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AN ANALYSIS OF POLITICAL INSTABILITY AND MACROECONOMIC MECHANISM IN SR LANKA: EMPIRICAL STUDY FROM 1980 TO 2018.

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Abstract

Political instability is regarded by economists as a serious discontent harmful problem to economic performance. It is creating major problems & hindering the development in Developing countries. Likewise, Political Instability is becoming continues to threaten Economic history in Sri Lanka. Therefore, this study tries to identify the Political instability effect on the economic growth in Sri Lanka from 1980 to 2018. The specified indicators had been analyzed by the method of Ordinary Least Squares (OLS). In this multiple regression model, GDP at current market price is the dependent variable. Independent variables are the Political Stability Index, Economic Freedom Index, Investment Ratio, and Gross Fixed Capital Formation. This study proves that the estimated coefficient value shows that Political Stability has a positive significant impact on Economic Growth. In contrast to this our descriptive analysis finds out that through the years the political stability index has mostly the negative value which indicates the instability in the political system of Sri Lanka. This cause various direct and indirect impact on the economy. Therefore, it concludes that creating political stabilization will enhance economic growth. At the same time political stabilization positively correlated with investment and fixed capital formation. According to the results, this study suggests some recommendations for Policy implementation to *sustain the macroeconomic goals through strengthen Political stability in Sri Lanka.*

Keywords: Political instability, Gross Domestic Product, Investment, Capital Formation.

1. Introduction

The factors which determine economic growth are among the most broadly studied subjects in economic history. Politicians, and economists' proof with theoretical and the moral support that well established and efficient democratic institutions are good for Economic growth of a country. The empirical evidence shows Economic growth and political stability are deeply interconnected with each other in various disciplines. On the one hand, the uncertainty associated with an unstable political environment may reduce investment and the speed of economic development (Alesina, et.al, 1996)

An economy may have attractive policy measures, with technology, human and physical capital, and a higher level of resources to achieve higher economic growth. Regarding the Neo-Classical theories, these factors will lead to the higher economic growth of a country. Despite they could not be able to achieve economic development unless it has peace, attitudes and beliefs, the power structure of societies and good governance. Political instability is regarded by economists as a serious discontent harmful problem to economic performance. Political instability is likely to shorten policymakers' horizons leading to suboptimal short-term macroeconomic policies. It may also lead to a more frequent switch of policies, creating volatility and thus, negatively affecting macroeconomic performance.

Political instability refers to the propensity of a change in the executive, either by "constitutional" or "unconstitutional" means. Sometimes high propensity of an executive collapse leads to a reduction of growth (Chowdhury, 2016). Every country has a certain number of political parties according to its socio-political setups. Those process under different kinds of principles and different perspectives. Political Instability has become a threatening and serious problem especially in developing and underdeveloped countries. It is creating major problems & hindering the development in these countries. Until the early 1990s, the world was in general characterized by two models of economic development: socialism: led by the Soviet Union, and capitalism, led by the United States. The breakup of the Soviet Union in the early 1990s brought about remarkable democratic reforms across the globe. In the literature, there are many detailed analyses on the impact of political reforms and democratization on economic growth, mostly for the Asian-Pacific region or Latin America. (Gurgul & Lach, 2012)

The history of political protests has been instrumental during the anti-colonial struggles of the subcontinent and later in strengthening the democratic progress in South Asia. However, even long after post-colonial periods and democracy restoration, political instabilities are still an unappeasable part of the political culture of South Asia. Along with 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 (Rudolph, 1987). Sri Lanka, officially the Democratic Socialist Republic of Sri Lanka, is an island country in South Asia, located southeast of India and northeast of the Maldives which is governed by a semi-presidential system, with a mixture of a presidential system and a parliamentary system. Most provisions of the constitution can be amended by a two-thirds majority in parliament. The Cabinet of Sri Lanka is the council of ministers that form the central government of Sri Lanka. It is responsible for and answerable to parliament. The current cabinet is the Sirisena cabinet. For administrative purposes, Sri Lanka is divided into nine provinces and twenty-five districts. Each district is administered under a District Secretariat. The districts are further subdivided into 256 divisional secretariats, and these, in turn, to approximately 14,008 Grama Niladhari divisions.

A number of development issues and problems emerged as threats to Sri Lanka's long-term development potential. In that way, Political instability is one of the major challenges to development. Good governance is the backbone of the country. Good administration of the particular government will determine the durability of that governs. To develop the country a government must ensure the stability of the political changes which are also let to identify the trustworthy of the current governance of a country. Therefore, this study tries to identify the Political instability effect on the economic growth in Sri Lanka from 1980 to 2018. Also, as a specific objective to check correlations between the investments and the political instability in Sri Lanka.

2. Methodology

This study completely based on the quantitative secondary data source. The data collected for the period of 1980-2017. This study based on multiple regression analyses to examine the impacts of Political Instability formation impact economic growth. The data collected from Department of Census and Statistics (DCS), Central Bank of Sri Lanka (CBSL). In addition, some data and information collected from World Economic Indicators Reports and Global Economy Website. The main objective of this study achieved by multiple regression analyses. The specified indicators had been analyzed by the method of Ordinary Least Squares (OLS). In this multiple regression model, GDP at current market price is the dependent variable. Independent variables are Political Stability Index, Economic Freedom Index, Investment Ratio, and Gross Fixed Capital Formation. In these explanatory variables except Political Stability Index, other Variables used as supportive variables to the Model.

$$\mathrm{GDP}_t{}' = \beta 0' + \beta 1'(\mathrm{PSI})t' + \beta 2'(\mathrm{EFI})t' + \beta 3'(\mathrm{IR})t' + \beta 4'(\mathrm{GFCF})t' + \mathrm{U}'$$

Where, GDP as the Gross domestic product, PSI as Political Stability Index, EFI as Economic Freedom Index, IR as Investment Ratio and GFCF as Gross fixed capital formation considered. Also, all the data standardized before the analysis.

3. Result and Discussion

Political instability generating various consequences in the country in the economic wise and the social wise. Government is the core institution of a country which directs the country to achieve Economic Growth at the same time it considers the standard of living of the people in the country. In the Mixed Economy, the Government has played a major role to make efficient Market Equilibrium which creates more benefits to the producers as well as the consumer. Not only these Micro problems but also considered the Macro level stabilization of a country in both cases of the Internal and external through various policy implementation. In this case, there is no doubt of the role of the government in a country is vital to development.

Political Instability means the ruling party has been changed over time. The cabinet is no longer the performer in the country. As all the Economic decisions at the micro and the macro levels made by the government. So this stability creates major consequences for the country. In context to Sri Lanka the recent decision about Prime Minister Change creates some problems in country. Sri Lanka has Complex and unsustainable political system. It has clear economic decision made by the Party who's in the power will undeniably changed by the party who came to the power next, throughout the political history of the country. The best Example is the trade Liberalization policies from 1970. Political Instability in Sri Lanka plays key role in determination of short and long-run economic growth directly and indirectly

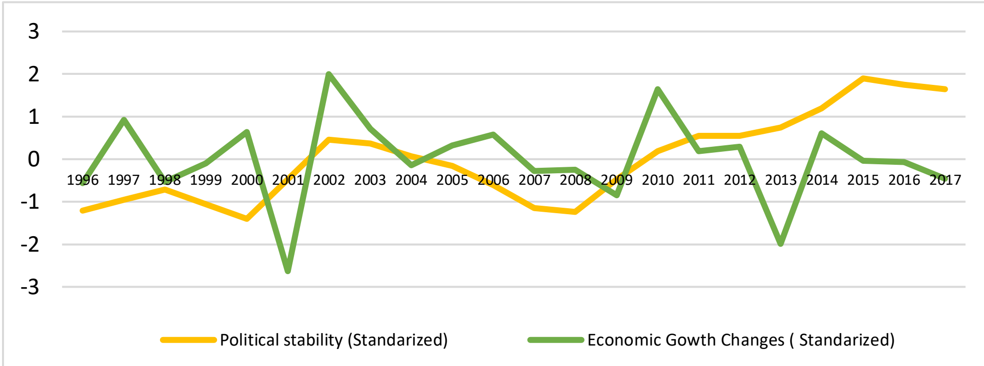

Figure 1: Political Stability & Economic Growth changes in Sri Lanka.
Source: Author constructed

The above graph shows the political stability and the Economic Growth of Sri Lanka between the periods of 1996 to 2017. The political stability explained through the political stability index. Most of the time the political instability had a positive relationship between economic growths in the long run. For example, in 1998 the political stability increase causes the Economic growth changes to increase in 2000. On the other hand, in 2000 the political stability decrease causes Economic growth changes decline in 2001. Various factor has been causes to changes in the Economic growth in between this period.

Table 1: Descriptive Statistics

Descriptive Statistics			
	Mean	Std. Deviation	N
GDP	2977822.89	3901006.837	38
PSI	-1.0137	.55112	38
IR	26.655	3.6083	38
EFI	63.37	4.222	38
GFCF	763664.00	1041618.272	38

Source: Author constructed

In table 1 Descriptive statistics are used to analyze data and to describe and summarize it in a systematic way. The standard Deviation shows the volatile of the variables. The 38 years have been observed by the analysis. Also the average political stability index is (-1.0137) which indicates the instability situation of the political structure of the country during the period of time.

Table 2. Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.999	.998	.998	175079.932	2.041

Source: Author constructed

Table 2 explains the model fitness of the gross domestic product and other variables. It tells us how much variation is explained due to the dependent variable for the independent variable. The above data shows the value of R square is 99% which means that 99% variation is occurred in GDP during the time period of 1980-2017 due to the changes in the Political instability and macroeconomic performance proxy to the investment. R square value results by taking the square of the R-value. According to the above results, R-value is 99 percent of the correlation between observed and predicted values of GDP is explained by the model and this value also shows that the model is good and strong. Also the Durbin-Watson statics Estimated d value is falling in $0<d<dL$ and also there is no positive autocorrelation.

Below, Table 3 shows the F value or significance level it tells us about the goodness of fit of the model. According to the above results, the P-value is 0.000 which means that the model is a good fit.

Table 3. Significance level or F value

ANOVAa						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	562049062276711.600	4	140512265569177.900	4583.967	.000b
	Residual	1011548420128.005	33	30652982428.121		
	Total	563060610696839.600	37			

a. Dependent Variable: GDP

b. Predictors: (Constant), GFCF, PSI, IR, EFI

Source: Author constructed

Table. 4 Coefficient Results

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	VIF
		B	Std. Error	Beta			
1	(Constant)	8293164.230	968678.448		8.561	.000	
	PSI	442367.088	84145.486	.062	5.257	.000	2.596
	IR	-22894.664	11096.445	-.021	-2.063	.047	1.935
	EFI	-107608.933	13373.395	-.116	-8.046	.000	3.847
	GFCF	3.356	.067	.896	49.906	.000	5.921

Source: Author constructed

The estimated coefficient value shows in table 4, that there is a significant positive relationship between Political Stability Index and Gross Fixed Capital Formation with the Gross domestic product (GDP). And the same time the Economic Freedom Index and Investment Ratio negative relationship with GDP. These findings brought the conclusion that political stability has a significant positive impact on gross domestic product.

The special case of October 26th political crisis of Sri Lanka

The most unexpected event in the political history Sri Lanka, the events of October 26 which turn over the political and economic domains of Sri Lanka. the 50 days of the unstable situation with the removal of Prime Minister Wickremesinghe and the appointment of former President Rajapaksa as his replacement by President Sirisena, amidst the absence of a parliamentary majority in favor of the latter. Since then, the President's decision to dissolve parliament and hold parliamentary elections was found to be unconstitutional by the nation's Supreme Court. And while there is no alternative choice, Wickremesinghe supported by the Majority of the Parliament which represent by the UNP. So again Wickremesinghe Appointed as a prime minister. The reappointment of Wickremesinghe as Prime Minister has terminated the constitutional crisis. Even though, the Uncertainty created by political instability causes the Economic problems.

The perception of uncertainty on the political front is likely to impact Sri Lanka's economic prospects as well. Firstly, given the potential for drastic policy changes over the next year or so, the private sector, both foreign and local, is likely to be more risk-averse with their investments. This will lead to a continuation of subpar economic growth. At the same time, the country's economy should continue its fiscal stabilization program—although, this may change under electoral pressures as the government is incentivized to make populist choices. Furthermore, Sri Lanka will be servicing debt obligations amounting to 5.9 billion US dollars, including dollar-denominated domestic debt. Notably, debt repayment was made even more challenging by the downgrade of Sri Lanka's credit rating during the constitutional crisis. (Hewage, 2019)

Outcomes of October 26th Political crisis

- The economy seems to be weakening. GDP Growth projection has come down from 5% to 3.5%. The Lankan rupee (LKR) has been losing value vis-à-vis the US dollar steadily to be Rs. 181 now.
- However, the fall of the LKR has been on even before the political crisis sparked off on 26 October. According to the Central Bank, the LKR weakened by 4% in September and 3% in October. Overall, through 2018, it had come down by 15.4% vis-à-vis the US Dollar. The LKR's value vis-à-vis the Euro has also fallen – from Rs. 181 in August to Rs. 200 now.
- The fall of the LKR has curtailed household consumption. Companies have put on hold expansion plans and new projects. The banking sector may see a rise in non-performing loans. The retail sector is also set for a downturn. The Christmas season, which is a time for people to go on a buying spree, is not likely to see much cheer as people are not exactly making a beeline to the shopping malls.
- Sri Lanka being import-dependent, the fall in the value of the rupee could lead to slow down of imports. It could lead to inflation followed by a tight monetary policy and higher interest rates. This, in turn, will slow down investment and growth.
- The Government had taken a $ 1 billion loan from the China Development Bank to ease the pressure on the currency. In September, the Sri Lankan Central Bank said that it proposes to raise $ 250 million by issuing Renminbi-denominated 'Panda' bonds and $ 250 million by issuing Yen denominated 'Samurai' bonds in an effort to expand the country's investor base. These bonds will allow Sri Lanka to tap into the Chinese and Japanese capital markets.

- In addition, Sri Lanka is talking to Qatar and Oman about a currency swap amounting to $ 2 to 3 billion.
- The government hoped to raise tax revenue by 22% in 2018, but the rise was only to the tune of 3% despite a new revenue collection law.
- Due to the price reductions and tax cuts announced by the short-lived post-26 October Mahinda Rajapaksa Government, the IMF has decided to put on hold aid under it's Extended Fund Facility (EFF) program. The new giveaways contradicted IMF's conditions. Therefore, the pending IMF tranche of $ 500 million has not been disbursed.
- Some of the key concessions announced by the then Prime Minister cum Finance Minister Mahinda Rajapaksa are: Reduction of tax rate for agricultural businesses from 24% to 14%; reduction of tax on Small and Medium Enterprises from 24% to 14%; the increase of the threshold for VAT for small businesses from Rs. 12 million to Rs. 24 million; and for wholesale and retail businesses from Rs. 50 million to Rs. 100 million.
- Rajapaksa had lifted the Withholding tax on interest on deposits and the tax on remittances. He had also cut the Telecom tax from 25% to 15%. Petrol prices were brought down by Rs. 10 per liter and diesel by Rs. 7 per liter. (Balachandran, 2018)

4. Conclusion & Recommendations

Sri Lanka, officially the Democratic Socialist Republic of Sri Lanka, is an island country in South Asia a number of development issues and problems emerged as threats to Sri Lanka's long-term development potential. In that way, Political instability is one of the major challenges to development. This study found Political Instability in Sri Lanka plays a key role in the determination of short and long-run economic growth directly and indirectly.

Eliminating political instability in a developing country is not an easy task. The Economy needs to take more precautions and strategic frameworks to solve the problems and faced the uncertainties. Various countries dealing with this condition in different ways. Some applicable suggestion and recommendation to Sri Lanka are:

- Recognizing the Risk: Risk management sector of the country should recognize what kind of impact should happen because of the changes in the political parties. They should develop the types of risk and their solution by conducting the workshops with intellectuals.
- Avoiding Political Risk with Control Procedures: Companies need to be practical and avoid states with overt party-political risk. The large companies use *urbane scoring systems* to appraise political risk in areas.
- Dealing with Risk as Ongoing Procedure: biased could be major threats, so every politician should control by the law and the facts
- Understanding Political Risk Movement: Risk should identify at both the macro level and the micro level. At the same time, the spreading effect of the risks and uncertainties should control by the policies.
- Implementing strategies: Medium-term strategies should cover-up this situation while the long term strategies should eliminate these problems.
- Political influences in the economic sector should control and limited on a different basis.

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