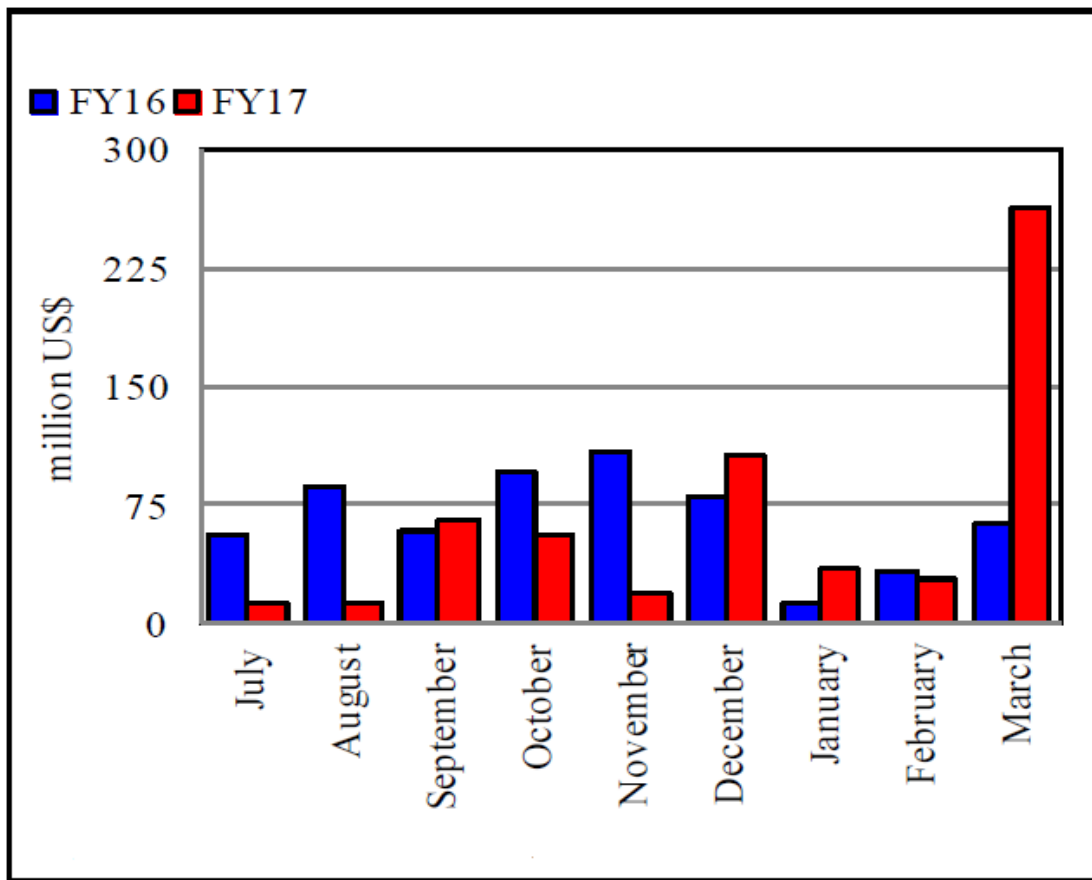


Source: China Statistical Yearbook 2014-2016

With the introduction of the B&R in 2013, China has reinforced its will to be more open and go global by getting more than 60 countries joining its huge project that consists in a win-win cooperation by promoting common development and prosperity. Pakistan was strategically associated to this project through the CPEC which was meant for the realization of big infrastructures projects in Pakistan from 2014 to 2030. Consequently, Chinese overseas investments in Pakistan have experienced an amazing boost. Currently, China has supplanted Pakistan inward FDI with a total contribution of US\$ 594.8 million, counting for 37.1% of the net FDI inflows as reported by the Pakistan State Bank. In March 2017 alone, Chinese FDI was worth US\$ 262.5 million (Figure 4). This trend is expecting to keep evolving as

the corridor's projects move on.

Figure 4. China Net FDI Inflows in Pakistan 2016-2017



Source: State Bank of Pakistan

3. THE RECENT MOTIVES OF CHINESE INVESTMENTS IN PAKISTAN

On the light of the analysis from the above section, it has been highlighted that before 2013, China has always had a preference to tie economic cooperation with Pakistan in South Asia from the past. However, as the level of this cooperation has reached a critical peak in the recent years, it was important to examine the new motives of this cooperation. Therefore, a number of motives has been identified to justify this keen interest of China to Pakistan. The paper suggests that the Belt and Road initiative, the establishment of the CPEC and the Pakistan increasing demand for new investments have played a crucial role in the increasing interest of Chinese firms in Pakistan.

3.1 The Belt and Road Initiative (B&R)

The Belt and Road Initiative (B&R) has been introduced in 2013 by the Chinese President Xi Jinping and is supported by top Chinese officials including the China's

top economic planner, the National Development and Reform Commission and ministries of foreign affairs and commerce. The initiative is not only for Asian countries but welcomes all countries willing to join and seeking for common prosperity.

The objectives of the B&R are meant to embrace a common brighter future for all partakers. This is planned to be achieved through the enhancement of regional connectivity, the promotion of economic openness, free trade flow, the efficient allocation of resources, the promotion of maritime cooperation and the integration of markets.

Simply said, the B&R translates the Chinese government's will to be more open and implicated in the economic development of the region. The initiative can be seen as a multidimensional ambitious project of the Chinese government that bonds all existing and available mechanisms such as regional and bilateral cooperation agreements, trade agreements, economic treaties, and infrastructures to set up a stronger and unique channel for economic expansion. The initiative just makes best use of what exists already and creates what does not in order to enhance economic opportunities for all the partakers. The B&R is intended to be a win-win cooperation although China remains the main actor with an approximate participation of 26%.

However, the projects proposed by the B&R are not only seducing the Chinese neighborhood countries but also Western Balkans countries with a high demand for infrastructure. Though the concept of the B&R remains confusing for the Western, a sizeable economic gain over years is expected as side benefits of the B&R in these countries.

Though still not well pictured or at times misunderstood by many from its beginning, the initiative at current stage, offers investments opportunities to everyone in each partakers' respective countries. Policies, measures, incentives and facilities are being setting up in most B&R countries to stimulate the fluent implementation of the initiative's projects. From its primary stage, the initiative has received number of critics, however many partakers countries are already benefiting from huge infrastructure and industrial projects.

In 2014, an emphasis of the Chinese government was on fostering the development of the economic corridors established along the Belt and Road that are the Bangladesh-China-India-Myanmar (BCIM) Economic Corridor and the China-Pakistan Economic Corridor (CPEC). The establishment of these two corridors is closely related to the B&R, therefore their evolution is closely observed and appears to be imperative for the successful implementation of the B&R given the facilities that the corridors will offer once completed.

3.2 The China-Pakistan Economic Corridor (CPEC)

The China-Pakistan Economic Corridor (CPEC) created under the B&R initiative, is an important consensus taken by China and Pakistan to improve the promotion of economic integration in the region. It is officially designed as a long-term development project worth \$62 billion for various sectors comprising of power plants and energy pipelines, 46 Special Economic Zones (SEZs), fiber optic network, and network of highways and railways linking western China's Kashgar to a deep-water Gwadar port on Pakistan's Arabian Sea coast, with expected impacts not only beneficiary for China and Pakistan but also for the region. Since its establishment, the corridor has boosted Chinese investments in Pakistan. A recent report by the State Bank of Pakistan (SBP) has released that the rapid growth of China's foreign direct investment in Pakistan has recorded the 1.186 billion dollars during the financial year 2016-17 and greater investments are expected as the CPEC projects progress. This data is an illustration of the economic impact of the corridor for the two countries.

Initially budgeted at 46 billion dollars, the CPEC has increased to an estimated 55 billion dollars official budget, then finally reached 62 billion dollars. The said budget is financed by both parties but most investment capital is provided by the Chinese side. Since the beginning of the corridor, Chinese investment in Pakistan has unceasingly increased, more than a capital of 14 billion dollars has already been infused by Chinese companies in various power and transport infrastructure projects in Pakistan. Besides the CPEC related projects, private Chinese investors are also landing to Pakistan attracted by various investments schemes. Therefore, including the private Chinese sector, the volume of China's investment in Pakistan would then peak higher than \$62 billion invested through the CPEC.

However, on the Pakistan side, in addition to their capital contribution, the costs appear under the various forms of more friendly and flexible investment measures that are tax incentives policies, gradual tariff liberalization, preferential treatment for Chinese enterprises on contracts bidding, and so on. Moreover, the increasing public concern in Pakistan over the CPEC creates a kind of burden for the Government. More transparency on the utilization of the corridor's funds is suggested by the general opinion in order to reduce the confusions on its hidden costs. For the Government, all decisions taken are considered as well thought and carefully taken. The Pakistani government claims to be conscious that the CPEC is not a free lunch offered by its long time Chinese partner and that it has to contribute to the project by playing an important role in the implementation of fiscal, security and administrative conditions that will ease the realization of the corridor's projects. Thus, at the current stage of the evolution, the primary results of the corridor's projects are satisfying and all is being done at various levels to ensure their completion and offer Pakistan an outstanding economic profile.

The CPEC is seen as a factor of equitable development and is expected by both parties to offer great economic and trade development opportunities. It is also considered as the fruitful friendship that comes to stimulate growth in the economies of the two countries. The CPEC will offer benefits to the two countries by opening markets, offering necessary infrastructures to ease trade, offering fiscal heavens in the established special economic zones and thus improving the welfare of the populations. Many in Pakistan consider the CPEC initiative as a game changer for the economic development and integration of the country and some others also view it as a potential to bring Pakistan into the global economic mainstream. Interviewed by a national radio station, some Pakistan economic experts expressed their opinions on the B&R and the CPEC taking the CPEC as a central piece of the B&R. They praised the B&R and stressed that the regional strategic position of Pakistan gives the country the impetus to play a critical role in the implementation of the B&R. They also reported that the B&R will offer Pakistan access to Central Asian and European markets, stressing that all countries joining the CPEC will have to connect with Pakistan which will in counterpart help Pakistan restoring the confidence of foreign investors. Finally, they identified the CPEC as a golden gate open for Pakistan to enhance its infrastructures, overcome energy and power challenges and boost industrial development.

According to Riaz A. and Mi H. (2017), China is endowing Pakistan with a massive new brand network of roads, highways, railways, and pipelines through the realization of the CPEC. The authors relate the capital importance of the project for Pakistan as a motor of economic and infrastructure development, poverty relief, peace and prosperity triggers. They also support that the CPEC will contribute in improving the tense relationships between Pakistan and India. However, some challenges are associated with the realization of the CPEC which are related to the international concerns of India and Bangladesh against the development of the corridor. Importantly, security and provincial issues along with high tax and power tariff in Pakistan were also considerable obstacles in the progress of the corridor.

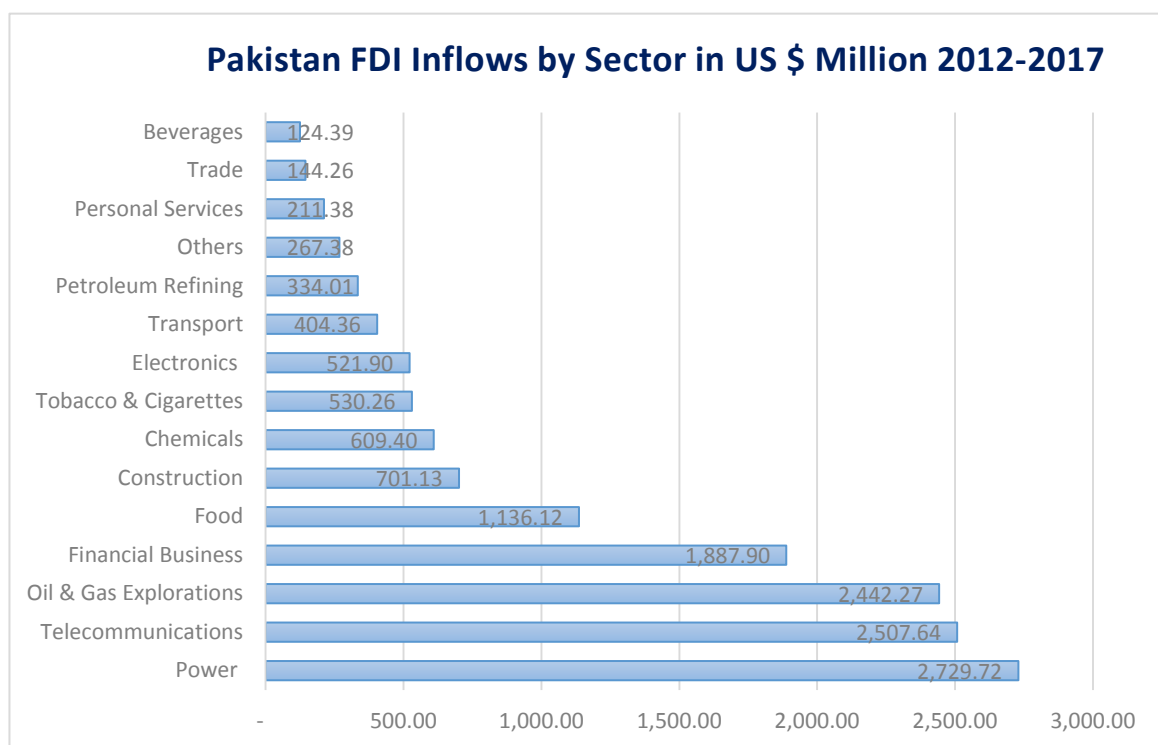
3.3 Pakistan Demand for Investment

Beside the B&R and the CPEC, the increased willingness of Chinese firms to set up in Pakistan can be motivated by the demand for investments expressed by Pakistani authorities.

The call for investments in Pakistan in the last years has not only been pointed to Chinese investors but also to other regional countries. In fact, new investments were required in a various sectors such as infrastructure construction, energy infrastructure development, minerals exploration, oil and gas, pharmaceuticals, telecommunication, information technology, textile, agriculture and more to boost Pakistan economy. Figure 5 shows the main sectors that have received higher

foreign investments inflows from 2012 to 2017. We can observe that in the past five years, the sectors of power, telecommunications and Oil & Gas were very attractive to foreign investors. These sectors received more than US\$ 2,400 million of foreign investments inflows. The inflows brought to these sectors came to quench Pakistan's thirst for investments; however some other sectors are remaining poor in foreign investments. This is the case of the textile sector which received a very low attraction for foreign investment in the past five years.

Figure 5. Pakistan FDI Inflows by Sectors from 2012-2017



Source: State Bank of Pakistan

The Pakistan demand for more investments has driven the tax policy makers of the country to create a favorable tax environment for the matter. Consequently, number of measures have been taken within the taxation system supported by the establishment of infrastructures to ease investors setting up in the country. These incentives expressly made up to ensure a friendly investment environment are intended to drag more investors' attention to Pakistan but more precisely Chinese investors who have been expecting better business conditions in order to outflow their capital.

4. SPECIAL INCENTIVES SCHEMES FOR CHINESE INVESTMENTS IN PAKISTAN

Recently, Pakistan has been offering attractive conditions to both domestic and

foreign investments by allowing new industrial undertakings to enjoy a 100% tax credit, or by allowing foreign investment to set up 100% equity investments, or by not requiring any FDI minimum investment amount or by allowing the full remittance of royalty, capital or dividends. All these policies made Pakistan an ideal destination for investment. Thus, in order to maintain the rising quantum of Chinese investments, Pakistan has created a friendly investment climate that is enticing more Chinese firms to relocate their investments.

4.1 Tight trade bonds

Since 1963, China is among the Most Favored Nation (MFN) of Pakistan through the signature of a bilateral trade agreement. Decades later in November 2002, the two countries strengthened their trade bonds and proceeded to the signature of a preferential trade agreement (PTA) in Beijing thus allowing tariff preference to a limited number of products. The PTA was then followed by the signature of a free trade agreement (FTA) in Islamabad in November 2006. The FTA established a progressive customs liberalization plan in order to eliminate gradually tariffs on 30% then on 90% of certain goods and products traded between the two countries.

To enhance the FTA, the General Agreement on Trade in Services (GATS) and the Early Harvest Program were included with the purposes to open market access and facilitate enterprises from both sides to benefit from the FTA.

All these bilateral efforts have contributed to establish a solid trade and investment framework between China and Pakistan. This framework is sustained by the progressive reduction and elimination of trade barriers as well as an interesting package of investments incentives that surely benefit both countries.

4.2 Tax concessions

The readiness of Pakistan to welcome worldwide investors has been expressed through the reduction of the cost of doing business and the creation of appropriate business conditions for investments. However, for Chinese projects in particular, a special set of fiscal incentives is offered including tax exemptions, tariff reductions, and other investment facilitation services.

a. Flexible investment-led tax policy for all

The existing tax policy in Pakistan offers propitious facilities to worldwide investors through tax holidays, tax concessions, tax credits, special allowances for depreciation and capital expenditure, tax treaties and customs duties reduction. Tax holidays have been set up to promote specific industries, specific projects and specific areas all with the purpose of boosting private and foreign investments in the country.

At the corporate level, a progressive reduction of the income tax is observed every

year bringing corporate income tax rate from 33% in 2015 to 30% in 2018. About the incentives for specific industries projects, we can refer to the income tax exemptions available for power generation and coal mining companies. These companies can also benefit from the exemption of the minimum tax on turnover. Power generation companies are offered a reduced tax rate on dividends payment to shareholders for 7.5% against a regular rate of 15%. While coal mining projects are free from withholding tax on shareholders dividends for 30 years, they benefit from an input tax adjustment as well as an exemption from sales tax on the import of coal mining machinery and equipment.

There are special measures on tax credit allowing up to 100% tax credit for investments in new industrial undertakings, and tax credit between 10% and 20% for investments in existing industrial undertakings. For the promotion of employment, 11% tax credit is granted for every 50 new employed staff.

An industrial undertaking set up in specified rural and underdeveloped area can avail for a first-year allowance equal to 90% instead of 25% initial allowance. Likewise, alternate energy projects can enjoy an accelerated depreciation of 90% instead of 25% initial allowance.

A reduced corporate tax rate of 20% is applicable for all foreign direct investments set up with a minimum foreign equity of 50%. Foreign investment can also benefit from a withholding tax exemption for the purchase of immovable property.

b. Special tax treatment for CPEC related projects

In special economic zones, which are currently being constructed for the purpose of the CPEC projects, zone developers and zone enterprises can benefit from 10 years tax holidays on income and customs duties for the import of plant, machinery and equipment. The management of these zones is regulated by the Special Economic Zones Act, 2012 which provisions' are seeking at the promotion of investments in manufacturing sector by providing attractive incentives to new investors in the country.

Specific projects such as Pioneer Industry projects can also benefit from 5 years income tax exemption, while 23 years income tax exemption is authorized for the Gwadar Port operations. Similarly, materials and equipment for construction and operations of the Gwadar Port free zone are exempt of sales tax and federal excise duty. Likewise, imported machinery and equipment for the construction of the Karachi-Peshawar motorway project and the KKH-Phase II project also benefit from income tax and sales tax exemptions. Meanwhile, many other Chinese companies-led projects in Pakistan benefit from special tax treatment. The Orange Line project as well allows the China Railway Corporation to enjoy exemptions from sales tax and federal excise tax for the import of machinery and equipment. Same case for the rail-based mass transit projects that are under advance income tax

exemption regime for imports. Some financial corporations have benefited from special tax treatments offered by the Pakistani government. Thus, there is an exemption from income tax for interests and income derived by the Industrial and Commercial Bank of China (ICBC) from loans related to the CPEC energy projects.

c. The use of Chinese currency “Yuan” in trade and investments

In order to promote monetary cooperation between their central banks, China and Pakistan have for a while considered to use their local currencies to ease bilateral trade. Finally, the two nations have concluded in January 2018 on the issue by approving Chinese Yuan as an official foreign currency to be used for imports, exports, financing and investment activities. This move will considerably grease the wheels of the transactions of the CPEC and thrive the confidence of Chinese investments in Pakistan.

4.3 Other incentives

On diverse occasions, Chinese authorities have expressed their desire to invest in host countries that would offer fairly attractive investments facilities. Pakistan has particularly been pressed by China to offer extra incentives to favor the establishment of Chinese firms in the primary and secondary industries. In response to that, Pakistan has fostered its investment climate to be suitable not only for its long-term economic partner but also for investors from the rest of the world. Thus, besides a designed flexible tax policy, Pakistan had combined some extra incentives necessary for a better investment climate. These extra incentives include:

a. Cheaper labor and accessible raw materials

In its quest for foreign investment, Pakistan intends to sell hardworking labor force along with an easy access to raw materials to allow great profit margins for foreign investments. Such measure makes Pakistan quite competitive next to its neighbor countries which also offer competitive cheap labor force (Syeda et al., 2016). As main inputs of production, cheaper labor and raw materials will offer a comparative advantage to Chinese and other foreign companies investing in Pakistan.

b. Social and political security

Political instability will play against all other efforts made by a country in order to improve its economy and consists in a disincentive for international investment. Therefore, since the beginning of the CPEC, Pakistan has fostered its military security around the sites of the different projects in order to ensure peace and security throughout the implementation of the corridor. For Pakistan, this is crucial and all efforts are being converged with the indirect support of China to maintain stability in the country and along the corridor's projects in particular. These measures are quite motivating more Chinese firms to join Pakistan.

c. Friendly working climate

Due to the considerable number of Chinese firms already installed in Pakistan, new Chinese people intending to work in Pakistan will not feel lonely. This makes Pakistan a friendly environment to Chinese people to be established in Pakistan. Beside, as the Chinese culture and language is being expanded in Pakistan, this is offering Chinese firms and individuals in Pakistan a more convenient working and living climate.

5. CONCLUSION

China and Pakistan are known as natural trading partners and their long term friendship based on many bonds has been strengthened over time especially since the introduction of the B&R and the CPEC. Since, their economic relations have entered a new phase. The CPEC initiated along with the B&R has thus become a real impetus for Chinese investments in Pakistan in the recent years. Additionally, Pakistan on its side, has also worked on creating favorable conditions to be more attractive on the investment market through tax concessions and investments-led policies in order to boost its FDI and adjust its export deficit for the years to come.

From the analysis conducted in this paper, it was perceptible that the increased quantum of Chinese investments in Pakistan was the simple result of joined efforts from both sides triggered by the ongoing CPEC projects in Pakistan. As the corridor's projects are progressing, more investments and greater trade transactions are expected between the two countries. Although these investments are beneficial for the two parties, analyses of the risks associated with them also deserve to be taken into consideration in future studies. For now, investing in Pakistan offers China a great market channel for its domestic production to foreign destinations, while Pakistan is developing huge infrastructure assets that will consist in a great advantage for future investments.

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