Political institutions and economic volatility

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Most of the existing literature about political institutions and economic volatility focus on developed countries or countries including both developed countries (e. g., Denizer et al., 2002; Mobarak, 2005; Debrun et al., 2008; Klomp and Haan, 2009; Perira and Vladimir, 2011). These papers always examine the impact of political institutions on economic volatility from one or two aspects, seldom do they analyze this relationship in a more broad way.

The existing papers study the relationship between political institutions and economic volatility from different dimensions. Many of these studies provided empirical evidence that democratic political institutions generate less volatile growth. The paper written by Rodrik (1997) shows democratic countries are less volatile than nondemocratic regimes. This opinion is supported by a number of studies. Mobarak (2005), Quinn and Woolley (1996, 2001), Klomp and de Haan (2009) and Cavallo and Cavallo (2010) report a strong negative correlation between democracy and economic volatility, strengthening democratic institutions can eliminate the negative effects of financial crisis and decrease output volatility.

Democratic institutions may reduce macroeconomic volatility in several ways. First, a democratic institution which highly respects individual interest will implement policy to keep countries' stability, since most of people prefer a stable environment. Politicians in democratic political institutions have the opportunity of future replacement. The future replacement of these politicians will be affected by median voter who would prefer a more stable economy. To get the support of these voters, politicians in democratic institutions always avoid policies with high risk (Black 1948; Downs, 1957).

Second, democratic political institutions decentralize political power, which keep policy's stability and decrease its variance. In Partha and Malik's (2010) view, the degree of democracy in a country is determined by the proportion of the population who are in the process of political decision making. In a perfect democracy each individual has right to give their opinion in the political process and political institutions will not only represent a particular group's interest. They also find a high correlation between disparity in political regimes across countries and differences in volatility. Thus, the decentralization of political power inherent to democratic political systems can effectively reduce the policy uncertainty which will lead to smaller economic volatility.

This paper is closely related to cross-country empirical studies that examine the link between political governance –related variables and economic growth volatility. Acemoglu et al. (2003) think that a society where elites and politicians are effectively constrained will experience less infighting between various political groups to take control of the state and to pursue more sustainable policies. In their opinion, if a country has less executive constraints, politicians and elites will find various ways of getting greater political power to increase their own interest. This type of infighting between different political groups for the political power will increase political and economic turbulence.

There are several papers argue that executive constraints can reduce economic growth volatility due to their decentralization function. Henisz (2000) shows that there is positive relationship between the number of politicians with independent veto power over policy changes and the

possibility of large shifts in policies which may increase the economic volatility. Nooruddin (2003) suggests that effective constraints on politicians and elites, for example independence of the executive from the legislature, minority parliamentary government, and coalition government, can significantly reduce the economic growth volatility.

It has been shown that the ability of governments to handle economic crisis depends on the quality of institutions (Rodrik (2000); Arin et al. (2011)). Cariolle (2014) says one important reason of the occurrence of 2008 worldwide financial crisis is poor transparency and lack of accountability mechanisms in private and public fund management. The occurrence and consequences of this crisis can be seen an illustration of the complex link between governance quality and output fluctuations. As an important part of institution quality and a variable of the World Governance Index, corruption has been discussed in some papers which examine its effect on economic volatility.

Corruption can be viewed holistically as an institutional arrangement arising from the lack of inappropriateness, or ineffectiveness of formal institutions (Andvig, 2006; Williamson, 2009). Evrensel (2010) analyzes the corruption-growth volatility relationship and find that high corruption increase economic volatility. Attiya et al. (2011) argued that high corruption and low institutional quality lead to more fluctuations in the budget deficit which may increase the level and volatility of inflation.

Another dimension of political institutions that some research analysis is the stability of the regime. Rodrik(1999) shows that external conflicts make

economic growth more volatile. In addition, Asteriou and Price (2001) conclude that there is a strong positive relationship between political instability, measured by various political violence indicators, and macroeconomic volatility. Klomp and Haan (2009) use a four-factor model which includes “ aggression”, “ protest”, “ regime instability” and “ government instability” measure the political instability. Their results show that all four factors of political instability are positively related to growth volatility, but only regime instability and government instability have a significant effect.

There are several reasons why political instability may affect economic volatility. Violent challenges may increase economic volatility because they damage or destroy physical capital, divert resources from economically productive activities and discourages such activities by the uncertainty they generate (Jong-A-Pin 2009). Ari and Francisco (2006) say that countries with political instability are often sensitive to political shocks, resulting in discontinuous monetary and fiscal policies and higher inflation volatility.

From the studies discussed above, I can see that most of them study the relationship between political institutions and economic volatility in developed countries and they examine the impact of political institution from one particular aspect. This work tries to fill the gap about the impact of political institutions on economic volatility in developing countries. Compare with previous studies, this thesis analyze the relationship between political institutions and economic volatility in a more broad way by focusing three dimensions of political institutions. This paper also compares the results between different regions. The hypotheses are to see whether democracy,

executive constraints are negatively related to economic volatility and corruption, internal conflicts are positively related to economic volatility.