

# THE SOCIO-ECONOMIC COST OF THE POST-ELECTION CONFLICT

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## ABSTRACT

*Both theory and empirical evidence suggest that political instability hinders domestic investment and foreign direct investment, therefore retarding economic growth. Moreover, political instability generates inefficiently high inflation, which hinders investment, reduces welfare and retards economic growth. In Lesotho periods of political instability are associated with very low levels of investment and economic growth. However, there is no evidence to suggest that political instability has led to high levels of inflation in those troubled periods.*

## INTRODUCTION

Post-election conflict, which manifests itself in politically motivated assassinations, deaths as a result of domestic violence, coup attempts (successful and unsuccessful), anti-government demonstrations, and general strikes, among other things, are good indicators of socio-political instability (SPI) in an economy. Generally, SPI can be defined as the degree of propensity for a change of governance of a country. More specifically, SPI is defined in terms of the frequency of events which increase the likelihood of social and political unrest (Awokuse & Gempesaw 2005).

Theoretically there are several channels through which SPI can have a negative impact on economic growth. SPI reduces investment and employment, thus retarding growth. Frequent political crises (coups d'état, riots, strikes, and so on) lead to regular stoppages of investment projects and productive activities. Consequently, foreign direct investment (FDI) is reduced and this, in turn, reduces economic growth.

SPI not only reduces productivity it can also lead to a significant decline in highly skilled human capital because of brain drain. Moreover, SPI induces financial capital flight and, therefore, reduces the incentive for the accumulation of physical capital. This not only has a negative impact on investment, it may also erode a nation's international reserves and its ability to finance imports, which serve to substitute for losses in domestic production caused by the disruptive effects of SPI. SPI can also impede economic growth by contributing to high inflation, which, in turn, discourages economic growth. SPI is notorious for generating hyperinflation.

Section two of the paper discusses the adverse effects of SPI on investment, the major determinant of economic growth; section three highlights the effects of SPI on inflation; section four considers the possible effects of SPI on trade balance; section five focuses on the economic impact of SPI in Lesotho; and section six concludes and highlights the social costs of SPI emanating from its negative impact on investment, employment, and economic growth. The final section sets out policy implications.

### POLITICAL INSTABILITY AND INVESTMENT

Economists and political scientists have long recognised that, over and above economic failure, political and institutional failure adversely affect economic performance. Notable studies in this field include Greene & Villamueva (1990), Feng & Chen (1997), Feng (2001), and Le (2004). Unlike most researchers Le (2004) employs a model which divides political risk into three types, namely, SPI, regime change instability (RCI), and policy uncertainty, while at the same time controlling economic risk.

Le (2004) defines SPI as series of widespread politically violent and non-violent protests and internal uprisings involving the use of physical force. The main finding is that SPI characterised by non-violent protest promotes private investment while violent uprisings have a negative impact on investment. SPI is said to reduce investment in two ways. First, it destroys physical capital and displaces human capital, thereby reducing job opportunities and disrupting personal savings. This process hinders private investment.

Second, SPI induces investors to shift their assets from fixed capital stocks to more liquid and speculative forms of investment.

Le (2004) argues that RCI is caused by constitutional or unconstitutional change in the executive power. In common with Feng (1997, pp 391-418), Le differentiates between two types of change – major regular government change and irregular government change. Major regular government change is a constitutional power transfer of the executive office within the ruling party or the

coalition of ruling parties. It represents a policy adjustment and can cause uncertainty if such a change leads to a distortion in the fundamental market structure. But it may also lead to the adoption of market reform policies. Irregular government change which takes place by unconstitutional means can disrupt the political system and reduces private investment. RCI characterised by constitutional government change, on the other hand, encourages private investment.

Le (2004) focuses on two different types of policy uncertainty, the variability of government political capacity and the variability of contract enforcement. The former is measured by the political capacity of government to implement policy. A measure called Relative Political Capacity (RPC) is often used in this case. It is based on the ratio of actual to predicted government revenue.

The basic notion is that a country with high RPC has a strong government which can implement policy effectively. Conversely, a government with low RPC is unable to extract resources to implement its policy. The variability of RPC generates uncertainty because the direction of policy is not clear to investors (Feng & Chen 1997). From a policy point of view private investment declines because the government fails to provide comprehensible policy direction to the private sector (Le 2004). The variability of contract enforcement is measured by contract intensive money (CIM), an indicator of property rights enforcement based on the type of financial assets held. This measure, developed by Clagure, Keefer, Knacks & Olson (1999), is defined as the ratio of non-currency money to the total money supply:

$$\frac{M_2 - C}{M_2}$$

where  $M_2$  is a broad definition of money supply and  $C$  is currency in the hands of the non-banked public.

The variability of CIM is used as another measure of policy uncertainty. Le (2004) finds that policy uncertainty characterised by the variability of contract enforcement encourages private investment, while the variability of government political capacity discourages private investment.

Moreover, a vast amount of literature shows that political instability causes the value of a country's currency to decline and makes the exchange rate more volatile. The foreign exchange volatility reduces FDI inflows. Since FDI serves as a supplement to domestic saving and investment, investment is hindered by political instability.

## POLITICAL INSTABILITY AND INFLATION

It is hypothesised that economies with weaker institutions might be unable to build efficient tax systems, thereby resorting more frequently to the use of seigniorage<sup>1</sup> as a source of revenue (Aisen & Veiga 2005). The underlying cause of most episodes of high inflation and hyperinflation is government's need to obtain seigniorage.

The link between politics and inflation basically relates to the demand for public expenditure, which is, in turn, financed by seigniorage or inflation tax. It is noteworthy that, though seigniorage and inflation tax are used interchangeably, the two concepts are different. Seigniorage is the revenue the state enjoys by having the monopoly to issue a monetary base while inflation tax is the loss sustained by the holder of real money balances and non-indexed government bonds because of inflation.

Inflation reduces the purchasing power of real money balances and, therefore, reduces consumption. The two terms (inflation tax and seigniorage) are closely related but are identical only when any increase in money supply is translated into inflation (Sachinides 1995). The confusion between seigniorage and inflation tax emanates from the mistaken assumption that the growth rate of money is equal to the growth rate of prices. This assumption holds only for a static economy. In a growing economy, however, the government can increase money supply by change in income times the measure of responsiveness of demand for money to changes in income. The newly issued money provides revenue for the government – this is seigniorage and is quite different in concept from inflation tax (Sachinides 1995; Friedman 1971; Blanchard & Fischer 1989; Kimbrough 1992). In most cases a high inflation rate is explained by the need to raise revenue from money creation to finance the budget deficit.

## THE COSTS OF INFLATION

### *Easily Identifiable Costs*

In many simple models steady inflation merely adds an equal amount to the growth rate of all prices and nominal wages and to the nominal interest rate on all assets. Consequently, inflation has no effect on relative prices, real wages, or real interest rates (Romer 1996). This makes it difficult to identify its real effects. But since the nominal return of high-powered money (cash holdings of the non-

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1 Profit made by issuing currency, especially coins, rated above their intrinsic value

banked public plus bank reserves) is fixed at zero, inflation necessarily lowers its real return. The increased gap between the rate of return on money and that on other assets leads people to hold less high-powered money – they make smaller and more frequent conversions of other assets into currency. Since it essentially costs the government nothing to produce high-powered money these efforts have no social benefit. Therefore, they represent a cost of inflation (Romer 1996).

One other easily identifiable cost of inflation is that nominal prices and wages have to be changed quite often, or indexing schemes have to be adopted. There are some costs associated with these efforts.

### *Other Costs of Steady Inflation*

Since individual prices are not adjusted continuously (different firms adjust their prices at different times), steady (anticipated) inflation may cause variations in relative prices. Consequently, inflation widens the departures of relative prices from the values they would take under continuous price adjustment.

Inflation-induced relative-price variability may disrupt markets where firms and customers form long-term relationships and prices are not adjusted frequently. Formal theoretical models suggest that inflation can have complicated effects on market structure, long-term relationships and efficiency (Romer 1996).

Individuals and firms that do their financial planning in nominal terms (in money terms – not in real terms) can make major errors in long-term investment (eg, in saving for retirement) even under moderate inflation. For instance, 3 per cent inflation, though moderate by all standards, can cause price levels to triple over 40 years.

### *Costs of Variable Inflation*

High inflation is more variable and less predictable. Since many assets are denominated in nominal terms, unanticipated inflation will redistribute wealth (from lenders to borrowers). Therefore, high inflation variability increases uncertainty and reduces welfare. Moreover, with debts denominated in nominal terms, greater uncertainty about inflation can make firms and individuals reluctant to undertake long-term investment.

Highly variable inflation may also hinder long-term investment if firms and individuals perceive it to indicate a poorly performing government that is likely to resort to confiscatory taxation or other policies detrimental to capital-holders (Romer 1996).

The empirical evidence suggests a strong negative association between inflation and investment; and between inflation and growth.

## POLITICAL INSTABILITY

### *Political Instability and the Trade Balance*

Since SPI discourages economic growth by inducing financial capital flight, thereby reducing the accumulation of physical capital, it encourages imports, at least in the short to medium term. The basic notion is that domestic production is disrupted by SPI and therefore imports serve as a foreign substitute for losses in domestic production. Although the purchasing power of the importing nation declines as a result of the negative impact of SPI on the income level, the import bill enlarges, as most imports are basic necessities (food, fuel, and so on). Consequently, SPI leads to trade imbalance and possibly to an overall balance of payments deficit. Almost all politically unstable economies have low incomes, ever-enlarging trade imbalances, and a large and unsustainable national debt burden, with detrimental consequence for economic growth.

### *Political Instability and its Economic Impact in Lesotho*

The paper focuses on three distinct periods in which one of the following took place: unconstitutional regime change, constitutional regime change followed by political instability, and/or re-election of regime followed by political instability.

In particular, it concentrates on the years 1986, 1993, and 1998. 1986 was marked by an unconstitutional regime change – a military coup. The military regime lasted for about six years. In 1993, a memorable year in the history of Lesotho, the first democratic elections were held following a long ‘holiday from politics’ (since 1970). The political instability that followed these elections led to the temporary downfall of the democratically elected government. In 1998 Lesotho experienced its most violent post-election political protest following the landslide victory of the Lesotho Congress of Democrats (LCD).

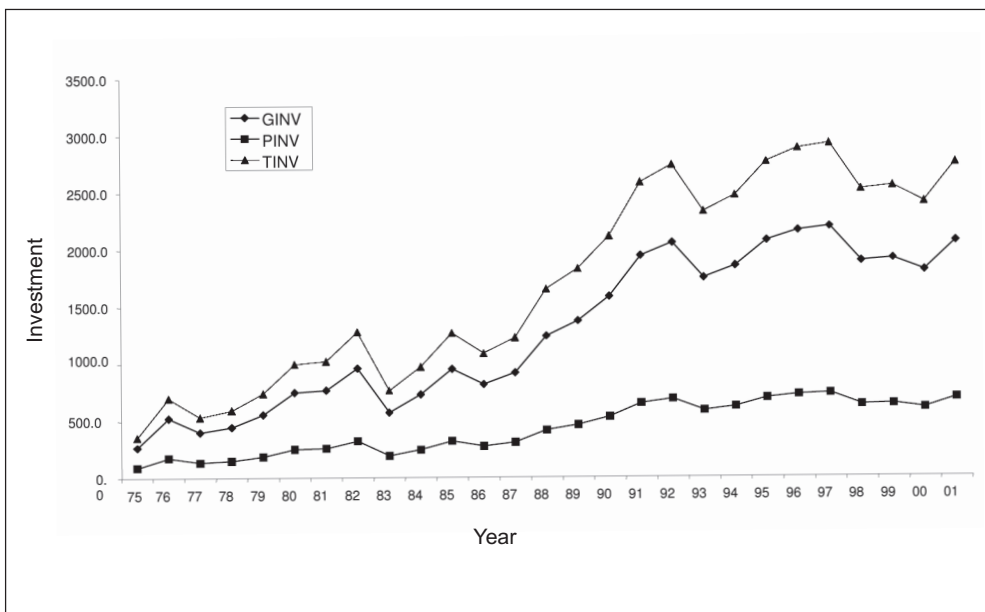
### *Political Instability and Investment in Lesotho*

A glance at Lesotho’s data on the variables of interest, namely, investment and economic growth, reveals that both variables were negatively affected by political developments which preceded or followed regime change. For instance, as indicated in Figure 1, total investment dropped by 14 per cent in 1986, the year in which Lesotho experienced its first military coup.

Investment began to pick up after 1987 following the signing of the Lesotho Highlands Water Project Treaty between Lesotho’s military regime and South Africa’s white minority government. The upward trend reached a peak in 1992 before dropping by 15 per cent in 1993, the year in which the first democratic

elections were held. The drop in investment was a direct result of the political instability that led to the temporary downfall of the democratically elected government. The effect on investment was, however, short lived – it began to pick up from 1994 until 1997, the year before the second democratic election. Investment dropped by 13 per cent in 1998 compared to 1997, again as a direct result of the most violent political protests Lesotho had experienced since independence. These observations are consistent with Le's (2004) findings on 25 developing countries. Specifically, Le (2004) demonstrates that violent uprisings seriously hinder private investment.

**Figure 1**  
**Political Instability and Investment (Government Investment, GINV;**  
**Private investment, PINV; and Total Investment, TINV)**

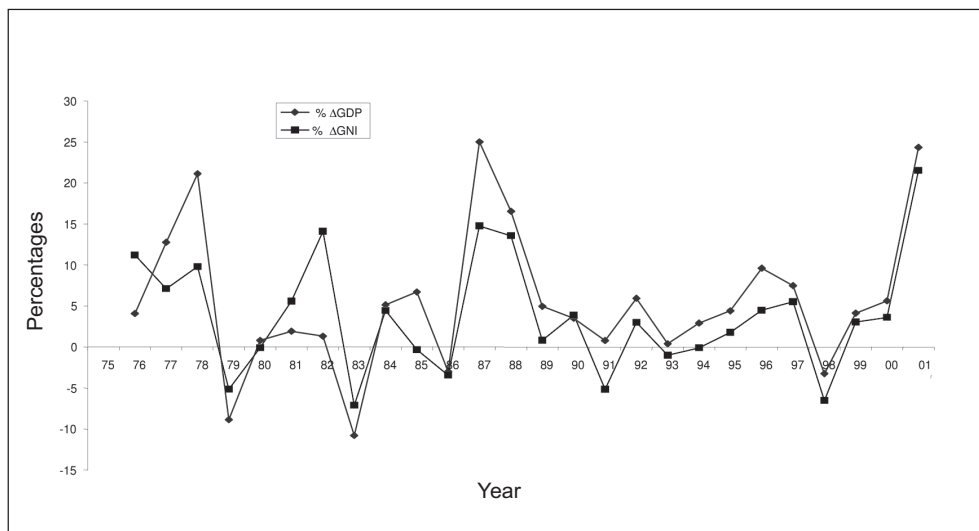


### *Political Instability and Economic Growth*

Like investment, economic growth was adversely affected by the political upheavals highlighted above. In particular, as seen in Figure 2, the economic growth rate declined significantly, from 6,7 per cent in 1985 to -3 per cent in 1986, the year in which Lesotho experienced its first military coup.



**Figure 2**  
**Political Instability and Income Growth Rate (Percentage Change in GDP, % $\Delta$ GDP; and Percentage Change in Gross National Income, % $\Delta$ GNI)**



This drop is not unexpected given that investment fell by 14 per cent in the same year. Particularly noteworthy is the fact that the economy began to register positive and high growth rates from 1987 to 1990. Significant economic slowdowns are notable in the years 1991 and 1993. In particular, the growth rate declined from 5,9 per cent in 1992 to 0,4 per cent in 1993, the year in which there was a constitutional regime change.

Although such regime change should, under normal circumstances, lead to high investment and therefore high economic growth, the political instability that followed the overwhelming victory of the LCD led to the temporary downfall of the democratically elected government during this period. This should, by all laws of probability, have been the source of an economic downturn during this period. However, economic growth started to pick up substantially from 1994 (from 0,4 in 1993 to 2,9). The reason behind this quick recovery is the fact that the political instability was short lived and the measures taken to reinstate the democratically elected government were swift and decisive.

On average the economy grew at the rate of 6 per cent a year between 1994 and 1997. These unprecedented growth rates are largely attributable to the country's relative political stability during this period and to the implementation of the Lesotho Highlands Water Project. Lesotho's economy registered a negative

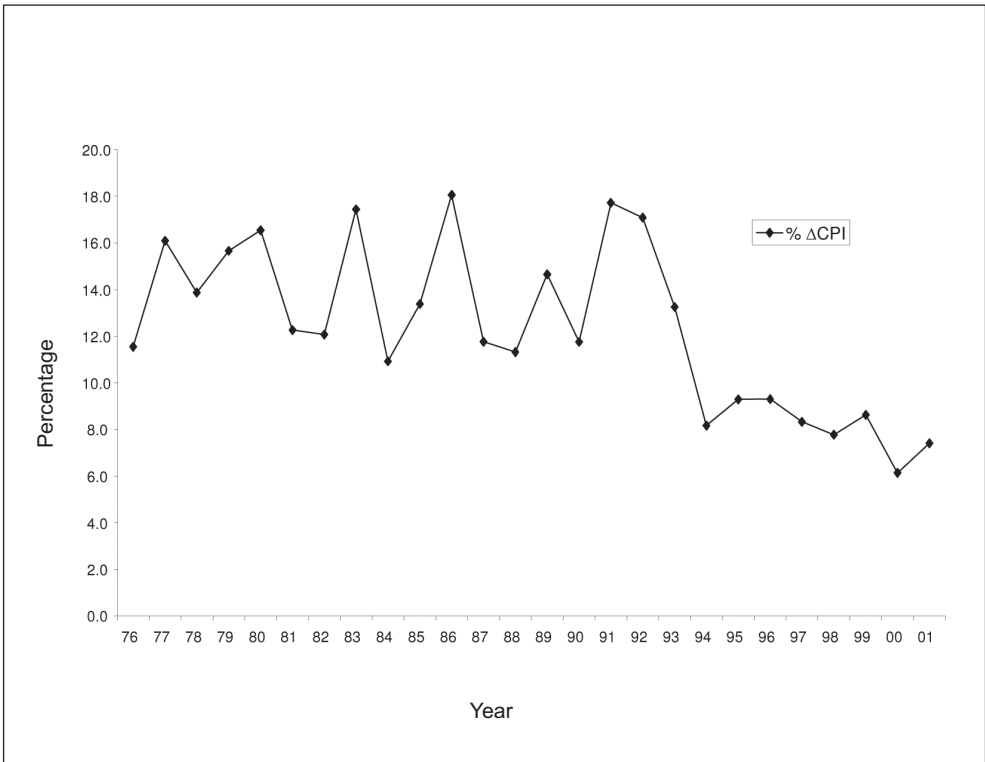


growth rate of -3,3 percent in 1998, after enjoying positive and high growth rates (an average of 6%) since 1994 – a result of the political instability cited above.

It is noteworthy, however, that the economy began to recover from 1999, an occurrence consistent with the findings of studies on the subject in other countries. For instance, Abadie & Gardeazabal (2002); Fosu (2004) and Gelb (2001) demonstrate that political instability leads to a decline in economic growth.

Figure 3 makes it clear that there is no noticeable correlation between inflation and political instability. The reason for this is that the option of seigniorage revenue is not available to Lesotho under the CMA arrangement. This is one of the most obvious benefits of participation in the arrangement. It is noteworthy, however, that studies in other countries demonstrate that political instability leads to high inflation. For instance, Aisen & Veiga (2005) demonstrate that between 1960 and 1999 political instability led to high inflation in about 100 industrial and developing countries.

**Figure 3**  
**Political Instability and Inflation Rate (Percentage Change in**  
**Consumer Price Index, % $\Delta$ CPI)**



## CONCLUSION

Both the theory and the empirical evidence suggest that political instability generates inefficiently high inflation, which reduces welfare and hinders domestic investment and foreign direct investment, retarding economic growth. Moreover, politically unstable economies have a low income, ever-growing trade imbalances, and large and unsustainable national debt burdens, with detrimental consequences for economic growth.

Declining income levels put governments in a very vulnerable position and undermine their ability to pay civil servants and provide basic social services (health, education, and so on). This raises frustration in the population and may trigger further political instability. Since employment is procyclical a decline in income leads to higher unemployment. The immediate impact of this on the population is poverty, misery, disease (including HIV/AIDS), and crime of all sorts.

In the case of Lesotho periods of political instability have been associated with very low levels of investment and economic growth, which have, in time, resulted in a declining income which undermines government's ability to provide basic social services. Moreover, declining investment and low levels of income lead to higher levels of unemployment. The end result is poverty, frustration, an increase in crime, and the outbreak of disease.

There is, however, no evidence to suggest that political instability has led to high levels of inflation. The main reason is that, under the current CMA arrangement, the government of Lesotho cannot resort to seigniorage revenue, the need for which is the main source of high inflation and hyperinflation. As indicated, above moderate inflation may not entail substantial costs at macro level, but it hurts the vulnerable sections of society (the old, the unemployed, and the children). Inflation, however moderate, reduces the purchasing power of money, making basic necessities unaffordable by the vulnerable groups.

## POLICY RECOMMENDATIONS

Periods of political instability in Lesotho have been fairly brief since 1993 because of effective intervention by neighbouring countries. Foreign intervention of this nature should be encouraged and strengthened as it contributes to mitigating the adverse effects of political instability on economic performance. The fact that Lesotho, because of its participation in CMA, has experienced low levels of inflation despite political instability makes it imperative that the country remain a member of CMA.

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