The Impacts of Political Stability on Economic Growth: Evidence from Panel data Analysis

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ABSTRACT

This thesis empirically investigates the relationship between political stability and economic growth as well as regulating with regards to consequences concerning labor and physical capital factors in panel data valuation. A model panel data was used encompassing the time between 1994 – 2012 via running a growth model for the selected nations (Ukraine, Romania, Indonesia, Thailand, Ecuador, Brazil). The thesis mainly aims at ascertaining that the political stability and other comparatively vital factors enhance the procedure of economic growth in the light of exogenous modelling structure via utilizing Panel unit root and panel cointegration methods. Estimated outcomes imply that economic growth in the selected nations are in long-term equilibrium relationship; political stability has long-term significant influence on economic growth and consequently, economic growth converge to their long-term equilibrium levels by the means created by Capital. However, the selected countries which are listed as lowest scores in terms of the political stability have long term and short term economic growth effect whereas labor has no impact on economic growth for the selected countries. This supports the reality that political certainty or stability in listed countries as lowest scores in terms of the political stability is capable of stimulate a country's development process. Outcomes of this survey reveal that there exist a relationship between the political stability of a nation and the economic growth.

Keywords: Economic growth, political stability, capital, labor growth.

ÖZ

İş bu teze göre siyasi istikrar ve ekonomik büyümenin arasındaki ilişki sermaye ve emek işçileri değişkenlerini kullanılarak ölçülür. Bu veriler 1994 ile 2012 yılları arasındaki seçilen ülkelerin verilerine göre belirlenmiştir. Bu tezin ana amacı büyüme modeli çerçevesinde panel kök birim ve panel eş bütünleme teknikleri kullanılarak siyasi istikrarın ekonomik büyüme üzerindeki etkileri analiz edilmiştir. Deneysel olarak seçilen ülkelerde Ukrayna, Romanya, Endonezya, Tayland, Ekvator ve Brezilya dır. Bu uzun süreçte siyasi istikrarın ekonomik büyümeyi etkilediği gözlemlenmiştir. Bu çalışma kapsamı içerisindeki ülkelerde yerel sermaye ekonomik büyüme üzerinde uzun ve kısa dönemli etkileri görülmesine ragmen, ile emek piyasasının hiçbir dönemde etkileri bulunamamıştır. Bu bulgular seçilmiş ülkelerde siyasi kararlılığın ekonomik büyüme üzerinde çok önemli olduğunu gösteriyor. Dolayısıyla, uzmanlar sermaye ve emek politikalarının siyasi kararlılıkta verimliliği ve ekonomik gelişimi artırabilmesi bağlamında daha iyi uygulaması gerekir.

Anahtar Kelimeler: Ekonomik büyüme, siyasi istikrar, emek, sermaye, birim kök, eşbütünleme.

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Chapter 1

INTRODUCTION

The relation between political stability and economic growth has been one of major topics of researchers interested in the study of political economy. A lot of literature exists about this but each researcher discussed the issue from a very different perspective. Many of them found out mutual effects of these factors, for example: Gupta (1990), Barro (1991), Alesina et al. (1996), Perotti (1996) and Ades and Chua (1997). Benhabib and Rustichini (1996), Blomberg (1996), Devereux and Wen (1998), Svensson (1998), Ghate et al. (2003) and Darby et al. (2004) examined the same topic and trying to find connection between economic growth and political instability. What makes this studies different is definition of variables. The defining elements of economic growth and political instability have not necessarily been identical in all researches done on the subject. The current thesis studies this relation empirically, using an 18 years panel data on 6 carefully selected cases (countries).

1.2 Aim of the Study

This study examines the relationship between economic growth and political stability. Aim of study is to find out if political stability has influence on economic development of the country and if political circumstances could affect growth of its economy or not. As a matter of fact, not only political stability but several other factors have the ability to influence on the economic growth. One of important ones is capital accumulated via foreign direct investment (FDI) that can cause economic growth. On the other hand uncertainty in the political environment is capable to slow

down country's development process what contributes to unsuccessful of the country.

1.3 Methodology and Data

The data used in this thesis is panel data based for the countries Ukraine, Romania, Indonesia, Thailand, Ecuador and Brazil for the period of 18 years - from 1994 to 2012 annually. According to the empirical model in this thesis we considered 4 following variables: Gross capital formation (GFC), labor participation rate (L), Real GDP (RGDP) and political stability (PS).

Panel co-integration method based on Pedroni approach was used to check whether there is a long run relationship between the variables. First the stationary issue for all variables was considered and then the Pedroni approach made. After that by using vector error correction model short run effect of political stability on economic growth was examined.

1.4 Findings of the Thesis

Estimated results suggest that economic growth in the selected countries is in long-term equilibrium relationship; political stability has long-term significant effect on economic growth and consequently economic growth converge to their long-term equilibrium levels through the channels of capital. Politically less stable selected countries have long term and short term economic growth effect whereas labor has no impact on economic growth of them.

1.5 Structure of the Study

The framework of the work is following: in the first chapter introduction and short discussion of the research is made, the second chapter examines the literature review about the topic of the research and third chapter gives the summary of the economic and politic situation of 6 selected countries. Chapter four presents data, methodology

and empirical model and in chapter 5 we can find discussion of the results. Last chapter - chapter 6 – discusses managerial implications as well as gives some recommendations for future studies and limitations of this research. At the end short conclusion is made.

Chapter 2

LITERATURE REVIEW

2.1 Introduction

Political stability and economic growth are closely correlated. Reduction in external investment and slowing down the economic progress could be result of unstable political environment. On the other hand weak economic functioning may result in the collapse of government and political conflicts. In this chapter will be described both, political instability and economic effects associated with it, based on existing literature. Moreover several previous studies related to the topic of the research and two criteria mentioned above will be explained.

2.2 Political instability

To define the political instability as the main concept of this study we will use the definition of Alesina et al. (1996) who described political instability as "the propensity of a change in the executive, either by constitutional or unconstitutional means". Higher is the political instability, higher is the probability of change of the government in a particular period of time.

Economists describe political instability as sum up of fluctuations and mutability in political situation which are damaging the economical functioning of the society (Aisen and Veiga, 2010). Absence of political stability could lead to undesirable decision making environment for policy makers and officials, what would result in short-term reactions and decisions instead of desirable long-term planning. As Aisen

and Veiga (2010) explain political uncertainty shortens ability of reliable forecasting, leading to sub-optimal short-term economic policy making.

Significant regional differences of this phenomena could be observed from the "Political instability index" measured by Cabinet Changes. It measures the number of times that premier is changed in one year and/or more than 50% of the cabinet members are replaced with the new staff.

2.3 Growth theory in new political economy

A strong new political economy growth theory movement started in the first half of the 1990s. Studies conducted in that period were trying to measure the importance of political stability on economic development. It became very popular topic among studies of mainstream economists of that period. Separation of Soviet Union followed by social and economic renovation of Eastern European countries were the main geopolitical changes motivating researchers to become more and more interested in these topics.

Researchers found out very quickly the the topic has a very fundamental logical bottleneck caused by many things. This conflict can be easily observed in the study made by Przeworski and Limongi (1993) where they have pointed out 21 different empirical studies examining correlation between different types of political regimes and their economic progression. Their results were following:

- Eight out of twenty one studies were in favor of democratic institutions as the most suitable political environment for economic growth.
- Eight studies emphasized the contributions of autocracies on economic growth.

- The remaining five studies did not find any major differences between different types of political regimes and their influence on economic growth.

The discussion about type of political power and it's connection to economic development has been studied and argued frequently since 1990s. Many different studies were held and consequently many different theories were demonstrated, rejected and approved. In this study we will focus on political instability of the government therefore the only relevant issue for us is which of the different types of government is more stable or more fragile.

Concerning the issue of political stability and its connection to new political economy and economic development, first studies were done in late 1980s such as one of Venieris and Gupta (1986). In 1990s main wave of the studies and researches about this subject were carried out. Among them the research done by Alesina et al. (1996) is very significant. They have chosen a big sample – 113 countries and long period – 32 years (1950 to 1982). Their conclusion was that high political instability slows down economic development. More details about this study will be presented in the following sections of this chapter. In another study Barro and Lee (1994) used similar approach on the sample of 116 countries in the same time period than Alesina et al. (1996) and they have concluded completely the same - the causal relation between political instability and uncertainty and slow economic growth. Even in recent studies Aisen and Veiga (2010) and Qureshi et al. (2010) found out the negative correlation between political instability and economic improvement. Aisen and Veiga (2010) used a cross-section sample from 169 countries and Qureshi et al. (2010) have chosen Pakistan as the subject of their research.

To evaluate the correlation between political instability and economic growth and measure its effects we should use a proper method of measurement. The one more difficult to measure is political instability (or stability) which has a lot of variables, and considering all of them together with all the factors effecting them is very difficult. Jong-A-Pin (2009) suggested a method of measurement for political instability and its effects on economic growth. He used factor analysis by dividing the political instability into four dimensions:

- Aggression motivated by political issues.
- Civil protests.
- Internal volatility and instability within the regime`s structure.
- Political instability of governing regime.

In this study Jong-A-Pin (2009) focuses on the representatives of unstable governments and examines their reliability whereas political cabinet is changing or not, looking for a more general index to represent the political instability.

Many other studies based their approaches on the similar multidimensional structure like Jong-A-Pin (2009) considering just one dimension and investigating its impacts on the subject. This type of methodology and terminology can be seen in the studies of Fosu (1992), Gyimah-Brempong and Dapaah (1996), Aisen and Veiga (2010) and Kouba and Grochová (2011). All of these four studies conventionally have concluded the same correlation between political uncertainty and non-progressive economics.

2.4 Does political instability effect economic growth?

Numerous samples chosen in these studies and their similar outcomes can confirm this correlation. There are also articles where there was found non-causal relationship

between our measurement concepts suggesting that there might be other factors affecting political stability and economic development and that they are not necessarily influencing each other. Even though these papers represent arguable and worthy discussions, they cannot completely reject the hypothesis that relation between these two factors logically and statistically exists.

Destructive effects of political instability's on economy of the country can be even more surprising when observed from global perspective. That's why is broadly stated that political instability is disadvantageous for economic growth performance of countries (Jong-A-Pin, 2009). Political scientists worldwide have been investigating the relation between political stability (or instability) and economic growth (or decline) by trying to find out different ways and means to measure this relation. It should be mentioned that this relation is a two-way relation - change any side of this relation directly influences the other side. Therefore economists became interested in the phenomena of political and policy instability and its destructive effects on economic situation of the country. There is significant amount of researches made on the topic examining negative effects of this phenomena by evaluating variables like inflation, private investment and growth of GDP.

Several studies found out the adverse two-way relationship among political instability and economic growth, for example: Gupta (1990), Barro (1991), Alesina et al. (1996), Perotti (1996) and Ades and Chua (1997). Based on these fundamental studies other researchers such as Benhabib and Rustichini (1996), Blomberg (1996), Devereux and Wen (1998), Svensson (1998), Ghate et al. (2003), and Darby et al. (2004) have (re)examined and completed previous studies by presenting a theoretical relation between political instability and economic growth.

Measuring many of the concepts is very challenging and may become statistically unreliable. Studies analyzing the correlation between political uncertainty and economic changes have become subject of critics because of that. One of the most significant critics made about this framework is the study of De Haan (2007), who argues that there are unavoidable errors existing in the measurement of most of the variables exploited in the empirical analyses on economic growth, including political instability. This can seriously question the reliability of previous studies and researches. Besides measurement errors there have been other critics about the fact that a negative correlation between this two variables would not necessarily point towards a causal relationship. This was pointed out in the study of Campos and Nugent (2002) where authors provide statistical evidences and proofs for their statements.

There have been attempts to find different solutions for this measurement problem. Usually analysis of correlation between political instability and growth in economics have been conducted by three different methods:

- Through principal component analysis (PCA), resulting in one dimensional indexes (Perotti, 1996).
- Using the discriminant analysis (Gupta, 1990).
- By using the logic analysis (Alesina et al., 1996, Alesina and Perotti, 1996).

On the other hand there is number of studies suggesting that the political instability is not one dimensional therefore should be observed and analyzed in multidimensional manner (Feierabend and Feierabend 1966; Tanter 1966; Morrison and Stevenson 1971; Hibbs 1973). The problem arising would be finding the right number of dimensions appropriate for analysis therefore we could get either inaccurate result

because of the measurement errors or at least few aspects or dimensions of uncertain political situation (Jong-A-Pin, 2009).

Generally the argument in academic literature about this relation is that uncertain political situation of the country including uncertain future decisions of the government about economy, investment policies, supplying labor and overall production has negative impact on economic growth (Rodrik, 1991). Investors already invested in the country may exit this kind of uncertain market. Meanwhile foreign investors wanting to invest and initiate businesses are looking for safe and stable political situation in the country would also avoid countries with high possibility of government change and collapse of political system (Goodrich, 1992). This relationship may be examined from many different perspectives and further surveys on this topic should be done.

2.5 Different approaches used to model the relation in academic literature

The fact that a government with uncertain future can intentionally accept bad suboptimal economic and non-economic decisions to worsen the situation for the next government, have been pointed out in studies conducted by Alesina and Tabellini (1988), Alesina and Tabellini (1990), Edwards and Tabellini (1991) as well as Ozler and Tabellini (1991). All of these studies agree about the idea that political instability leads to undesirable economic situation of the country. Among them the most direct approach has been carried out by Alesina and Tabellini (1988) studied political instability by measuring its effects on the flow of capital and investment. Results showed that changes in tax policies and productive activities of government rise the possibility of government collapse. When industrious internal

investment is replaced with capital flow and consumption domestic production is deducted.

Grossman (1991) argues that when the government is weak political system can easily collapse. The probability of a revolution is much higher because the population has more interest to participate in revolutionary activities instead of concentrating on productivity and financial growth of the country. On the other hand Grossman (1991) adds that a stronger political power can diminish tendencies to a revolution what will allow the society to concentrate more on evolving the market and economic growth. This simple but very rational argument proves the existing and unavoidable relation between strong and stable political system and economy, mostly through non-economic analogy and social behavior analysis.

Another effect surveyed about correlation between economic progress and political instability is the increased probability of rent-seeking policies in the government. This effect has been studied by Murphy et al. (1990) who suggest that weak government with more risk of being changed is more likely to be involved in policies where lobbyists or/and other pressure groups gain more benefit since the government may need to please them to survive financially. This rent-seeking policy is harmful for society including taxpayers and ordinary consumers.

Two common points can be found in all mentioned approaches:

1. When the current government is weak and incompetent there is a higher chance that investors and other economical decision makers understand change of government as a positive reform and improvement of situation, viewing this change as an investment opportunity. In most of the studies was found out that

the possibility the new government will be more competent than the current collapsing one is very low.

2. Another critics is that when political instability is very high, it could decrease the uncertainty by itself since power transition becomes very obvious and predictable. Problem becomes that unreliable and incompetent political situation leads to even more unknown new one with new government. Uncertainty remains as well as political instability`s adverse effects on economy.

Apart from these two critics there is another important issue to be addressed when the effects of political instability on economic growth is being analyzed - the problem of joint endogeneity. This problem arises when there is a connection between the main variable and error term in the model. This means that statistically measured variables could have two way correlation and logical conclusions might become unreliable. Concerning the political instability effects on economic growth the endogeneity problem is that, even if the political instability is causing low economic growth, it cannot be denied that low economic growth may have impact on increased probability of government change (Londregan and Poole, 1992).

For instance, in democratic governments growth rates during the last pre-election years are very essential for survival of the current government, since the citizens are more interested in keeping the competent government. On the other hand if during those last pre-election years the government fail to manage the economy of the country properly the possibility of being replaced by a new government increases. Voters usually are very concerned about their income rates what has strong impact on their decision who to vote what directly affects the probability of survival of the

current government. Also success of dictator in dictatorship regimes and possibility for his change is directly correlated with the economic efficiency of the regime. Bad economic environment can easily affect the political regime`s stability in both democratic and no-democratic political regimes. This reverse effect has been studied by Londregan and Poole (1990).

Alesina and Perotti (1996) examined effect of democratic governments on the economy of a country. There are some political and social scientists who believe that democratic institutions are harmful for the economic growth. As cited in Alesina and Perotti (1996) these researchers believe that democratic governments are usually forced to (re)act in the interest of a few particular groups in order to get re-elected and consequently performing not optimal for the country.

The concept of future uncertainty of the regime is the main cause behind the bad decision making and economic inefficiency of the politic leaders of the country, in this particular case initiated because of characteristics of democratic governmental systems. Alesina and Perotti (1996) rejects this problem saying that non-authoritarian constitutions are not necessarily decisive and dictatorship regimes also may act irrational in case their survival is in danger. We can conclude again that both democratic and authoritarian institutions have a relatively similar relation with the economic progression of their countries. Alesina and Rodrik (1991) also rejected this theory and based on their evidence concluded that democratic governments progress in economy faster than kelptocratic (populists) type of authoritarian regimes and technocratic type of dictatorships grow economically faster than democracies.

Fosu (1992), Gyimah-Brempong and Dapaah (1996) and Kouba and Grochová (2011) also used the single equation model considering political instability as one dimensional variable and that political instability negatively affects the economic progress of countries. Main difference between older articles and Kouba and Grochová (2011) research is that both Fosu (1992) and Gyimah et al. (1996) work with a sample of African countries where mostly non-elite political uncertainty is. Gyimah et al. (1996) argue that researches measuring political instability as elite or executive change are not reliable. Meanwhile Kouba and Grochová (2011) focus on elite political instability which can be seen also in European countries.

Research done by Alesina et al. (1996) is very significant since in this study 113 countries in the time between 1950 and 1982 were examined to illustrate that in countries with political instability and uncertainty GDP growth is expressively lower and government collapse occurrence is significantly more probable than in politically stable countries. This study also argues that this type of effect works for two different types of change of government:

- Government turnovers without any fundamental ideological changes within the structure of the governmental policies.
- Sudden irregular government transformation where power is exchanged between different ideologies.

Alesina et al. (1996) provided three noticeable findings about the relation between economic growth and probability of government collapse:

1. Contemporary increased tendency of government change is not necessarily the result of simultaneous inferior economic growth.

2. There is no evidence suggesting that authoritarian regimes are different from democracies concerning economic growth.
3. Persistence of political instability, meaning that frequent governmental change would increase the probability of government change continuously, would generate continuous governmental changes in the future.

Alesina and Perotti (1996) demonstrated that uncertainty in socio-political environment of the society produce uncertainty in politico-economic segments by deducting private investment and increasing risks. Later on Jong-A-Pin (2009) showed that higher instability in political environment leads to lower economic growth. In research of 10) the effects of political instability on inflation were investigated. The functions explaining and evaluating the inflation used in this study are very similar to the ones influencing the economic growth. Among effects causing inflation as the result of political instability the most significant one is the shortening of the government mandate what causes inevitable performance drop in economic planning.

Aisen and Veiga (2010) examined in their recent study correlation between GDP growth and political uncertainty. They investigated negative relationship between political instability and economic growth by focusing on the question "What are the main transmission channels from political instability to economic growth?" They examined the importance of political instability effects on the main factors of economic progress such as human and physical capital accumulation and total factor productivity conducting panel date regression using systematic General Method of Moments estimator (System-GMM) on an accumulated set of data of 169 countries

from 1960 to 2004. They defined the variables as economic growth measurement aspects:

- initial GDP per capita,
- investment (% GDP),
- number of enrolments in private schools,
- population growth,
- freedom in trades,
- cabinet changes,
- inflation rate,
- government (% GDP).

These variables are very popular in the studies done about this subject. Aisen and Veiga (2010) worked with both - simple proxy, the cabinet changes governing the elite political instability and indexes of general political unsteadiness. Similar and in line with the previously conducted studies, Aisen and Veiga (2010) concluded that political instability significantly lowers the growth of GDP. In the study they noted that adverse properties of political instability on total factor productivity growth are the main reason of this reduction which is responsible for more than half of the effects on GDP growth (Aisen and Veiga, 2010). Concerning the physical and human capital Aisen and Veiga (2010) found out that capital as a way in which political instability effects growth is less essential than it was previously thought. These results suggest that governments should take political instability very seriously and sustain it fundamentally in order to stabilize and maintain economic growth.

Apart from political instability several authors argued that basically a weak institution can have a great impact on economic growth, financial crisis and

volatility. On this subject Acemoglu et al. (2003) gathered a noticeable amount of evidence from a large cross-section of countries to illustrate that feeble microeconomic enactment is explainable through weaknesses of institution. Their explanation is based on the fact that weaknesses such as lack of sufficient quantity of contract attraction, caused by lack of appropriate financial mechanisms, lead to inefficient economic policy. Cukierman et al. (1989) and later on Aisen and Veiga (2010) both suggest that weak governments cannot optimize their tax system therefore have to use seignior age more often to replace their losses as a source of income since that affects the economic growth and produce inflation.

Chapter 3

THE SELECTED COUNTRIES ECONOMIES IN RETROSPECTIVE

3.1 Introduction

In this chapter there is important information about the economic and political background of the six countries analyzed in this study. To illustrate their economic position and growth history the chapter introduces their political structure and functions. In the next short sections of this chapter first brief economic background and few statistics will be explained. In the second section there is brief and general information about the political history of the examined countries and their current situation. The brief background information about the countries is important and provides basis for the further analysis and discussions.

3.2 Brief Economic History of Chosen Countries

3.2.1 Ukraine

Ukraine does have an emerging free market in its economy and its gross domestic product (GDP) decreased after they became independent from Soviet Union. From 2000 to 2008 they managed to grow their economy significantly. Country experienced a deep economic recession in 1990 after being one of the main parts of the Soviet Union`s economy. Ukraine`s economy faced a deep recession throughout 1990s, such as very high inflation and a severe deduction in economy. At the lowest point of their economic crisis in 1999, country's GDP per capita was even less than half of the GDP per capita Ukraine had before it became independent from the Soviet

Union. The first GDP growth was noticed in year 2000 and it continued till 2008. In 2007 growth of real GDP was 7% what indicates quite intense economic growth. Ukraine's rank based on the nominal GDP among countries all around the world in 2008 was nr. 45 with the total nominal GDP of 188 billion USD and nominal GDP per capita 3,900 USD.

The estimation of the Ukrainian politicians is that 40% of Ukraine`s economy is actually a shadow economy. Since official GDP data and the average salary data have some faults cannot be used directly in order to understand the true situation of Ukraine's economy (Rogers and Sedghi, 2011).

3.2.2 Romania

Romania has an emerging market with higher income than average economic status. Based on total nominal GDP they have the 17th largest economy in the European Union. Based on purchasing power parity (PPP) they are on 13th place in Europe. Collapse of the communism in 1989, bunch of reforms taken place in the period between 2000 and 2010 accession to the European Union in 2007 improved significantly their economic position.

Romania grew economically through foreign investment. Accumulative FDI was more than $170 billion since 1989. In last years of 2000s and during the last financial chrisis their economy has been considered as a "Tiger" because of its extraordinary high growth rates and rapid economic expansion.

Until 2009 economy of Romania grew as rapid as the economies of the quickest growing countries in Europe (official economic growth was 8.4% in 2008 what more than the EU average was three times in that year). Romania is the leader in its region in several fields such as information technology and motor vehicle manufacturing.

Also its capital city Bucharest is among the largest financial and industrial centers in Eastern Europe (Rogers and Sedghi, 2011).

3.2.3 Indonesia

The largest economy of Southeast Asia has Indonesia and it is one of the developing market economies in the world. The country is one of the newly industrialized countries and it is among the members of the G-20 major economies. Indonesian government plays a significant role in Indonesia`s market economy through the ownership of the enterprises and controlling of the prices of basic goods such as fuel, rice and electricity. Their government took over a major percentage of private sector companies through procurement of profitless bank loans and corporate assets through the debt rearrangement procedure. This happened as the result of the financial and economic crisis in 1997. Since 1999 the Indonesian economy has recuperated and its economic growth has been between 4 % and 6 % in last years.

Indonesia recaptured its speculation investment rating from Fitch Rating at the end of 2011 and from Moody's Rating in 2012 after losing its venture evaluation rating in December 1997. Indonesia used more than Rp 450 trillion ($50 billion) to bail out moneylenders from banks. Indonesia's long-term and neighborhood cash obligation rating raised to BBB- from Bb+ by Fitch with both steady evaluations. Moody's raised Indonesia's remote and nearby cash bond appraisals to Baa3 from Ba1 with a stable standpoint. Indonesia overtook India and became second fastest growing economy of G-20 in 2012 just after China (Bisara and Unditu, 2012).

3.2.4 Thailand

Thailand is a recently mechanized country. The economy of Thailand is intensely export-reliant, since export represents more than 65 percent of its gross domestic product (GDP). The Office of the National Economic and Social Development Board

announced that the country had a GDP of USD366 billion in 2012. Their economic growth was in 2012 more than 6.5 percent, price rise rate was 3.02 percent and a record surplus 0.7 percent of the country's GDP. The Thai economy was predicted to raise between 3.8 and 4.3 percent in 2013. in the first half of 2013 (Q1-Q2/2013) the Thai economic growth was 4.1 percent after balanced since the Thai GDP shrunk 1.7 percent in the first three months of 2013. GDP decreased again for 0.3 percent in second three months of the same year. Assumed a constriction in two back to back quarters the Thai economy is currently in recession.

The key areas consisting Thai gross domestic product (GDP) are industry and with the 39.2 percent of GDP, agriculture with 8.4 percent of the GDP, what is less than logistic and trade sector with 13.4 percent of GDP and communication contributing 9.8 percent to country's GDP. Other 4.3 percent of gross domestic product of Thailand consists of mining and construction sector. Financial sector, education, tourism and other service sectors are responsible for 24.9 percent of the Thailand's GDP. As industrial hubs expand and the economic competitiveness rises, telecommunications and trade of services is developing and will be one of the most important sectors in the future.

In Southeast Asia Thailand has the second largest economy after Indonesia. Considering its GDP per capita Thailand`s rank was close to average similar to those of Singapore, Brunei and Malaysia. The international reserve of Thailand on 19 July 2013 was 171.2 billion USD according to the Bank of Thailand, the second largest in Southeast Asia after Singapore. Thailand`s external trade is as well the second largest in Southeast Asia just after Singapore's (Lee, 2013).

3.2.5 Ecuador

Iafter Sixto Durán Ballén became the president of Ecuador for the third time in 1992. Although his intense macroeconomic activities were disliked he succeeded to implement a number of modernization reforms. The next president elected in 1996 was Abdalá Bucaram. He made couple of populist financial and social changes disliked by congress of Ecuador which proclaimed him as mentally ill in February 1997. Bad economic situation in 1997-98 ended up with financial crisis in 1999. This financial crisis had numerous consequences, such as the El Niño in 1997, a harsh descent in worldwide oil charges in 1997-98 and instability of international developing markets in 1997-98. All this influenced on the Ecuador resulted in 7.3% reduction of GDP, yearly inflation of 52.2% and a 65% weakening of the Ecuador's currency in 1999.

President Jamil Mahuad announced the U.S. dollar as the official currency of Ecuador on 9 January 2000 in order to improve position of the country. This provoked protests and resulted in the 2000 coup d'état in Ecuador, replacing Mahuad with Gustavo Noboa on the position of the president of the country. Noboa's government continued negotiations about the dollar as the nation`s official currency as an solution for country's awful economic situation and finally they managed to do it in 2001. In March 2003 after the adoption of one-year stand-by system imposed by International Monetary Fund (IMF) in December 2001, Ecuador received $205 million help from the IMF.

Gaining power due to the higher prices of oil in the period 2000-2001 the Ecuadorian economy recuperated with 2.3% increase of GDP in 2000 and 5.4% in 2001. GDP

dropped for 3.3% in 2002. Swelling decreased from a yearly rate of 96.1% in 2000 to a yearly rate of 22.4% in 2001 (Gill, 2012).

3.2.6 Brazil

The Brazilian economic history is full of economic changes. In the 16th century Portugal colonized the area and after forced colonies to merge and pact with Brazil. These grand mercantile strategies influenced on economic growth of Brazil for the subsequent three centuries. They became independent in 1822 and eliminated slavery in 1888. In 1930 they initiated several significant fundamental structural transformations to modernize Brazil and transform it into an industrialized country.

After the World War II a socioeconomic revolution occurred. In the 1940s there was approximately 41.2 million inhabitants living in towns and cities what represented only 31.3% of Brazil's population. In 1991 146.9 million of inhabitants lived in cities what represented 75.5% of the population. São Paulo and Rio de Janeiro are two of Brazil`s largest cities and at the same time two of the world's largest metropolitan centers. From 1947 to 1992 GDP of the country dropped from 28% in to 11%. During the same nearly fifty year period the GDP of industry of Brazil raised from below than 20% to 39%. The industry and production consist of a big range of goods for the local market and export like commodities, intermediary products and capital assets.

In the 1980s and 1990s the Brazilian economy experienced huge expansion what stifled financial development. After a few fizzled financial activities made by the legislature in 1994 the Plano Real was presented. This arrangement empowered Brazil to manage monetary development over that of the worldwide economy through the next decade. In spite of this fast improvement Brazil still experiences

high amounts of corruption, significant ignorance of national and local government and poverty (Elliott, 2011).

3.3 Brief Political Background of Chosen Countries

3.3.1 Ukraine

Governmental system of Ukraine is law based republic with multi-party framework and presidential delegate. Executive power has parliament and official power cabinet. Researchers defined Ukraine's political framework as feeble, cracked, profoundly individual and ideologically vacuous while the legal and media neglect to consider legislators responsible. Ukrainian governmental structure has been arranged as over-incorporated what a result of the soviet activities is and brought on because of separation from Soviet Union.

Soon after separation in 1991 Ukraine established a parliamentary commission to set up another constitution and received a multi-party framework and set common and political rights for national minorities. On 28 June 1996 a new constitution was accepted establishing multi-ethnic political framework and protecting basic human rights apart from presidential manifestation of government.

In December 2004 the constitution was changed to prevent cases like presidential election crisis in 2004. The political system of Ukraine was converted a semi-presidential in which the president of Ukraine needs to accept decisions together with a prime minister and government got more power. In the middle of January and May 2006 the constitutional amendments were made (Bader, 2010).

3.3.2 Romania

Romania is democratic republic with incomplete presidential political system. The head of government is prime minister of Romania and the president of Romania represents the head of state. The country has a multi-party legislature framework. Administrative force is divided between legislature and the two assemblies of parliament - the Chamber of Deputies and the Senate. Legislature is independent and lawmaking body of the country. Romania's constitution which was accepted in 1991 and corrected in 2003 declares Romania as social democratic republic with the rule of majority determining its power from the individuals. Country values and respects human nobility, human rights and equal opportunities for everyone, human identity, equity and political pluralism are essential qualities country respects (Nohlen and Stöver, 2010).

3.3.3 Indonesia

Indonesia is republic with presidential political a system with parliamentary characteristics. Head of state and head of government is the president who is also the same time head of a multi-party framework. Official power has legislature and authoritative power is divided among both the legislature and two of the representative councils. Legislation is independent governing body. The constitution from 1945 defined division of official, administrative and legal power in the country. After the Indonesian mobs in May 1998 and the resignation of president Suharto a few political changes was made and Constitution of Indonesia was changed what brought progressions to all limbs of the government (Pasandaran, 2009).

3.3.4 Thailand

Before 22 May 2014 the political structure of Thailand was governmental where the prime minister was the head of government and a hereditary monarch (king) was the head of the state. The legal sectors and judiciary were separated and independent from the official and the administrative members of the country.

Since the rebellion (coup d état) of 22 May 2014, the 2007`s Constitution was changed and political power of Thailand got military association called National Council for Peace and Order (NCPO) which took control over the national parliament. The Chief of the NCPO took the power from national assembly and gave all responsibilities to the authoritative bodies of Thailand. Martial law was implemented and according to the new rule the military courts took over a few cases that are usually under the control of regular civil courts. The court structure including the constitutional court still stayed the same (Chomchuen, 2014).

3.3.5 Ecuador

Ecuador is democratic republic with presidential political system. The president of Ecuador is both - head of state and head of government in a system of multi-party framework. Authoritative power is divided among the legislature and the national assembly. While administration has no real power. Judiciary is independent and separated from other government bodies. The constitution of Ecuador provides mandate of four years for the president, vice president and members of the national assembly. Presidents and lawmakers may be re-elected instantly. Citizens must be no less than 16 years old to vote. Suffrage is general and mandatory for educated persons aged 18–65 and discretionary for 16 and 17 years old citizens (Andrade, 2001).

3.3.6 Brazil

Brazil is democratic republic with presidential political system. The main position in the state as the head of government and also the head of a multi-party system is the president. The political and executive power in the country is in the hands of centralized government, the states, the centralized regions and the metropolises.

Activities of the central government regulates the focal government and are divided into three free parts: administrative, legal and executive. The president has the executive power. Administrative power is divided among the National Congress and two-chamber council including the Federal Senate and the Chamber of Deputies. Legal power have the magistrates.

Federative Republic of Brazil is composed of the states which are self-sufficient nationally managed elements controlled by one common administrative body. The country is separated politically and authoritatively into 27 government units - 26 states and one elected area. The official power of a state has governor chosen for a period of four years. The legal power have courts of first and second range. Each of these States has their unicameral assembly with agents authorized to vote as well about the state laws. Brazil`s Constitution contains two components of immediate vote based system. The executive power of the states and districts have their authoritative bodies (Barros, 2010).

Chapter 4

DATA, MODEL AND METHODOLOGY

4.1 Data

The data set used in this thesis is panel data based for six countries: Ukraine, Romania, Indonesia, Thailand, Ecuador and Brazil for the period of 18 years: between 1994 and 2012 annually. According to our empirical model, we consider four following variables: Gross capital formation (GFC), labor participation rate (L), Real GDP (RGDP) and political stability (PS) which is measured on the basis of government framework, political violence, conflict, terrorism and popularity of the government.

4.2 Methodology

4.2.1 Panel Unit Root Test

To investigate whether the variables are stationary or not we have to conduct panel unit root tests. There are some approaches that analyse unit roots such as PP - Fisher Chi-square, Im, Pesaran and Shin ,W-stat, Levin, Lin & Chu Breitung t-stat and ADF - Fisher Chi-square for the benefit of variables.

4.2.2 Panel Co-integration Test

To examine the long run relationship amongs the variables it is necessary to conduct panel co-intgeration test. In this place many approaches exist like Pedroni (Engle-Granger based), Kao (Engel-Granger based), Fisher (Johansen combined). I have used pedoroni approach with three different scenarios: with trend and intercept,

without trend and intercept, with intercept without trend to examine the existance of long run relationship between the variables.

4.2.3 Vector Error Correction Model Test

After having found out a long run relationship using panel co-integration test will be applied vector error correction model test to examine short run relationship between the variables. This model test will show how fast such this disequilibrium would be corrected after a year by using the applied equation.

4.3 Empirical Model

According to Abeyasinghe (2004) and Fethi (2007) in this survey I have used the model below to examine the effect of political stability on economic growth in this survey for both short run and long run periods. The model is following:

$$LRGDP_t = \beta_{0+}\beta_1\ LGFC_t\ + \beta_2\, LLA_t + \beta_3\, LPS_t$$

$$\Delta LR\mathrm{GDP}_t = \beta_0 + ECT(-1) + \beta_1 \Delta \mathrm{LGFC}_t + \beta_2 \Delta \mathrm{LLA}_t + \beta_3 \Delta \mathrm{LPS}_t + \mathrm{u}_t$$

Where,

RGDP is real **GDP, GFC** is gross fixed capital formation as a proxy variable for capital, **LA** is labour participation rate and **PS** is political stability. Δ and L are defined as differences and logarithms respectively and ECT is the error correction term.

Chapter 5

EMPIRICAL ANALYSIS

5.1 Analyses of Unit Root Tests

First I examined whether the variables are stationary or not. I conducted the panel unit root test according to PP - Fisher Chi-square, Im, Pesaran and Shin W-stat, Levin, Lin & Chu Breitung t-stat and ADF - Fisher Chi-square approaches for level the results shown in tables below. According to the panel data of selected countries from different continents Breingtung LLC, IPS, ADF- M W, and PP tests were implied to reject null hypothesis in intercept and without trend model. Real GDP per number of workers, real GDP, GFC (gross fixed capital formation), LA (labour participation rate) and PS (political stability) became non-stationary. Unit root test results in level are shown in tables 5.1, 5.2, 5.3, 5.4. Unit root test shows different forms revealed in tables 5.5, 5.6, 5.7 and 5.8.

Table 5.1: LNRGDP

Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	3.38745	0.9996	6	108
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	5.41900	1.0000	6	108
ADF - Fisher Chi-square	0.36962	1.0000	6	108
PP - Fisher Chi-square	0.46841	1.0000	6	108

Table 5.2: D(LNRGDP)

Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	-7.22394	0.0000	6	99
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	-5.50573	0.0000	6	99
ADF - Fisher Chi-square	49.9260	0.0000	6	99
PP - Fisher Chi-square	41.6011	0.0000	6	102

Table 5.3: LNGCF

Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	2.16264	0.9847	6	107
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	2.84570	0.9978	6	107
ADF - Fisher Chi-square	6.79256	0.8710	6	107
PP - Fisher Chi-square	3.18837	09941	6	108

Table 5.4: D(LNGCF)

Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	-6.24360	0.0000	6	100
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	-4.12511	0.0000	6	100
ADF - Fisher Chi-square	38.2472	0.0001	6	100
PP - Fisher Chi-square	41.1503	0.0000	6	102

Table 5.5: LNPS

Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	0.70449	0.7594	6	105
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	4.33987	0.6723	6	105
ADF - Fisher Chi-square	4.23513	0.9788	6	105
PP - Fisher Chi-square	4.61948	0.9695	6	108

Table 5.6: D(LNPS)

Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	-8.30826	0.0000	6	94
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	64.3320	0.0000	6	94
ADF - Fisher Chi-square	73.8948	0.0000	6	94
PP - Fisher Chi-square	92.7155	0.0000	6	102

Table 5.7: LN(LA)

Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	-1.23487	0.1084	6	102
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	0.55178	0.7094	6	102
ADF - Fisher Chi-square	8.13733	0.7743	6	102
PP - Fisher Chi-square	8.58463	0.7379	6	108

Table 5.8: D(LN LA)

Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	-5.57121	0.0000	6	96
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	-3.60954	0.0000	6	96
ADF - Fisher Chi-square	35.7905	0.0000	6	96
PP - Fisher Chi-square	58.8729	0.0000	6	102

We can reject the null hypothesis (unit root test) based on tables above for all four variables and conclude that all 4 variables are non-stationary at this level. I did panel unit root test by using 3 different scenarios. All four variables are non-stationary at this level and they will get stationary at first difference since variables are followed by I (1).

5.2 Analyses of Co-integration Tests

Before testing long run relationship, I checked correlation matrix to find out whether the studied variables do not have problem of multicollinearity. As table 5.9 shows, the pair wise correlations between the variables are logically normal. It is important to emphasize that we expect low correlation between explanatory variables and high correlation between dependent (GDP) and explanatory variables.

Table 5.9: Corrolation matrix

	LNGDP	LNGFC	LNLABOR	LNPSR
LNGDP	1.000000	0.708234	0.423942	0.927929
LNGFC	0.708234	1.000000	0.248256	0.756840
LNLABOR	0.423942	0.248256	1.000000	0.523255
LNPSR	0.927929	0.756840	0.523255	1.000000

At this place co-integration test is considered to test long run relationship between variables. I have conducted the Pedroni approaches with 3 scenarios to test the co-integration between the variables. The results are shown in table 5.10.

Table 5.10: Pedroni Residual Cointegration Test/Long run test

	Statistic	Prob.	Statistic	Prob.
Panel v-Statistic	4.601018	0.0000	4.812828	0.0000
Panel rho-Statistic	2.338278	0.9903	1.670714	0.9526
Panel PP-Statistic	1.315466	0.9058	0.411812	0.6598
Panel ADF-Statistic	-1.742788	0.0407	-2.768433	0.0028

Alternative hypothesis: individual AR coefs. (between-dimension)

	Statistic	Prob.
Group rho-Statistic	2.015428	0.9781
Group PP-Statistic	-1.161543	0.1227
Group ADF-Statistic	-3.349544	0.0004

LNGDP	**1.00000**
LNGFC	**0.287017**
	(0.13976)
	[2.05362]
LNLABOR	**0.053028**
	(0.11584)
	[0.45778]
LNPSR	**4.739651**
	(0.83570)
	[5.67148]
C	**-4.19449**

Pedroni (Engel-Granger based), Kao (Engel-Granger based), and Fisher (combined Johansen based) tests are usually applied as cointegration tests. Engle – Grenged based Pedroni cointegration test is mostly done with three different scenarios: with trend and intercept, with intercept and without trend and without trend and intercept.

Table 5.10 shows cointegration test outcomes for the selected countries from different continents. Engle-Granger based Pedroni test shows that an autoregressive coefficient within dimensions rejects single null hypothesis of no integration where with intercept and trend are involved regarding to almost one percent alpha. The level of v-statistics provides co-integration relationship at 1 % alpha while based on the model according to rho-statictics the co-integration relationship does not exist.

In level equation capital and political stability are statistically significant and have positive influence on economic growth in the long run except labor growth. 1% change in capital causes 0.28 % rise of economic growth. One percent change in labor growth causes 0.05 % increase of economic growth and 1% change of political stability leads to 4.73 % increase of economic growth.

Table 5.11: Vector Error Correction Test/Short- run test

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.012561	0.001505	8.347717	0.0000
CointEq1	-0.128496	0.033761	-3.806611	0.0001
D(LNGFC)	0.268293	0.013291	20.18666	0.0000
D(LNLABOR)	0.011764	0.131684	0.089335	0.9289
D(LNPSR)	0.210902	0.060656	3.477047	0.0006

R^2	0.711156	Mean dependent var	0.019930
Adjusted R^2	0.706547	S.D. dependent var	0.037450
S.E. of regression	0.020287	Akaike info criterion	-4.937069
Sum squared resid	0.077373	Schwarz criterion	-4.869204
Log likelihood	477.9586	Hannan-Quinn criter.	-4.909583
F-statistic	154.2902	D-W	1.277858
Prob	0.000000		

In error correction model error correction term is statistically significant at 1% (-3.80), it is negative and has reasonable score. ECT shows that 12.84 % of distinction between short-term and long-term equilibrium is eliminated annually. Therefore disequilibrium in economic growth encounter equilibrium at normal levels.

Short-term coefficients of capital are statistically significant at lag 1 at 5%. This shows positive short-term movements. When capital rises for 1%, economic growth rises for 0.26 % at lag 1. Labor is not statistically significant at conventional levels.

Political stability is statistically significant as a short-term coefficient and is statistically significant at 1% level at lag 1 (3.47). This indicates positive short-term movements. When political stability increases for one percent, economic growth rises for 0.21 % at lag 1.

Chapter 6

CONCLUSION AND RECOMMENDATION

6.1 Empirical Findings

This thesis investigates the relationship between economic growth, capital, labor and political stability of six selected countries from different continents. The aim of research was to find out whether political stability influences on economic growth. Countries examined were carefully selected from World Bank database according to different factors.

In the study panel data was used. The panel data approaches show that economic growth in the chosen countries is in long-term economic and statistical relationship with its determinants: capital, labor growth and with other variable: political stability. These factors turned out to have statistically significant effects on economic growth both in short-term and long-term periods except labor. Political stability influences on the level of economic growth long term with growth of capital and labor.

It is important to emphasize that political stability is influenced by growth of capital and labor both long-term and short-term in the case of all selected countries but there is no such influence on the selected countries when only labor is considered. Especially labor proxies have not resulted as having long and/or short-run effect on political stability.

This indicates that political stability in developing countries or countries with less stable political systems can stimulate a country's process of development. Results of the research indicate that there exist a relationship between the political stability of a country and its economic growth.

6.2 Suggestions for further research

The results of research show that in specific countries political stability is the biggest factor to stimulate economic growth specially the flow of the capital. Econometric results of this study proved long-run relationship between political stability and economic growth. This relationship is affected mostly by capital in the countries we selected for the research while political stability and labor factors do not have strong influence on economic growth of them. The political stability plays an important role in every nation regarding the literature reviewed on the topic. Governments of countries have to have in mind these factors when planning their economies. Political instability and internal crisis can easily have quick and destructive effects economic growth. It wold be interesting to see in the future researches the influence of political freedom as an defining factor of economic growth on political stability in politically stable as well as politically instable countries and compare the results. It is my suggestion for future research.

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