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Political Instability and Growth in Nepal

*Ari Aisen**

Abstract

Political instability is often associated with changes of economic policies and uncertainty, which delay structural reform implementation. These factors may contribute to lower investment and economic growth. This paper examines the effect of political instability measured by cabinet changes on economic growth in Nepal. It uses publicly available data on political economy variables for 167 countries worldwide (including Nepal and other South Asian countries) from 1970-2000, to estimate the impact of political instability on growth. The coefficient estimates are negative and broadly centered around 2, implying a robust effect of political instability on growth across the different model specifications.

Introduction

Cross country experience suggests that political instability is associated with weaker macroeconomic outcomes, including lower economic growth. Political instability is often associated with changes of economic policies and uncertainty, which delay structural reform implementation. These factors may contribute to lower investment and economic growth. In many cases, it shortens the tenure and horizons of elected officials, creating incentives for fiscal laxity, including overspending. Lax fiscal policies, then, lead to large government deficits and inflation. Several theoretical and empirical studies in political economy investigate the relationship between political instability and macroeconomic performance. Examples of these studies include Barro (1991), Cukierman, Edwards and Tabellini (1992), Alesina and Perrotti (1993), Fosu (2002), Woo (2003), Aisen and Veiga (2005), and Aisen and Veiga (forthcoming).

In line with the literature, this paper examines the effect of political instability on economic growth in Nepal. It uses publicly available data on political economy variables for 167 countries worldwide (including Nepal and other South Asian countries) from 1970 2000, to estimate the impact of political instability on growth[1]. In the analysis, Nepal is compared to

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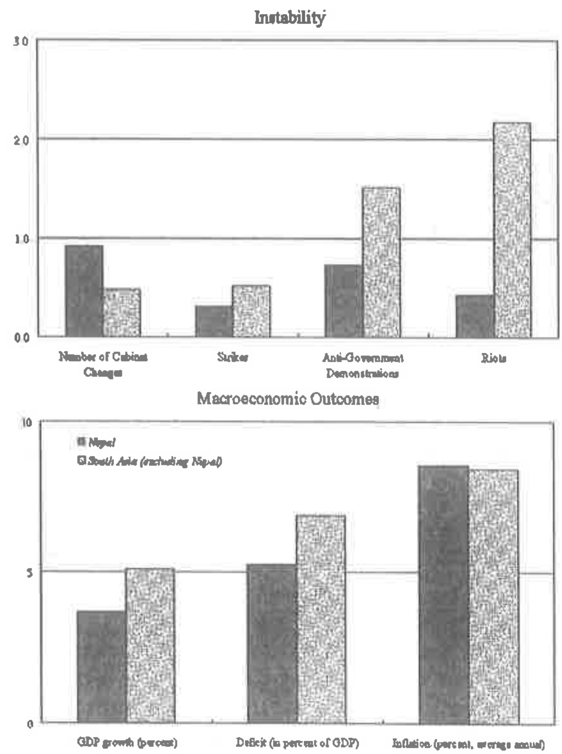
[1] The principal data sources are Cross National Time Series Archive and Polity IV.

other South Asian countries (Bangladesh, Bhutan, India, Pakistan, and Sri Lanka). The main findings of the paper are: (i) Nepal has witnessed higher political instability (measured by the number of cabinet changes) compared to other countries in the region; (ii) average growth rates in Nepal have been around 1-1½ percentage points lower than the region for the sample period; (iii) political instability can account for roughly ½-¾ percentage point of the difference in average growth rates; and (iv) political instability in Nepal does not seem to have led to higher public deficits and inflation.

Political Instability and Growth in Nepal

Socio-political instability is measured in the literature using a range of variables. Variables such as cabinet changes (number of times in a year that a new prime minister is named and/ or 50 percent of the cabinet posts are occupied by new ministers) are used to measure political instability while strikes, riots, and anti government demonstrations are commonly used measures of social instability. Compared to other countries in the region, Nepal has witnessed more frequent cabinet changes, while other manifestations of instability have been less frequent.

Nepal and Other South Asian Countries
(Annual average; sample period: 1970-2004)



Sources:Cross National Time Series Archive; and IMF staff estimates.

In Nepal, frequent shifts in government during the early 1990s appear to have slowed the pace of reforms, although the overall direction of policies has remained unchanged. Overall, macroeconomic policies have remained stable. Fiscal policies have been prudent. The exchange rate has been pegged to the Indian rupee, and has helped to import stable monetary conditions and keep inflation in line with price developments in India. Nepal also undertook significant trade liberalization in the 1990s. Since 2003, the Poverty Reduction Strategy Paper (PRSP) has provided an overall framework for policies and reforms. Since the PRSP was prepared by a series of governments, with extensive consultation with stakeholders, the overall direction of reforms has been constant. Nevertheless, political instability and the insurgency have impeded the pace at which it has been possible to undertake structural reforms, with adverse consequences for growth.

While growth in Nepal has been lower than the average of other South Asian countries, deficits and inflation have also been lower. For the entire sample period, Nepal had an average growth rate of 3¾ percent, while average annual growth in the rest of South Asia was a little over 5 percent. A part of this difference is attributable to greater political instability in Nepal; this is further examined in Section C. However, instability in Nepal appears to have had only a moderate impact on deficits and inflation. Nepal maintained deficits lower than the regional average, while inflation remained broadly in line with the regional average. To some extent, the potential negative effect of political instability on inflation may have been avoided by the exchange-rate peg with the Indian rupee.

Econometric Analysis

To examine the impact of political instability on growth, growth regressions were estimated using panel data for 167 countries applying an instrumental variable approach. Since political instability, measured by cabinet changes, does not only affect, but can also be affected by growth, an instrumental variable two-stage least squares (2SLS) approach is appropriate. In particular, the average of the previous five years of cabinet changes is used as an instrument to contemporaneous cabinet changes[2]. In addition, the model uses random effects to control for unobserved heterogeneity. The random effects specification is appropriate given the presence of several explanatory variables which vary across countries but do not vary across time. Nevertheless, the estimation incorporates regional dummies to account for idiosyncratic regional characteristics that may affect growth and are not explicitly incorporated as explanatory variables in the estimation models. They also reduce the probability of omitted variable biases in the estimated coefficients, augmenting their robustness and strengthening the results of the paper.

The estimation method proceeds from a simple regression model specification to multivariate estimation. The following table presents five model specifications. Model 1 starts with cabinet changes and regional dummies as the explanatory variables. Regional dummies are included for OECD, Latin America, Africa, and South Asia. The successive models proceed along the lines of the growth and political economy literatures. Thus, Model 2 includes the convergence term, i.e., initial GDP levels. Model 3 introduces the investment-to-GDP ratio as a regressor. Models 4 and 5 introduce a series of variables considered to affect growth, such as human capital (primary education, trade (openness and terms of trade), government finances, and political economy variable (rule of law and democracy). Models 4 and 5 introduce a series of variables considered to affect growth, such as human capital (primary education), trade (openness and terms of trade), government finances, and other political economy variables (rule of law and democracy).

2 The F test in the first stage of the 2SLS estimation indicates that the instrument is relevant.

Cabinet change is a significant explanatory variable across all specifications. The coefficient estimates are negative and broadly centered around 2, implying a robust effect of political instability on growth across the different model specifications. In Model 2, the expected negative sign for the convergence term receives empirical support. An interesting result from Model 3 is that the effect of cabinet changes on growth is reduced by the introduction of investment, but it is still statistically significant and quantitatively important. This suggests that only a small part of the effect of political instability on growth occurs through its negative effects on investment. The major effect seems to be independent of investment and may suggest that frequent cabinet changes delay the implementation of growth-enhancing structural reforms. Most of the coefficients of the explanatory variables in Models 4 and 5 are statistically significant and have the expected signs with the exception of fertility growth,[3] democracy, openness, and growth of terms of trade, which were not statistically significant at standard levels.[4]

The panel data estimates can be used to obtain information on the impact of political stability in Nepal. While Model 4 indicates that an increase in one cabinet change per year reduces the average growth rate by 2.3 percentage points, Model 5 provides an estimate of the marginal effect of an additional cabinet change a year on growth in South Asia using an interaction variable (cabinet changes * South Asia). The total marginal effect of a cabinet change in the region would be the sum of the coefficients from the variables cabinet changes and its interaction with the South Asian dummy. Since the interaction variable is not statistically significant, the marginal effect of an additional cabinet change in a year is equal to 2.12. An application of the model is to compare the average cabinet changes per year in Nepal (0.91) with the average cabinet changes per year in South Asia including Nepal (0.56). With a difference of 0.35, the model suggests that relatively more political instability in Nepal has cost the country ¾ percentage points of GDP growth on average per year (0.35*2.12).[5] This result explains roughly half of the difference in the average growth Nepal has experienced relative to its neighbors in South Asia over the sample period.

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3 The paper uses population growth as a proxy for fertility growth.

4 Data for the variable rule of law is taken from La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997).

5 A confidence interval for this estimate could be constructed using one-half of the standard error of the coefficient for cabinet changes in the regression. The range for the marginal effect of cabinet changes on growth would be ½-1.

Cross Country Growth Regressions : 1970–2004

Dependent variable : Real GDP growth

	(1)	(2)	(3)	(4)	(5)
Cabinet changes	-2.628	-2.598	-1.803	-2.305	-2.116
	(0.871) ***	(0.669) ***	(0.753) **	(1.323) *	(1.089) *
Lagged log (real GDP)		-0.277	-0.528	-0.75	-0.679
		(0.130) ***	(0.139) ***	(0.281) ***	(0.255) ***
Investment/GDP			0.163	0.14	0.142
			(0.014) ***	(0.025) ***	(0.024) ***
Enrollment in primary school				0.026	0.025
				(0.008) ***	(0.008) ***
Fertility				0.624	0.658
				(0.453)	(0.435)
Government expenditures/GDP				-0.102	-0.094
				(0.023) ***	(0.022) ***
Rule of law				1.246	1.257
				(0.410) ***	(0.365) ***
Democracy				-0.021	-0.03
				(0.029)	(0.027)
Openness				0.001	-0.001
				(0.007)	(0.006)
Terms of trade growth				0.009	0.008
				(0.011)	(0.011)
Inflation				-0.01	-0.01
				(0.004) ***	(0.004) ***
OECD	-0.827	-0.312	0.245	0.842	0.732
	(0.405) **	(0.410)	(0.435)	(1.074)	(0.965)
Latin America	-0.992	-1.01	-0.371	-0.017	-0.043
	(0.484) **	(0.374) ***	(0.405)	(0.580)	(0.520)
Africa	-0.242	-0.722	-0.661	-0.52	-0.554
	(0.368)	(0.331) **	(0.352) *	(0.598)	(0.550)
South Asia	1.749	1.189	0.697	1.242	1.864
	(0.757) **	(0.620) *	(0.654)	(1.025)	(3.023)
Number of cabinet changes * South Asia					-0.717
					(3.582)
Observations	3,276	3,276	3,143	830	830
R-squared	0.05	0.05	0.11	0.18	0.18
Number of countries	167	167	161	77	77

Regressions include constant and year dummies.

Robust standard errors in parentheses.
* significant at 10 percent; ** significant at 5 percent; *** significant at 1 percent.

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Book Review

Joshep E. Stiglitz (2006). ***Making Globalization Work: The Next Steps to Global Justice.*** As imprint of Penguin Books, Allen Lane, England, pages ix + 358. ISBN: 0-713-99909-8. Price: GB£ 20.00 (NRs 952.00).

When John Williamson coined the phrase **Washington Consensus**, also known as neo-liberalism (a set of ten economic policy prescriptions or reform packages directed towards the policy reform of the developing world), in the late 1980s, it was taken as a boon for the developing countries with respect to their economic growth and development. Most of the developing countries, particularly in Latin America, adopted this prescription since they under the prediction that these countries' economic growth would be heightened provided they formulated their economic policies along the lines of Washington Consensus that they would have the opportunity to enter into the international markets without restriction and thereby would have a chance to increase there production, which would have multiplier effect in the domestic economy.

However, in the immediate 1990s, discontents for liberalization of the market were clearly on the air when several Latin American countries, particularly Argentina suffered a devastating economic setback in 1999-2000. Also the "shock therapy" being prescribed for the socialist transition economies was collapsed. Amidst such as delusive world economic scenario, Joseph E. Stiglitz came up with his second thought-provoking book *Making Globalization Work: The Next Steps to Global Justice.* This is the follow up of his previous epoch-making book *The Roaring Nineties: Globalization and Its Discontents.*

Embellishing upon his experience with the World Bank and the White House, and dwelling upon his critical economic information about countries in East Asia, Latin America and Africa, he has visualized the possibility of another economically just world through globalization, which has the potentiality of delivering enormous benefits to the developing world. In this book, he has rightly and vividly projected the pros and cons of globalization and its likely impact on poverty reduction in the third world countries. He sees the limitations of liberalization and suggests for an untied foreign assistance to the developing countries from the developed ones. Realizing the importance of linkage between environment and development, he advocates for environmental protection as well. It is his belief that globalization leading to export-led growth could pull countries from poverty taking the instance of East Asia. Nonetheless, he believes that development is for people and people are the core of development, the preset catchword of economic development. No doubt, he has visualized markets, government and individuals as the pillars of the successful development strategy with due emphasis on good governance whereby globalization works for people.

He has prescribed ten central ingredients for a new global social contract between the developed and developing countries. In short, these are:

- Commitment by the developed countries to a fairer trade regime
- A new approach to intellectual property (rights) and reorganization of the importance of developing countries' access to knowledge
- That developed and less developed countries alike share one planet
- Commitment by developed countries to compensate developing countries for their environmental share
- Fair payment by the developed countries to the developing ones for their natural resources
- A pledge for the provision of 0.7 percent of GDP by the developed to the developing countries
- An extension of the debt forgiveness made in 2005 to more countries
- Reform of global financial structure
- Restriction on the emergence of new global monopoly
- Curtailment of arms shipments and bribery

To sum up, the Nobel Laureate in his book on economics of globalization argues that global justice through democratizing globalization is the main concern of both the developed and developing countries. Such an action well and truly leads these countries along a win-win path. However, a concern could be raised when he advocates for the export-led growth strategy without paying due consideration for the opposite side of the coin-the domestic-led growth to avoid dependency syndrome on the part of the developing countries since lots of hassles are there for their products to cross the international border.

Moreover, export-led growth would prevent the development of domestic market. It also lures these countries towards a "race to bottom" among themselves. The critics of this strategy believe that it would aggravate the deteriorating terms of trade of the developing countries. Stiglitz did not directly see that recessions in developed countries would translate into slow growth in the developing countries. A world characterized by competitiveness is sure to manifest in excess capacity and deflationary forces unless policies are framed to stimulate effective demand. Thus, such a strategy might obstruct the main act of poverty reduction whereby the chance of raised growth and productivity in compliance with economic, environmental and social sustainability in these developing countries would be slim.

Nevertheless, this book is a classic on globalization, which has been dissected from many angles so that countries on both parts of the globe can fetch benefits. No doubt, as he warns, "the task will be long and arduous". This book is a must for the students of economics, academics as well as for the policy makers in the concerned continents.

Central Department of Economics
Tribhuvan University, Kathmandu

Kanhaiya Mathema, Ph.D.
Professor of Economics