**Political stability and growth: An application of dynamic GMM and quantile regression**

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**ABSTRACT**

This paper studies the effect of political stability on economic growth by taking 120 developing countries over the period of 1996–2014. We apply relatively advanced dynamic two step system-GMM and quantile regression. Political stability is found to be a key determinant of economic growth. More importantly, political instability (or risk) is found to be higher in the OIC countries and is a deterrent to economic growth. Also, for the lower and middle income OIC countries, political instability appears to affect economic growth more severely perhaps due to the absence of strong economic and political institutions. Moreover, political instability is also found to be significantly higher in the oil-dependent OIC countries. Notably, political instability is likely to affect growth through the channels of investment and human capital accumulation in the developing countries. Finally, the impact of political stability and political instability on growth is found to be equally distributed across the OIC countries with higher or lower growth level. Therefore, the development of political and economic institutions along with human capital development is recommended for all the developing countries in general and the OIC countries in particular.

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**1. Introduction**

Muslim world has been found persistently entangled in war, foreign invasion, coup, ethnic rivalry, and sectarian violence. In spite of having tremendous economic prospect, developing Muslim countries have lost their growth trajectory in the last decade or so. Persistent political instability, internally and externally, has threatened not only the socio-political structure but also the economic development process. Not surprisingly enough, Muslim countries have been devastated by sixteen major wars, many coups, political, religious and ethnic insurgencies, and revolutions since the World War II. Furthermore, ongoing political instability with economic and political repression resulted in many Arab springs like revolutions in many Muslim countries. Therefore, the importance of political stability on economic development in the Muslim world deserves much attention. The Organization of Islamic Conference (OIC) countries represent one of the world’s largest market having around 1300 million consumers which roughly constitute 25 percent of the world population. With the objective of promoting close cooperation among Islamic countries in the economic, political and cultural fields following the demolition of Masjid AL Aksa, almost all Muslim majority countries set out a new journey in the name of OIC. The commencement of this journey is still quite young established in 1969. Apparently the 57 countries throughout the world are members; those Islamic countries are known to be diverse in terms of their economic structure, political system, level of development, ethnic and socio-cultural background.

Is political stability or instability a new phenomenon in the Muslim world? The answer is obviously negative. The importance of political stability for economic prosperity and greater human welfare was repeatedly mentioned in the Holy Quran and traditions of the Prophet (PBUH). Therefore, we argue that theoretical underpinnings of political stability and economic growth from Islamic perspective are based on the Holy Quran and the Sunnah. With the recent development of Islamic Economics, contemporary Islamic scholars have already proposed the so called Islamic growth model (Anwar, 1987; Khaldūn et al., 1969; Mannan, 1989) in which they identify political stability as an important determinant of growth. At the same time, a good number of researchers have found strong empirical evidence in support of the...
proposition that political stability promotes growth (Aisen and Veiga, 2013; Alesina et al., 1996; Barro, 1991; Devereux and Wen, 1998; Fosu, 1992; Goldsmith, 1987; Londregan and Poole, 1989). However, some others have not found significant relationship between political stability and growth (Goldsmith, 1987; Londregan and Poole, 1989). In the meantime, several attempts have been made to study this relationship in only a very few Muslim countries even idiosyncratic (Ahmed and Pulok, 2013; Armanah, 2009; Gurr et al., 2005; Mohamed, 2015; Slesman et al., 2015; Tang and Abosedra, 2014). To the best of our knowledge, no comprehensive study has been conducted so far to study this phenomenon, and even if such research exists, there is no study talking about this phenomenon considering the dichotomy of political stability and political risk together in such a wide number of countries. Hence the importance of political stability for sustainable economic development is still not settled yet in the literature. Therefore, we make an humble attempt to examine the impact of political stability on economic growth in OIC countries and how it is different from other developing countries from the point of view of the so called Islamic growth model (Anwar, 1987; Khalidun et al., 1969; Mannan, 1989; Mirakhor and Askari, 2010) by using important determinants which truly reflect economic growth in Islam, namely human, institutional, financial, and environmental development.

Most of the previous studies focus on political instability rather than stability, which is obviously a dichotomous concept (Olson cited in Goldsmith, 1989). In our study, we use two indicators both political stability and political risk. The political stability index 1 by Worldwide Governance Indicator (WGI) and political risk index is calculated by Oxford Economics based on WGI. In developing econometric model, most of the previous studies did not incorporate the lag of economic growth, rather used only initial GDP per capita, which is really important in growth studies, as economic growth is considered dynamic rather than static i.e., current economic growth depends on the past growth. To test our hypothesis whether political stability and risk affect the economic growth in Muslim countries, we apply advanced dynamic two step system-GMM and quantile regression. This estimator handles important modeling concerns, namely the fixed effects and endogeneity of regressors, whilst avoiding dynamic panel bias. Also, time dummies have been included to control for the time-specific effects and to eliminate cross-sectional dependence in the data. We have also studied various channels through which political stability affects economic growth. In addition to that, when there is evidence of outliers and heavy tailed distributions, quantile regression results are characteristically robust for such cases but standard OLS regression estimators are not robust even to a modest departure from normality.

Our results tend to show that the three most important aspects of development in Islam, namely institutional, financial and human development, are found to be significant contributors to growth. Political stability is one of the key determinants of economic growth for OIC and non-OIC developing countries. Political stability has a positive but political risk has a negative effect on economic growth. Political risk is significantly higher in OIC countries which obviously hinder economic growth. For the lower and middle income OIC countries, political risk affects economic growth severely perhaps due to the absence of strong economic and political institutions. In oil-dependent OIC countries, political risk is also found to be significantly higher. The importance of strong economic institution for sustainable growth is also reconfirmed. We have identified two channels, investment and human capital accumulation, through which political stability affects economic growth. The significance of economic institutions is greatly reduced in the absence of strong political institutions and for the OIC countries the development of political institutions is more important compared to other developing countries.

Our humble contributions in this paper lie in the following: (i) this is the first attempt to theoretically propose the importance of political stability on economic growth from the perspective of Islamic economics. (ii) Also, we test empirically the Ibn Khaldun’s proposition of the importance of political stability in the Muslim countries compared to that in the non-Muslim countries. (iii) Moreover, we contribute to the existing growth literature by extending the works of Alesina et al. (1996) and Aisen and Veiga (2013) by applying dynamic two-step system GMM and quantile regression techniques simultaneously. (iv) We also study various channels through which political stability can affect economic growth. (v) Finally, we test Olson’s theory which implies that political stability and instability are dichotomous by using two unique variables hitherto unexplored.

The rest of the paper is organized as follows. Section 2 discusses the theoretical foundation of political stability from the Islamic perspective. Section 3 presents the relevant theoretical and empirical literature. The theoretical model specification, data and the econometric methodology are explained in Section 4. The empirical results and discussions are presented in Section 5. The last section ends with the concluding remarks and policy implications.

2. Theoretical foundation of political stability and economic growth in Islam

The history of economic development in Islam started in Medina since the first Islamic state was established by the Holy Prophet (PBUH). The Prophet Mohammad (PBUH) founded a progressive state based on divine principles which became one of the most powerful political movements within a very short period of time.

Allah the Almighty mentions in the Glorious Quran:

O you who have believed, obey Allah and obey the Messenger and those in authority among you. And if you disagree over anything, refer it to Allah and the Messenger, if you should believe in Allah and the Last Day. That is the best [way] and best in result. [The Quran, 4:59].

This verse portrays the fundamental principles of religious, social, cultural and political life in Islam. One of the significant lessons from this verse is obeying the leader in power right after Allah and His Messenger Prophet Mohammad (PBUH). There are also numerous Hadiths5 on this regard. Even though Muslim accept the Quranic injunction without any doubt in their mind, our inquisitive mind wants to investigate the rationality behind this revelation. While discussing different Quranic interpretations, Rafique (2015) argues that following the leader would ensure stable law and order, political stability, protect countries from foreign aggression, and ensure peace and prosperity. The consequence of recent Arab uprisings in many Middle Eastern and North African countries is evident to us and post revolutionary situation clearly restates that this has led to an intense political instability and slower economic growth. However, silence against brutal dictator who does not uphold Islamic values and public interest is also not acceptable. Even in this situation uprising is not recommended in Islam rather concerted counselling is recommended as insurgency may create not only disorder but also unnecessary bloodshed. In another verse Allah (SWT) says:

...fitnah is worse than killing.... [The Quran, 2:191].

Here, the word fitnah means confusing state or corruption. In this way, Islam clearly prohibits social disorder, arm revolution, political

5 Sahih International translation of the Holy Quran.
6 Authentic sayings and traditions of the Prophet Mohammad(PBUH).
7 Sahih International translation of the Holy Quran.
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