Institutional Quality and Political Risk

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Abstract

The purpose of this paper is the preferred proxy for the political and institutional quality. This work is also bounded by an econometric study on panel data for countries emerging for integrating senior institutional categories, such as civil liberties, political freedoms, the size of government, the corruption index, property rights in order to assess the relationship between this institutional quality and the evolution of political risk.

Keyword: political risk, corruption, institutional quality

Introduction

The political risk is born following the evolution of economic theory in the early 20th century in most industrialized countries, such a risk from political events and adverse conditions in international affairs. The wars, internal conflicts and external terrorist attacks are all prerequisites for the birth of political instability. Institutional quality is considered one of the fundamental determinants of political risk. Thus the change of government plans, uncertainty and democratic domination of the phenomena of corruption created fertile ground for the proliferation of political risks which are as serious as the political structure of the country. The high degree of political risk has prompted economists to rethink this risk by focusing on institutional quality.

I-Institutional and political risk:

The use of institutional research marked the last decades. Extensive use of institutional and paradoxes come to alleviate some results of work in various economic disciplines. This practice proved to be relevant, particularly in investigations involving environmental and political instability to highlight a strong correlation between institutional quality and political risk. In this institutional perspective, political risk is interpreted as resulting from the uncertainty of the actions of governments and political institutions.

I-1- Political risk: Concept and determinants:

Political risk refers to changes and changes, often arbitrarily made by governments and leading to a reconfiguration of the business environment in a country. It is appreciated by the government's stability, the extent of an independent judiciary and the credibility of a legal system. According to Agmont a political risk is defined as unexpected changes in factors of production of traded goods and services caused by the actions and reactions of government. Is the probability that a political event occurs to induce a negative impact on foreign investors. This impact comes from new legislation and / or practices imposed by local partners and controlling strategic sectors aspiring to impose a region or industry.

According to Jodice, political risk is the set of changes in operating conditions of foreign firms coming from the political process more directly by war, political violence or the change of government. It can be

conceptualized as a series of national events that affect the assets or revenues anticipated by the investor. These national and international events can affect the physical assets, personnel and operations of foreign companies.

The portfolio investments are also exposed to risks, including share restrictions on flows of capital goods and other uncertainties inherent in economic policy, new regulations and administrative procedures and government. But the economic crisis of 1997-1998 in South East Asia, have generated a political risk when governments become unpopular because of their inability to address an economy in collapse. Greek current crisis seems to have altered the political stability of Greece and degrade the note or the European Union. A combination of factors serves as explanatory principles of political instability; the latter is in fact its origins in:

i. **Terrorism: a new form of political instability:**

This term has emerged in the early 90s, it contains the geographic areas that have experienced wars, inter-and intra-state, with illicit trade of products with high added value: raw material consumption of luxury goods (precious wood). These areas are victims of identity factors of nationalism with an aggressive assertion of ethnicity and religion. According to Bounan\(^3\) "Terrorism is the set of criminal operations, nature and importance, variables designed to frighten a particular population in order to obtain political concessions. To achieve their goals, terrorist crimes should be known as widely as possible and terrorism of any kind is primarily a media operation."

Since September 11, 2001, there is a new generation of hyper-violence called terrorism also called mass terrorism, whose goal is twofold and aims to destabilize and create a general panic. These attacks may lead to economic, plunging many developing countries in an unfavourable environment. After passing through a difficult initial period from mid 1997 to mid 1999, emerging nations need to confront new constraints resulting from these attacks. International terrorism means violent or dangerous acts affecting the internal stability of nations such as violation of criminal laws of the State or any other country. These actions destabilize civil life and government policy. It originates outside or beyond national borders by making vulnerable the public context; it can be likened to a war imported into the country.

Countries whose macroeconomic environment is the least stable are those who know the greater volatility of deposits and bank loans. The deteriorating economic and financial situation of nations prior to the razor's edge (Argentina) or in difficult situations (Turkey, Lebanon, Brazil, Thailand, Philippines), was transformed into a transport to the trajectories of the worst economic history of these countries. Thus the impacts of both economic and financial terrorism are often more important than physical and material destruction. Terrorism generates political instability, since citizens of the space in which terrorist acts are committed, are beginning to lose confidence in the rule of law when they see that it is unable to effectively prosecute such actions.

ii. **The social and ethnic conflict:**

Conflicts usually occur by civil wars, riots or unrest affecting the country and generate a deterioration of its economic growth and human development. These conflicts result in political instability that damages economic growth. Social conflict stems from the social organization itself, since it is based on a differentiation of positions and on economic disparities, political and social. The risk of this conflict are more in hierarchical societies, they are degenerate in particular following the wave of decolonization in Africa and / or interference with its own

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foreign birth syndrome support the plan. The end of World War I induced delayed conflicts everywhere, rendered latent.

Ethnic conflict is distinct from other types of conflicts. It is often ranked among the major sources of recent internal and international conflicts. Ethnicity is considered a major cause of political instability. It refers to a shared cultural identity involving similar practices, initiations, beliefs and linguistic characteristics that have been inherited over time and generations. According to Crawford B\(^4\), economic factors can increase the likelihood of ethnic conflict either by the politicization of ethnicity or by discrimination based on cultural identity. Irrespective of their type conflicts, social or ethnic cause private and social costs and leads to a serious political and social instability. Similarly, regardless of their ethnic or religious sources, these transnationalized conflicts and create political problems.

But the economic and financial linkages are often cited as the transmission channels of the effects of conflicts between countries.

I-2 - Institutions: Concept and determinants:

a) Concept and typology of institutions:

The institutional economics, the term institution refers to a plurality of meanings. Institutions are thus considered as the set of rules within a society and are also regarded as an organization. For North D.\(^5\) institutions are all regulations that structure political interaction, economic and social. The national institutional structure is the most important factor reflecting the economic performance of a country. The World Bank (1998), "Institutions are formed by all the rules (constitution, laws and regulations, political system) and informal (reliability of transactions, value systems and beliefs, representations, social norms), which govern the behaviour of individuals and organizations, the latter being the entities comprising individuals who are pursuing common goals (business, labor)\(^6\)."

According to Aron. J\(^7\), institutions are defined as sets of formal and informal constraints imposed economic and political activities. In formal terms, the emergence and evolution of institutions are modelled by means of repeated games and evolutionary game original (built from a specific historical analysis) that can evolve gradually as the game repeats. Institutions can be economic, political or social. The laws governing the election of presidents or prime ministers are political institutions\(^8\). Economic institutions bring together all the economic rules such as the degree of enforcement of property rights and contractual rights. These rights mean that contracts can be written and implemented and certain rules and regulations governing economic transactions (individual property rights, commercial law, contracting the Patents Act, the type of credit agreements). Such institutions may be directed by the state, by individuals or organizations.


\(^6\) North D. C (1990),op.cit.


\(^8\) North D.C.,(1990),op.cit.
Political institutions summarize the structure of the state as well as the political process. They aim to set the limits of political power and how that power changes according to the constitution, electoral rules and voting. The institutional structure is composed of formal rules, informal enforcement mechanisms. Formal rules are the written rules of a society, all laws governing contracts, product information, the imposition of tariffs (customs duty) and bank regulation.

**b) Determinants of the institutional framework:**

i. Governance and Institutional Quality:

The term governance is not new; it originated in the public sector. Governance is an application of authorities to manage the affairs of a state at all stages. It is the existence of proper decision-making procedures and to execute, adjust and control the government initiatives that are planned or underway. World Bank (1992) defines governance as the manner in which power is exercised in managing economic and social resources of a country. Similarly, the OECD governance equates to the exercise of government authority and the political arena. And good public governance can strengthen democracy and human rights, promote economic prosperity and deepen confidence in government and public.

For Kaufmann. D. and Kraay. A. (2002), good governance leads to a positive effect on growth of income per capita. The quality of governance in a country is compromised by the likelihood of violent conducts to changes of governments, which not only has a direct effect on the continuity of the policy but also to a deeper level, implications for all citizens in Choice and changes those powers. Yartey.C.A found that good quality institutions such as public order, democratic accountability and bureaucratic quality are important determinants of stock market development because they reduce the political risk and improve the variability of finance externally, particularly in less developed regions.

Institutional quality is the degree to which institutions reduce uncertainty for economic decision makers in terms of production. A significant level of certainty involves low transaction costs for more profitable economic projects. Institutional change in the positive direction could result in transaction costs for short-term growth. While a negative effect should be expected if the change results in the reduction of institutional quality. Good governance and institutional quality have been central to studies of development policies in recent years. According to Shah AK (1996), "governance is explicitly linked to the notion of institutions. That all aspects of the exercise of authority by formal and informal institutions in the management of State resources."

Various studies have addressed the relationship between institutional quality and economic development, because a high level of economic growth stimulates the development of better institutions. Thus the measure of

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institutional quality in empirical analysis includes indicators such as property rights, bureaucratic structure, the political right and civil freedom\textsuperscript{13}.

ii. Democracy

Democracy is a process by highlighting the importance of elections, human rights and the various modalities allowing active participation of citizens in political decisions taken through an expanded and more representative basis for consultation while ensuring respect for the minority. Democratize is to respect cultural diversity, ethnic, linguistic and religious country. This requires a representative democracy such as political parties and interest groups, free elections, separation between the judicial and legislative as well as media freedom.

According to Burdeau. G.\textsuperscript{14}, democracy is freedom and equality of citizens; it refers more to a vision of society and less to a form of government. It is at the heart of the organization of a State, the supreme body to which all other members of the political hierarchy must bid. The democratic regime changes that perception of the government interposing, through these expansions and specificity, other bodies or institutions between leaders and citizens.

Several arguments, sometimes controversial, are advanced for describing the impact of political regime on development. And individual liberties in stimulating growth may cause a negative effect in causing conflict in terms of income distribution that is political instability. However, some economists have found that the democratic regime is detrimental to economic development that is the case for Erich Weede (1983) and Jean Paul Azam, J Claude and Stephane Barthelemy Calipel (1996). The study by Erich Weede\textsuperscript{15} on 90 countries from 1960 to 1979 includes the negative impact of democracy on economic growth. According to Helliwell\textsuperscript{16} democracy can both stimulate and slow down economic growth, it promotes growth in part.

According to Rodrick. D\textsuperscript{17}, participatory and democratic institutions mitigate the negative impact of external shocks on economic growth. Democracy also promotes economic growth through better protection of property rights and freedom of initiative to encourage and even protect the savings of more affluent members of society. It is detrimental to encourage the poor to save more because they would vote in favour of a regime engaged in pro-poor income redistribution. However, this policy is capable of pressing the state in a situation of over-consumption and low capital accumulation, thereby reducing economic growth.

Democracy may be favourable to economic growth by reducing political violence that creates high costs. In non-democratic regimes, governments increase the likelihood of eruption of political violence that negatively affects growth\textsuperscript{18}.

Persson and Svensson (1989)\textsuperscript{19} think that they should generalize this result; a government can influence the policies of his successor if it is able to affect some variables that affect its decisions. They show that a Conservative government borrows more when it knows that a more expansionary government will succeed and grow in a significant proportion of public debt which would limit opportunities for future growth.

iii. Corruption

Corruption is defined as the illegal trade between market and political / administrative and economic market. It is a violation of public standards, legal and ethnic sacrifices the public interest to private interests. This is the transaction that allows private parties to have access to public resources (contracts, funding, decisions) in the absence of transparency\textsuperscript{20}. To Shleifer and Vishny, "Corruption is the sale by government officials of government property for personal gain." \textsuperscript{21} It is clearly stated in international law and can take different forms that vary in size depending on the culture and the national context. Corruption remains a rampant problem in many developing countries, which makes the normal functioning of their economies more difficult.

In early 1990, corruption was the subject of renewed interest in a variety of social worlds, scientific, legal and political. It is translational and affects political stability and socioeconomic development in various countries. This corruption aggravates the already difficult circumstances that characterize the states in conflict and countries in transition economies. It is widely accepted that corruption is an obstacle to growth. In some poor countries, the phenomenon of corruption has become a major problem. Resulting in a deterioration of the rule of law and a loss of legitimacy of government. Given these conditions, the magnitudes of the political and bureaucratic problems worsen and create interest groups that expropriate the wealth of the community. Corruption creates destruction in the allocation of resources. And its costs and consequences are bad; its effects are either as a direct loss of revenue, or indirect, in the form of impaired growth and deterioration of relations between state, market and civil society.

For S. Wei, corruption affects the level of direct investment abroad; the effect of the uncertainty of corruption on the level of investment is negative. Thus, by way of illustration, the evolution of the level of uncertainty in Singapore is similar to increasing the level of taxes for multinational companies about 32\%\textsuperscript{22}.

Tanzi and Davoodi\textsuperscript{23} studied the effect of corruption on investment by deducting a high level of corruption weakens the level of investment projects. Since corruption increases the level of public expenditure negatively affecting productivity. It can also be classified as a cultural phenomenon intrinsically related to the structure of the state and the economy in which it operates.

It is therefore a purely political phenomenon that may be perceived more intensely in society and leading to inflation involving morality in Anglo-Saxon restriction of a bidding war between the political authorities. And

normative conflicts between various factions of society favour the chances of occurrence of corruption. The incidence of corruption is also related to the properties of the legal and regulatory aspects of political society and the proliferation of laws and regulations. For most economists, corruption is a transaction corresponding to the appropriation of an amount and operating an illegal exchange between agents. It covers cases of political and administrative corruption. Corruption can take many forms:

From all these considerations, it appears that the institutional and political variables induce a clear effect on growth and development. A plurality of empirical work has sought to highlight such a relationship by studying the correlation between political instability and economic growth. Political instability creates uncertainty in the future institutions and policy makers who in turn change the behaviour of private agents and companies in terms of accumulation of capital. Thus the phenomenon of political instability can be explained by a lack of determination in the fight against certain government corruption. For some countries, this instability is inherent to the country's political structure and less electoral uncertainty, as in Western democracy. The term political risk, has been used to describe the influence of political events in a country, particularly the operations of private foreign firms in the economy. Such a risk appears in an institutional, economic and political instability.

According to Howell and Chaddict, "political risk may involve many factors and events such as blocked funds, constraints in the form of repatriation of foreign exchange controls, expropriation or nationalization of property and resources, the damage of war, civil strife, government interference with contractual terms, discriminatory taxation regulations based political operations and the loss of protection of law."

II: Methodology and empirical validation:

II-1-Research methodology:

Presentation of the sample:

Our econometric study covers a panel of 20 emerging countries for a period from 1995 to 2008 to assess the relationship between institutional quality and political risk. These variables are collected from the Heritage Foundation, Transparency, and ICRG Governance Indicators Database / Data Gov.

Presentation of variables:

Dependent variable:

Political risk (Rpol): the risk that a government changes the rules that define the business environment in the country. Political risk is often characterized by lack of government stability, the judiciary and legal system. It includes all the political events destabilizing the domestic or international, such as violence, terrorism, social conflict, etc.. This variable (Rpol) comes from the PRS Group, an agency specializing in the evaluation of such risk. This is a notation that collects various indices representing political risk, such as democratization, stability of government, war and conflict.

Explanatory variables:

Corruption (cor): it means the level of corruption that is ranked among the governance problems that refer to institutional failure and the company's ability to manage on the basis of a device, disputed and social powers, legal, political and economic. Although unquantifiable variable, corruption was approximated by subjective ratings of perceived corruption. In this work, we chose a widely used measure of corruption by the PRS group ICRG (a higher value means less corruption).

The government size (Gov. Siz): the government size is by definition highly correlated with income tax and public spending. We considered spending unrelated. It is measured by the volume of government spending on defence, homeland security, government and diplomatic representation.

The property right (Prop R): according to North (1990), property rights are defined as the right of individuals appropriate to their own work, goods and services they own. Ownership is a function of legal norms, organizational forms and norms of behaviour, that is to say institutional structures.

The role of law (RL): "rule of law" is an indicator that reflects a legal system and legal, independent, effective and accessible with a government that enforces laws and fair. It can be considered a statutory policy under which the law restricts the government by promoting certain privileges and creating order and predictability of the functioning of the country.

Political rights (PR): they are designed to protect individuals against the interference of the state and are immediately applicable. They can be considered as a blanket right of political participation, that is to say, the right of citizens to seek to influence and participate in public affairs of the society to which they belong. These rights may take various forms such as voting, participation of candidates in elections, the right to participate in a demonstration and freedom of association.

Political Stability and Absence of Violence (SP): This variable measures perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means including terrorism and social violence. It is an indicator considered by investors to the choice of location. Political violence includes all violent incidents of political origin.

Voice and accountability (V_Acc): the ability of citizens to express their opinion to influence government priorities or ranges of governance, including greater demand for transparency and accountability.

Presentation of the Model:

The model we present attempts to analyze the relationship between institutional quality and political risk. This is a linear model between variables representing the institutional and political risk. The econometric model is as follow:

\[
RPol_{i,t} = \beta_0 + \beta_1 \text{COR}_{i,t} + \beta_2 \text{GOV}_{i,t} + \beta_3 \text{PROP}_{i,t} + \beta_4 \text{RL}_{i,t} + \beta_5 \text{PR}_{i,t} + \beta_6 \text{ACC}_{i,t} + \beta_7 \text{PS}_{i,t} + \mu_{i,t}
\]

\[
\beta = (\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6, \beta_7) \quad \text{Coefficients to estimate for each category.}
\]

\[
\mu_{i,t} \quad \text{Error term}
\]
$RPoli_{t,i}$ : Political risk rating for the period t and country i.

$COR_{t,i}$ : Level of corruption for the period t and country i

$GOV_{t,i}$ : Size of government (government size) for the period t and country i.

$PROP_{t,i}$ : Property rights (property rights) for the period t and country i

$RL_{t,i}$ : Role of rights (Rule of Law) for the period t and country i.

$PR_{t,i}$ : Political rights (political right) for the period t and country i.

$V_{ACC_{t,i}}$ : Voice and Accountability (voice and accountability) for the period t and country i

$PS_{t,i}$ : Political Stability and Absence of Violence for the period t and country i.

II-2- Validation and interpretation of results:

Our model is estimated with the method of generalized least squares (GLS) for correcting the problem of autocorrelation, the results obtained are given in the following table:

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>COR</td>
<td>5.459312</td>
<td>1.045883</td>
<td>5.219810</td>
<td>0.0000</td>
</tr>
<tr>
<td>GOV</td>
<td>0.331358</td>
<td>0.054360</td>
<td>6.095665</td>
<td>0.0000</td>
</tr>
<tr>
<td>PS</td>
<td>5.361045</td>
<td>1.896563</td>
<td>2.826717</td>
<td>0.0051</td>
</tr>
<tr>
<td>RL</td>
<td>-9.549881</td>
<td>3.028270</td>
<td>-3.153576</td>
<td>0.0018</td>
</tr>
<tr>
<td>V_{ACC}</td>
<td>0.723956</td>
<td>2.739522</td>
<td>0.264264</td>
<td>0.7918</td>
</tr>
<tr>
<td>PROP</td>
<td>0.228916</td>
<td>0.072328</td>
<td>3.164970</td>
<td>0.0018</td>
</tr>
<tr>
<td>PR</td>
<td>1.464594</td>
<td>0.815958</td>
<td>1.794937</td>
<td>0.0739</td>
</tr>
<tr>
<td>AR(1)</td>
<td>0.628997</td>
<td>0.045852</td>
<td>13.71807</td>
<td>0.0000</td>
</tr>
</tbody>
</table>

According to the estimate presented in the table above, the Gov variable is significant and positive, which justifies the existence of a direct relationship between the size of government and political risk. According to Persson et al (1999) changes in the size of government increases the responsibility policies in the public sector, giving more chance to increase political risk. Thus a high probability of government change creates uncertainties about future policies, each change of government leads to unpredictable changes in the political system. Alesina and Tabellini (1989) tend to explain the magnitude of capital flight in developing countries. Political uncertainty has its roots in increasing government instability. This can create an underinvestment in

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infrastructure, or even structural changes. The evolution of government size marked by ineffective regulation has negative effects on growth and economic stability, thus causing political instability.

A large size involves considerable expenses, which is likely to amplify deficits. To contain such imbalances, governments tend to use austerity policies. This practice is still causing unrest and social violence. The COR variable is significant. This is a positive relationship between corruption and political risk. This is consistent according to previous work. Rothstein B (2007) considers corruption as a crucial phenomenon that can be compared to an epidemic as it spreads rapidly in the political-economic system of the country. Corruption diverts national resources in favour of a social class, degrading the national resources of countries and helping to maintain the vicious circle of poverty and unemployment trends.

It encourages the threats of social, economic or cultural country, reducing the relevance of governments and the credibility of public institutions. This reduces the efficiency given to judicial branches of government and creates a climate of insecurity and political instability by provoking civil peace marked by inequalities between social groups. The RL variable is significant with a negative coefficient of -9.54. The role of law is one of the greatest threats to political stability. The tendency of political risk is compounded by weak democratic institutions and by the absence, or inadequate development of pluralism and the rule of law.

PROP variable is significant and the presence of social inequalities creates tensions on the purchasing power thus disturbances in the political atmosphere. Very marked social inequalities are likely to foster conflict between the various layers. An ideal society and stable assumes more equity and less disparity of wealth. PS variable is significant that the likelihood of political instability and the presence of violence offer more opportunities to increase political risk. This variable is classified as a representative indicator of political stability of states.

The PR variable is significant, political rights hamper economic growth in the sense of minimizing the savings and an increase in consumption which creates a trade deficit and thus a limitation of social projects. Some models attribute an effect of defective democracy in growth, which creates indirect effects on political instability.

V_Acc is not significant face to political risk. Freedom of expression for citizens and the responsibilities are limited in our sample. The presence of the state in making decisions with a lack of transparency degrades the responsibility of individuals in political life.

Political instability, government corruption, the presence of ethnic and religious minorities and the lack of territorial control are sources of political risk. Political instability is linked to institutional instability and generates a constant reformism. According to Azam et al (1996) "political instability occurs in most non-democratic regimes than democratic ones." The volatility of the institutional framework and quality provides an unsatisfactory regulatory and governmental context, which gives rise to political risk. Government

intervention in the economy produces many points of conflict between private and public interests, creating an environment conducive to the development of corruption in a context of institutional and administrative deficit.

Conclusion:

The institutional quality is associated with the political situation of the states. Thus the government size and its position on the right, creating an environment conducive to economic development, limit corruption and promote political stability. Government intervention to stabilize the political situation may negatively affect economic growth by forcing agents to follow a regulatory and legal system that does not necessarily fit their goals. This opens the debate on a different aspect of financial and political repression practiced by governments to limit exposure to international risks.

Bibliography:


Annexe
Dependent Variable: RPOL
Method: Panel Least Squares
Date: 11/09/09   Time: 16:00
Sample (adjusted): 1996 2008
Periods included: 13
Cross-sections included: 20
Total panel (unbalanced) observations: 243
Convergence achieved after 12 iterations

<table>
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</table>

R-squared 0.459844     Mean dependent var 63.73025
Adjusted R-squared 0.443754     S.D. dependent var 10.02522
S.E. of regression 7.476997     Akaike info criterion 6.893907
Sum squared resid 13137.79     Schwarz criterion 7.008905
Log likelihood -829.6097     Hannan-Quinn criter. 6.940227
Durbin-Watson stat 1.844753
Inverted AR Roots .63