

10

Pakistan's "Export or Perish" Challenge – Institutional Dimensions

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Abstract

The paper analyzes the underlying reasons for the country's recurrent balance of payment crises using the framework of institutional economics and systems theory. It addresses the institutional challenges in expanding exports in the long term. A systems approach shows how the institutions are embedded in belief systems and mental models (social and cultural values and norms). Some mitigating factors that can weaken the balancing feedback loop are discussed. The analysis indicates that the elites and the belief systems encapsulated in culture and social values play a critical role in institutional change. Therefore, strategies to break out of the vicious cycle, balance of payment crisis-IMF bailouts, need to pivot on these two dimensions. There is a need to develop long-term strategies which would incorporate measures to strengthen economic, political, and social institutions.

Introduction

As Pakistan recovers from a near-default experience and initiates another IMF program, an opportunity arises to restore macroeconomic stability and address persistent structural imbalances. Given the country's continued reliance on imports, there is a compelling rationale for adopting an export-led growth strategy, encapsulated in the phrase "export or perish." While extensive analysis exists on economic policies needed to boost exports, this paper adopts a broader approach by examining the institutional challenges and referencing established research from New Institutional Economics and Dynamic Social Systems.

In discussions of Pakistan's complex economic challenges, limited attention has been paid to the country's political, economic, and social institutions, with solutions

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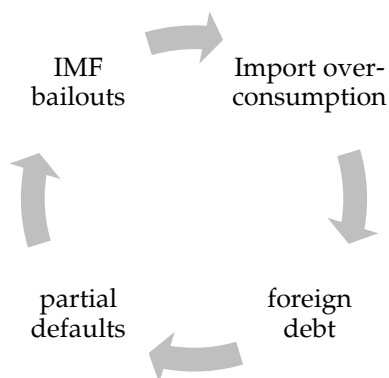
often focused on the short term. For sustainable, long-term progress, insights from institutional economics and complex systems theory offer coherent and complementary frameworks for addressing structural change.

The following section describes the dynamics of the recurring foreign exchange crises, attributing their origins to a consistently high propensity for imports, which underscores the necessity of expanding exports. Adopting a top-down approach, Sections 3 and 4 present analytical frameworks from new institutional economics and social dynamic systems models to analyze institutional change. Political and economic institutions directly influence export policies, while political failures, governance challenges, and corruption significantly hinder the adoption of effective export expansion strategies. Additionally, the cultural and social environment, by shaping belief systems, can either facilitate or impede institutional change. Section 5 explores how specific trade growth issues—such as exchange rate policy, export financing, global competitiveness, participation in global value chains, and the impact of cultural proximity on international trade—are embedded within political and economic institutions. Section 6 addresses the nexus between exports, foreign direct investment and capital flows. The final section provides a summary and conclusion.

A Vicious Cycle

Pakistan's economy appears trapped in a *vicious cycle* of import-overconsumption, financed by foreign debts, leading to periodic balance-of-payments crises, partial defaults, and repeated reliance on IMF bailouts as illustrated in Figure 1.

Figure 1: Vicious Cycle of BOP Crises



The most recent external financing caused severe economic strain, as the IMF program initiated in 2019 faltered, resulting in stalled economic growth, rising inflation, and pushing large segments of the population below the poverty line. Most

notably, Pakistan's external account came under severe pressures due to stagnant exports, high import dependency and a drop in faced significant pressure due to stagnant exports, high import dependency and a decline in foreign direct investment. This culminated in a near-default situation, which was averted only by an emergency stand-by arrangement with the IMF in mid-2023.

The country's recurrent BOP crisis suggests a systemic failure arising rooted in deep structural and institutional factors. The IMF programs primarily aim to rationalize fiscal and monetary policies, expand the tax base by incorporating retail, agriculture, and export sectors and eliminate exemptions and subsidies. The importance of adopting a market-determined foreign exchange rate has been repeatedly emphasized. Although these measures and program conditionalities have been attempted in previous programs, Pakistan has not succeeded in breaking this vicious cycle. The implementation of necessary structural reforms has remained elusive and politically challenging. Therefore, it is essential to examine whether the roots of these economic crises are deeply embedded in the political and cultural realms. To better understand the foundations of this chronic economic malaise, insights can be drawn from disciplines at the intersection of economics, politics, and culture. In this regard, New Institutional Economics and Dynamic Social Systems offer valuable perspectives.

Roots of Import Dependence

The country's dependence on imports has persisted due to several strong underlying factors (Uppal, 2023).

- a) The country is heavily reliant on imports for essentials and necessities, such as energy. Even domestically produced goods have a significant indirect import content. This dependence is likely to increase in the future (Mangla and Uppal, 2014; and Uppal and Khalid, 2019).
- b) There is a strong consumers preference for foreign products, driven by the convergence of lifestyles across countries as a result of globalization.
- c) Foreign products embody technology, providing a competitive advantage to local producers in both domestic and international markets.
- d) Foreign Direct Investment (FDI) requires profit repatriation or debt servicing at a later stage, thereby increasing demand for foreign exchange.

An Asian Development Bank (ADB, 2023), working paper analyzes Pakistan's recurring balance-of-payments crisis using data from 1980 to 2017 and long-term estimates of import and export income elasticities. The empirical evidence suggests that Pakistan's BOP constrains its economic growth rate to an estimated 3.8%. The authors conclude that, "in the current structural and product specialization circumstances, if Pakistan's economy is to grow faster than 3.8% in the medium-

term, external imbalances will occur.” This growth constraint at a relatively low level is driven by a high income-elasticity of imports, estimated at 0.8, meaning a 1.0% increase in GDP leads to a 0.8% increase in imports. “On the other hand, stagnating value of exports since 2012 and slowing remittance growth since 2014 are likely further shifting the BOP equilibrium growth rate downwards.”

Given Pakistan’s persistent high propensity to import, shifting to an export-led growth strategy is widely viewed as the most viable path forward, encapsulated in the slogan *export or perish*. It remains to be seen how such a shift in economic policies will unfold within the institutional context. For this reason, we now turn to relevant concepts from New Institutional Economics, Dynamic Social Systems and Cultural Economics.

New Institutional Economics

According to the New Institutional Economics (NIE) literature, institutions are created to reduce uncertainty by structuring the environment and generating predictable behavior, thereby constraining members to adhere to both formal and informal rules. These structures, known as institutions, emerge from ongoing social interactions and are shaped by the dominant beliefs within a society. Beliefs systems influence how individuals’ perceptions of reality and their responses; however, the beliefs held by those in power (*dominant beliefs*), have a greater impact on institutional development. Thus, belief systems provide “both a positive model of the way the system works and a normative model of how it should work”; North (2005, 2).

Institutions generally evolve incrementally but can also change episodically, as influential actors revise their perception of reality and institutional performance according to their subjective criteria, which usually relate to generating economic benefits for themselves and their social groups. Significant change often occurs when new actors acquire legitimacy, influence and power. Institutional change is far from quick or easy. The rate of institutional change depends on the degree of competition among organizations and their entrepreneurs.

Systems Approach

Another relevant field for understanding institutional emergence and change is the Science of Complexity. Complex Social Dynamic Systems or Complex Adaptive Systems (CAS) have contributed to the development of complexity economics, which views the economy as a network of evolving, interacting agents. In this framework, the adaptive behavior of the economy results from the individual adaptations of its agents. Although the behavior of individual actors is unpredictable, certain repeating and persistent behavioral patterns emerge over time, providing stability and allowing for the anticipation of likely actions. These

stable patterns eventually create structures that influence and constrain behavior. Some of these structures are formalized as organizations, regulations and legislation, while others remain s informal as customs and social norms. In Complexity Science, such structures are called attractors and boundaries, whereas in social sciences, they are referred to as institutions.

The theories of institutional economics and of complex systems reach very similar conclusions about how institutional structures shape relatively persistent patterns of behavior.

As institutions emerge in a society, they establish 'the rules of the game' governing personal interactions between agents as well as interactions among organizations, firms and government. Institutional structures shape the competitive environment in an economy. A major benefit to the economy is the reduction of transaction costs and the creation of positive externalities, such as enabling specialization of production. Institutions build the incentive structure for economic units, for example, relating to investment, innovation, defining and protecting property rights. Effective institutions are essential for a market economy to operate efficiently; market exchanges are regulated and governed not only by laws and regulations but also by local customs and norms.

Figure 2: Systems Iceberg Model

Events	FX Crisis
Patterns	Vicious Cycle – BOP crisis
Structures	1) Organizations: Corporations, governments, schools 2) Policies: laws, regulations, taxes 3) Rituals: customs, norms, habits
Paradigms	Attitudes, beliefs, morals, values underpin the structure

A valuable tool to conceptualize and map the institutional structure in an economy is the Systems Iceberg Model. It differentiates between what is directly

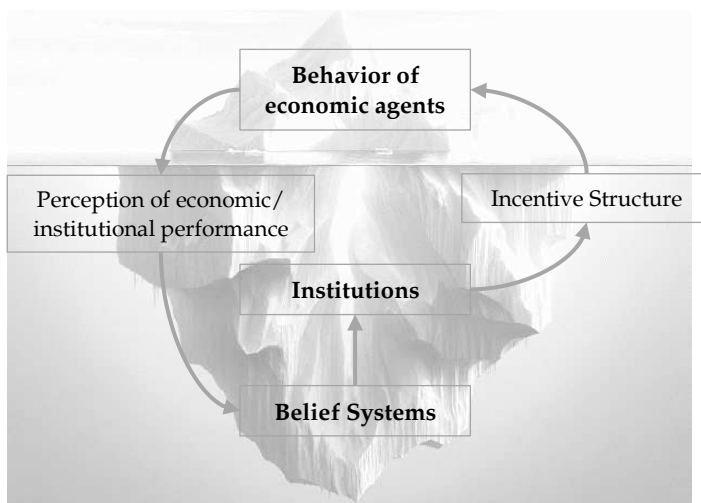
observable (the events and patterns that these events follow, thus above water) and what remains unobservable but drives these patterns, consisting of structures or institutions and their underlying mental models or paradigms. These mental models or paradigms, also called society's belief systems, shape people's perception of reality and drive their responses. A simple Systems Iceberg Model is shown in Figure 2.

The model shows at the tip of the iceberg events, such as the BOP crises, observed from time to time. Below these, persistent patterns of behavior, which repeat in a similar manner (recurrent IMF bailouts), are also detectable. Beneath the surface lie systems structures that are not easily visible. These structures can be physical (infrastructure, terrain, roads, etc.), but more importantly include formal and informal institutions encompassing organizations, policies (laws, regulations, tax code, etc.) and rituals (customs, norms, habits, etc.). At the deepest level, underpinning the structures are mental models that include attitudes, beliefs, morals and values.

The dynamics of institutional change

Based on Jenal (2019), Figure 3 replaces the terms Patterns, Structures and Paradigms from the general iceberg model with the parallel concepts used in New Institutional Economics: behavior of economic actors, institutional frameworks, and belief systems. The figure also introduces arrows to illustrate the theoretical causality proposed by North (2005).

Figure 3: Dynamics of institutional change per Jenal (2019)



North posits that institutional change is driven by powerful and dominant actors, who assess the performance of economic agents according to their own criteria. Change can also occur when new actors acquire influence and power, rather than through existing power structures revising their perceptions. As influential actors evaluate institutional performance and adjust their perceptions and belief systems, institutional change occurs through a feedback loop. Beliefs shape the structure and evolution of institutions, which in turn influence the behavior of economic actors through incentive structures, thereby affecting economic performance.

Factors that mitigate institutional change

Several factors mitigate the feedback loop and slow down the process of institutional change. First, the way we perceive and evaluate institutional performance is shaped by our prior belief system, which are anchored in earlier experiences and entrenched in the cultural and social environment. This makes it difficult to think outside the box and creates a balancing loop that hinders institutional change and may even lead to institutional stagnation.

Secondly, since change agents are typically influential and powerful actors, even if economic performance is suboptimal from a societal perspective, decision makers may not perceive it as such; their belief systems can render them blind to these shortcomings. For example, powerful elites may fail to comprehend the hardships faced by the impoverished because they cannot relate to their reality. This phenomenon, known as elite capture, is well-documented phenomenon where a small powerful group evaluates the system according to its own class interests rather than broader societal needs.

A third factor that may mitigate the balancing feedback is that belief systems can become entrenched within ideological boundaries, making it much harder to revise perceptions of institutional performance or reevaluate institutions. For example, if a society is ideologically committed to socialism, it will be very difficult to question the performance of publicly owned enterprises, as doing so may seem to challenge the ideology's foundation and hinder change even when evidence supports it. In Pakistan, any discussion about opening relations with its neighbor, is thus severely constrained.

Fourth, institutional change also depends on the adaptive efficiency of institutions and the legal and regulatory framework in which they operate. Formal institutions may change relatively faster, though the process is political and subject to negotiations that can considerable time. Social norms, on the other hand, tend to evolve more slowly. The overall speed of change varies across societies; some cultures are more open to change, while others are more conservative or resistant. However, social and cultural change can be accelerated, especially when political

and civic leaders raise awareness about the need for reform. The power structures within society and the internal structure of institutions also influence the pace of adaptation and change. According to North, institutional change is primarily driven by elites with influence and power. Thus, powerful groups or classes make decisions about institutions, policies, rules and regulations, thereby defining the incentive system for businesses and individuals. The challenge is to align the interests of decision makers with those of society at large, which can be achieved by creating a more democratic and pluralistic society that allows broader participation in decision-making through informed, fact-based discussions. Conversely, when a small group holds power, they are likely to resist institutional change, as the existing system disproportionately benefits them at the expense of the majority.

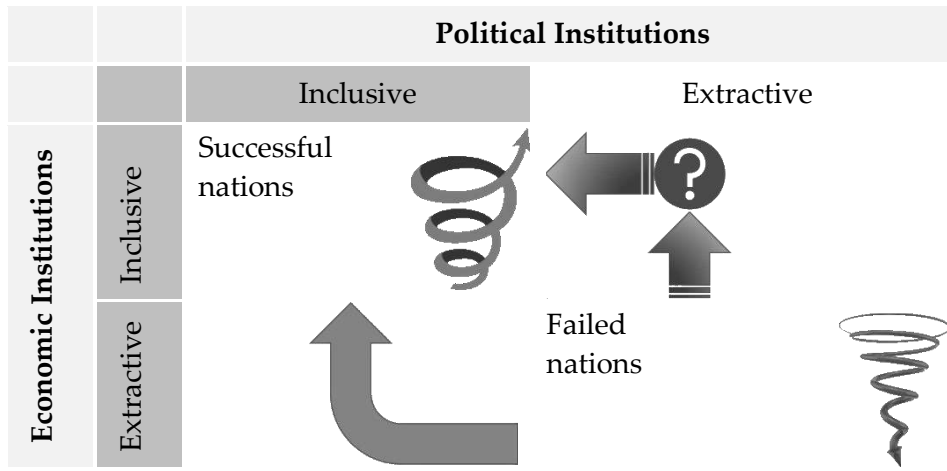
These larger dynamics that mitigate institutional change have been termed by Acemoglu and Robinson in their book *Why Nations Fail* as the vicious and the virtuous circles (Acemoglu and Robinson, 2013).

Extractive vs. Inclusive Institutions

One way of looking at the role institutions play in advancing or hindering economic progress is to characterize them as to whether they are extractive or inclusive in nature.

In their seminal work *Why Nations Fail*, Acemoglu and Robinson argue what determines whether a nation progresses or not is grounded in its institutions; it depends on whether its political and economic institutions are extractive or inclusive. Inclusive institutions are pluralistic, participatory and provide incentives for people to be innovative and engage in business. They create an environment for markets to function, which includes secure property rights and a just system of law and order. These institutions provide public services that ensure a level playing field, allowing people to conduct economic exchange and contract. Most importantly, the institutions permit the entry of new businesses. Extractive institutions, on the other hand, concentrate power in the hands of an elite who restricts opportunities, safeguards oligarchical power to extract value and benefit themselves to the detriment of innovation and emergence of new industries. The creative-destructive process at the heart of economic progress is thus disrupted. Their theoretical framework is depicted in Figure 4.

Figure 4: Institutional Landscape-Acemoglu and Robinson



The interplay between political and economic institutions can set in motion either a virtuous or a vicious cycle. Successful nations are those where both political and economic institutions are inclusive, generating a virtuous cycle. In this cycle, inclusive political institutions enable inclusive economic institutions because they involve pluralistic decision-making, making them resilient to attempts by interest groups to capture political and economic power through extractive institutions. An example of the virtuous circle is the rule of law, which according to Acemoglu and Robinson, "is not imaginable under absolutist political institutions. It is a creation of pluralist political institutions and of the broad coalitions that support such pluralism;" (Acemoglu and Robinson, 2013). Inclusive economic institutions, in turn, reinforce inclusive political institutions creating a self-reinforcing cycle that supports sustained development and stability.

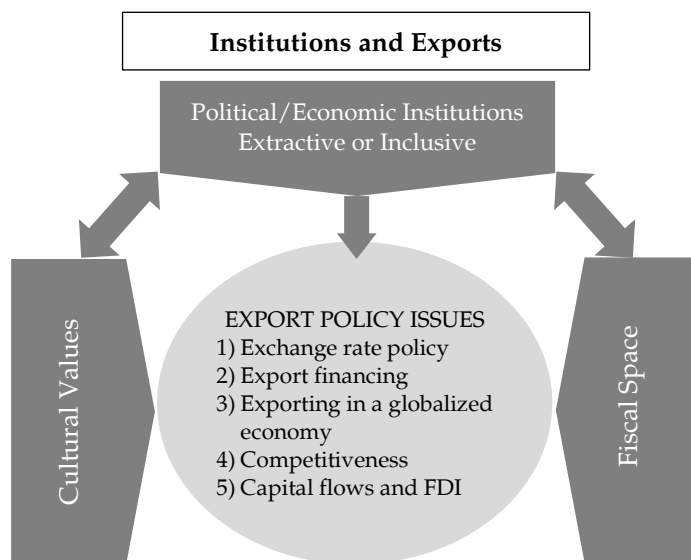
Extractive political and economic institutions, conversely, generate a vicious circle in which each reinforces the other, enhancing their resilience. Elites in power benefit from extractive economic institutions and sustain their dominance through extractive political institutions. Consequently, there is little incentive to reform institutions or make them more inclusive. Although these vicious cycles may occasionally be disrupted due to internal conflicts, extractive institutions remain vulnerable to infighting. However, as the authors emphasize, "The essence of the iron law of oligarchy this particular facet of the vicious cycle is that new leaders overthrowing old ones with promises of radical change bring nothing but more of the same;" Acemoglu and Robinson (2013)².

² The "iron law of oligarchy" states that all forms of organization, regardless of how democratic they may be at the start, will eventually and inevitably develop oligarchic tendencies, thus making true democracy practically and theoretically impossible, especially in large groups and complex organizations.

According to Acemoglu and Robinson, while institutional change is possible, it is often difficult due to powerful balancing feedback loops that impart stability to the existing institutional landscape, reinforcing either a vicious or virtuous cycle. This stability does not mean change is impossible; the authors provide numerous historical examples of countries transforming their institutions from extractive to inclusive.

In terms of the sequence of change, their analysis suggests that it is generally easier to move from exclusive to inclusive political institutions first, which can then pave the way for inclusive economic institutions. The alternative path—developing inclusive economic institutions before inclusive political institutions, as proposed by the modernization hypothesis³—is more challenging, tend to resist reforms and maintain extractive economic arrangements.

Figure 5: Institutions and Export Policies



Acemoglu and Robinson (2013) conclude: “Despite the vicious circle, extractive institutions can be replaced by inclusive ones. But it is neither automatic nor easy. A confluence of factors, in particular a critical juncture coupled with a broad coalition of those pushing for reform or other propitious existing institutions, it often necessary for a nation to make strides toward more inclusive institutions. Some luck is key, because history always and folds in the contingent way.”

³ The modernization hypothesis is a theory that suggests that a country's economic development can lead to political and social change, and that more economically developed countries are more likely to be democracies, Gwynne (2009).

Institutions and Exports

Having laid out a generalized framework describing how institutional factors influence economic policy making and performance, we can now turn to their role in issues related to export promotion strategies. A country's political and economic institutions directly impact major export policy areas such as exchange rate policy, export financing, exporting in a globalized world, export competitiveness, capital flows and foreign direct investment. This analytical framework is illustrated in Figure 5.

Exchange Rate Policy

At the macro level, as the first step in encouraging exports and curtailing domestic consumption of imported products, foreign exchange policy needs to reflect the expected demand for hard currencies. This implies that the foreign exchange rate should be closely aligned with the market determined rate.

On the contrary, there is empirical evidence that the Pakistani rupee suffers from *chronic overvaluation* (Ahmed, 2009); Makhoul and Mughal, 2013; Javaid, 2009; Jalil, 2020; Lopez et al., 2007). Pakistan's economy seems to be afflicted by Dutch Disease, as the country has been receiving inflows of hard currencies from sources other than exports of goods and services, such as workers' remittances and foreign aid. On average, workers' remittances have been almost as large as exports, which is a major cause of the rupee's overvaluation and, consequently, the loss of competitiveness in Pakistan's export sector. Imports are encouraged while exports are penalized. This leads to an increase in the share of the non-tradable sectors in the economy, such as real estate, and capital flight out of the country.

The failure to rationalize foreign exchange policy in line with scholarly analysis and policy recommendations can be understood through the institutional framework. First, the persistent overvaluation of the rupee not only disadvantages the exporters but also shortchanges ex-patriate workers and their families, who see the value of their remittances eroded. Conversely, the main beneficiaries of this policy are urban elites and upper middle-class consumers, who enjoy cheaper imported goods, energy and luxuries. This group, rather than exporters or expatriate workers, holds significant influence and power, and thus has little incentive to support policy change. Second, at the level of belief systems, the notion of a *strong rupee* has become a symbol of national pride and a perceived indicator of government economic performance, even though it undermines the export sector.

Financing for Export Promotion

Finance plays a key role in facilitating international trade, since working capital cycles are longer than in domestic trade. The export sector is also more exposed to

credit risk and defaults from foreign customers. A lack of access to trade finance is a significant non-tariff barrier to trade (Asian Development Bank, 2023; World Trade Organization, 2016).

To expand in the international markets and remain competitive, exporters need to invest in physical capital and technology, particularly for higher value-added products. Over time, production processes have become more capital-intensive, involving large-scale automation and robotics to ensure high quality. Therefore, lack of access to finance can severely constrain exporters from investing in plants, machinery and human capital needed to grow and compete.

The State Bank of Pakistan (SBP) has two major programs: the Export Finance Scheme (EFS) and the Long-Term Finance Facility for Plant & Machinery (LTFF). The first provides short-term working capital loans, while the second offers long-term loans for investment in machinery and equipment.

A study by Defever, Riaño and Varela (2020) evaluates the impact of the two SBP facilities—EFS and LTFF—on firm-level export performance. The study shows that firms benefiting from these financing facilities are substantially larger, export a large share of products, and are concentrated in traditional sectors such as clothing, textiles and apparel. While the schemes have helped expand exports of individual firms (*intensive margin*), neither scheme has helped increase the range of products being exported nor the number of destination countries (*extensive margin*). The impact of the facilities has been weaker in Pakistan compared to similar schemes in other countries. From a simple *back-of-the-envelope* cost-benefit analysis, the authors conclude that “Our evaluation indicates that from a fiscal standpoint, EFS and LTFF offer an expensive way to increase tax revenues because they offer loans to firms at negative real interest rates.” A similar study by Zia (2008) finds that approximately half of the subsidized credit appears to have gone to large and financially unconstrained firms.

The empirical evidence suggests that trade promotion policies are driven by influential groups rather than by economic merit. Malik and Duncan (2022) find that sectors exposed to politically powerful businesses have disproportionately benefitted over the last 20 years through a complex mix of tariff and non-tariff measures. Pakistan has one of the most protectionist trade policies in the world, creating an anti-export bias (World Bank, 2021) which may also reflect the extent of elite capture of the state.

Achieving Global Competitiveness

The share of Pakistan’s exports in GDP has been declining. One major underlying factor is the decreasing relative competitiveness of the country’s exports. There is also a relatively low entry rate into the export sector, coupled with a high failure rate

among new entrants attempting to upscale their business. As a result, there has been little diversification or sophistication in exports.

A World Bank (2021) report notes that the economy has become more inward-oriented, which carries consequences for the country's foreign exchange, employment, and productivity growth. The report identifies three main causes of Pakistan's stagnant exports. First, protectionist policies aimed at import substitution create an anti-export bias, incentivizing domestic firms to prioritize local markets over export markets. Second, support services for exporters, particularly long-term finance and market intelligence, have been inadequate. Third, low productivity of Pakistani firms is a major factor underlying their unfavorable competitiveness.

As per international business literature (Porter, 1998), achieving competitiveness in global markets generally follows from first becoming competitive in local markets. Porter's main thesis is that "companies achieve competitive advantage through acts of innovation. Their capacity and push to innovate is affected by four broad attributes of a nation, attributes that constitute the *diamond* of national advantage: (i) Factor conditions, (ii) Demand conditions, (iii) Related and supporting industries, (iv) Firm strategy, structure, and rivalry. These four attributes create the national environment in which companies are born and learn how to compete," Porter (1990). The competitive advantage thus gained locally is then leveraged to enter foreign markets. This local completeness arising out of productivity, innovation and efficiency is achievable only in a competitive economic environment, which often conflicts with protectionist policies. Based on Porter's analysis, "government should act as a catalyst and challenger—but not get involved directly in competition. Companies should create pressures for innovation; seek out the toughest competitors and most-demanding customers; improve the whole national diamond; and use alliances only selectively," Porter (1990). He also notes that "as the basis of competition has shifted more and more to the creation and assimilation of knowledge, the role of the nation has grown."

A competitive business and economic environment needs to be embedded within a competitive social and cultural environment. The issue of a competitive environment, therefore, circles back to mental models and belief systems. It implies building societal values that favor equal opportunity, innovation and creativity, create merit-based incentive systems for individuals as well as for businesses; and protect property, individual freedom, and rights within a fair and just legal framework.

Becoming a Part of Global Value Chains

In a globalized world, supply chains have become complex and cross national boundaries. Increasingly, firms participate in international trade by becoming links in global value chains (GVC). Public policy can play a critical role in facilitating local

firms' engagement with these global networks, such as by reducing import duties and other indirect costs involved in international trade, thereby improving the ease of doing business.

According to a joint report of the Asian Development Bank and Islamic Development Bank Institute (ADB/IDB, 2022) Pakistan has the lowest GVC participation rates in the world. The report recommends the following measures to adopt a more outward oriented trade strategy: (i) incentivize exports of products that rely heavily on processing abroad; (ii) build up human capital appropriately to match the opportunities provided by GVCs in the export of services; (iii) provide institutional support to groups that might be adversely affected by opening up to GVCs; and (iv) continue to pursue new trade agreements to lower trade barriers, exchange information, and establish mutual trust.

In the globalized trading environment, multinational corporations are key to accessing global value-chains. Strategic alliances with multinational corporations can also be instrumental in gaining market intelligence, trade financing and investments to bring technology and to increase productivity (Lovo and Varela, 2020).

However, Pakistan has become increasingly inward-oriented since the turn of the century, which hampers its ability to integrate effectively into global supply chains (World Bank, 2021). The inward orientation is also reflected in cultural orientation and international relations, which have developed an anti-Western sentiment. To successfully promote exports, government policies must recognize and address these broader cultural and political factors influencing international trade.

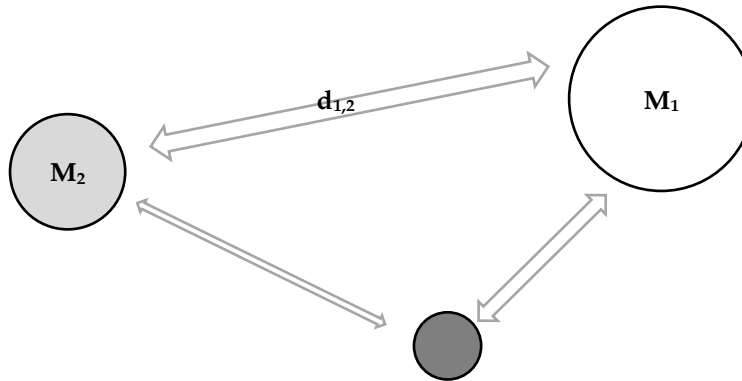
Cultural Closeness and Trade Potential

In international economics, the *gravity model* of trade (Figure 6)—first developed by Isard (1954)—has consistently proven robust in empirical testing (Carrère et al., 2020). This model explains that the volume of trade between countries is positively related to the product of their economic sizes and negatively related to the geographical distance separating them.⁴ Salinas (2021) highlights the need to reduce the *effective geographic distance* between trade partners by improving transportation logistics, easing trade barriers, enhancing trade facilitation, and leveraging communication technologies. The study also identifies four economy-wide factors—

⁴ The basic model for trade between two countries (i and j) takes the form $F_{i,j} = g \cdot \frac{M_i M_j}{D_{ij}}$, where g is a constant, F stands for trade flow, D stands for the distance and M stands for the economic weights of the countries i, j . Most scholars consider the distance in the model to be the effective rather than geographical distance, reflecting frictions impeding bilateral trade.

governance, education attainment, infrastructure quality, and open trade policies (*horizontal policies*)—as essential drivers for fostering diverse, complex, and higher-value-added non-commodity exports.

Figure 6: Gravity Model of Trade



Other scholars have suggested that psychic or cultural distance plays a greater role than geographic distance in explaining bilateral trade patterns (Håkanson, 2014); Horner et al., 1970; Vahlne and Wiedersheim, 1973). This perspective highlights how differences in societal norms and customs shape cultural closeness, which can either facilitate or impede trade between countries.

For policymakers, this implies the need to assess whether their country is culturally drifting away from key trade partners or becoming increasingly isolated, as such cultural gaps can pose substantial barriers to expanding trade. Cultural factors end to exert a stronger influence on trade in knowledge-intensive products and services-sectors that hold considerable promise for growth and diversification.

Foreign Direct Investment and Exports

A fundamental characteristic of foreign direct investment (FDI) is that it entails an obligation to repatriate foreign exchange later as debt servicing and/or profits. Therefore, the litmus test of FDI should be whether it increases the country's FX earnings by expanding exports; the rate of return on FDI in foreign currency should be the key criterion. Typically, FDI brings an additional infusion of foreign exchange into the economy, as it is usually accompanied by imports of plant, machinery, and other services denominated in foreign currency.

The economic logic would therefore suggest that the FDI funded projects need to be carefully evaluated in terms of their export-building capacity. On the contrary, there seems to be an unqualified enthusiasm for FDI in private as well as official circles. Bringing FDI in has become a yardstick of the success of government's

economic policies. Such mental attitudes and beliefs seemed to be shaping the public policy towards FDI.

Following the internationalization theories—such as the OLI eclectic paradigm (Dunning, 1977, 1980, 1988) and the Uppsala model (Johansson and Vahlne, 1977, 1990)—FDI represents a stage in a foreign firm's decision to invest in physical facilities abroad. It emerges as mutual trust and business relationships deepen between the foreign firm and its local partners. Therefore, it is crucial to consider FDI from the foreign investor's perspective and understand the factors influencing their decisions.

Within the field of international business, the construct of psychic distance (and similar constructs, such as national cultural distance, institutional distance, and sociocultural distance), has been considered a potential predictor variable for a broad range of management decisions including FDI market selection (Davidson, 1980; Dow et al., 2009).

Cultural factors also play a prominent role in forming perceptions of a “friendly business environment” and country risk, which influence FDI flows. Unfortunately, Pakistan's perception among the international business and investor community has deteriorated over the last several decades, damaging its country brand. Negative perceptions have been fueled by rising terrorism, increasing Islamization of the society, and anti-West attitudes. Increasingly, credit rating agencies and country risk assessment agencies incorporate cultural and social factors into their analysis (Leavy, 1984).

Capital Flows – a Two-Way Street

Capital flows are another area where analyzing the institutional landscape, rooted in belief systems and cultural values, can provide valuable insights. Capital flight out of the country is often portrayed as the villain in political rhetoric and public discourse, which is reflected in regulatory controls on the flow of capital.

However, the issue is complex and involves economic trade-offs. First, there is an inherent contradiction in trying to attract foreign capital while simultaneously making it harder to move that capital out of the country. For liquidity reasons, a foreign investors' primary concern is their ability to repatriate capital when needed. Therefore, restrictions on capital outflows are likely to have a negative impact on foreign direct investment.

Capital flight can take many forms, such as over-invoicing, under-invoicing, smuggling, and use of cryptocurrencies, in addition to illicit financial flows. Multinational corporations may also move capital out by manipulating transfer prices and exploiting loopholes in tax codes.

It is important to recognize that firms and individuals have legitimate economic reasons to transfer capital abroad, including portfolio rebalancing, seeking safety, expanding business internationally, and maintaining funds overseas for operational purposes. Likewise, foreign investors are motivated to invest in local markets to optimize their risk-return profiles through foreign portfolio investment.

A balanced approach is needed to target money laundering and illicit gains while protecting the country's tax base, avoiding unintended harm to the investment climate. Coercive measures to restrict capital flows are likely to be counterproductive (Arezki et al., 2013). A prudent approach involves fostering a stable macroeconomic environment and allowing market-determined FX rates through sound policies. Political risk affects both domestic and foreign investors and is a major driver of the capital flight to safety. Ensuring long-term political stability and a reliable legal environment should be a priority. Conversely, if the country's policies are driven by entrenched anti-capital belief systems among political elites, the results will be counterproductive.

Summary and Conclusion

This paper analyzes the underlying causes of the country's recurrent balance of payments crises—a vicious cycle—within the framework of institutional economics and systems theory. It highlights the challenges faced in expanding exports over the long term and emphasizes the need for long-term strategies that strengthen economic, political, and social institutions.

The systems approach shows how institutions are embedded in belief systems and mental models (social and cultural values and norms). Institutions influence the behavior of economic agents through incentive systems. Economic outcomes are then evaluated by these agents who may revise their prior beliefs and, if influential, bring about institutional change. This creates a balancing feedback loop capable of correcting the system's course. However, several factors can weaken this corrective mechanism: (i) agents of change tend to be powerful and influential groups whose perceptions and interests dominate; (ii) their perceptions are bounded by prior beliefs and ideologies; and (iii) the adaptive capacity of institutions themselves. Thus, elites and the belief systems embedded in culture and social values play a critical role in institutional change. Strategies to break out of the vicious cycle of balance of payments crises and IMF bailouts must therefore focus on these two dimensions.

The first question to consider is how economic policies and strategies are developed. Political failure, governance challenges, and corruption often result in elite capture by vested interests, leading to policies that do not align with the public good. Evidence suggests that such elite capture is central to Pakistan's economic difficulties. Alavi (1972) highlighted the oligarchical control Pakistan's state by a

bureaucratic-military complex. More recently, Ahmed (2023) provided empirical evidence of political and bureaucratic capture in public sector resource allocation in Baluchistan. Similarly, Ahmed (2017) discusses state capture and extractive behavior of Pakistan elite.

Elite capture in Pakistan is highlighted in the World Bank's (2020) Systematic Country Diagnostic Report. Another World Bank (2022) report notes that, "... [these elite groups] have not supported policies that could have addressed factor market failures, as this would have diluted their own economic power and their grip over state resources." The report concludes that, "the effectiveness of reforms crucially depends on alleviating public governance environment constraints and ensuring incentive compatibility."

The second dimension of the problem lies in the belief systems embedded in the cultural and social environment. Sound policies are more likely to emerge when they are evidence-based, developed through informed dialogue, and free from ideology or beliefs lacking rational basis. Rational public policies, implemented within a stable political and economic environment, are essential for export growth. The influence of cultural factors on export performance cannot be overemphasized.

Economic progress is driven by innovation, risk-taking, and entrepreneurship-qualities that flourish in cultures that actively encourage, reward, and celebrate them. In today's globalized economy, cultural affinity with export markets and a deep understanding of customer expectations regarding quality and service have become critical competitive advantages. Success in global markets begins with building strong competitiveness at home, which can then be leveraged for international expansion. Export competitiveness—rooted in productivity, innovation and efficiency—is best cultivated within a dynamic and competitive domestic environment. With global supply chains growing increasingly complex and crossing multiple borders, integration into global value chains (GVCs) is essential. Broader economic factors—such as governance, high educational attainment, robust infrastructure, and open trade policies—play a vital role in enabling countries to diversify their exports and move towards higher-value, non-commodity products.

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