

The Effect of Political Instability on Bank Profitability: Evidence from Ethiopia

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ABSTRACT

The study aims to examine the effect of political instability on Bank profitability. To achieve this object, the researcher used the World Bank database and data from annual audit financial statements of 15 selected commercial Banks for the period 2012-2016. The researcher applied the generalized method of moments to analyze the effect of political instability on Bank profitability. Both descriptive analysis and inferential statistics are made in this regard. The result of the generalized method of moments estimation shows that political instability positively affects Bank profitability. Bank specific variables such as credit risk ratio, Non-interest income to total asset ratio, and Cost to income ratio are essential factors for Bank profitability. Growth of gross domestic product and inflation are significant determinants of Bank profitability. Bank size, liquidity and credit risk ratio are insignificant. The study is helpful to higher government officials, policymakers, Banks shareholders, Banks top management, etc. Moreover, the study contributed to the existing literature by linking political instability and Bank profitability.

JEL Classification: G2, G22, N17

Keywords: Bank profitability, political instability, panel, generalized method of moments.

INTRODUCTION

Political stability is paramount important for a given society to perform in an orderly manner. Countries regardless of their economic status need stable socio-political environment in their move towards improving and developing the livelihood of their society. According to the UN Security Council report (UNSC, 2015), political stability is an engine for economic reform and promotes a society built on trust especially in transitioning states. The report stated that political stability is sine qua non for economic and political development (UNSC, 2015). Chawdhury (2015) argued that there is a strong association between Political stability and economic growth.

Both private and foreign direct investments (FDI) are essential for human and economic development. Under the right conditions it creates job, new technology and innovation, boosts firms, suppliers, and distributors by creating market and demand for goods and services (organizations for economic cooperation and development (OECD, 2015)). Investment improves access to and quality of infrastructure and services critical for the development of entrepreneurship, small business, finance and Banking. To exploit these opportunities the host countries are expected to have policy reform and insure appropriate policy frameworks (OECD, 2015). However this can't be assured without stable political environment.

On the other hand, political instability retards economic growth, deters investment, triggers illicit capital flight and creates uncertainty about the future. Unsteady political environment reduce investment (Mbaku, 2016) and the speed of economic growth (Abeyasinghe, 2004).

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Abeyasinghe (2004); Roe and Siegel (2011) and Radu (2015) stated that political instability reduces financial development and overall economic growth. According to Mbaku (2016) political instability not only encourages capital flight including brain-drain but also discourages foreign direct investment. Tamadonnejad, Abdul-Majid, Rahman and Jusoh (2013) argued that the quality of governance in politically unstable countries is poor. These countries are characterized by high political risk, country risk, and corruption; suffer from lack of public trust (investment community) and causes capital outflow.

Political instability and conflict are fuelled by corruption. Corruption distorts government decisions and understates public service provisions. The rents seeking opportunities that come with corruption can provide incentives for violent conflict as those excluded from power and rents use violence to seek access and control over these opportunities. Corruption also weakens and undermines state legitimacy, power and security (TI, 2015). Corruption deprives public services of, especially security services, financial resources, weakens the ability of the state to maintain the minimum level of security without external assistance.

The Institute for Economics and Peace (IEP) is a non-partisan and independent think tank that is dedicated to shift the world's attention to peace as a positive, achievable, and objective measure of human wellbeing. IEP (2012) defines violence containment spending as: "Violence (political instability) containment spending is economic activity that is related to the consequences or prevention of violence where the violence is directed against people or property".

Evidences show that countries across the world incur significant amount of Cost in relation to violence. The Cost of political instability is worse especially in developing countries. The IEP report (2012) revealed that the global impact of violence containment is \$ 9.6 Trillion. It ranked 162 countries on the basis of their violence containment cost per capita and as a percentage of GDP. Ethiopia is one of the highest countries in violence expenditure. According to the report the total violence containment cost and violence containment cost per capita of Ethiopia are \$8,345 and \$100 respectively. Containment cost as a percentage of GDP is 7.5%, which puts Ethiopia 42nd out of 162 countries.

The consequence of political instability and violence as a result of high level corruption and poor governance is worse in developing countries. Mbaku (2016) stated that political instability contributed significantly for the poor performance of many countries in the world. The author added that political instability is an endemic and has contributed significantly for the stagnant economy in Africa. It is an important obstacle for the economic development of Sub-Saharan Africa (SSA). Roe and Siegel's (2011) approach shows a direct channel from political instability to financial and economic backwardness and weaknesses.

Institute for security studies (2018) reported that SSA countries face multiple structural pressures that increase the risk of political instability and violent conflict in the region. These pressures stem from demographics, low levels of development, regime type, and horizontal inequalities or cross-group discrimination.

Ethiopian has been led by Ethiopian people's revolutionary democratic front (EPRDF) that advocates developmental democracy for the last twenty seven years. However this party is

autocratic in practice, which violets democratic and basic human rights. EPRDF is criticized for creating regional inequalities, group discriminations, economic inequalities, lack of good governance, injustice corruption, etc. Opposing the undemocratic practices of the EPRDF public protest began in 2016 in a more organized manner and continues till now. The public protest began in Gonder (historical city) and expanded to almost all part of the country. It causes overall political, societal and economic unrest such as mass displacement, mass killings, cross-group discriminations, cabinet changes, violence, lockdown of federal roads, lockdown of many private and public enterprises such insurance companies, transportation, Banks, etc. Given these facts the effect of that political instability was not studied. Hence, the researcher is interested to scrutinize its effect more specifically on the profitability of the Banking sector.

The world governance index survey of World Bank (2016) shows profitability of Ethiopian Banks continuously declined for the period from 2012-2016. According to the report return on asset (ROA) was 5.39% and declined to 3.75% in 2016. Similarly return on equity (ROE) was 75.26% in 2012 and decreased to 54.08% in 2016. In the same period political stability index was negative that shows Ethiopia's week political stability. So, the basic question is does political instability reduce Bank profitability?

The key feature of political instability is uncertainty of environment where investment take place that reduces returns and incentives to attract saving and investment (Gyimah-Brempong & Traynor, 1999). From the investment point of view investors require high interest rate to compensate their risky and unsafe investment in uncertain environment. This interest rate reduces interest margin and Bank profitability. Otherwise business people and investors prefer to keep their money at home or at a more preferable place, which may cause Banks illiquid. Political instability creates frustration among customers. In such scenarios, Bank customers deposit less and withdraw more, which reduces Bank's interest margin.

Tremendous researches have been conducted on the determinants of profitability of Banks (Dietrich & Wanzenried, 2011; Obamuyi, 2013; Petria, Capraru & Ihnatov, 2013). Dietrich and Wanzenried (2011) studied determinants of profitability of commercial Banks in Switzerland that include 372 Banks over the period from 1999 to 2009. In this study authors consider only the macro-economic variables such as GDP and Inflation and Bank specific variables like size, ownership structure, and age. Petria et al., (2013) analysed Bank profitability and its determinants using evidences from the EU Banking system for the period from 2004-2011. The study split Bank profitability determinants in to two parts as internal factors and external factors. Internal factors refer to Bank specific factors that may include Credit risk, liquidity risk, management efficiency, the diversification of business. External factors represent macro-economic variables such as market concentration/competition and the economic growth. Obamuyi (2013) investigated determinants of Bank profitability in developing economies using evidences from 20 Nigerian Banks for the period of time from 2006 to 2012. Authors took in to account GDP growth rate and interest rate as macro-economic variables and capital, Bank size, and expense management as Bank specific variables.

Despite many efforts are exerted in studying Bank profitability and its determinants, researchers gave less attention to examine the impact of political instability on Banks

profitability. Few researches have been conducted, to the best of the researcher's knowledge, on the relationship between political instability and Bank profitability in Ethiopia. The specific objectives of the study are; (1) To determine the relationship between political instability and Bank profitability; (2) To analyze the relationship between Macro-economic variables and Bank profitability; and (3) To investigate the association between Bank- specific variables and Bank profitability. The study scrutinizes empirically the impact of political instability on the profitability of Ethiopian Banks for the period from 2012-2016 employing evidences from Ethiopian commercial Banks and international organizations such as WB. The study will contribute to the existing literature by linking political instability and Bank profitability. It will also help policy makers, political elites and various stakeholders to better understand the relationship between political instability and Bank profitability. The rest of the paper is organized as follows: Section 2 review of literature, section 3 research methodology, section 4 data analysis and results, section 5 conclusions, Limitations and Implications for further research.

LITERATURE REVIEW

In Ethiopia, the Banking industry has around 100 year's old history. According to Fasil and Merhatbeb (2012) and Maury (2014) the first Bank of Ethiopia called "Bank of Abyssinia" was established in 1905. It was formed by the agreement of the Ethiopian government (Emperor Minilik II) and National Bank Egypt with a start-up capital of 1 million Shillings. Later on, The Ethiopian Government, under Emperor Haile Sellassie, changed the Bank of Abyssinia by the Bank of Ethiopia and the Bank started its operation in 1932. In 1963, the State Bank of Ethiopia split into the National Bank of Ethiopia and the Commercial Bank of Ethiopia (Fasil & Merhatbeb, 2012). The intention was to isolate the central Banking function from Commercial Banking function.

Then after a number private commercial Banks joined the banking industry in different times. Currently the number of commercial Banks including private Banks reached 17 and at least four commercial Banks are under establishment including Amhara Bank S.C.

The government of Ethiopia made many changes since the resignation of the former Prime Minister Haylemariam Desalegn. Following his resignation a new Prime Minister came to power and has been making significant reformations. Such as the change in cabinets, the replacement of regional state presidents, the reshuffling of state owned Banks' top management, and so on. In this time mass displacement, mass killings, killings of higher government officials, kidnapping of university students, public protests, and state-federal government disagreements became common and made Ethiopia socially, economically and politically instable. This political instability disordered the lives of thousands of individuals, women, children, etc. It left many individuals homeless and jobless; many also lost their life. Although this political unrest affects almost every aspect of the individuals and companies, I would like to study its effect on the Banking sector. The researcher limits his study only to commercial Banks (1 state owned and 14 private) because Banks have more organized data than other sectors.

Political instability is defined by various individuals. Fosu (1992) defined political instability as: instability of government's, regimes, and communities within a nation is likely to result from forcefully overthrowing or subjecting existing authorities to a relatively high probability of involuntary removal. Political instability is a condition in political systems in which the institutionalized patterns of authority break down, and the expected compliance to political

authorities is replaced by political violence (Morrison & Stevenson, 1971). According to Arriola (2009), political instability takes different forms such as, communal violence, rural insurgency, urban riots, coups d'état, and civil wars. Morrison and Stevenson (1971) defined three conceptual dimensions of political instability: elite instability, involving conflicting elites in successful or attempted removals of the incumbent political authorities by violence or the threat of violence; communal instability, involving communal groups in conflict with political authorities or their supporters in violent attempts to restructure the political status of the communal groups; and mass instability, involving mass movements in conflict with the national regime in violent attempts to reorganize the distribution of power and the goals of policy within the nation. TI anti-corruption help desk report (2013) revealed that political instability is driven by political and economic factors (i.e., power and resource). Elite disagreements are consequential for instability in Africa because they can spiral into other mass forms of violence. Similar to other companies political instability also affects the profitability of the Banking sector. First political instability causes political risk and then the political risk affects both microeconomic and macroeconomic aspect of the country (Yalcinkaya, Celik & Huseyni, 2017). According to the authors, political instability influences the finance sector in general and the and more specifically the Banking sector. In relation to Banks, political instability has dual effect: on the first hand, it causes political risk and increase interest rate and on the other hand it increases the Cost of credit and reduces the demand for credit.

Empirical evidences that documented political instability-Bank profitability are limited. However, there is a general consensus that political instability results political risk and uncertainty which diminishes saving, investment, performance, economic development and growth (Chawdhury, 2015; Gyimah-Brempong & Traynor, 1999; Mbaku, 2016; Sanlisoy, Aydin & Yalcinkaya, 2017; TI, 2013). Sanlisoy et al., (2017) analysed the effect of political risk on Bank profitability for a panel of turkey Banks. Authors Found negative and statistically significant relationship between political instability and Bank profitability. Yahya, Akhtar & Tabash (2017) studied the impact of political instability, macroeconomic and bank-specific factors on the profitability of Islamic banks. They employed empirical evidences from Yemen Banks that involves a panel of three Islamic Banks for the period from 2010-2014. The result shows that political instability positively and significantly affects Bank's profitability. Campos Karanasos and Tan (2012) examined the financial development, political instability and economic growth of Argentina for the period from 1896 to (2000). They divided political instability as informal and formal (political motivated). Their finding shows that informal political instability has direct and significant effect of financial development. However, formal instability has not effect on financial development.

Determinants of Bank Profitability- Factors that determine Bank profitability can be broadly classified as Bank specific variables and macro-economic variables. In this section the dependent variable (Bank profitability), macro-economic variables, and Bank specific variables are presented, respectively.

Dependent Variables

Bank profitability (ROA) - The study aims to investigate the effect of political instability on Bank profitability by using evidences from panel of Ethiopian Commercial Banks and some other international organizations. In this study Bank profitability is the dependent variable. There are a number of alternative measurements for Bank profit but return on asset is (ROA) preferred for this study due to its wider application in measuring profitability and financial performance.

Independent variables

Literatures in the area of Finance evidenced, that there are numerous factors that affect the profitability of Banks. The study considers, however, the following factors due to data limitations. Political instability (PI) is one of macro-economic variables that determine Bank profitability (Gyimah-Brempong & Traynor, 1999; Yahya et al., 2017). According to the World Bank report (WGI, 2016), Political Stability and Absence of Violence/Terrorism measures perceptions of the likelihood of political instability and/or politically-motivated violence, including terrorism. Various international organizations have developed to measure political instability (see, The Banks Cross National Time Series Archive, The International Country Risk Guide, The International Peace Research Institute of Oslo (PRIO), and World Governance Index Survey of the World Bank (WGI) and The Database of Political Institutions of the World Bank (DPI)). The World Governance Index Survey of the World Bank (WGI) data is employed in this regard to make use of source of macro-economic data consistent. WGI computed political instability index over 200 countries as an average of several other indexes from the Economist Intelligence Unit, the World Economic Forum, and the Political Risk Services, among others. WGI assign values that ranges between (-2.5 and +2.5). Negative values represent political instability and positive values represent absence of political instability (i.e. politically stability). In this regard values assigned to Ethiopia from 2012-2016 are negative, which means Ethiopia was politically instable for last five years. Anyways annual political instability index values for the period from 2012-2016 are used for the study.

GDP growth rate (GDP GR) - affects Bank profitability. GDP growth rate refers to the annual growth rate and the data is accessed from World Bank data base. The result of the studies of (Gul, Irshad & Zaman, 2011; Kosmidou, Tanna & Pasiouras, 2008; Moges, 2017; Rahman, Hamid & Khan, 2015; Sanlisoy et al., 2017; Yahya et al., 2017) show that GDP growth rate positively and significantly affect Bank profitability. Alper and Anbar (2011) found no statistically significant relationship between GDP growth rate and Bank profitability.

Inflation rate (IR) influences Bank profitability. Research findings about the effect of inflation rate on Bank profitability are inconclusive. Davydenko (2010); Kosmidou et al. (2008); Vong and Chan (2006) and found that inflation rate has positive and significant effect on Bank profitability. However, Rahman (2015) argued that inflation rate negatively and significantly affects Bank profitability. Other studies (Alper & Anbar, 2011; Moges, 2017) found no significant correlation with Bank profitability.

Bank size (BSZ) - although different measures of Bank size are available, Bank's total asset size in logarithmic form is frequently used in literature. Authors such as Moges, (2017); Rahman, (2015); Sanlisoy et al., (2017) found positive and significant correlation between Bank size and Bank profitability. Kosmidou et al. (2008) concluded that there negative and significant correlation between Bank size and Bank profitability.

Capital adequacy ratio (CAR) - shows the Bank's strength is measured by the ratio of total capital to total asset. Previous studies (Hassan & Bashir, 2003; Kosmidou et al., 2008; Sanlisoy et al., 2017) show positive and significant correlation among capital adequacy ratio and Bank profitability.

Credit risk ratio (CRR) - is one of the Bank specific determinants of Bank profitability. Credit risk ratio is measured by the ratio of total non-performing loan to total asset. According to Rahman (2015) credit risk ratio has positive and significant effect on Bank profitability. The influence of credit risk ratio on Bank profitability is statistically significant and negative (Imad & Thair, 2011; Osuagwu, 2014).

DATA ANALYSIS AND RESULTS

Data Analysis

Descriptive Analysis

The table below represents the descriptive statistics of Bank profitability and its determinants

Table 1:
Summary Statistics

Variable	Observation	Mean	Std. Dev.	Min	Max
ROA	75.000	0.028	0.011	0.000	0.067
CAR	75.000	0.147	0.057	0.004	0.382
CRR	75.000	0.004	0.008	-0.004	0.045
NIITAR	75.000	0.034	0.015	0.000	0.078
COIR	75.000	0.688	0.583	0.161	4.905
LIQUR	75.000	0.740	0.100	0.070	0.870
INFL	75.000	11.400	6.473	7.300	24.100
BSIZ	75.000	20.316	6.332	2.398	24.045
GGDP	75.000	9.488	1.193	7.562	10.582
PI	75.000	-1.486	0.101	-1.620	-1.340

Source: Authors' Computations

From table 1 above, one can see that the maximum value of political instability index is – 1.34 and the minimum value is – 1.62, which results a mean political instability index value of -1.486. This index is based on world governance index (WGI). According to WGI political instability index ranges from -2.5 to +2.5. As it can be seen from table 1 that the maximum, minimum and average Bank profitability are 0.067, 0.000, and 0.28 respectively, which shows that Banks earn on average ETB 0.282 of profit from each asset owned.

Table 2:
Descriptive Statistics

Variables	Correlation Matrix									
	ROA	CAR	CRR	NIITAR	COIR	LIQUR	INFL	BSIZ	GGDP	PI
ROA	1									
CAR	0.0762	1								
CRR	-0.1073	0.0051	1							
NIITAR	0.2646	-0.165	0.2606	1						
COIR	-0.5262	-0.0712	-0.0388	-0.0331	1					
LIQUR	0.0068	-0.4367	-0.5217	0.1336	0.2079	1				
INFL	0.0604	0.1499	0.0352	0.1363	-0.1994	-0.2943	1			
BSIZ	0.0905	0.3074	0.0378	0.2391	0.1553	0.0099	-0.0583	1		
GGDP	0.1292	-0.0059	-0.0684	0.0337	-0.0296	0.0881	-0.2792	0.1825	1	
PI	0.1491	-0.0138	-0.0979	0.0114	-0.0434	0.0692	-0.3728	0.1517	0.843	1

Source: Authors' Computations

Table 2 represents the correlation matrix, which shows the correlation among each variable. The correlation matrix has a value that range between +1 (perfect positive correlation) and -1

(perfect negative correlation). Correlation matrix shows there is no perfect correlation between independent variables. It can be observed also there is no multicollinearity problem. One can understand from table 2 above that there is negative correlation between ROA and CRR and COIR. ROA positively correlate with CAR, NITTAR, INFL, BSIZ and PI.

Econometric Analysis

Table 2:
The Dynamic Panel- Data Estimation

Dynamic Panel- Data Estimation, One- Step Difference GMM									
VARIABLES	ROA	ROA	ROA	ROA	ROA	ROA	ROA	ROA	ROA
CAR	0.049	0.042	0.041	0.006	0.018	0.001	0.002	-0.002	-0.002
	0.039	-0.037	-0.035	-0.026	-0.039	-0.029	-0.029	-0.029	-0.029
CRR		-0.308**	-0.357**	-0.242**	-0.339*	-0.241*	-0.240*	-0.227*	-0.201
		-0.146	-0.138	-0.106	-0.195	-0.128	-0.126	-0.128	-0.130
NIITAR			0.265**	0.279***	0.332**	0.293***	0.289***	0.269***	0.263***
			-0.115	-0.088	-0.131	-0.091	-0.090	-0.092	-0.092
COIR				-0.00762***	-0.00847***	-0.00795***	-0.00792***	-0.00775***	-0.00763***
				-0.001	-0.002	-0.001	-0.001	-0.001	-0.001
LIQUR					-0.025	-0.002	-0.002	-0.001	-0.001
					-0.025	-0.012	-0.012	-0.012	-0.012
INFL					-0.001	0.000	0.000	0.000	0.000
					-0.001	0.000	0.000	0.000	0.000
BSIZ					0.000		0.000	0.000	0.000
					0.000		0.000	0.000	0.000
GGDP					0.001			0.001	0.000
					-0.001			-0.001	-0.001
PI									0.012
									-0.012
Obs.	60	60	60	60	60	60	60	60	60
No. of Banks	15	15	15	15	15	15	15	15	15

Note: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$ indicate 1%, 5%, and 10% significance level.

Source: Authors' Computations.

According to Roodman (2006) the Sargan /Hansen test for joint validity of the instruments is standard after GMM estimation. These tests tell us there is no endogeneity problem in the model. Similarly in the GMM estimation result one can see that the p-value for first and second order autocorrelation is not significant which shows absence of serial correlation.

RESULTS

As it can be observed from table 3, political instability and Bank profitability are positively and significantly correlate each other. The result is similar with previous findings such as Campos et al., (2012); Yahya et al. (2017). The answer for the question “Does political instability reduce Bank profitability?” is No. Rather, it has positive contribution for Bank profitability, according to the finding of this study under question. CAR and NITTAR have positive and significant (5%) relationship with Bank profitability. Banks can increase their profitability by increasing their capital adequacy ratio (CAR). (Sanlisoy et al., 2017; Kosmidou et al., 2008; Bashir, 2003) found the same. CAR shows the capital strength of Banks. Therefore, the more Banks get strong the more they earn profit. Table 3 above revealed the increase in Non-interest income to total asset ratio (NIITAR) results in an increase in Bank profitability. Rahman (2015) found similar relationship between NIITAR and Bank profitability. According to the result Banks can increase profitability if they

properly manage their non- operating income, keeping other things constant. INFL positively and significantly (10%) correlate with Bank profitability. The result is similar with previous studies such as Davydenko (2010); Kosmidou et al., (2008), Vong and Chan (2006) found that inflation rate has positive and significant effect on Bank profitability. However, the finding contradict with Rahman (2015) study, that inflation rate negatively and significantly affected Bank profitability. Table 3 also reported GGDP negatively and statistically significantly (10%) affect Bank's profitability. The result is similar with Alper and Anbar (2011)'s finding and dissimilar with (Gul et al., 2011; Kosmidou et al., 2008 ; Moges, 2017; Rahman, 2015; Sanlisoy et al., 2017; Yahya et al., 2017)' s finding. Bank size and liquidity ratio positively correlate with Bank profitability but are not statistically significant. As it can be seen from table 3 above, credit risk ratio (CRR) has negative correlation with Bank profitability but remained insignificant.

CONCLUSION, LIMITATIONS AND IMPLICATIONS FOR FURTHER RESEARCH

The study analyzed the effect of political instability on Bank profitability using empirical evidences from Ethiopian commercial Banks and others. The stud has contributed to the existing literature by linking political instability with Bank profitability. The study found political instability influence Bank profitability positively. Actually there result is against the theory and the researcher's expectation. Bank specific variables such as CAR, NIITAR, and COIR are important factors for Bank profitability. GGDP and INFL are significant determinants of Bank profitability. In this study political instability is measured by political instability index which is the average value of other indexes which may provide unexpected result. The average political instability index is used in the study. Researchers can analyze the effect political instability on Bank's profitability by factoring individual political instability variables for recent Bank data.

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