Investigating the Trajectory of Egypt’s Potential Output: Pre and Post the Arab Spring

El-Baz, Osama

5 November 2016

Online at https://mpra.ub.uni-muenchen.de/75778/
MPRA Paper No. 75778, posted 25 Dec 2016 01:35 UTC
The Economic Society
Workshop On: The Arab Spring: Post shock policy responses

Working Paper On:
Investigating the Trajectory of Egypt’s Potential Output:
Pre and Post the Arab Spring

Name: Osama El-Sayed Mohamed El-Baz.
Nationality: Egyptian.
Mobile: +966-0592723181.
E-mail: osamaeces@gmail.com
Investigating the Trajectory of Egypt’s Potential Output: Pre and Post the Arab Spring

Osama El-Baz

E-mail: osamaeces@gmail.com, Mob: +966-0592723181

Abstract

The Egyptian economy has witnessed a plunge in its main macroeconomic indicators after the Arab spring as reflected in the estimated Economic Stability Trend Index (ESTI). The main purpose of the paper was to estimate Egypt's potential output and identify the factors that might be responsible for the divergence of actual and potential output from each other. The production function approach was used to derive estimates of both potential output and output gap over the period (1990-2014). The results of the analysis revealed that capital stock was the dominant factor contributing to potential GDP growth in Egypt, while the shares of both labor and total factor productivity in potential GDP growth rate have been fluctuating over time. Intellectual property protection, efficiency of the legal framework in settling disputes, strength of investor protection, and other factors exhibited a strong positive relationship with output gap in Egypt over the period (2010-2014).

1. Introduction

The Egyptian economy has witnessed a plunge in its main macroeconomic indicators over the period (2008-2014), which has been aggravated mainly after the Arab spring as political instability concerns induced economic slowdown.
The estimation of potential output has become an issue of high importance as it represents one of the widely used tools for policy formulation. Potential output is defined as the level of output or productive capacity that an economy can reach without triggering either upside or downside pressures on inflation under full employment. The output gap is an important concept which refers to as the difference between the actual and potential output in percent of potential output (Blagrave et al. 2015). When the output gap is zero, it means that there is no either upward or downward pressure on inflation, as actual demand coincides with economy’s potential productive capacity. While when the output gap is positive, it means that actual output level "demand" exceeds the potential level and this would build upside inflation pressures.

Output gap and potential output estimates are important for policymakers and Economists as it shades light on the economic performance of the country; as it indicates the relative deviation of actual output from its potential level and the availability of spare capacity in the economy. Also, it is an indicator regarding the success of government economic policies in stimulating economic activity and adopting a business friendly environment.

As for studies analyzed output gap in the Egyptian economy, only one study was conducted by the Central Bank of Egypt, it concluded that potential output in Egypt decelerated by the end of 2008 compared to its previous trend, while a positive gap started to appear by the end of 2009, which is consistent with the late increases in actual output growth rates (CBE, 2010).

Accordingly, the empirical contribution of this paper is the estimation of Egypt's potential output using the production function approach, deriving
estimates of output gap, calculating the contributions of numerous factors to potential growth rate, and discovering the relationship between output gap and other indicators related to the macroeconomic and business environment and providing policy implications to spur economic growth.

This paper consists of seven sections as follows: **First:** Introduction. **Second:** The Egyptian Economy: Challenges and Stylized Facts. **Third:** Empirical Methodologies to Estimate Potential Output. **Fourth:** Econometric Analysis: The Production Function Approach. **Fifth:** Contributions to Potential GDP Growth Rates in Egypt. **Sixth:** Factors Affecting Egypt's Output Gap. **Seventh:** Conclusion and policy implications.

## 2. The Egyptian Economy: Challenges and Stylized Facts

The Egyptian economy has witnessed a plunge in its main macroeconomic indicators over the period (2008-2014). Real GDP growth rates over this period recorded an average of about 3.6 percent, while growth rates exhibited a significant fall starting from 2011 as the average real GDP growth rate during (2008-2010) was around 5.7 percent (Figure 1), also real GDP per capita declined after 2011(Figure 2). Both national saving-to-GDP ratio and total investment-to-GDP ratio declined after 2011 and recoded around 13.2 percent and 14 percent in 2014, respectively (Figures 3 & 4). In tandem with a significant increase in structural budget deficit-to- potential GDP ratio, which increased from 8.3 percent in 2010 to 13 percent in 2014 (Figure 5). Unemployment rate has also increased from 8.3 percent in 2010 to 13 percent in 2014. To sum
up, the Egyptian economy suffers problems in its macroeconomic fundamentals and structural reforms needs to be undertaken to put the economy on a sustainable growth path.

In a nutshell, Egypt's economic stability has been negatively affected gradually after the revolution; this can be easily visualized in (Figure 7). The Economic Stability Trend Index (ESTI)\(^1\) has been in the negative area since 2011 and recorded -0.98 in 2014; which reflects a higher level of economic instability and the increasing buildup of vulnerability risks. That's why it is important to investigate Egypt's potential output and the main factors affecting it, to be able to derive empirical policy recommendation to spur economic growth.

![Figure (1): Real GDP Growth Rates, (2008-2014)](source)

\(^1\)The Economic Stability Trend Index (ESTI) was estimated using eight macroeconomic variables. It ranges between (-1: 1), where -1 reflects the buildup of economic vulnerability in the system and 1 reflects higher levels of economic stability. The methodology and data used to build this index are available in details in Annex 1.
**Figure (2): Real GDP Per Capita (LE 1000), (2008-2014)**

Source: International Monetary Fund. World Economic Outlook.

**Figure (3): National Saving-to- GDP Ratio, (2008-2014)**

Source: International Monetary Fund. World Economic Outlook.
Figure (4): Total Investment-to-GDP Ratio, (2008-2014)

Source: International Monetary Fund. World Economic Outlook.

Figure (5): Structural Government Budget Balance-to-potential GDP Ratio, (2008-2014)

Source: International Monetary Fund. World Economic Outlook.
Figure (6): Unemployment Rate in the Egyptian Economy, (2008-2014)

Source: International Monetary Fund. World Economic Outlook.

Figure (7): Egypt's Economic Stability Trend Index (ESTI), (2002-2014)

Source: Researcher's Calculations.
3. Empirical Methodologies to Estimate Potential Output

All commonly used methodologies to estimate the potential output involve filtering of the macroeconomic time series to extract the unobservable underlying potential output level from cyclical variations in the output series. There are three main methodologies which are commonly used to estimate potential output, which are singlevariate, multivariate, and hybrid methods.

- **Singlevariate Statistical Methods:**

  **Hodrick Prescott (HP) filter** has become the most commonly used statistical method to estimate potential output due to its flexibility in tracking the fluctuations of trend output and decomposing the aggregate output into both trend and cyclical components. The HP filter estimates potential output by minimizing the sum, over the sample period, of squared distances between actual and potential output at each point in time, subject to a restriction on the variation of potential output. The restriction parameter $\lambda$ captures the importance of cyclical shocks to output relative to trend output shocks, and thereby controls the smoothness of the series of potential output; a smaller value of $\lambda$ indicates a smaller weight of cyclical shocks and leads to a more volatile series of potential output.

  The singlevariate (SV) methods provide an easy tool to estimate potential output. However, these methods are purely statistical techniques, which filter the actual GDP data to extract the trend component as its estimate of potential output. The most common SV filter is the Hodrick-Prescott (HP) filter. The HP filter is advantageous as it only requires one data
series (output). However, the HP filter does not take into consideration the information available from other economic indicators such as inflation or labor market indicators, to guide its estimate of potential output.

- **Hybrid Methods:**

  The Production Function (PF) approach is better than a SV filter because it allows for more detailed examination of the drivers of potential output. A downside of this approach is that it assumes capital is always at its potential. The hybrid approach also suffers from the end of-sample problems. This approach takes into consideration the contribution of labor, capital, and total factor productivity to potential output. This approach will be used in this paper to estimate Egypt's potential output.

- **Multivariate Methods:**

  Multivariate (MV) filtering methodologies are used in the literature to estimate potential output. Some examples are models of Laxton and Tetlow (1992), Kuttner (1994), Benes and others (2010), Fleischman and Roberts (2011), and Blagrave and others (2015). MV filtering involves separating potential output from cyclical fluctuations, through the use of data and relationships between output and other macroeconomic variables, such as inflation, labor market indicators, capital formation indicators, etc. This approach adds economic structure to estimates by conditioning them on some basic theoretical relationships, such as the Phillip’s curve equation which expresses the relationship between inflation and output gap. MV filtering methodologies are more complicated than SV filtering methodologies and require more data, but are at the same time more reliable because they use more information from the data for their estimates.
The MV filtering approach needs a long time series data. However it provides the advantage of imposing well-known empirical relationships.

4. Econometric Analysis

The Production Function Approach

- **Methodology:**

  Following a standard application in the literature (Konuki. 2008) and (Epstein and Macchiarelli. 2010), the Egyptian economy is assumed to be characterized by a Cobb-Douglas production function with constant returns to scale (CRS) ($\alpha + \beta = 1$).

  \[
  Y_t = A_t L_t^\alpha K_t^\beta \quad (1)
  \]

  where $Y_t$ is output and $L_t$, $K_t$ and $A_t$ are labor and capital, and total factor productivity (TFP), respectively; and the output elasticities sum up to one under the assumption of constant returns to scale (CRS).

  The Terms on the right hand side of equation (1) are defined as follows:

  - **The labor input:** it is defined as the number of people employed in the economy.
  - **The capital stock:** this series is constructed from total investment assuming perpetual inventories, hence:

    \[
    K_t = K_{t-1}(1-\mu) + I_t \quad (2)
    \]

    capital stock in each period is estimated using the previous-period stock (net of depreciation) augmented with new investment flows. Consistent with previous studies, the depreciation rate ($\mu$) ranges between .04 and .05. In order to construct a time series for capital
stock an initial value is needed for a reference year, which could be estimated by the following formula:

\[ K_t = K_t / (\mu + i) \]  \hspace{1cm} (3)

Where \((i)\) is the average growth rate of investment over the sample period included in the analysis.

- **The total factor productivity** term is obtained from equation (1) as a Solow residual as expressed by equations (4) and (5).

\[ A_t = Y_t / (L_t^\alpha K_t^\beta) \], where: \(\alpha = 1 - \beta\)  \hspace{1cm} (4)

\[ \ln A_t = \ln Y_t - (1 - \beta) \ln L_t - \beta \ln K_t \]  \hspace{1cm} (5)

- **Output elasticities** to inputs of labor and capital are needed to estimate total factor productivity (TFP), we will estimate them using the following OLS regression models:

\[ \ln Y_t = \ln A_t + (1 - \beta) \ln L_t + \beta \ln K_t \]  \hspace{1cm} (6)

\[ (\ln Y_t - \ln L_t) = \ln A_t + \beta (\ln K_t - \ln L_t) \]  \hspace{1cm} (7)

Equation (7) could be estimated by an OLS regression model to estimate \(\beta\) and \(\alpha\), where \((\alpha = 1 - \beta)\).

- **Potential Values of K, A, and L:** potential values of capital, labor, and total factor productivity are needed in order to estimate potential output using the following equation:

\[ Y^*_t = A^*_t L_t^\alpha K_t^\beta \]  \hspace{1cm} (8)

As for the potential utilization of the capital stock, a capacity utilization series is not available. In this regard, and consistent with the literature, we assume the full utilization of the existing stock of
capital. Such a simplification mostly relies on the assumption that, given the perpetual inventories rule, the capital stock can be regarded as an indicator for the overall capacity of the economy. Potential values of both total factor productivity and labor could be estimated by Hodrick Prescott (HP) filter to derive their trend components from their actual values.

- **Data and Variables:**
  - **Real GDP (Real Output):** real gross domestic product was estimated using data for gross domestic product at market prices deflated by the GDP deflator.
  - **Employed People (Labor):** employed people in millions.
  - **Real Investment:** total investment was deflated by the GDP deflator.

All data used are from the IMF World Economic Outlook database and covering the period (1990-2014).

- **Model Estimation:**
  - The elasticities of output to labor and capital inputs could be estimated using the following regression model:

  \[
  (\ln Y_t - \ln L_t) = \ln A_t + \beta (\ln K_t - \ln L_t) \tag{1}
  \]

  Both the dependent and the explanatory variables were tested for stationarity using Augmented Dickey Fuller (ADF) unit root test, they were found to be integrated of order one (Table 1). The output of the regression model is summarized by (Table 2), and diagnostic tests were used and it was found that the model does not suffer any serial correlation, heteroscedasticity, and normality problems (Table 3), all details of the model and
diagnostic tests are in the appendix. The elasticities of output to capital and labor inputs were found to equal 0.74 and 0.26, respectively.

Table (1): ADF Unit Root Test for Variables of Equation (1)

<table>
<thead>
<tr>
<th>Variable</th>
<th>t-Statistic</th>
<th>P- Value</th>
<th>Order of Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>(LnYt – Ln L0)</td>
<td>-4.241</td>
<td>.0174</td>
<td>I(1)</td>
</tr>
<tr>
<td>(Ln Kt - Ln L0)</td>
<td>-3.60</td>
<td>.0569</td>
<td>I(1)</td>
</tr>
</tbody>
</table>

Source: Researcher's calculations.

Table (2): Elasticity of Output to Capital and Labor Inputs

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>t- Statistic</th>
<th>P- Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>0.008730</td>
<td>3.235195</td>
<td>0.0038</td>
</tr>
<tr>
<td>D((Ln Kt- Ln L0), 1)</td>
<td>0.743021</td>
<td>9.121040</td>
<td>0.0000</td>
</tr>
</tbody>
</table>

Source: Researcher's calculations.

Table (3): Results of Diagnostic Tests

<table>
<thead>
<tr>
<th>Variable</th>
<th>Test Statistic</th>
<th>P- Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jarque Bera Test of Normality</td>
<td>0.2715</td>
<td>0.8730</td>
</tr>
<tr>
<td>Breusch-Godfrey Serial Correlation LM Test</td>
<td>2.167666</td>
<td>0.1406</td>
</tr>
<tr>
<td>Heteroskedasticity Test: Breusch-Pagan-Godfrey</td>
<td>3.143538</td>
<td>0.0901</td>
</tr>
</tbody>
</table>

Source: Researcher's calculations.
Capital Stock was estimated according to equations (2 & 3) (Figure 8), and total factor productivity was calculated as a Solow residual using the following equation (Figure 9):

\[ \ln A_t = \ln Y_t - (1-\beta) \ln L_t - \beta \ln K_t \]  \hspace{1cm} (2)

**Figure (8): The Natural Logarithm of Estimated Capital Stock (1990-2014)**

![Graph showing the natural logarithm of estimated capital stock from 1990 to 2014. Source: Researcher's calculations.]

**Figure (9): The Natural Logarithm of Estimated Total Factor Productivity (1990-2014)**

![Graph showing the natural logarithm of estimated total factor productivity from 1990 to 2014. Source: Researcher's calculations.]

15
In order to estimate potential output level \((Y^*)\), the potential levels of both labor employed \((L^*)\) and total factor productivity \((A^*)\) were derived as the Hodrick Prescott filtered series of the aggregate series of actual labor and TFP (Figures 10&11). Potential output was estimated using the production function approach \((Y^*)\) and was compared to potential output level estimated by the HP filter \((Y_{HP}^*)\) (Figure 12). Output gap was also estimated, it is important to mention that the Egyptian economy exhibited successive negative output gaps starting from 2012 and the forecasts starting from 2015 (period 26 in Figure 13) onwards using an ARMA (1,1) model revealed that the Egyptian economy would be expected to witness positive output gaps starting from 2020.

**Figure (10): The Natural Logarithm of Potential Employment (1990-2014)**

![Graph of Natural Logarithm of Potential Employment](image-10)

*Source: Researcher's calculations.*

**Figure (11): The Natural Logarithm of Potential Total Factor Productivity (1990-2014)**

![Graph of Natural Logarithm of Potential TFP](image-11)

*Source: Researcher's calculations.*
Figure (12): Potential Output Estimates for the Egyptian Economy (1990-2014)

Source: Researcher's calculations.

Figure (13): Estimates and Forecasts for Egypt's Output Gap

Source: Researcher's calculations.
5. Contributions to Potential GDP Growth Rates in Egypt

The production function framework enables us to estimate the contribution of each factor of production to potential GDP growth. Changes in these contributions can be assessed as a signal for structural changes in the economy. The contributions of labor and capital inputs to potential GDP growth rate were estimated, accounting for their respective shares in output. Contributions are computed as year-on-year percentage changes (Epstein and Macchiarelli, 2010). Labor, capital and TFP contributions sum up to potential GDP growth rates, as according to equation (1) it is accepted that the sum of percentage changes in labor, capital, and total factor productivity equals the percentage change in output "GDP Growth".

The contributions of Labor, capital and TFP to potential GDP growth rates were estimated (Figure 14). It could be easily visualized that capital stock was the dominant factor contributing to potential GDP growth in Egypt over the period (1991-2014), while the shares of both labor and total factor productivity in potential GDP growth rate have been fluctuating over time. As for labor and TFP, it is noticed that the relative importance of both of them in GDP potential growth rate has changed over the period (1991-2014); the contribution of TFP to potential GDP growth rate over the period (1991-2010) has been outweighing that of labor, while starting from 2011 the contribution of labor to potential GDP growth rate exceeded that of TFP (Figure 15). The average share of labor and TFP in potential GDP growth rate over the period (2011-2014) recorded 22.3% and 17.4%, respectively.
Figure (14): Contributions to Potential GDP Growth Rates in Egypt, (1991-2014)

Source: Researcher's calculations.

Figure (15): The Relative Share of Labor and TFP's Contributions to Potential GDP Growth Rates in Egypt, (1991-2014)

Source: Researcher's calculations.
6. Factors Affecting Egypt's Output Gap

In order to identify the economic factors that might affect output gap in the Egyptian economy, we will depend on selected sub indices which falls under the umbrella of the Global Competitiveness Index, and Egypt's rankings in them were used to identify their relationship with output gap.

The indices used were intellectual property protection, efficiency of legal framework in settling disputes, strength of investor protection, quality of overall infrastructure, government budget balance-to-GDP ratio, quality of the education system, intensity of local competition, pay and productivity in labor market, availability of financial services and capacity for innovation.

Data used for these indices are covering the period (2010-2014), and output gap estimates for the same period were derived from the production function analysis conducted in section four. It could be visualized form the simple regression analysis that the rankings of Egypt in all the variables mentioned earlier are inversely related to output gap; which means that better rankings of the Egyptian economy in these sub indices implies the convergence of actual output to potential output or exceeding it with the absence of negative output gaps (figures 16: 25).

Data for the Economic Stability Trend Index (ESTI) estimated in section one, also Egypt's scores on political stability, regulatory quality, government effectiveness and rule of law were used to investigate their relationship with output gap in Egypt over the period (1996-2014). A positive relationship between these variables and output gap could be visualized from figures (26: 30), especially over the period (2011-2014) as depicted by the red points.
Figure (16): Relationship between Intellectual Property Protection and Output Gap (2010-2014)

Source: Researchers' Calculations.

Figure (17): Relationship between Efficiency of Legal Framework in Settling Disputes and Output Gap (2010-2014)

Source: Researchers' Calculations.
Figure (18): Relationship between Strength of Investor Protection and Output Gap (2010-2014)

Source: Researchers' Calculations.

Figure (19): Relationship between Quality of Overall Infrastructure and Output Gap (2010-2014)

Source: Researchers' Calculations.
Figure (20): Relationship between Government budget balance/GDP (%) and Output Gap (2010-2014)

\[
y = -0.211x + 29.204 \\
R^2 = 0.5418
\]

Source: Researchers' Calculations.

Figure (21): Relationship between Quality of the Education System and Output Gap (2010-2014)

\[
y = -0.2924x + 40.502 \\
R^2 = 0.5051
\]

Source: Researchers' Calculations.
Figure (22): Relationship between Intensity of Local Competition and Output Gap (2010-2014)

Source: Researchers' Calculations.

Figure (23): Relationship between Pay and Productivity and Output Gap (2010-2014)

Source: Researchers' Calculations.
Figure (24): Relationship between Availability of Financial Services and Output Gap (2010-2014)

Source: Researchers' Calculations.

Figure (25): Relationship between Capacity for Innovation and Output Gap (2010-2014)

Source: Researchers' Calculations.
Figure (26): Relationship between Economic Stability and Output Gap, (2002-2014)

Source: Researchers' Calculations using the estimates of both the Economic Stability Trend Index (ESTI) and output gap.

Figure (27): Relationship between Regulatory Quality and Output Gap, (2002-2014)

Source: Researchers' Calculations.
Figure (28): Relationship between Political Stability and Output Gap, (2002-2014)

\[ y = 1.3604x + 1.0995 \]

\[ R^2 = 0.252 \]

Source: Researchers' Calculations.

Figure (29): Relationship between Government Effectiveness and Output Gap, (2002-2014)

\[ y = 2.6901x + 1.187 \]

\[ R^2 = 0.1904 \]

Source: Researchers' Calculations.
According to the global competitiveness report (2015/2016), the factors adversely affecting doing business in Egypt include policy instability, inefficient government bureaucracy, poor work ethics in labor force, inadequately educated work force, access to finance, inadequate supply of infrastructure, foreign currency regulations, government instability, inflation, and other factors (Figure 31).

Source: Researchers' Calculations.
Figure (31): Factors Negatively Affecting Doing Business in Egypt

7. Conclusion

The Egyptian economy has witnessed deterioration in its main macroeconomic indicators over the period (2008-2014), including real GDP growth rate, GDP per capita, saving-to-GDP ratio, investment-to-GDP ratio, unemployment rate and structural government budget balances. Under these conditions, it is crucial to stimulate investment in order to allow actual output to converge to its potential level and avoid the existence of spare capacity in the economy.

The main purpose of the paper was to estimate Egypt's potential output and identify the relationship between selected economic variables and the estimated output gap, trying to identify the factors that might be responsible for the existence of negative output gaps witnessed in Egypt starting from 2012.

The paper shaded light on different methodologies used in the literature to estimate potential output, and focused on the production function approach which was used to estimate potential output. The contributions of labor, capital stock and total factor productivity to potential GDP growth rates in Egypt over the period (1991-2014) were calculated. Output gap estimates were also derived and used to visualize their relationship with selected economic indicators.

The results of the analysis revealed that capital stock was the dominant factor contributing to potential GDP growth in Egypt over the period (1991-2014), while the shares of both labor and total factor productivity in GDP growth rate have been fluctuating over time. The relative importance of labor and TFP in contributing to GDP potential growth rate has changed over the period (1991-2014); the contribution of TFP to potential GDP growth rate over the period (1991-2010) has been
outweighing that of labor, while starting from 2011 the contribution of labor to potential GDP growth rate exceeded that of TFP.

Intellectual property protection, efficiency of legal framework in settling disputes, strength of investor protection, quality of overall infrastructure, government budget balance-to-GDP ratio, quality of the education system, intensity of local competition, pay and productivity in labor market, availability of financial services and capacity for innovation all exhibited a strong positive relationship with output gap in Egypt over the period (2010-2014). Moreover, Overall economic stability, political stability, higher quality of the regulatory environment, government effectiveness and the rule of are all positively affecting output gap in Egypt.

It is important for the Egyptian government to exert efforts to promote investment and facilitate doing business to allow actual output to approach its potential levels. Intellectual property protection, the efficiency of the legal system in settling disputes, the quality of overall infrastructure with more government expenditure on infrastructural projects, fiscal consolidation and low structural budget deficits, the quality of the education system with policies targeting the education-occupation mismatch problem, promoting competition in the domestic market and curbing monopoly practices, improving the skills of the labor force in order to improve the link between wages and productivity levels, promoting capital market development to attract foreign direct investment and portfolio investments, and encouraging research and development are all crucial. Also, political stability, appropriateness of the regulatory system, government effectiveness and the rule of are crucial to put the economy on a sustainable path to economic growth, stimulate productive operations and spur a speedy recovery from the prolonged spectrum of
negative output gaps which is expected to sustain till 2019 unless necessary policies and structural reforms are undertaken.
References


International Monetary Fund, World Economic Outlook database.


World Bank, World Development Indicators database.

Annex 1

Methodology to the Economic Stability Trend Index (ESTI)

• Definition:
The Economic Stability Trend Index (ESTI) was estimated using eight macroeconomic variables. It ranges between (-1: 1), where:
  o -1: reflects the buildup of economic vulnerabilities in the system.
  o 1: reflects higher levels of economic stability.
  o Zero: is a neutral case; where neither excessive risks are built into the system, nor higher levels of economic stability are in place.

• variables:
This index was built using FDI-to-GDP ratio, Inflation rate, GDP per capita growth rate, savings-to-GDP ratio, total investment-to-GDP ratio, unemployment rate, current account balance-to-GDP ratio and general government gross domestic debt-to-GDP ratio. Annual data series for these variables over the period (2002-2014) were obtained from the World Bank World Development Indicators and the IMF World Economic Outlook databases.

• Index Calculation:
All variables used are normalized as follows:

$$Z = \frac{(X - \mu)}{\sigma}$$
Where: \((X)\) is the variable of interest, \((\mu)\) is the mean of the variable of interest over the period (2002-2014) and \((\sigma)\) is the standard deviation of this variable over the same period.

The index is then estimated using the simple average of the Z scores. It is important to mention that the Z scores for the variables which are expected to have a negative impact on economic stability where taken in their reciprocal signs.
Appendix

**ADF test for (Ln K- Ln L):**

Null Hypothesis: LN_K__LN_L has a unit root  
Exogenous: Constant, Linear Trend  
Lag Length: 5 (Automatic - based on SIC, maxlag=5)

<table>
<thead>
<tr>
<th>Prob.*</th>
<th>t-Statistic</th>
<th>Probabilities and critical values calculated for 20 observations and may not be accurate for a sample size of 19</th>
</tr>
</thead>
</table>
| 0.0862 | -3.364543   | Augmented Dickey-Fuller test statistic  
|        |             | Test critical values:  
|        |             | 1% level  
|        |             | 5% level  
|        |             | 10% level  
| -4.532598 | 1% level   |  
| -3.673616 | 5% level    |  
| -3.277364 | 10% level   |  


Augmented Dickey-Fuller Test Equation  
Dependent Variable: D(LN_K__LN_L)  
Method: Least Squares  
Date: 05/18/16  Time: 17:09  
Sample (adjusted): 1996 2014  
Included observations: 19 after adjustments

| Prob. | t-Statistic | Std. Error | Coefficient | Variable  
|-------|-------------|------------|-------------|-----------|
| 0.0063 | -3.364543   | 0.330854   | -1.113173   | LN_K__LN_L(-1)  
| 0.0233 | 2.631609    | 0.252684   | 0.664965    | D(LN_K__LN_L(-1))  
| 0.0568 | 2.127511    | 0.239396   | 0.509315    | D(LN_K__LN_L(-2))  
| 0.0422 | 2.297592    | 0.270473   | 0.621437    | D(LN_K__LN_L(-3))  
| 0.1305 | 1.634253    | 0.207679   | 0.393400    | D(LN_K__LN_L(-4))  
| 0.0470 | -2.236134   | 0.161029   | -0.360083   | D(LN_K__LN_L(-5))  
| 0.0060 | 3.388833    | 1.530806   | 5.187647    | C  
| 0.0127 | 2.970479    | 0.003507   | 0.010417    | @TREND(1990)  

0.010094  Mean dependent var  0.709832 R-squared  
0.024385  S.D. dependent var  0.525179 Adjusted R-squared  
5.038943  Akaike info criterion  0.016803 S.E. of regression  
4.641285  Schwarz criterion  0.003106 Sum squared resid  
4.971644  Hannan-Quinn criter.  55.86996 Log likelihood  
2.126794  Durbin-Watson stat  3.844148 F-statistic  
0.023201  Prob(F-statistic)
ADF test for the first differenced series of (Ln K- Ln L):

Null Hypothesis: D(LN_K- LN_L) has a unit root
Exogenous: Constant, Linear Trend
Lag Length: 4 (Automatic - based on SIC, maxlag=5)

<table>
<thead>
<tr>
<th>Prob.*</th>
<th>t-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0569</td>
<td>-3.601270</td>
</tr>
</tbody>
</table>

Augmented Dickey-Fuller test statistic
-4.532598 1% level
-3.673616 5% level
-2.773644 10% level

Warning: Probabilities and critical values calculated for 20 observations and may not be accurate for a sample size of 19

Augmented Dickey-Fuller Test Equation
Dependent Variable: D(LN_K- LN_L,2)
Method: Least Squares
Date: 05/18/16   Time: 17:10
Sample (adjusted): 1996 2014
Included observations: 19 after adjustments

<table>
<thead>
<tr>
<th>Prob.</th>
<th>t-Statistic</th>
<th>Std. Error</th>
<th>Coefficient</th>
<th>Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0036</td>
<td>-3.601270</td>
<td>0.480829</td>
<td>-1.731597</td>
<td>D(LN_K- LN_L(-1))</td>
</tr>
<tr>
<td>0.0733</td>
<td>1.962401</td>
<td>0.395859</td>
<td>0.776825</td>
<td>D(LN_K- LN_L(-1),2)</td>
</tr>
<tr>
<td>0.0680</td>
<td>2.005512</td>
<td>0.354013</td>
<td>0.709977</td>
<td>D(LN_K- LN_L(-2),2)</td>
</tr>
<tr>
<td>0.0297</td>
<td>2.466351</td>
<td>0.257250</td>
<td>0.634470</td>
<td>D(LN_K- LN_L(-3),2)</td>
</tr>
<tr>
<td>0.0347</td>
<td>2.380669</td>
<td>0.211721</td>
<td>0.504041</td>
<td>D(LN_K- LN_L(-4),2)</td>
</tr>
<tr>
<td>0.0679</td>
<td>2.006435</td>
<td>0.018635</td>
<td>0.037389</td>
<td>C</td>
</tr>
<tr>
<td>0.3417</td>
<td>-0.990036</td>
<td>0.001085</td>
<td>-0.001074</td>
<td>@TREND(1990)</td>
</tr>
</tbody>
</table>

-0.000580 Mean dependent var 0.637934 R-squared
0.031096 S.D. dependent var 0.456901 Adjusted R-squared
-4.436612 Akaike info criterion 0.022916 S.E. of regression
-4.088661 Schwarz criterion 0.006302 Sum squared resid
-4.37725 Hannon-Quinn crit. 49.14781 Log likelihood
2.032322 Durbin-Watson stat 3.523852 F-statistic
0.030129 Prob(F-statistic)
ADF test for (Ln Y - Ln L):

Null Hypothesis: LN_Y__LN_L has a unit root
Exogenous: Constant, Linear Trend
Lag Length: 0 (Automatic - based on SIC, maxlag=5)

<table>
<thead>
<tr>
<th>Prob.*</th>
<th>t-Statistic</th>
<th>Augmented Dickey-Fuller test statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.5105</td>
<td>-2.118020</td>
<td></td>
</tr>
<tr>
<td></td>
<td>-4.394309</td>
<td>1% level</td>
</tr>
<tr>
<td></td>
<td>-3.612199</td>
<td>5% level</td>
</tr>
<tr>
<td></td>
<td>-3.243079</td>
<td>10% level</td>
</tr>
</tbody>
</table>


Augmented Dickey-Fuller Test Equation
Dependent Variable: D(LN_Y__LN_L)
Method: Least Squares
Date: 05/18/16   Time: 17:11
Sample (adjusted): 1991 2014
Included observations: 24 after adjustments

<table>
<thead>
<tr>
<th>Prob.</th>
<th>t-Statistic</th>
<th>Std. Error</th>
<th>Coefficient</th>
<th>Variable</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0463</td>
<td>-2.118020</td>
<td>0.161938</td>
<td>-0.342989</td>
<td>LN_Y__LN_L(-1)</td>
<td></td>
</tr>
<tr>
<td>0.0412</td>
<td>2.174600</td>
<td>0.599595</td>
<td>1.303880</td>
<td>C</td>
<td></td>
</tr>
<tr>
<td>0.0949</td>
<td>1.749210</td>
<td>0.003399</td>
<td>0.005945</td>
<td>@TREND(1990)</td>
<td></td>
</tr>
</tbody>
</table>

0.020159 Mean dependent var 0.257577R-squared
0.025039 S.D. dependent var 0.186870Adjusted R-squared
-4.627121 Akaike info criterion 0.022579S.E. of regression
-4.479864 Schwarz criterion 0.010706Sum squared resid
-4.588053 Hannan-Quinn criter. 58.52545Log likelihood
1.565106 Durbin-Watson stat 3.642983F-statistic
0.043837 Prob(F-statistic)

38
ADF test for the first differenced series of (Ln Y - Ln L):

Null Hypothesis: $D(LN_Y - LN_L)$ has a unit root
Exogenous: Constant, Linear Trend
Lag Length: 4 (Automatic - based on SIC, maxlag=5)

<table>
<thead>
<tr>
<th>Prob.*</th>
<th>t-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0174</td>
<td>-4.241842</td>
</tr>
</tbody>
</table>

Augmented Dickey-Fuller test statistic

-4.532598 1% level
-3.673616 5% level
-3.277364 10% level

Warning: Probabilities and critical values calculated for 20 observations and may not be accurate for a sample size of 19

Augmented Dickey-Fuller Test Equation
Dependent Variable: $D(LN_Y - LN_L,2)$
Method: Least Squares
Date: 05/18/16   Time: 17:11
Sample (adjusted): 1996 2014
Included observations: 19 after adjustments

<table>
<thead>
<tr>
<th>Prob.</th>
<th>t-Statistic</th>
<th>Std. Error</th>
<th>Coefficient</th>
<th>Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0011</td>
<td>-4.241842</td>
<td>0.532249</td>
<td>-2.257717</td>
<td>$D(LN_Y - LN_L(-1))$</td>
</tr>
<tr>
<td>0.0233</td>
<td>2.597584</td>
<td>0.454856</td>
<td>1.181528</td>
<td>$D(LN_Y - LN_L(-1),2)$</td>
</tr>
<tr>
<td>0.0217</td>
<td>2.637396</td>
<td>0.400820</td>
<td>1.057122</td>
<td>$D(LN_Y - LN_L(-2),2)$</td>
</tr>
<tr>
<td>0.0089</td>
<td>3.119401</td>
<td>0.323499</td>
<td>1.009124</td>
<td>$D(LN_Y - LN_L(-3),2)$</td>
</tr>
<tr>
<td>0.0071</td>
<td>3.239992</td>
<td>0.249072</td>
<td>0.806991</td>
<td>$D(LN_Y - LN_L(-4),2)$</td>
</tr>
<tr>
<td>0.0038</td>
<td>3.580948</td>
<td>0.021173</td>
<td>0.075820</td>
<td>C</td>
</tr>
<tr>
<td>0.0613</td>
<td>-2.064062</td>
<td>0.000983</td>
<td>-0.002029</td>
<td>@TREND(1990)</td>
</tr>
</tbody>
</table>

-0.000966 Mean dependent var 0.727947 R-squared
0.033107 S.D. dependent var 0.591921 Adjusted R-squared
-4.597136 Akaike info criterion 0.021149 S.E. of regression
-4.249185 Schwarz criterion 0.005367 Sum squared resid
-4.538249 Hannan-Quinn criter. 50.67280 Log likelihood
2.352607 Durbin-Watson stat 5.351510 F-statistic
0.006688 Prob(F-statistic)
Regression Model

Dependent Variable: D(LN_Y-LN_L,1)
Method: Least Squares
Date: 05/18/16   Time: 17:13
Sample (adjusted): 1991 2014
Included observations: 24 after adjustments

<table>
<thead>
<tr>
<th>Prob.</th>
<th>t-Statistic</th>
<th>Std. Error</th>
<th>Coefficient</th>
<th>Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0000</td>
<td>9.121040</td>
<td>0.081462</td>
<td>0.743021</td>
<td>D(LN_K-LN_L,1)</td>
</tr>
<tr>
<td>0.0038</td>
<td>3.235195</td>
<td>0.002699</td>
<td>0.008730</td>
<td>C</td>
</tr>
</tbody>
</table>

R-squared          0.790861
Mean dependent var 0.020159
Adjusted R-squared 0.781355
S.D. dependent var 0.025039
S.E. of regression 0.011708
Akaike info criterion -5.977376
Sum squared resid   0.003016
Schwarz criterion   -5.879204
Log likelihood      73.72851
F-statistic         83.19337
Durbin-Watson stat  1.081988
Prob(F-statistic)   0.000000

Diagnostic Tests for the Regression Model

Normality Test

Series: Residuals
Sample 1991 2014
Observations 24

Mean       -1.81e-18
Median     0.000665
Maximum    0.024707
Minimum    -0.021824
Std. Dev.  0.011451
Skewness   -0.218889
Kurtosis   2.717390
Jarque-Bera 0.271518
Probability 0.873053
Serial Correlation Test

Breusch-Godfrey Serial Correlation LM Test:

<table>
<thead>
<tr>
<th>Prob.</th>
<th>t-Statistic</th>
<th>Std. Error</th>
<th>Coefficient</th>
<th>Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.8721</td>
<td>0.163115</td>
<td>0.002574</td>
<td>0.000420</td>
<td>C</td>
</tr>
<tr>
<td>0.6915</td>
<td>-0.402654</td>
<td>0.079382</td>
<td>-0.031964</td>
<td>D(LN_K-LN_L,1)</td>
</tr>
<tr>
<td>0.0659</td>
<td>1.945733</td>
<td>0.225180</td>
<td>0.438141</td>
<td>RESID(-1)</td>
</tr>
<tr>
<td>0.9420</td>
<td>-0.073639</td>
<td>0.225023</td>
<td>-0.016571</td>
<td>RESID(-2)</td>
</tr>
</tbody>
</table>

Presample missing value lagged residuals set to zero.

Test Equation:
Dependent Variable: RESID
Method: Least Squares
Date: 05/18/16  Time: 17:14
Sample: 1991 2014
Included observations: 24

Prob. F(2,20) 2.167666
Prob. Chi-Square(2) 4.275593

Obs*R-squared

R-squared 0.178150
Mean dependent var -1.81E-18
Adjusted R-squared 0.054872
S.D. dependent var 0.011451
S.E. of regression 0.011132
Akaike info criterion -6.006906
Schwarz criterion -5.810564
Hannan-Quinn criter. -5.954816
Log likelihood 76.08287
F-statistic 1.445111
Durbin-Watson stat 2.024802
Prob(F-statistic) 0.259479
Heteroscedasticity Test

Heteroskedasticity Test: Breusch-Pagan-Godfrey

<table>
<thead>
<tr>
<th>Prob. F(1,22)</th>
<th>F-statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0901</td>
<td>3.143538</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Prob. Chi-Square(1)</th>
<th>Obs*R-squared</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0832</td>
<td>3.000569</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Prob. Chi-Square(1)</th>
<th>Scaled explained SS</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.1412</td>
<td>2.165037</td>
</tr>
</tbody>
</table>

Test Equation:
Dependent Variable: RESID^2
Method: Least Squares
Date: 05/18/16   Time: 17:15
Sample: 1991 2014
Included observations: 24

<table>
<thead>
<tr>
<th>Prob.</th>
<th>t-Statistic</th>
<th>Std. Error</th>
<th>Coefficient</th>
<th>Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0176</td>
<td>2.565518</td>
<td>3.71E-05</td>
<td>9.51E-05</td>
<td>C</td>
</tr>
<tr>
<td>0.0901</td>
<td>1.773002</td>
<td>0.001197</td>
<td>0.001985</td>
<td>D(LN_K-LN_L,1)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Prob.</th>
<th>t-Statistic</th>
<th>Std. Error</th>
<th>Coefficient</th>
<th>Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.000126</td>
<td></td>
<td></td>
<td>0.125024</td>
<td>R-squared</td>
</tr>
<tr>
<td>0.000168</td>
<td></td>
<td></td>
<td>0.085252</td>
<td>Adjusted R-squared</td>
</tr>
<tr>
<td>-14.55205</td>
<td></td>
<td></td>
<td>0.000161</td>
<td>S.E. of regression</td>
</tr>
<tr>
<td>-14.45388</td>
<td></td>
<td></td>
<td>5.69E-07</td>
<td>Sum squared resid</td>
</tr>
<tr>
<td>-14.52600</td>
<td></td>
<td></td>
<td>176.6246</td>
<td>Log likelihood</td>
</tr>
<tr>
<td>1.691886</td>
<td></td>
<td></td>
<td>3.143538</td>
<td>F-statistic</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>0.090075</td>
<td>Prob(F-statistic)</td>
</tr>
</tbody>
</table>