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Assessment of German–Pakistani Relations in Trade, Investment and Strategic Cooperation

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Abstract

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by Talat Mahmood

German-Pakistani relations cannot be analyzed in isolation of the larger domestic and international trajectories, economic and political, on both sides of the partnership. After a recent democratic power transfer in 2013, Pakistan continues to face complex challenges. The instable security situation in the region exerts pressure on the Pakistani state, multiplying domestic challenges like macroeconomic and trade instability, societal conflicts and crises in energy supply and infrastructure. In light of these aspects, this paper explores the magnitude and development of German-Pakistani relations, focusing especially on trade, economic cooperation and strategic interests on both sides. The analysis of the German-Pakistani trade and investment relations over the last decade show only very moderate volumes with room for expansion. These dynamics are mirrored in private trade business relations with German SME's active on the Pakistani market (mostly through agents) and a lack of internationalization and economic diversification among Pakistan's private businesses. A related structural reason for these predicaments is the lack of a dedicated and clearly-defined policy infrastructure among both states, resembling the long-standing and amicable, though unenthusiastic German-Pakistani relationship. The recent EU-Waiver assignment, the adoption of the EU's GSP+ and related trade diversification programs signify the most significant parts of the EU-Pakistani partnership, and mirror an integral part of the discourse in German-Pakistani relations. Pakistan should attempt to reap the benefits of these developments. Strategic relationships between Germany and Pakistan need to be developed further and strengthened. The content of a recent bilateral signing of a multifaceted roadmap for strategic dialogue among Germany and Pakistan has to be implemented effectively.

Keywords: Trade policy, Country and Industry Studies of Trade, International Investment, Foreign aid, International relations and political economy, Intergovernmental Relations, Govt. policy, Joint ventures, Diversification, Asia & Middle East

JEL classification: F13, F14, F21, F35, F59, H77, I38, L24, L25, N45

1. Introduction

German-Pakistani relations cannot be analyzed in isolation of the larger domestic and international trajectories – economic and political - on both sides of the partnership. Recent developments in bilateral relations have revealed the necessity of a re-assessment. Certainly many challenges for the Pakistani state have remained: Since 9/11 and the “War on Terror”, Pakistan has found itself in the spotlight of the international community’s attention, while the country struggles with severe domestic political and economic problems, including fiscal crises, energy shortages, water scarcity, growing food insecurity for the poor, and the threat of terrorist activities and rising sectarian violence, which culminated in extensive law enforcement operations by the government and major humanitarian crises. These predicaments have cost Pakistan tremendously in terms of human lives and have had a devastating economic impact and substantial financial losses. These crises also complicate the difficult relations to neighbours and Western partners.

However, there are also some developments that could be judged more positively. In May 2013, for the first time in Pakistan’s history, an elected government completed its term and ceded power to another elected government – this signifies an important step in Pakistan’s democratization efforts. The improved election laws and legal framework, high voter turnout (despite violent events surrounding the election days) and increased female share in voters add to the significance of this election. These political developments followed the implementation of the 18th amendment in 2010 that reduced the president’s powers, turned Pakistan into a parliamentary political system and shifted the country’s political focus to the provinces. Another positive development has been the recent non-interference of the armed forces in politics, even though the Army remains excluded from civilian control. Of special importance for German-Pakistani relations is the adaption of Pakistan to the EU’s Generalized System of Preferences Plus (GSP+) in January, 2014. Throughout Pakistan’s application process, Germany has fully supported and backed the bid for the tariff exemption package.

This paper underlying question of interest concerns the reasons of the overall diffident bilateral relations between Germany and Pakistan. Why have, for example, trade and investment potentials not achieved or improved as much, as they have between Germany and other South Asian states? This paper argues that war on terror and the security situation following the military operations in Afghanistan can only be one of many causes. In development of this argument, this paper seeks to measure the magnitude and direction of German-Pakistani relations, focusing most on trade, economic cooperation and strategic interests. In the following section (2) the state of Pakistan will be explored and recent international economic situation analyzed. The German-Pakistani relations are subject of the next section (3), containing the core arguments of this paper. The empirically oriented analysis is structured into three parts: trade and investment, business cooperation and strategic and security cooperation. Section (4) summarizes the main findings of this paper and the last section (5) presents an outlook.

2. On the state of Pakistan

After five years of civilian rule, the country made its first transition between democratically elected governments in 2013. Pakistan's new government, led by the third time elected Prime Minister Nawaz Sharif, overtook many complex challenges from the previous civilian government. These include rising extremism and terrorism, domestic polarization, regional conflicts, civil-military imbalance, energy shortages, a bad shape of the economy, all-time high corruption, extremely bad governance, poverty, unemployment, target killings in Karachi, unrest in Balochistan and U.S. drone attacks.

Throughout the recent election campaign, Prime Minister Nawaz Sharif cited poor governance, deteriorating law and order, and breaches of the nation's sovereignty as central problems. Pakistan, both as a country and society has been confronted with these concerns for a long time.

In a recent development the army declared the prioritization of internal security problems, instead of perceiving India and Afghanistan as external threats. The effects of this declaration remain to be seen: It may indicate that, while terrorism and sectarian violence are Pakistan's main challenge, the Army itself has shifted its main security focus from its traditional enemy, India, to domestic concerns. At present the reconciliation peace talks have begun between representative committees of the government and the Tehrik-e-Taliban Pakistan (TTP). This demand has been raised jointly by all parties on a conference a few months ago.

The biggest challenge of the present government in international relations is the formulation of a coherent foreign policy under the supremacy of the elected civilian government. Pakistan has to deal with Afghanistan on issues concerning the Taliban, with India on the law and order situation and terrorism, and with the U.S. on economic problems. An approach toward all three interrelated issues should be found, keeping in mind its impact on Pakistan. Policy solutions on dealing with India, Afghanistan and the U.S., should incorporate ways in which relations with Pakistan's neighbors are no longer dominated by the security interests of the armed forces or by non-state actors.

The stability in this region will depend a lot on how Pakistan, India and Afghanistan trilaterally address the complicated issues to improve the situation in Afghanistan and the region. A special focus should be on stabilizing Afghanistan rather than addressing the previous bilateral issues at this moment. A resumption of composite dialogue with India should be focused more on promoting bilateral trade relations, the granting of a complete MFN status and other social cooperation, rather than on unsolved and complicated issues like the Mumbai attacks or the Siachen heights and Kargil disputes. Internally, the serious challenges to be addressed are the revival of the economy, the energy sector, the improvement of governance mechanisms on all levels, and lowering corruption. The relations and dynamics between federal and provincial governments should be an essential part of the government's strategy.

2.1 Recent economic developments

Pakistan's economy is semi-industrialized and the 27th largest in the world in terms of purchasing power parity and 44th largest in terms of nominal GDP. Pakistan has a population of over 183 million, the world's 6th largest, with a GDP per capita of 3,056 US$, ranking 140th in the world. Pakistan ranks as the 15th largest trader of goods in the world and 6th largest trader of services. Major industries include textiles (garments, bed linen, cotton cloth, and yarn), chemicals, food processing (mainly sugar, salt, wheat, rice, and fruit), agriculture, fertilizer, cement, dairy and rugs. Unfortunately, the economy has suffered in the past from decades of internal political disputes, a rapidly growing population, and mixed levels of foreign investment. Pakistan is currently undergoing a process of economic liberalization with privatization of many government corporations in order to attract foreign investment and to decrease the budget deficit.

Since 2008, under the previous civilian government, Pakistan's economy has stagnated and faced macroeconomic instability, fiscal retrenchment and weaknesses in its external accounts. The average growth rate between 2009 and 2012 is 2.8%, which is lower than of the average of South Asian countries of 3.6%. The GDP growth rates are expected to stay between 4 to 5 percent in the next years, with projected inflation rates between 8% and 12% yearly (projection until 2018). The current account balance has sharply declined from 3,993 million US$ in 2009 to 2,024 million US$ in 2012.

Table 1: Key economic indicators, Pakistan and South Asia

		Pakistan				South Asia
		2009	2010	2011	2012	2012
GDP	(billion US$)	168.2	177.4	213.9	225.1	2286.1
GDP growth	(annual %)	2.8	1.6	2.8	4.0	3.6
Cash surplus/deficit	(% of GDP)	-4.6	-5.0	-6.4	-8.0	-
Inflation, consumer prices	(annual %)	13.6	13.9	11.9	9.7	9.4
Current account balance	(million US$)	-3993.4	-1354.0	-2234.0	-2024.6	-
Foreign direct investment	(% of GDP)	1.4	1.1	0.6	0.4	1.2
Gross domestic savings	(% of GDP)	10.3	10.0	9.1	7.0	24.4
Exports	(annual % growth)	-3.4	15.7	2.4	-15.3	2.1
Imports	(annual % growth)	-15.9	4.3	-0.1	-3.6	6.1
Tax revenue	(% of GDP)	8.9	10.0	9.2	10.1	-
Government expenditure	(% of GDP)	10.5	10.3	9.7	10.5	11.3

Source: World Bank Data 2014

The foreign direct investment also shows a decline from 1.4% of the GDP to 0.4% in 2012. Pakistan's trade balance is negative, with its imports higher than its exports. The country needs an urgent rise in the tax to GDP ratio. The average of the tax to GDP ratio in the four reported years is 9.5 %, which is one of the lowest in the world. An IMF bailout of 7.6 billion US$ has helped to stabilize the external account, while compelling the government to phase out subsidies and tighten its monetary and fiscal policies. Some of these measures have fueled inflation, worsened by the rising international food and fuel prices.

Moreover, Pakistan is on the drip-feed of international donors. Here, the U.S. is by far the biggest donor. In 2010, the USAID assistance to Pakistan amounted to 1.3 billion US$, making Pakistan the second largest benefiter in 2010 and 2011, right after Afghanistan and before Haiti. In the fiscal year of 2012, the USAID assistance Pakistan amounted to almost 1 billion US$, again placing Pakistan in second place of the most benefitting countries. Since 9/11, the United States has provided Pakistan with over 25 billion US$ in military and economic assistance.

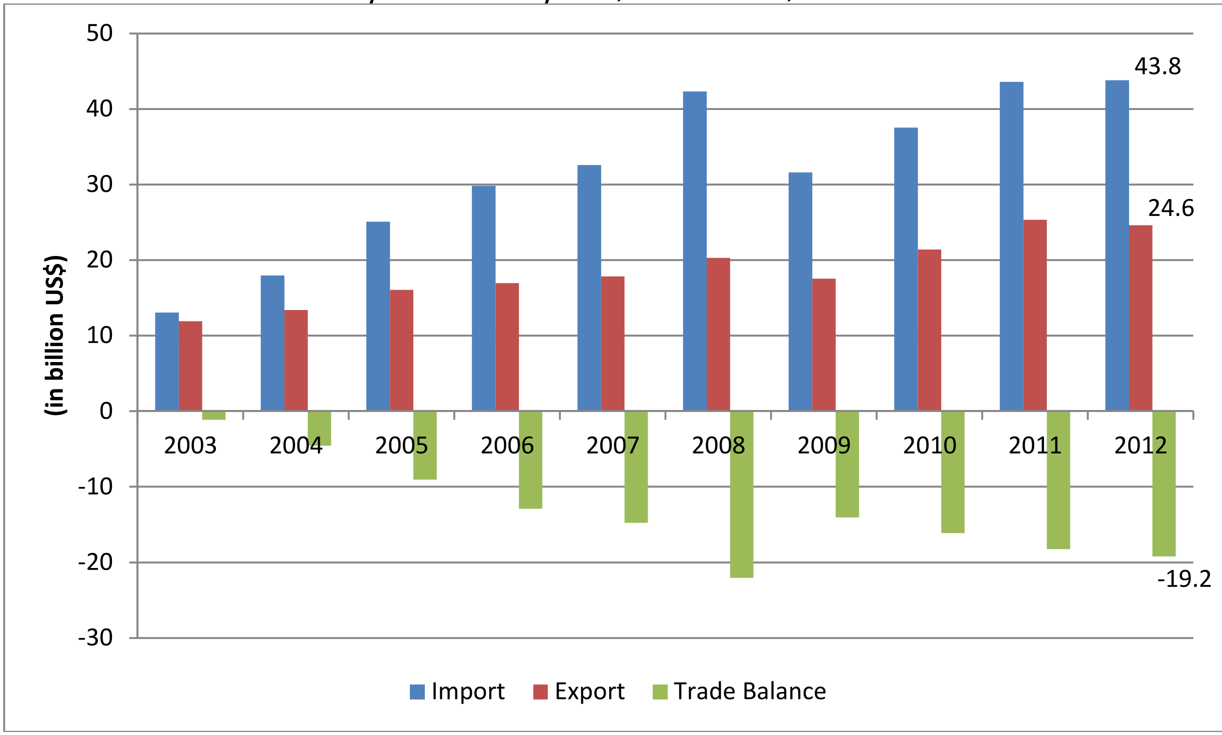
In order to overcome this dependency on other nations, tough economic reforms, such as the reformed general sales tax (GST), need to be put in practice. This would raise the extremely low tax revenue in Pakistan. Then again, an attempt to generate revenue through taxes would make life difficult for the masses and the ruling elite class could see their interests violated. These reforms, however, are the IMF's prerequisite to release the last two tranches (amounting to 3.4 billion US$) of the current standby facility, which is urgently needed. Hence, Pakistan might have to apply for another IMF loan without having completed the current loan program on very tough conditions. Moreover, an urgent decrease in non-developmental expenditures is required, while overall Government expenditure, with only around 10% of the GDP, should potentially be increased.

Another impediment standing in the way of the country's economic recovery is the acute energy crisis: Pakistan's generating capacity falls well below its demand. The current electricity shortfall is approximately 5,000 megawatts (MW) per day. There is an urgent need to address key issues such as eliminating circular debt, dismantling the fuel subsidy structure, tackling transmission and distribution losses, addressing cultural change to counter theft and non-payment, and introducing new legislation, particularly renewable and energy efficiency standards and regulations (Mills 2012).

This situation grows more severe with time, with an anticipated shortage of natural gas during winters. Load shedding is set to increase in the wake of the circular debt crisis as well. Steps taken by the government to address the energy crisis are marred by accusations of corruption and bad governance. Misplaced spending priorities continue and despite all hardships, federal as well as provincial governments have not shown any signs of austerity to reduce their non-developmental expenses.

International trade figures for Pakistan between 2003 and 2012 show that imports have always exceeded exports for every year (Table 2). In 2012, Pakistan observed an international trade deficit of 19.2 billion US$. Hence, the country is dependent on external products to satisfy domestic consumption. Analysing a long term view of Pakistan's export performance over the last ten years, its share in the global market, according to WTO data, has declined from 0.21% in 2000 to 0.13 % in 2012, which is a tremendous decrease.

Table 2: Pakistani total imports and exports, 2003-2012, in Mio US$



Source: United Nations Commodity Trade Statistics Database 2014

Globally, Pakistan's primary export commodities include textiles and synthetics, such as garments, bed linen, yarn, cloth and cotton. Other products exported are rice, leather and sport goods, carpets and rugs, manufactures and chemicals. Most of the export-goods are directed to Saudi-Arabia followed by China, UAE, Kuwait, the U.S., Malaysia, Germany, Japan, and others. The most relevant export-sector is textiles and clothing followed by food and leather goods such as leather clothing and shoes.

Most important imports have been petroleum and oil products, machines and automotives, chemical goods, finished products, and iron and steel. Pakistan imports mainly from the U.S., UAE, Afghanistan, Saudi-Arabia, Germany, China and others. When looking at regional groupings, the EU is the largest trading partner for Pakistan and accounts for 20% of Pakistani external trade. In 2012, EU goods exports to Pakistan totalled 5.3 billion US$, while imports from Pakistan to the EU were roughly the same, creating an almost equal trade balance (European Trade Commission 2013). The sectors of agriculture, manufacturing and services contribute the main share of the GDP generation (more than half) of the country.

The continuous trade-deficit (green bar in Table 2) can be explained by the fact that Pakistan's exports are too confined to a limited range of products and that the economy is not well-diversified. Due to the low demand for its exports, Pakistan is very much exposed to shifts in world demands, for instance in the textile industry. Entry-strategies into foreign markets simply do not exist and internationalization of Pakistani private business should become a policy issue. The persistent political and economic instability additionally conveys a very negative image to the world community and inhibits further investment and founding of new companies. Also, the ever-lasting energy crisis has led incumbent investors to go abroad and look for other markets.

3. German-Pakistani relations

In German foreign policy regarding South Asia, a differentiated approach can be identified, especially when comparing German policies towards Pakistan with those to other countries. The differentiation on the policy side is reflected in the heterogeneity of the South Asian region: It is home to hundreds of millions people of different ethnicities and religions, unequal economic conditions and soaring inequalities between rich and poor. Although the countries of this sub-continent have developed a multilateral regional organization, the SAARC (South Asian Association for Regional Cooperation), the prospect of forging a sustainable political cooperation is still very remote at this stage. The following sections, examining German-Pakistani trade, business and strategic relations, will thus also highlight some differences to bilateral relations of Germany to other countries in the region, to depict this differentiated approach (for example the differentiation among policies towards Pakistan and India).

Historically, Germany and Pakistan have shared a long-standing and amicable, though unenthusiastic relationship. In response to Pakistan's acute, complex and urgent security challenges, Germany has intensified its engagement with Pakistan over the past years in the areas of security and stability, building capacity and improving democratic governance, while India is met with policies that focus to a larger degree on economic cooperation. It is assessed as a promising location for investment, where already approximately 800 German companies have formed subsidiaries and joint ventures in different production areas (Matter and Helbig 2009). The country is considered to be a reliable and successful partner in bilateral trading. Germany considers India, the world's largest democracy, which has a secular structure and an enormous ethnic, linguistic and religious diversity, a country with extreme social disparities and appreciates Indian advances in the democratic system and the quality of its rule of law (German Federal Foreign Office 2002). German policy has aimed to further strengthen these governance matters through political dialogue and by using the instruments of development cooperation and political foundations. Economically, the Indian market is the third largest economy in Asia, with the increasing purchasing power of the growing middle class and hence growth potential for German businesses.

By comparison, the German-Pakistani dialogue has focused more on prioritizing the establishment of human rights programmes and the consolidation of existing democratic structures. In previous decades, the Pakistani state established itself around security issues rather than focusing on economic and social development. Since independence of Pakistan, democracy has not been able to develop strong roots. Previous democratic developments were hindered by at least four times through various coups by the military, which has also been unable to deliver in terms of good governance. The administrations' lack of clear development-oriented policies has further discredited democracy in the eyes of large section of the population.

3.1. Trade and investment

In the context of international and EU trade, we now analyse the German-Pakistani trade relations. The bilateral trade statistics between the two countries (Table 3) reveal that the total trade volume of the previous 10 years has almost consistently increased, from 1.2 billion US$ in 2003 to 2.3 billion US$ in 2008, decreased slightly from 2009 until 2010 to a value of 1.9 billion US$, but rose again in 2011 to 2.3 billion US$ and finally decreased slightly in 2012 to 2.1 billion US$. The average trade volume of the previous ten years reaches just under 1.9 billion US$, which appears to be very moderate and leaves room for further expansion.

In most years (except 2003 and 2011) of this reported timespan, Germany showed a trade balance in its favour. In 2011 a significant improvement of the trade balance in Pakistan's favour can be observed: Germany imported Pakistani goods amounting to over 1.3 billion US$, indicating a surplus of 31.3%, and exported a value of 1.0 billion US$ with a decrease of 1.5%. This led to a trade balance surplus increase after six years of deficits for Pakistan, to 312 million US$ in 2011. However, in 2012 Pakistani export decreased and caused another negative trade balance.

Table 3: Pakistan's trade with Germany, 2003-2012, in million US$

	Import	Export	Total Trade Volume	Trade Balance
2003	576.1	608.1	1184.3	32.0
2004	706.6	665.1	1371.6	-41.5
2005	1145.0	724.4	1869.5	-420.6
2006	1190.3	697.5	1887.8	-492.7
2007	1127.4	726.0	1853.3	-401.4
2008	1465.6	880.0	2345.6	-585.6
2009	1271.1	719.2	1990.4	-551.9
2010	985.6	981.2	1966.8	-4.4
2011	1000.5	1312.2	2312.7	311.7
2012	1144.0	988.5	2132.5	-155.5

Source: United Nations Commodity Trade Statistics Database 2014

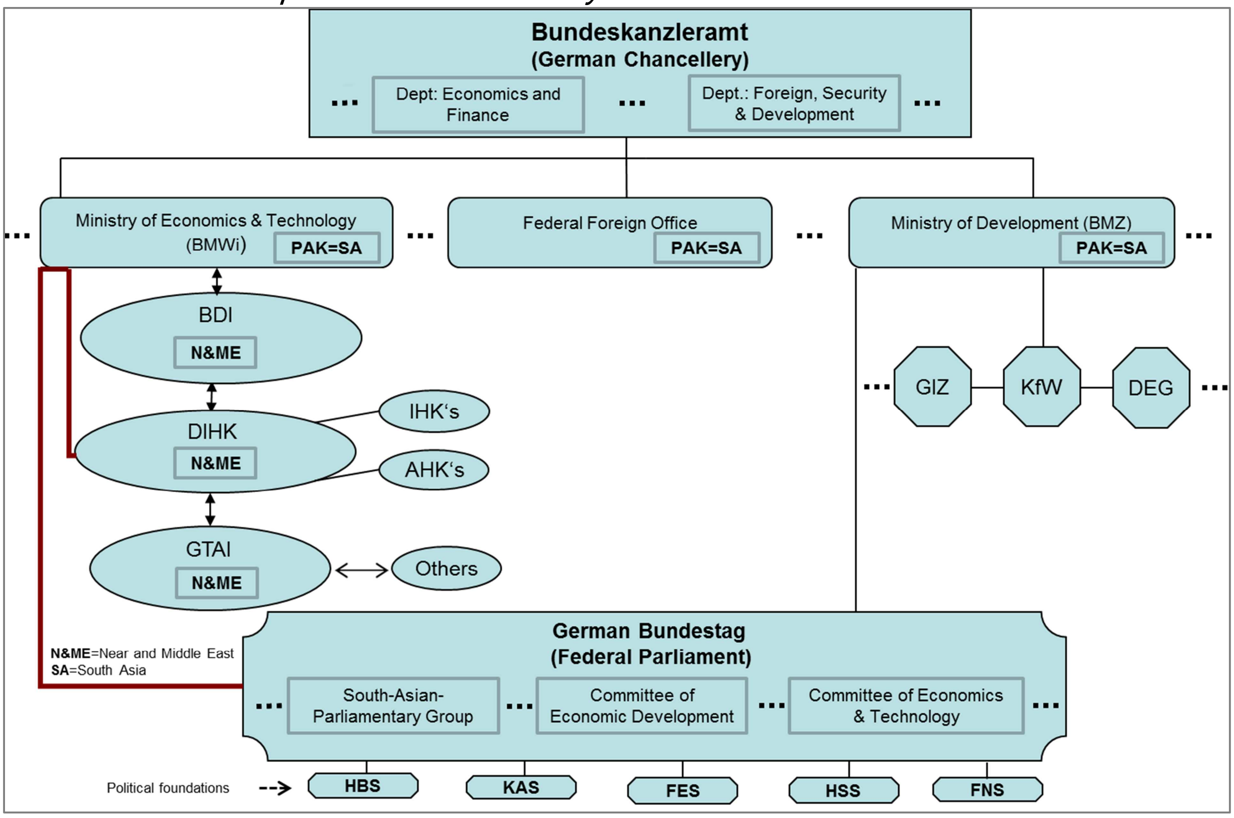
Germany's exports to Pakistan are mostly comprised of machinery, chemicals and electrical products, while Pakistani exports overwhelmingly textiles and garments (over 80.0%) to Germany.

Comparing these German-Pakistani trade volumes with those of Germany and India, the Indian trade volume in 2009 reached roughly 17.6 billion US$ and rose to 23.6

billion US$ in 2012. A great deal of the profound growth in German-Indian trade can partly be accredited to the strong presence of trade policy groups within national institutions. Especially, the role of the joint German-Indian Chamber of Commerce, which has promoted bilateral economic and business relations since 1956, cannot be discounted. With more than 6,700 German and Indian companies among its members in 2014, it is the largest chamber of commerce in India.

Pakistan, by contrast, has no dedicated and clearly-defined "policy infrastructure" within Germany and its regional status is often relegated. In some cases it is classified among Middle Eastern states (within "Near and Middle-East regional initiatives"), or it is grouped among South Asian states. Pakistan drifts between these two very different regional groupings within German institutions, resulting in a lack of focus where policy-making is executed.

Table 4: Pakistan's placement in Germany's institutional structures



Source: Mahmood 2012

Table 4 reveals Pakistan's placement among Germany's political and commercial institutional infrastructure. In the German Bundestag, Pakistan is placed in the South-Asian Parliamentary Group, whereas within the BDI (Federation of German Industry), the DIHK (The Association of German Chambers of Commerce and Industry), the state's two largest business associations, and within GTAI (Germany Trade and Invest), it is placed in the "Regional Initiative of Near and Middle East Countries". A more uniform and clearer approach on classifying Pakistan as a South-Asian nation, or within a "Near and Middle East regional initiative", would enable a more serious commitment to further German-Pakistani relations. For the formation of a joint Pakistan-German Chamber of Commerce and Industry, which is urgently needed, the AHKs (German Chamber of Commerce Network) are supported by the Federal Ministry of Economics and Technology on the basis of a resolution by the German Bundestag. The red line in Table 4 shows the interconnection of decision making and lobbying activities.

All advisory and supervising services for market entry for German business interests in India are conducted by a liaison office in Düsseldorf. The Chamber's offices in India take the responsibility of providing other services such as searching partners, preparing individual market studies, offering assistance in establishing new companies, conducting personal recruitment and finally, organizing events and delegation visits. Roughly 1,800 small and medium-sized German companies (SMEs) are engaged in India, signifying an increasing diversification of bilateral business (Wagner 2011a). In Pakistan, however, such a structure does not exist, resulting into fewer German SMEs doing business in Islamabad, Karachi or Lahore.

In 2014 the Generalized System of Preferences Plus (GSP+) took effect after it had been granted to Pakistan (among others) by the EU parliament on December 12, 2013. Throughout the process, Germany has fully supported and backed the bid for the EU's GSP+ status. The status offers important opportunities for further expansion of Pakistan's trade with the EU. Given the natural resource base, manpower and entrepreneurial skills and the size of the European import market (2011 imports from extra-EU 27 were US$ 1.54 trillion), Pakistan's current export to the EU does not reflect its potential volume. The performance gap rises from various domestic inconsistencies, one of which is the inability to diversify the country's basket of export commodities. As a result, Pakistan's exports to the EU are observed to be supply-driven rather than demand driven. Except for goods covered by knitted and woven apparel, the top six categories that constitute almost 90% of Pakistan's exports to the EU, do not find a place in the top 45 EU import categories. This mismatch extends also to GSP exports, where only three of Pakistan's top 20 exports to the EU find a place in the EU's top 10 GSP imports, against eight from India and six from Sri Lanka (TRTA II 2013).

Pakistan's main characteristics of exports to EU are such that 88% of exports fall within two commodity categories, textiles and leather, a feature that has not changed for a decade and led to the GSP+ "vulnerability" in product diversification. Further, 80% of Pakistan's exports are directed to seven countries – Germany, UK, Italy, Belgium, The Netherlands, Spain and France and 6% to other five (Portugal, Poland, Denmark, Sweden and Finland). Pakistan's exports to the remaining 15 EU member states comprises only 14%. Pakistani exports have not fully penetrated geographically into the EU.

However, because of GSP+, Pakistan may see significantly increased investments in the textile industry, originating from inside the country as well as outside the country. Many expect Chinese businesses to be among those that will use the improved tariff conditions with the EU, to invest in the Pakistani market. There have been some reports from industry representatives that Chinese investors are pursuing joint ventures in their investment efforts and that they have already made first purchases in late 2013. Additionally, Pakistani state governments seem to have begun the preparation of investment packages tailored for Chinese and other global investors.

One should be careful to be overly euphoric of the GSP+ status. It should be perceived as only one part of a possible solution of Pakistani economic problems. The GSP+ status has been called a remedy to almost all Pakistani problems, including unemployment, foreign exchange reserves, currency stability and even law and order questions, while in economic literature the effect of Generalized Systems of Preferences on developing countries is not unanimously decided upon. Some empirical analyses suggest that GSP schemes tend to raise the developing country's exports significantly in the short run, but cannot confirm similar findings for later phases in the process (Herz and Wagner 2011). In contrast, other models confirm the overall significance of a positive effect on developing countries' economies, but also make differentiations among countries due to their specific economic predicaments

(Sapir 1981). In any case, Pakistan should focus to not forget the aim of sustainable economic development instead of short-term winnings in the respective product lines. Sri Lanka enjoyed the GSP+ benefit from July 2005 to August 2010. Because the EU's tariff preferences depend on the beneficiary countries' willingness to respect the substantive eligibility criteria, Sri Lanka was withdrawn the GSP+ status, based on findings of an exhaustive EU investigation. These reports identified shortcomings in respect of Sri Lanka's implementation of three UN human rights conventions.

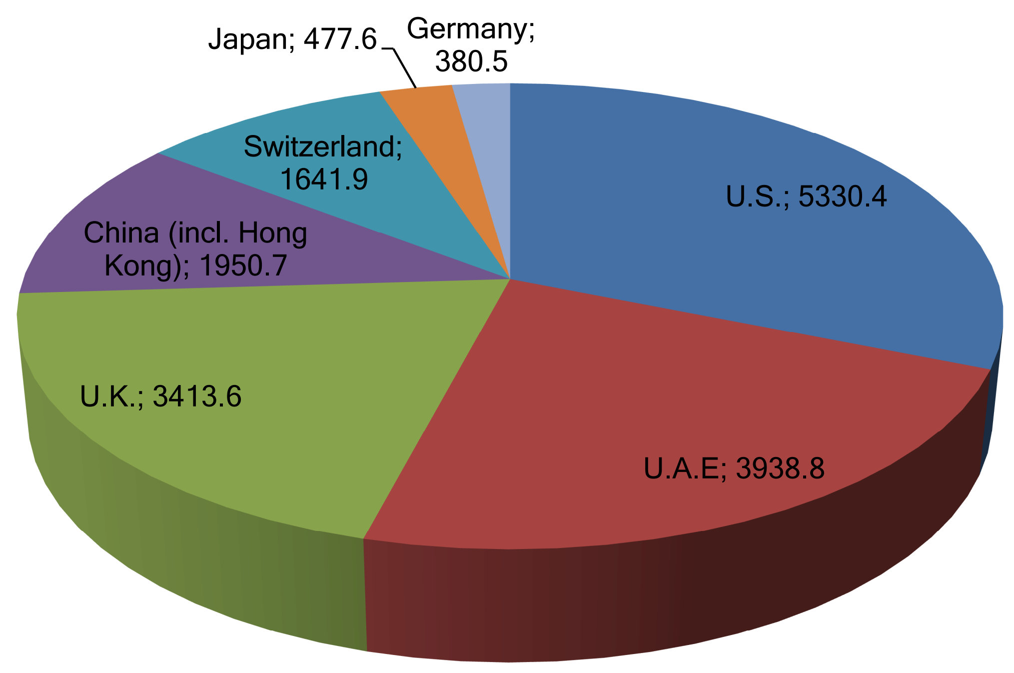
However, an analysis of the years, in which the GSP+ status was active in Sri Lanka, shows how the preference system has favored Sri Lankan export to the EU. Export rose by large margins after 2005. Especially the textile and clothing product group increased significantly during those years. Even after the cancellation of GSP+, the export size did not decrease, but increased lightly.

Bangladesh can be taken as another successful example of tariff reduction. However, its experience with reduced tariffs to the EU dates back to 1971. Currently, Bangladesh continues to get duty- and quota-free access for all its products except for arms and ammunition for an indefinite period under the "Everything But Arms" initiative of the EU. Trough trade liberalization and export promotion since the 1990s, Bangladesh has risen to be a major player in the global textile industry in the last years. Exports increased significantly and were responsible for a steep increase of the GDP as well. Bangladesh was also successful in decreasing the share of primary commodities exported and it raised the share of manufactured goods in that time.

However, economists have pointed out that Bangladesh's export base remains narrow as the impressive success in garment exports has yet to be replicated in other industries. An important part of these export increases was the German-Bangladesh bilateral trade, which has risen to over 4 billion US$ and is weighed heavily in Bangladesh's favor with 3.4 billion US$ exports to Germany (with over 90 percent being Ready-Made-Garments). Naturally, there have been some attempts to prevent GSP+ status for Pakistan, to not jeopardize that position and these market advantages.

Looking back, the tariff advantages for other countries already granted an EU GSP status have put Pakistan in a difficult position in previous years. In the textile and clothing products, Pakistan's main competitors in the EU market are India, Bangladesh, China and Turkey. Apart from India, the other three countries rank among Pakistan's top 10 export destinations, creating an anomalous situation where Pakistan supplies textile raw materials (yarn and fabrics) to countries whose finished textiles and clothing products enjoy duty free advantage in Pakistan's main export market.

Table 5: Total FDI of largest investor countries (between 2003-04 and 2012-13), in million US$

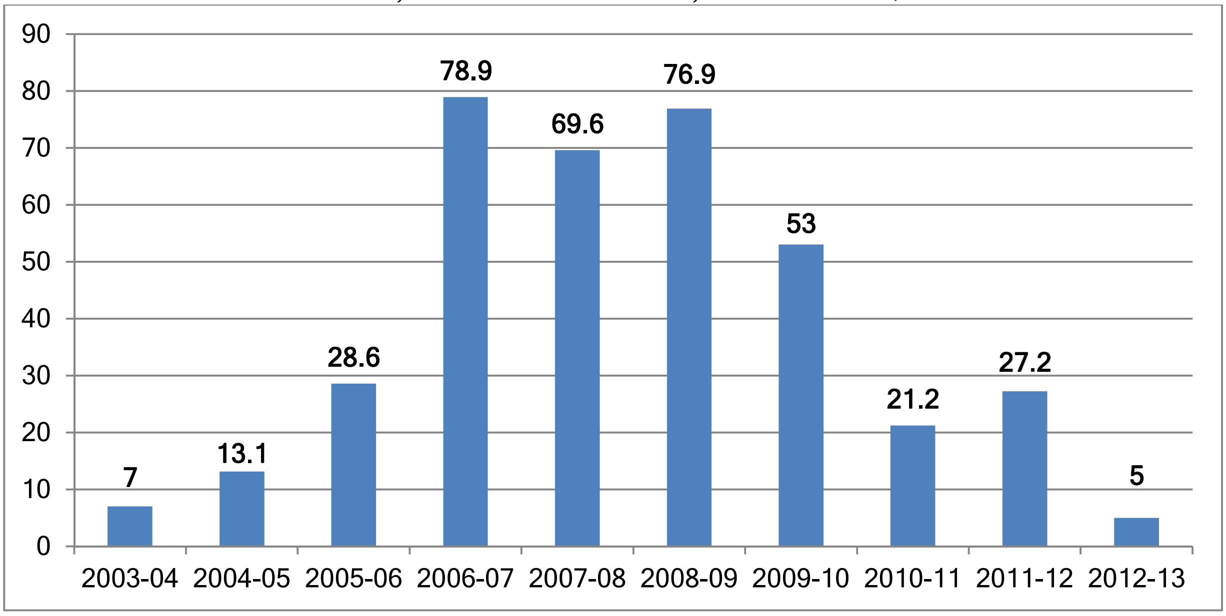


Source: Pakistan Board of Investment 2014

Table 5 shows the aggregated values of FDI in Pakistan, between 2003-04 and 2012-13. The largest foreign direct investment stems from the United States. The second largest aggregated investment is performed by the United Arab Emirates, followed by the United Kingdom and China. Switzerland and Japan are the 5th and 6th largest investors, respectively. Germany takes the last position of the seven largest investors.

According to the Pakistan Board of Investment, the most attractive sectors for foreign investment during the previous ten years have been the oil and gas industry, followed by the financial sector, power generation and transport. The highest level of foreign investment was during 2005-06 and 2007-08 in the IT and telecom sectors. The highest single investment figure was achieved in the year 2007-08 for financial services. According to the recent Economic Survey, total investment has declined from 22.1% of GDP in 2007-08 to 12.5% of GDP in 2011-12. In India, the top sectors attracting FDI inflows from April 2010 were the service sector (19%), chemicals-other than fertilizers (14%), trading (8%) electrical equipment (8%) and the automobile industry (7%).

Table 6: German FDI Inflow, 2003-04 to 2012-13, in million US$



Source: Pakistan Board of Investment 2014

As compared to other countries, German FDI investment in Pakistan (Table 6) does not show any significant pattern; its total volume remains continually low when compared to other countries. The second lowest German investment of about 7 million US$ is in fiscal year 2003-04, directly after the start of the "War against Terror". Afterwards the investments increased in the mid-2000s to 78.9 million US$ in 2006-2007, after failing reforms and an increasingly instable investment environment. The investment figure declines again to an eight-year low in 2012-13, to a volume of 5 million US$.

The large German multinationals that have been present in Pakistan since its independence are still in operation, however, during the last few years a number of new companies have opened their businesses. The average German business investment volume of the previous 10 years is only 33 million US$, which shows little interest of German companies in Pakistan's promising but difficult market. The average volume German investment of the previous ten years in India amounts to 272 million US$, which is a much higher value and reflects the interest of German companies in India. If we examine the FDI inflows from Germany to India, we observe that the FDI volume increased from 123 million US$ in year 2000-2001 to 199 million US$ in year 2010-2011. The highest FDI inflows were in the years 2008-9 and 2009-10 amounting to 629 million US$ and 626 million US$ respectively (Indo-German Chamber of Commerce 2012).

The volume of German FDI in the last decade shows that there has been low interest on part of German companies to invest in Pakistan. The decline in investment might also be caused by a deterioration of Pakistan's image as an investment destination since being involved in the security issues connected to the "War against Terror". Since the onset of the post-Musharraf era, this impression might have persisted. Moreover, there is a lack of institutional infrastructure conducive for bilateral trade and investment. Simultaneously, Pakistani direct investments in Germany are non-existent. Pakistani companies should start thinking of penetrating into the German, as well as European markets, as these offer excellent and modern infrastructure, a highly-educated workforce and, especially, attractive subsidies from the government. It is a positive development that over 500 Pakistani companies have actively participated in 16 different exhibitions and several of the world's biggest trade fairs held in Germany in 2011, supporting the Pakistani export sector. Also, an increasing number of business representatives from Germany travelled to Pakistan in 2010 as compared to 2009. This increase in business visitors can help to promote economic relations between the two countries.

Several treaties and agreements, for example for avoiding double-taxation, securing investment, and an agreement on social security, further strengthen the economic and business ties between the two countries and reduce possible obstructions to investments from both sides.

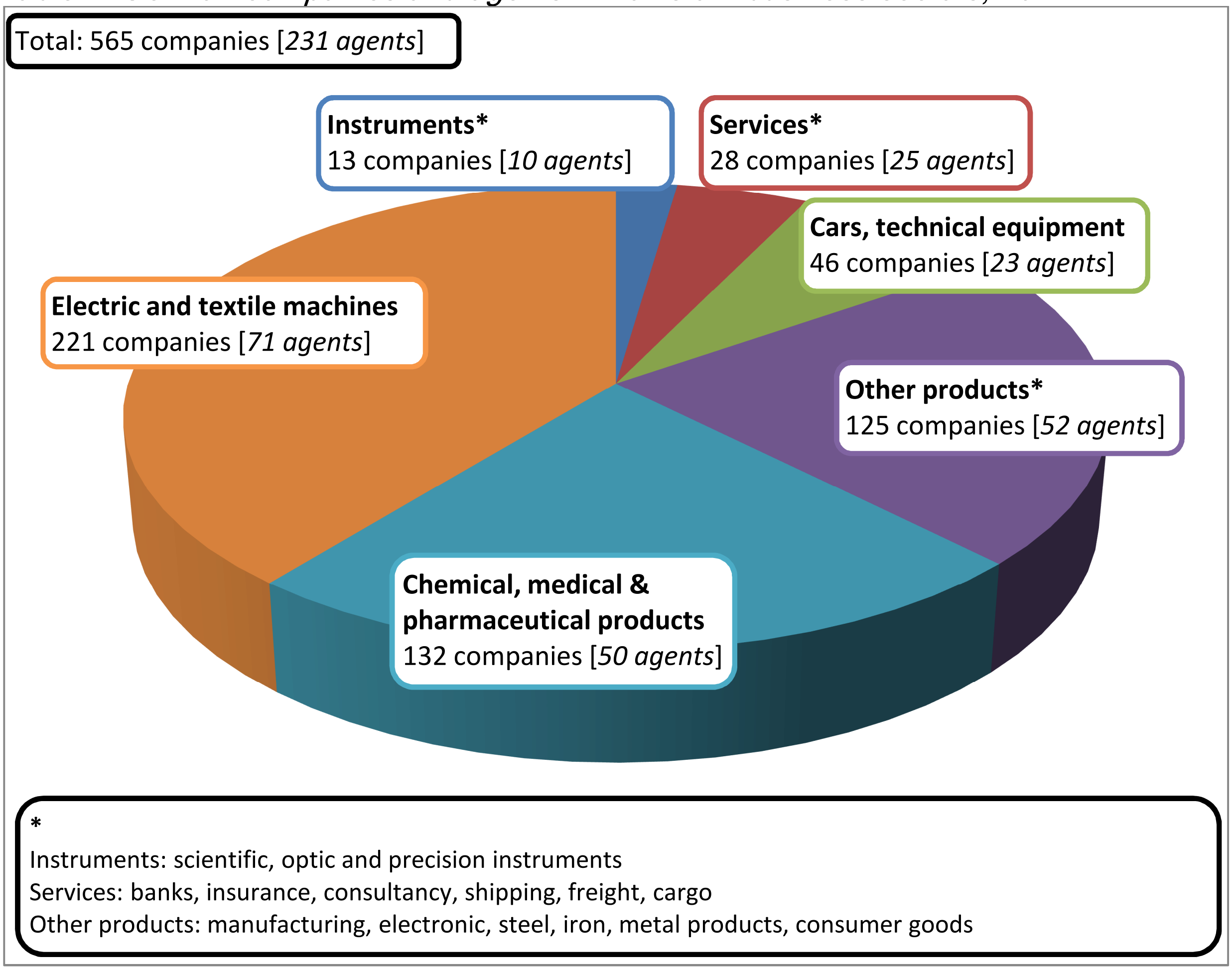
3.2. Business cooperation and partnerships

In Pakistan, German businesses are represented on the one hand by multinational corporations, who are mainly located in Karachi and Lahore, and on the other hand by Pakistani trading agents who represent the majority of the German companies in the areas of machinery, chemical and pharmaceuticals, instruments, automotive, and related equipment and services.

Our calculations show that roughly 35 German multinationals are engaged in Pakistan (Mahmood 2012). The majority have their production plants and offices in the metropolitan city of Karachi and at least another 5 companies have merged with other multinationals being headquartered in the port city. Another 5 German companies are located in Lahore and one in Quetta. Of all the multinational companies present in Pakistan, 55% of them are from the pharmaceutical and chemical industries. The second largest sector turns out to be the electronics industry with a share of around 20%. The services sector (15%) is followed by the transport sector and textiles machinery with 5% each.

Table 7 shows the representation and the business activities of German companies engaged in Pakistan, differing from German SME's activities in India. The business activities of altogether 565 German small and medium-sized companies are represented by 231 Pakistani agents. Comprised of electric and textile machinery, 221 German companies are represented by 71 agents - indicating that one Pakistani agent usually represents more than one company. The composition of the sectoral distribution reveals that the largest sector represented by the agents in Pakistan is the machinery sector. The second largest product group is chemical, medicine and pharmaceuticals. In this sector 132 German companies are represented by 50 Pakistani agents. The third largest group is manufacturing, electronics, steel, iron, metal products and consumer goods. Cars and technical equipment constitute the fourth largest sector, in which on average one Pakistani agent represents at least two German companies. The service sector consists of banks, insurance, consultancy, shipping and freight & cargo sector. In this fifth largest sector, the ratio of representation is almost one to one. The last and sixth sector constitutes the scientific, optic, and precision instrument sectors. In this sector, 10 agents represent 13 German companies.

Table 7: German companies and agents in Pakistani business sectors, 2012



Source: Mahmood 2012

All of these multinationals and a majority of their Pakistani business agents are members of the Pakistani German Business Forum, also with its head office in Karachi. The PGBF provides services relating to the bilateral-trade and investment activities of the chamber of commerce in the Karachi area as well as with an office in Lahore and the cities of Sialkot, Faisalabad and Islamabad/Rawalpindi with its “Northern Chapter“, which has recently been inaugurated.

The PGBF is in a process of transforming itself into a Pakistan-German chamber of commerce and industry (PGCCI) and is therefore an urgent requisite to further facilitate bilateral trade and investment. This initiative has been extensively supported by the representatives of the two countries. In December 2013, the PGBF and the Federal German Chamber of Commerce (DIHK) jointly organized the conference “Pakistan Business Days” in Berlin and Munich. These two successful events could attract around three hundred participants including the German Foreign Federal Minister and the Pakistani Chief Minister of Punjab along with high officials and members of the business communities from both countries in Berlin and similarly 200 participants including high officials in Munich. As a result, these events have certainly created awareness between the business communities of the two countries for the promotion of bilateral trade and investment opportunities. Adding to the efforts of the PGBF, the economic departments of the German Embassy in Islamabad and the Consulate General in Karachi represent the interests of the business community of both countries.

In December of 2009 a German-Pakistani bilateral treaty, the “Agreement on the Encouragement and Reciprocal Protection of Investments” replaced the “Bilateral Investment Treaty” of 1959, the latter being the first and oldest international treaty of its kind. However, because of EU regulations, this treaty has not yet become operational. It is believed that the new treaty could create further incentives for investment in Pakistan and can thereby play a strategic role in the growth and development of the economy. The German Federal Government in August 2009 dealt with the issue of financial investments and granted a decision for a single case guarantee cover for the invested equity capital, but the return coverage was not applied and considered. For its decision-making, the Government evaluates the investment initiative by the project type, the branch of the company and the type of the capital investment. This type of German engagement should certainly encourage the German business community to expand its investment relations with Pakistan.

Pakistan’s concentration of doing business with the international community should not only be centred only on the promotion of trade with Germany and other countries, but should also analyse the success stories of its neighbour India. How did the Indian economy manage to get access to the German and European markets under fair and open competitive market conditions?

Until today more than 240 Indian companies are operating in Germany (especially clustered in Hessen, Bavaria, North Rhine Westphalia and Baden-Württemberg) and many more vice versa. Initially, Indian companies entered into the German market through corporate buyouts and acquired a number of companies for instance, the textile company Trevira, the pharmaceutical company Betapharm and the forging company Peddinghaus. Recently, an Indian-UAE-led investment company Microsol acquired a larger share of an insolvent Berlin solar company. Not only did Indian companies enter the German market through corporate buyouts, but they established a presence through building their own subsidiaries and acquisitions and continue to do so: A recent study shows that the number of subsidiaries of Indian firms in Germany increased from 195 in August 2011 to 204 in May 2012. According to KPMG's Emerging Markets International Acquisition Tracker, published in April 2012, covering the period between 2005 and 2011, India was one of the key sources of investments/acquisitions in Germany and topped the list of all emerging market nations in terms of the number of transactions in Germany. Of 176 acquisitions in Germany, the majority were created by Indian parent companies (23%), followed by companies from Russia (22%), Central and Eastern Europe (18%), South and East Asia (12%) and finally by Middle East and North Africa (12%). Most of the Indian investment goes to the IT business sector in Germany (35%). However, the FDI to Germany is increasingly diversifying and investment in sectors like the automotive industry (Tiwari 2012).

The importance of the software industry in bilateral German-Indian business relations goes both ways: Of all companies, around 70 percent belong to the Information Technology sector. The German magazine *Der Spiegel*, has called India the most attractive destination for offshore development by German software companies. Other important sectors for Indian companies present in Germany are financial services, textiles, mechanical engineering, pharmaceuticals, and automobile subcontractors. All of these developments show that in the medium term, through successful diversification, Indian exports could increase. Indian multinationals and managers are taken seriously as winners in global competition.

Contrary to the German business activities in Pakistan, in German markets, Pakistan business presence is non-existent. However, during the past years, over 500 companies from Pakistan were represented in several world’s biggest trade fairs and participated in 16 different exhibitions which may have helped the export sector. Pakistan’s lack of internationalization and economic diversification of its private businesses as well as a permanent trade deficit pose problems, but at the same time offer opportunities of expanding businesses overseas to generate surplus revenues through expansion. Investing overseas provides a direct entry into these markets through investment and forming joint ventures, broadening existing clientele and using the local work-force. Most emerging economies are in the process of successfully globalizing their businesses and pursuing surplus capital. Pakistan can also achieve much required economic stability, if it begins to provide a more liberalized outward FDI policy for the private sector, which would certainly encourage businesses to access European and international markets. India can serve as a successful model of internationalizing SME’s and establishing access points to the German market.

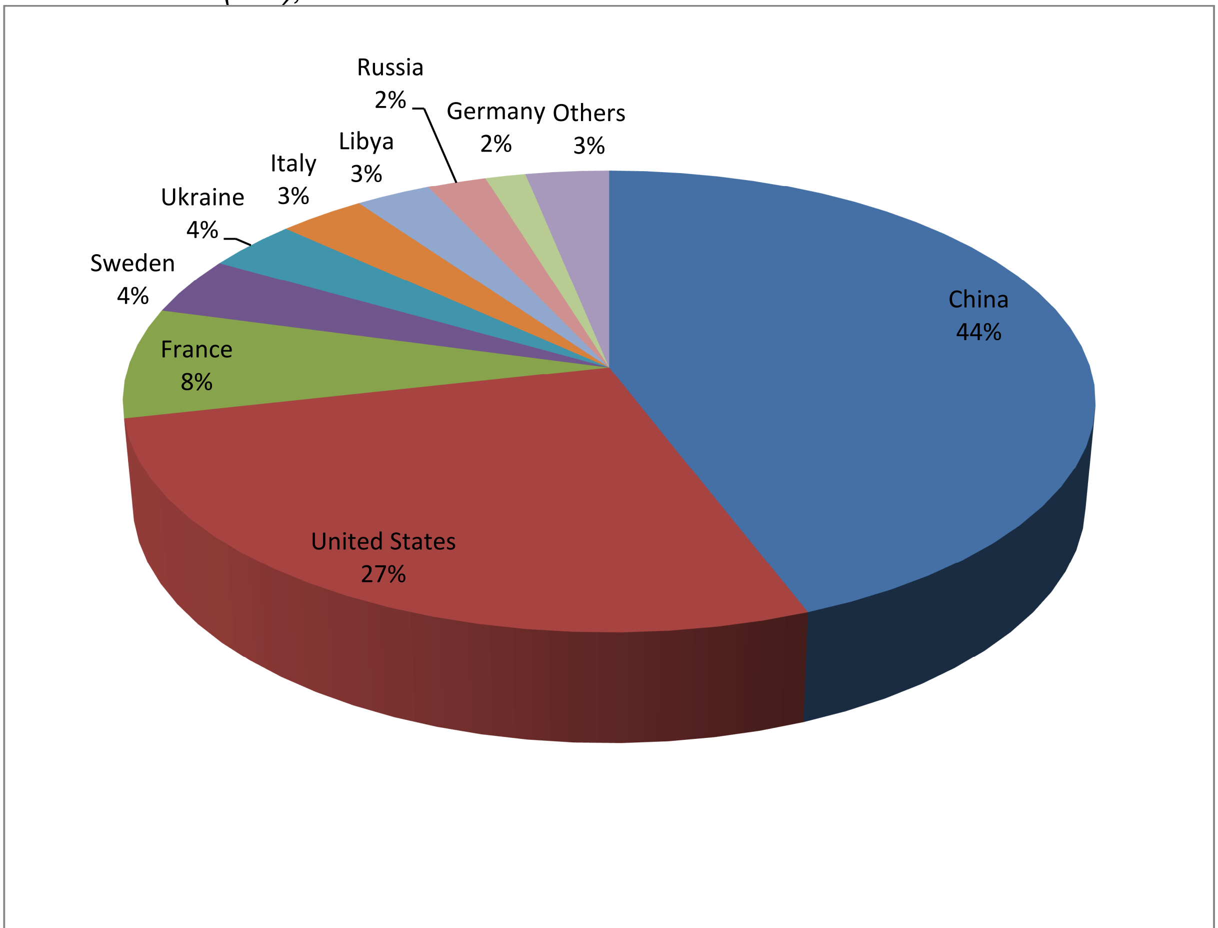
3.3. Strategic and security cooperation

Historically the strategic importance of Pakistan to Germany has been rather low. Since Pakistan’s existence it has neither been politically nor economically at the forefront of Germany’s foreign policy agenda. The relative importance of India contributed to these dynamics and at times caused further sidelining of Pakistan.

The intensification of the Kashmir conflict in the 1960s exemplifies these mechanisms. Although Germany and India generally did not conflict in security-related matters, the tensions between Pakistan and India did have an influence on German foreign policy: At the time, the German arms export to the Middle East that subsequently reached Pakistan through Iran caused severe discontent on the Indian side. Because of Pakistan’s relative insignificance, the German government did not jeopardize its relations with India with further arms export to Pakistan (Wagner 2007).

Arms transfers between countries are useful indicators of the constitution of security and foreign policy relations. In comparison, the German-Pakistani partnership in these transfers was in recent years. The largest trading partner in arms sales, based on the average percentage share of between 2003 and 2012, is China, which contributed 44 percent of arms transfers measured in SIPRI's trend-indicator-value (TIV). The U.S. is the second largest arms exporter to Pakistan. Of all the arms sales volume to Pakistan, German exports are quite insignificant, amounting to just 2%. However, there have been changes in recent years. Before 2004 German arms transfer was virtually non-existent, after 2004 it rapidly increased to over 200 million US$ in 2007 (BICC 2012). The German government stated that in 2005 Pakistan was the fourth most important recipient of German arms outside of NATO. During these peak years Pakistan received, among other things, radar equipment, aerial reconnaissance, evaluation equipment for torpedo exercising equipment, and electricity supply and missiles.

Table 8: Country share of arms transfers to Pakistan, in percentage of SIPRI trend-indicator-value (TIV), 2003-2012



Source: SIPRI Arms Transfers Database 2014

These developments corresponded with an increased U.S. engagement in money transfers for arms and development. The U.S. government increased the development and assistance programmes by 3 billion US$. It also corresponded with a general heightened awareness concerning Pakistan. After the incisive events following 9/11 and the percipience of security threats emanating from Afghanistan and Pakistan, reducing terrorism became one of the main national interests among most European states, including Germany (Gallenkamp 2009). While before German foreign policy's emphasis on Asian countries has focused on the export of political institutions and ideas of democracy, human rights and other "Enlightenment Values", after 9/11, however, all Asia-related policies of Germany and Western governments in general, came under an increasing focus of security issues (Robotka 2011). It was after this shift in foreign policy that Pakistan received more attention. However, even this immediate interest, right after the begin of military operations in Afghanistan, culminating in former chancellor Gerhard Schröder's visit of Islamabad in October 2002, did not maintain its volume – aside from issues related to conflicts with Taliban groups (Steinbach 2007).

German diplomats and officials have recently dismissed such critique of an insufficient engagement. In fact, there have been some initiatives taken to improve the bilateral relations on strategic matters. Especially the size of developmental assistance going to Pakistan is mentioned in this regard by officials. After 2001 the aid volume has indeed been significantly increased.

One result of the recent meetings and consultations between German and Pakistani state leaders was the development of a "Roadmap for the Pakistan-Germany Strategic Dialogue", signed in late 2012, clearing the way for consultations at the state and foreign secretary levels. This roadmap lists specific forums and objectives of increased dialogue to improve relations in political, economic, and scientific regards. Until today, not much implementation work in this regard has been done. A consistent execution could certainly make a difference for the enhancement of overall trade and investment relations. A number of working-groups should be established so the business communities from both countries can exchange concerns. Moreover, several comprehensive studies identifying factors that help or hinder bilateral trade and investment should be carried out.

If Pakistan transformed the emphasis of its policies from being security-oriented towards being more development-oriented, it could receive more external assistance and attention to develop similar partnerships as the “Agenda for the German-Indian partnership” (Wagner 2011a). As of 2012, more than 150 joint S&T research projects and 70 direct partnerships exist between Indian and German universities and even for the India-German relationship, science and technology cooperation are at their infancy stage and have potential for enhancement. Similar engagements in German-Pakistani relations could expand the cooperation in the area of economics and science and technology (S&T).

Additionally, German-Pakistani relations are also affected by EU stances and initiatives in regard to Pakistan. The already mentioned adaption of the EU’s GSP+ signifies one of most recent developments within the EU-Pakistani partnership. To optimize the realization of the opportunities that come with these tariff breaks, the EU has launched several trade diversification programs to reduce the country's reliance on the textiles and clothing sector.

Asides from the trade package, the rhetoric of EU statements concerning Pakistan has been focused strongly on issues of security and democratization. It mirrors an integral part of the discourse in German-Pakistani relations. In statements surrounding the fifty year anniversary of EU-Pakistani relations, the EU’s High Representative Catherine Ashton highlighted the perception of Pakistan as an important partner in security related matters on a regional scale, but also mentioned programs to strengthen the rule of law and governance within Pakistan itself. In this regard, and also in the trade packages offered to Pakistan, which were supported by the German government at the time, the EU’s engagements do not conflict with German interests concerning the partnership with Pakistan.

4. Conclusions

In 2013, after five years of civilian rule, the country made its first transition between democratically elected governments. The improved election laws and legal framework, high voter turnout and increased female share in voters add to the significance of this election. However, Pakistan continues to face deep complex challenges, often closely tied to international disputes and relations. The security situation in Afghanistan and border regions to Pakistan overshadows international relations, especially those to the U.S. Very recently regional trade issues have been discussed between India and Pakistan and India overturned its ban on foreign investment from Pakistan. Moreover, recent developments may indicate that the Pakistani Army has shifted its focus from its traditional enemy India to domestic concerns.

In recent years Pakistan's economy has been under immense pressure and faced severe macroeconomic instability. GDP growth rates have dropped and are expected to stay low, while inflation is projected to increase. Pakistan continues to be on the drip-feed of international donors, especially the U.S. In order to overcome this dependency economic reforms such as the reformed general sales tax need to be put in practice. In the last decade, international imports have always exceeded exports for every year, creating negative trade balance. Pakistan's trade share in the global market has declined significantly. Pakistan's exports are too confined to a limited range of products and the economy is not well-diversified. Entry-strategies into foreign markets simply do not exist and internationalization of Pakistani private business should become a policy issue.

Another impediment standing in the way of the country's economic recovery is the energy crisis. The government has addressed the key issues of eliminating circular debt, dismantling the fuel subsidy structure, tackling transmission and distribution losses, addressing cultural change to counter theft and non-payment, and introducing new legislation, particularly renewable and energy efficiency standards, but these challenges still remain to be solved.

The German-Pakistani trade volume in the last decade has remained moderate and leaves room for further expansion (average yearly trade volume of roughly 1.9 billion

US$). The performance rises from various domestic inconsistencies, one of which is the inability to diversify the country's basket of export commodities. As a result, Pakistan's exports to the EU are observed to be supply-driven rather than demand driven. Because of these predicaments, a full reaping of benefits of the newly issued GSP+ should be taken seriously. Over the last decade German interest in foreign direct investment in Pakistan has decreased and is only a marginal factor in total FDI in Pakistan. A comparison to the German FDI in the Indian market shows a much higher interest. Simultaneously, Pakistani direct investments in Germany are non-existent. Moreover, Pakistan and Germany do not share a dedicated and clearly-defined "policy infrastructure" and within Germany its regional status is either grouped with Middle Eastern or among South Asian states. These alternations between two very different regional focuses result in a lack of focus where policy-making is concerned.

German businesses are represented by some multinational corporations, but mainly by Pakistani trading agents who represent German SME's companies active in the areas of machinery, chemical and pharmaceuticals, instruments, automotive, and related equipment and services. The business activities of altogether 565 German small and medium-sized companies are represented by 231 Pakistani agents.

Pakistan's lack of internationalization and economic diversification of its private businesses as well as a permanent trade deficit pose problems. India can serve as a successful model of internationalizing SMEs and establishing access points to the German market.

Germany and Pakistan have shared a long-standing and amicable, though unenthusiastic relationship. In response to Pakistan's acute, complex and urgent security challenges, Germany has intensified its engagement with Pakistan over the past years in the areas of security and stability, building capacity and improving democratic governance. It was after this shift in foreign policy that Pakistan received more attention. However, even this immediate interest, right after the start of military operations in Afghanistan, did not maintain its volume – aside from issues related to conflicts with Taliban groups. After 2004 German arms transfer to Pakistan rapidly increased and in 2005 Pakistan was the fourth most important recipient of German arms outside of NATO. Of total arms sales volume to Pakistan, however, German exports are quite insignificant. Recent meetings and consultations between German and Pakistani state leaders led to a signing of and strategic understanding in 2012. Until today, not much implementation work in this regard has been done. A consequent implementation of these set goals could certainly make a difference for the enhancement of overall trade and investment relations.

German-Pakistani relations have largely been in line with EU stances and initiatives concerning Pakistan. The already mentioned adaption of the EU's GSP+ and recent EU waiver (WTO) and related trade diversification programs signify one of most significant parts of the EU-Pakistani partnership. These trade packages were supported by the German government at the time. The rhetoric of EU statements concerning Pakistan has also been focused strongly on issues of security and democratization. In this regard it mirrors an integral part of the discourse in German-Pakistani relations. Pakistan should take the advantages of this German-EU support and develop and implement the trade and investment policies to reap all the emerging benefits and to raise its missing self-sustained revenues. In order to boost bilateral trade, policies should be developed to foster an increased role of Pakistani SME's in Germany.

5. Outlook

The most serious concerns of the previous government have been described in a recent publication by the Bertelsmann Foundation as the lack of political will to introduce reforms and the societal inflexibility that prevents upward social mobility (Bertelsmann Stiftung 2014). Members of the political elite have fallen flat in their duties to encourage economic development, refusal to improve tax collection, and opt for a fiscal discipline, which would have an immediate impact on their resource base. The elite rest on Pakistan's size and its possession of nuclear weapons, making it against the interest of the international community to let the country fail. Perhaps, this attitude prevents them of concentrating on solving real issues in economic affairs, rather than relying on the inducement of security-related aid.

The current government should take all advantages of presently evolving democratic developments in the country and establish a political will to implement long awaited reforms and further strengthen democratic institutions and governance mechanisms, which have to be improved at all levels. One of the most important contributions of the present government would be the completion of the decentralization process that was started with the passing of the 18th amendment and the conducting of elections to form local/district governments in all provinces. These powers need to be devolved and decentralized, such that the people at the grassroots level have better possibilities of allocation and utilization of their resources. The decisions taken independently would be in accordance with the requirements and needs of those communities. Another main challenge will also be the formulation of a coherent foreign policy under the supremacy of the elected government, so that relations with the country's immediate neighbors are no longer dominated by the security interests of the armed forces or by non-state actors. Instead policies should promote regional trade and investment. Resulting policies can remove the assumed ambiguity of civil-military imbalance and will create a positive impact internally as well as externally. All these developments, if implemented, can certainly help to put forward robust economic trends and developments in Pakistan's trade with the EU and on international levels.

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