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The Resilience of Economic Growth to Political Risk: A Case Study of Pakistan

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Abstract

The objective of the study is to investigate the impact of political risk on economic growth of Pakistan and its inconsistency for the last 23 years using time series data. The variables Gross Domestic Product, Political Stability, Inflation, Interest Rate, Voice and Accountability have been used as political instability proxies. Time series analysis has been used to check the dependency of political risk on economic growth. The results show that the overall model has been significant with political risk. Economic growth and political risk have deep and strong relationship as when changes occur in political stability, it affects the economic growth of Pakistan. Political systems of developed and developing countries have change dramatically due to certain reasons in which the main factor is the economic growth. Political issues are responsible for bad economic growth. The overall result implies countries whose economic growth is stable they will not face political risk as compare to the counties whose economic growth is bad.

Key-Words: Political Instability, GDP, Inflation, Interest Rate, GDP Growth Rate, Accountability Voice.

1. Introduction

All over the world political instability has become a major threat specifically for developing and underdeveloped countries. The political parties' inefficacy, Government instability, and a poor political culture affirm an instable political state. It has more serious consequences for the society which is multi-ethnic, having people of diverse cultural attributes. For the achievement of nation building, political stability is very important such as political development and national integration, which is directly influenced by the formation of political parties.

Each country's political parties should remain committed to working for their countries' social and economic growth. It is anticipated that their actions and political efforts are aimed at improving the state of the nation and the people (Apeter 1965). If a country's political parties take very aggressive positions against each other, then the country's political instability increases. The desired economic growth of the country is thus hindered. It is closely linked to economic development and political stability (Javaid 1991). Investment and the pace of economic growth could be limited by the instability associated with an unpredictable, rapid political climate. In addition, poor economic performance could lead to a decrease in government and political instability. During the anti-colonial struggles of the subcontinent and later in the strengthening of democratic reform in South Asia, the history of political demonstrations was instrumental. Along with Pakistan, Afghanistan, Bangladesh, India and Nepal still face a concerning number of political incidents on a yearly basis, and its occurrence is rising quite sharply over the years.

Independent of the state of progress or their constitutional system, political instability has now become a source of concern for many countries around the world (Economic Survey of Pakistan, 2017-18). Previous research indicates that political conflicts can have a catastrophic effect on an economy. Domestic conflicts, on the other hand, can turn a nation into a fragile state under certain circumstances. Fragile and conflict-ridden countries typically lose the capacity within their communities to establish productive relationships and also suffer from a poor ability to execute governance functions. These countries are more susceptible to internal and external shocks and face economic uncertainty in turn (Acemoglu, 2011). Arguably, considering the dominance of the informal sector in economies such as Pakistan, when opposed to more industrialized countries, the adverse effect of political instability may be lower. Some other studies which have adopted a notion of political instability similar to ours have found effects of instability on inflation (Barro 1991).

Economists consider political instability to be a significant disorder that is fatal to economy achievement. Many scholars have paid attention to the comprehensive aspect of political instability in different nations and its unfavorable effects on their economic results. The tendency for government failure is recognized as political instability (Alesina et al., 1996). This may be either due to clashes or a major rivalry between many political parties. In addition, the emergence of a government transition will increase the possibility of consecutive changes. Malaysia has long been regarded as one of Asia's success stories. The nation with the third largest economy with the most educated population in relative terms. It is a rare example of a stable Muslim nation that is centrist and self-governing, one where Muslim prevalence lives with the Chinese and Indian communities of the nation in sufficient peace. But as the country risks slipping into autocracy, Malaysia's fragile political and ethnic balance is beginning to loosen. At a moment when economic darkness is also blackening, this is definitely a disturbing alteration. With real GDP growth at six per cent, Malaysia had a respectable 2014, the second-highest achievement in Southeast Asia. However, the country is a big net energy exporter, taking the downturn in oil prices to a weak point. In Malaysia, international bond ownership is increased by more than 40 percent and bondholders could become jittery if there is additional harm from the economic and political perspective of the country (Financial Times, 2015).

Over the years economic crises are a huge concern for the countries. Some countries have identified the problems and its remedies which they were facing in the economic growth. Some countries have linked economic growth with political instability, lack of resources, poor governance etc. But here our focus will be thoroughly on the economic growth of Pakistan as Pakistan economy is not in good state as it requires a lot of efforts and commitment to alive. In this research we will link and check economic growth of Pakistan with country political instability. By linking and examining political instability with economic growth we will collect data from different sources from 1996-2018, to investigate that how much political instability affect economic growth in Pakistan. Thus, this study intends to build on the existing literature of macroeconomic of the association of political instability with economic growth in the context of a developing country Pakistan.

2. Literature Review

In the literature of economics occasionally many contrasting altercation have been summon into action to make to the impact of political risk and economic growth. In spite of that there is general agreement that socio political instabilities decrease economic growth and deject investment. In reality political instability enfeeble institutions, demoralize investment and encourage corruptions, Moreover political instability create reluctance between prospective investors, hinder economic growth and penalizes capital acquisition. Ultimately socio-political instability thrive political-economic uncertainty which put forward to reduction in investment and increase in political risk. Otherwise, socio-political instability negatively influences economic growth by decreasing acquisition of human and physical capital and disorganize production. As a result, disputes negatively infect the muster of government revenues and dismantle capital stocks.

Different verifiable studies have asserted that the alliance among economic growth and political stability is not stable. In reality Fosu amplify ten years panel data via a production function which covers the period from 1975-2004 for thirty sub-Saharan African countries. However Fosu discovered electoral competitiveness indices which showed U-shaped alliances with the growth of GDP. The impact of alliances reflects intermediate and advanced effect which is quite separate from Africa political reforms. Moreover Fosu gathered thirty samples in the African countries that political instability penalizes exports and is more of a danger to exports than the tempo of economic growth. Therefore political instability is the only internal components which elaborate frail economic growth develop in African countries. Still, for the economic growth the essential state is political stability.

Indeed, democracy and political stability support private initiative and permit the population in the formation of pressure groups. Due to this the activities of public authorities becomes possible to increase. Thus in majority of countries democratic changes have assist increase in the level of economic growth. Hence high levels of democratic capital upgrade political stability. So that the acquisition of democratic and physical capital become vigorous, as a result encouraging economic growth.

Edwards, Tabellini & Cukierman (1989) examined that instability in the fiscal policy creates low risk taker investors and a fright of inconsistency in the policies of government because of this the investors are hesitant to invest in foreign countries. This capital flight reduces local private investors and eventually reduces economic growth. Velasco & Tornell (1992) examined that uncertainty in the safety of investor property right due to violence, protests civilian uncertainty creates instability in the government system. Asteriou, Simon price & Dimitrious (2001) argued that GDP growth and political instability have inverse correlation with each other, viewing causal relationship found. They examined that this opposite impact origins development in two directions. Firstly, the instability in the political environment causes uncertainty and this uncertainty lowers the volume of local or private investors which ultimately declines the economic growth. Secondly unstable environment shuffles investment and factor demands.

The examination of Alisena et al (1996) showed that political instability is the main reason of government’s weakness. Political variations create instability in democracy, elections in quick succession, internal disputes within parties, and inconsistent governments directs towards decline in economic growth. This political unstable environment has different influences. It not only brings uncertain political and legal situation but also creates disturbance in the markets.

3. Research Methodology

In this paper time series data approach is used to measure the relationship of political instability and economic growth. Population consists of the data from 1996 to 2018 of Pakistan. To understand the characteristics of the data descriptive statistics is used such as mean, median, standard deviation, maximum and minimum. Multivariate analysis is used for the collected data checked with the help of unit root test for stationarity.

Measurement of Variables

S. No	Variable	Measurement	Suggested By
01	Political stability	Political Stability Index	Khan and Saqib (2010)
02	GDP	GDP for the current year	Aisen & Veiga (2013)
03	GDP Growth rate	Change per year in GDP	Asteriou and Price (2001)
04	Inflation	(Current year Price/Base year price)*100	Khan and Saqib (2010)
05	Interest rate	SBP interest rate	Khan and Saqib (2010)
06	Accountability and Voice	Accountability and Voice Index	Ahmad (2016)

Model Specifications

$$PS_t = \alpha + \beta_1 GDP_t + \beta_2 GDPGR_t + \beta_3 AV_t + \beta_4 Inf_t + \beta_5 Int_t + \mu$$

PS: Political stability

GDP: Gross Domestic Product

GDPGR: Gross Domestic Product growth rate

AV: Accountability Voice

Inf: Inflation rate

Int: Interest rate

4. Results and Discussion

The appended table cover the details results of descriptive statistics of the selected variables of the study. The sample composed of total 23 observations (In years) from 1996 to 2018. The average value of political instability the dependent variable of the study stood at (2.0048) over the time frame of 23 years. For the other independent variables e.g. interest rates, inflation rates, GDP, GDP growth and accountability voice the mean value remains 9.6861, 7.5578, 11.884, 6.4481 and (0.8473) respectively.

Not surprisingly, statistical investigation of the performance indicator of Pakistan shown the value of skweness for dependent variables political instability is 0.3229 and for other independent variables interest rate is 0.0893, inflation rate is 0.6668, for GDP 0.0755, for variable GDP growth rate stood at 0.4558 and accountability voice (0.3102). The values of the total selected variables are between the set ranges of ±2 by the researchers.

On the other hand, the standard deviation of the data resulted in 0.6190 for political instability, 4.1759 for interest rates, 3.9431 for inflation rate, 0.5078 for GDP, 6.8422 for GDP growth rate and 0.2044 for accountability voice. The mean, standard deviation and Skewness of the variable are in normal range revealing that no outliers has been in the values of the collected data

Table 1.1- Descriptive Statistics

Variable	Obs (years)	Mean	Median	Skewness	Std. Dev.
Political instability	23	-2.005	-2.270	0.323	0.619
Interest Rates	23	9.686	9.690	0.089	4.176
Inflation rate	23	7.558	7.809	0.667	3.943
GDP	23	11.884	11.934	0.076	0.508
GDP Growth rate	23	6.448	5.050	0.456	6.842
Accountability Voice	23	-0.847	-0.830	-0.310	0.204

Time Series Analysis

Time series analysis is the type of analysis used for the interpretation of time series data either single variable or multivariate. In the first stage the unit root test used for checking the data is stationary or not and then further ARDL test used for the relationship of the dependent variable with independent variables.

Unit Root Testing

The unit test is used to identify that whether the time series variable is stationary or possesses a unit root, overall data has been checked for stationary. For the purpose of unit root checking null hypothesis and alternative hypothesis provided:

H0: Unit root found data is non-stationary.

H1: No unit root found the data is stationary.

The appended table 1.2 provides the inference of unit root test for regular level checking augmented dickey fuller test. Interest rate with the P-value of 0.08, Inflation rate with the p-value of 0.001 and GDP growth with P-value 0.05 confirmed the assumption of stationarity. But on the other side, political instability with P-value of 0.44, GDP of P-value 0.92 and accountability voice of P-value 0.30 having the problem of non-stationarity. Hence for interest rate, inflation rate and GDP growth rate alternative hypothesis accepted and for political instability, GDP and accountability voice null hypothesis accepted. To convert the non-stationary time series variables into stationary time series 1st level difference has been utilized with the test augmented dickey fuller GLS test, in the result the political instability P-value found 0.003, GDP value 0.10 and accountability voice 0.000. The problem of stationarity resolved in the 1st order level having significant results of the non-stationarity variables.

Table 1.2 - Unit Root Test of Stationarity

Variables (P-Value)	Level of variable	1st order level of variable
Political Instability	0.44	0.003
Interest rate	0.08	-
Inflation rate	0.001	-
GDP	0.92	0.10
GDP growth	0.05	-
Accountability Voice	0.30	0.000

Regression Analysis (Co-integrating Regression)

After estimation of unit root analysis the next step is to run regression analysis to find out the relationship between independent variables and dependent variable of the study. Ordinary least square is not valid for non-stationary data that why auto regressive distributed lags model has been applied on the data.

Independent Variables	Dependent variable Political Instability	
	Coefficient	*p-value*
Interest Rates	0.000229	0.991
Inflation Rate	−0.053240	0.004**
GDP	−1.12930	0.000***
GDP Growth Rate	−0.002939	0.707
Accountability Voice	0.945391	0.011**

*,**,*** Significance at 10%, 5% and 1% level

Table 1.3 - ARDL Test of Co- integration

ARDL Model	
R-squared	0.897393
Akaike criterion	1.820820
Adjusted R-squared	0.867214
Schwarz criterion	8.633785

The detain table 1.3 provides information that coefficient of interest rates when regressed with political instability is 0.000229 with P-value of 0.991 which is insignificant and therefore, the relationship among the dependent variable political instability with interest rates is positive and but insignificant. If the value of interest rate increases or decreases it will not influence the political instability of Pakistan. The result also reveals that the interest rates setting and announcement by the government of Pakistan are according to the present circumstances in the country hence providing no impact on political instability.

Moreover, the relationship between inflation rate and political instability found negative with coefficient value of −0.053240 and significant with P-value of 0.004. This provides the explanation that increase in inflation rate in Pakistan can affect the political instability in the opposite way and vice versa. Arison and Jose (2005) examined that the political instability is associated with the higher level of inflation. Thus the increase in inflation rate will decrease the political instability, this results is not consistent with their approach and results.

GDP coefficient value is -1.12930 with P-value 0.000 confirms significance and proves negative association with political instability in respect of Pakistan. Increase in the value of GDP will decrease the political instability in Pakistan. The results are consistent with the study of Noor Ul Ann et al., (2017). According to their study the political instability have negative relationship with GDP. The GDP rate reduces with the political instability in the country. GDP growth rate have negative relationship with political instability with coefficient value -0.002939 but insignificant. Hence no impact of growth rate proved any association political instability.

Last variable accountability voice with coefficient value is 0.9453911 and P-value 0.011 confirms significance of accountability voice with political instability and positive association. Increase in the value of dependent variable will increase the value of independent variable and vice versa. In the study of Zubair (2014) the political stability indicator found no correlation with accountability and voice. The outcomes of the current study are inconsistent with their results. The adjusted R square value of the analysis stood at 0.867214 indicating the strong changes in the dependent variable by independent variables.

5. Conclusion

The researchers are now so alert and influenced to take a close look at political instability on economic development and gross domestic product growth rate one day due to the decline of the political system. The reverse alliance between political instability and economic advancement has been examined in various studies. Hibbs (1977) examined different political issues that are responsible for bad economic activities. Gupta (1987) subsequently analyzed socio-psychological variables that generate political uncertainty or instability.

The effect of psychological influences on economic trends has also been shown by Gupta. Demolishing unfavorable economic policies and fragile economic growth. Public individuals advocate and support certain policies that are beneficial to them. Asteriou, Simon Preis & Dimitrious (2001) argued that there is an inverse link between GDP growth and political uncertainty, showing casual relationships. This paper investigated that growth in two directions is caused by this opposite impact. Second, uncertainty is caused by volatility in the political climate, and this uncertainty decreases the number of local or private investors, which eventually causes economic growth to decline. Investment and factor criteria are secondly shuffled by an unpredictable climate. In addition, Jong-a-pin (2009) clarifies that political uncertainty and economic development and growth, such as GDP, have been adversely linked.

Several different studies have found out that economic development is adversely affected by dysfunctional political structures. Similarly, these studies illustrate the connections between economic crises and changes in regimes and changes in government. Government crises and regime transitions have a major impact on economic growth, and a link among political instability and economic growth found (Campos & Nugent, 2002; Pei & Adesnik, 2010; Gormuu & Kabaskal, 2010). Porta et al., (2007) found that the dysfunctional political system has a negative effect on the economy in general and therefore on development as well. In comparison, political uncertainty influences the rate of economic growth indirectly. The links between political uncertainty and economic growth are found in (Alesina et al., 1992).

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