Political Instability and Financial Development

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Abstract:
Political instability impedes financial development and is a primary determinant of differences in financial development around the world. Conventional measures of national political instability - such as Alesina and Perotti's (1996) well-known index of instability, a subsequent index derived from Banks' (2005) work, and prevailing indices of managerial perceptions of nation-by-nation political instability - all persistently predict a wide range of national financial development outcomes for recent decades. These results are quite robust to measures of factors in financial development that have obtained substantial prominence in the past decade, such as legal origin, trade openness, and latitude. These findings are for a range of key financial outcomes for all available years and for all available countries over several decades - data that has been previously examined only partially. Political instability's significance is time consistent back to the 1960's, the period when the key data becomes available, robust in both country fixed-effects and instrumental variable regressions, and consistent across multiple measures of instability and of financial development. Overall, the results indicate the existence of a strong channel running from political instability to financial backwardness. Moreover, the robust significance of that channel opens up new ways to understand what policies will work for financial development, because political instability has causes, cures, and effects quite distinct from those of many of the key institutions most studied in the past decade as explaining financial backwardness.

Keywords: financial development, investor protection, political instability, debt market development, stock market capitalization, political economy

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