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INSTITUTE OF GRADUATE SCIENCES

THESIS
FOR THE DEGREE OF
MASTER OF BUSINESS ADMINISTRATION

KHUBIB YOUSEF ALI AL UBUD

THE COMPLEX RELATIONSHIP BETWEEN POLITICS,
ECONOMICS AND EXCHANGE RATES

ADVISOR: PROF. DR. ALI POYRAZ GÜRSÖN

ISTANBUL, 2024

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ABSTRACT

THE COMPLEX RELATIONSHIP BETWEEN POLITICS, ECONOMICS AND EXCHANGE RATES

States in the modern era show how dependent they are on International Political Economy (IPE), which combines economic tactics with social and political components. However, certain nations encounter difficulties that have a detrimental effect on sustainable development and quality of life, especially those in conflict zones and least developed countries (LDCs). Studies emphasize how crucial it is for leaders to work together to prevent disputes, yet ongoing political unrest can obstruct this cooperation and cause volatility in the economy. Here, we see how unfavorable policies make the state of the economy worse. Careful analysis of the political and economic aspects is necessary for comprehensive economic dynamics, highlighting the importance of fairness and openness in the administration of public policy. Recognizing how these dynamics affect the market necessitates strengthening stability and encouraging development, emphasizing that solving structural issues is crucial to accomplishing national objectives.

Thus, it is evident that attaining Purchasing Power Parity (PPP) to support economic well-being and a balance between political and economic factors are essential for promoting sustainable growth in conflict-affected areas. This calls for the adoption of methodologies like Nearest Neighbor (NN) approaches to study the effects of economic factors on political stability.

It is clear when looking at the Real Exchange Rate (RER) that political stability and currency stability are related. Market uncertainty brought on by geopolitical crises (GPR) has an impact on foreign investment and international trade. These oscillations, which show the connection between balance of payments (BOP) and exchange rates, have an economic impact that is especially felt by nations that are experiencing political difficulties. Unequal opportunities and other unfair economic practices serve as examples of how they can cause investment levels to drop. Furthermore, shifts in monetary and fiscal policy have a big impact on currency rates, which makes risk management techniques like the Reserve Option Mechanism (ROM) necessary. International firms are hesitant to make investments in shaky markets, highlighting the connection between

political and economic stability and the significance of the Consumer Price Index (CPI) as a gauge of inflation and its effects on stability.

Key Words: Economy and Exchange Rate Interrelationship, Exchange Rate Determinants, Foreign Exchange Risk Management, Modern Political Economy.



PREFACE

The relationship between politics, economics, and exchange rates has always been one of the most important and complex topics. The theories and models of exchange rates are constantly evolving and updating. Therefore, it has been my pleasure to explore this fascinating field. I have conducted a general review of the literature and articles, and I hope that this contribution, even if small, will assist researchers, policymakers, decision-makers, economists, and anyone working in the field of trade.

Thanks Allah for granting me patience, strength, time, and health to write this thesis. He blessed me with the completion of this work and placed people along my path who honored me with their support and assistance. They provided me with all kinds of help and never forgot me. Thank you all from the heart. I would like to especially thank my dear mother and father, my wife and children, and my brothers, each by name. I also remember with gratitude Professor Ali Poyraz Gürson, who guided me toward the right path, with all my respect and appreciation. I extend my thanks to this giving institution, with its distinguished staff, and everyone who works at Okan University in Istanbul.

I dedicate this thesis to the children of Gaza, to its martyrs and heroes, to all those who defend the honor of our nation, to the martyrs of the earthquake, to the heroes of duty in this beloved country, Turkey, and to all innocent and oppressed people worldwide. I also dedicate it to every noble soul who carries the concern for my beloved country, Jordan, and defends it and its sacred sites. I have drawn inspiration for this thesis from all of you, with everything it contains. Peace be upon you, the heroes of our hearts, the crowns of our heads.

KHUBIB YOUSEF AL-UBUD

ISTANBUL, 2024

ABBREVIATIONS

IPE	International Political Economy
IR	International Relation
LDCs	Least Developed Countries
ROM	Reserve Option Mechanism
GDP	Gross Domestic Product
CPI	Consumer Price Index
BOP	Balance Of Payments
PPP	Purchasing Power Parity
RER	Real Exchange Rate
NN	Nearest-Neighbour Methods
GPR	Geopolitical Risk

INDRODUCTION

Modern states depend heavily on political economy, which integrates social and political elements with economic strategies. Governments have to concentrate on enhancing economic performance, embracing morality in politics, and forming business partnerships. Improving quality of life and directing policies toward sustainable development require addressing problems like poverty and inequality. The notion of local economic growth policies includes factors that affect the political reasoning of local politicians, policy differences, and the function of the government. The limitations in the current literature must be the focus of future research. Additionally examined are the types of conflicts, how the public participates in decision-making, and the interests of dominating businesses¹.

Since choices are what ultimately determine which economic policies are implemented, political factors have a big influence on economic policy. The effect is dependent on a number of factors that could jeopardize a nation's stability, particularly if policymakers and economists are unaware of the dangers. To make strategic choices that protect the national security and economy, leaders must cooperate. To prevent disputes with national interests, it is essential to research international alliances. In order to achieve stability and sustainable development, cooperation between politics and economics is necessary. Political institutions are an essential component of economic decision-making, serving as a crucial framework for determining priorities and directing economic policy. The power dynamics between political players and society trends are reflected in these institutions. To promote sustainable development and raise living standards, these institutions' laws and regulations are depended upon. Increased trust between the public and decision-makers is another benefit of transparency and accountability, and this increases the efficacy of economic measures. In the end, the interaction between political institutions and the economy emphasizes how crucial it is for political and economic factors to work together in order to accomplish national objectives. There is a relationship between political electoral behavior and economic conditions in Western democracies. I

¹ Wolman & Spitzley, 1996, p.115-150.

have come to the conclusion that electoral campaigns are driven more by selfish goals of governments than economic goals. How interest groups and bureaucracies can obstruct the implementation of new government policies, and for this reason their inclusion in models is essential to understanding contemporary democracies². Furthermore, how comprehending development results across national borders is impacted by inefficient political markets and institutions as well as the function of collective action. Although political checks and balances seem to be crucial, voters' lack of information and the veracity of pre-election pledges are also causes for concern. These elements play a major role in influencing both economic growth and political performance³. Monetary and fiscal policies are essential for overseeing a country's economy. While monetary policy involves the central bank's control over the money supply and interest rates, which affects inflation and investment, fiscal policy encompasses decisions made by the government about public expenditure and taxes to promote economic growth. Coordinating these policies encourages economic stability by sustaining price stability, increasing aggregate demand, and highlighting the significance of integrated initiatives for sustainable development.

In the global economy, exchange rates play a critical role in establishing the relative value of national and foreign currencies. International trade, foreign investment flows, and inflation rates are all impacted by fluctuations in exchange rates. Businesses like stable currencies, and fluctuations in exchange rates can raise the cost of imports. To evaluate a nation's economic performance in a global context, one must have a thorough understanding of exchange rates. When it was established 60 years ago, the Bretton Woods System addressed exchange rate management in a global economy with constrained capital mobility. The significance of valuation channels in exchange rate adjustment has expanded due to financial globalization, which has ramifications for policy⁴. Exchange rates are greatly impacted by political issues. Currency stability follows from increased investor confidence brought about by political stability. Investment trends and economic success are impacted by fiscal policies like taxation and government expenditure. Currency value is determined by geopolitical tensions and international relations, with conflicts having the ability to devalue currencies. Exchange

² Eslava, 2006. The political economy of fiscal policy: survey.

³ Keefer, 2004, *Sci.*, 7(1), p.247-272.

⁴ Lane & Milesi-Ferretti, 2004.

rates are a reflection of how market expectations are affected by political statements and government choices. Comprehending the political landscape is essential for evaluating fluctuations in exchange rates. How the choice of exchange rate affects economic growth from a political economy perspective also has context-specific consequences by emphasizing the weak relationship between growth and cohesion, the choice of exchange rate regime, the importance of entry prices, and the debate over Britain and the euro⁵.

The value of a local currency is determined by exchange rates, which are heavily influenced by government policy. Currency demand is impacted by fiscal policy, which includes taxing and spending, since it affects economic activity. The central bank's monetary policy controls interest rates and the money supply, which has an impact on both domestic and foreign investment. Exchange rates are impacted by trade regulations that impact the balance of payments, such as tariffs and import restrictions. These elements show how decisions made by the government have a direct bearing on changes in exchange rates and the broader economy.

Moreover, risk causes the forward exchange rate to deviate when forecasting future spot exchange rates. Economic agents find it more difficult to predict currency price movements during democratic political events such as elections and cabinet formations. However, volatility in the currency markets cannot be explained by these events⁶.

China's depreciated renminbi has helped the country's economy flourish and create jobs, but it has also made the nation more vulnerable to financial threats, indicating that political goals are taking precedence above economic efficiency⁷.

There is an effect of government spending on GDP, trade balance, private consumption and the real exchange rate of the consumer price index, that higher government spending leads to a lower trade deficit and exchange rate⁸. Optimal monetary policy in a small, open, random economy with risk-averse customers. Focusing on policy efforts to achieve

⁵ Eichengreen & Leblang, 2003, p.797-822.

⁶Bernhard and Leblang, 2002, p.316-333 .

⁷Kaplan, 2006, World Development, p.1182-1200 .

⁸Monacelli & Perotti, 2010, The Economic Journal, p.437-461 .

the lowest possible interest rate while balancing the advantages of higher growth and future consumption with the disadvantages of lower real money balances⁹.

Exchange rates are strongly influenced by geopolitical events, as political unrest and crises affect the value of currencies. For example, increased regional tensions can lead to volatility in financial markets, such as the Israeli occupation army on Gaza and other areas in the Middle East. This can lead to investors withdrawing from currencies linked to the region, which can reduce their value. Economic expectations are also affected by the response of the international community and humanitarian relief. Therefore, exchange rate movements and economic stability are directly affected by geopolitical crises. The impact of geopolitical risks on major exchange rate markets, and there is a two-way causality relationship, as Covid-19 and the Russia-Ukraine crisis had a significant impact on exchange rate markets at the time of the events. However, as the fighting continued, this impact diminished. During volatile periods, governments and currency investors may find this information useful¹⁰. Crude oil markets are impacted differentially by news regarding geopolitical events and macroeconomic fundamentals. Geopolitical news increases trade volume and creates uncertainty, while macroeconomic news has an immediate effect on oil prices and forecasts long-term returns. News sentiment follows statistics announcements and helps forecast economic data realizations to some extent¹¹.

A number of intricate economic factors, including supply and demand for currencies as well as political and economic environments, affect the exchange rate. Governments have the authority to establish fixed exchange rates that might not reflect the actual market or to permit variations that could lead to economic instability and affect investment and commerce. Determining the exchange rate is a delicate and significant process since it necessitates a thorough examination of political and economic facts in order to comprehend these processes. The main risk in international trade is uncertainty expressed as a percentage change in real exchange rates, which can sometimes have a significant negative impact on trade volume. With small risks and smaller price impacts, the expectations variable has a positive impact in more circumstances¹².

⁹Turnovsky & Grinols, 1996, *Journal of International Money and Finance*, 15(5), p.687-716 .

¹⁰ Hung, 2024, p.91-107.

¹¹ Brandt & Gao, 2019, *Journal of Empirical Finance*, 51, p.64-94.

¹² Cushman, 1983, *Journal of international Economics*, 15(1-2), p.45-63.

How the real exchange rate (RER) affects world trade, economic expansion and development, the challenges and opportunities for future research, macro- and microeconomic dynamics and its use as a tool for development policy. To gain a deeper understanding of the impact of the real exchange rate on structural change and long-run growth¹³. Exchange rates have become more significant due to globalization, and they are essential for business partnerships. There is now more market flexibility and stronger economic links as a result of the Bretton Woods system breakdown. To find and fix vulnerabilities, businesses need to efficiently manage exchange rate risk¹⁴.

Exchange rate risk, which involves currency swings that affect the costs and returns of international trade, is a major concern for multinational corporations and nations. Exchange rate increases may result in higher import costs, which would reduce profitability. Furthermore, since investors steer clear of erratic markets, volatility may have an impact on investing choices. Stable financial performance and risk management require effective solutions such as hedging. There is a relationship between trade and exchange rates, with a particular focus on currency misalignments and exchange rate volatility. It tells us that exchange rate volatility negatively affects trade, depending on variables such as hedging instruments and the structure of production. In models with price rigidity, currency misalignments have short-term consequences, but unless there are other distortions, the long-term effects of trade disappear¹⁵.

How currencies are valued in financial markets is explained by exchange rate theories and mechanisms. While the interest theory contends that variations in interest rates have an impact on capital flows and exchange rates, the buying power theory contends that exchange rates represent price differences among nations. Prices are dynamically determined by market forces such as supply and demand in response to shifts in economic activity. These theories draw attention to how difficult it is to determine exchange rates and how important they are to the world economy. Foreign exchange rate forecasts,

¹³ Demir, & Razmi, 2022, *Journal of Economic Surveys*, 36(2), p.386-428.

¹⁴ AKARSU, & ALACAHAN, 2019, *Exchange Rate Risk And An Evaluation In Terms Of Turkey Economy*, p.79-90.

¹⁵ Auboin, & Ruta, 2013, *World Trade Review*, 12(3), p.577-605.

focusing on topics such as the forward premium dilemma, the generation of financial market expectations, the divergence of expectations, the partial structure of the market, time-varying risk premiums, and the performance of expectations. This means that the forward discount anomaly can be explained by time-varying risk premiums and irrational expectations¹⁶.

An essential tool for comprehending how monetary policy and exchange rates interact in open economies is the Mundell-Fleming model. It illustrates the effects of shifting fiscal and interest rate policies on capital flows and exchange rates. Others, which take political risks and shifts in the world economy into account, such as the "transient shocks" and "permanent dividends" models, provide more information about the behavior of currency rates. Integrating these models improves comprehension of the market. Developed in the 1960s, the Mundell-Fleming model provides a coherent analytical framework for global macroeconomics. It talks about the function of the exchange rate system, the ramifications of debt and tax financing, and the distinction between the short- and long-term policy consequences. The main mechanisms of the model are identified, elucidating its constraints and facilitating comparison with existing methodologies¹⁷. According to the Mundell-Fleming theoretical model, fiscal policy affects output at both fixed and flexible exchange rates, although its effect is greater at fixed exchange rates, maintaining a fixed exchange rate raises the fiscal multiplier in the long run¹⁸.

A formal technique for creating expectations and turning uncertainty into risk is forecasting. It helps turn uncertainty into risk, which is crucial for decision-making in an unpredictable world. Although it is not quantitative or scientific, forecasting is based on judgment, intuition, and data analysis techniques. A formal forecast is not what an expectation based on a "hunch" is. Forecasting is therefore essential for handling unpredictable situations¹⁹.

¹⁶ Jongen, Verschoor & Wolff, 2008, *Journal of Economic Surveys*, 22(1), p.140-165.

¹⁷ Frenkel & Razin, 1987, p.567-620.

¹⁸ Karras, 2011, p.29-44.

¹⁹ Moosa, 2016.

1. Understanding the dynamics of political economy.

1.1 Political Economy in Modern States.

Recent political science scholarship has refocused on analyzing the origins and growth of the modern state, amid speculation that the state has reached its peak. However, nations are gradually fragmenting into many entities, with some disintegrating rapidly. Some contemporary nations thrive in regulating social activities and influencing economic results, whereas others lack these skills. The study of state evolution has been relegated to a secondary role, with structural realism and deductive reasoning rendering a detailed examination of state formation unnecessary²⁰. Political economy, the study of political processes using economic principles, focuses on rational and self-interested individuals. Behavioral economics, which accepts cognitive biases in the market but not in politics, has evolved as a single methodology. This field is becoming more popular in political economic analysis, as are behavioral techniques. Political economy is a late bloomer in this way when compared to other branches of economics²¹.

This study looks into the level of knowledge and understanding of intellectual capital management (ICM) in Ankara, Turkey's manufacturing sector. A survey assessing the use and knowledge of ICM was carried out among big and medium-sized manufacturing enterprises. Findings indicated that while most businesses have some understanding of ICM, very few have a thorough framework. Subsequent investigations must delve into the interplay of ICM, research and development divisions, and other Ankara areas. The study's objective is to offer a broad model of ICM awareness and proficiency in Turkey's capital²².

There are two waves of sociological theories on the political economy of the environment: one focuses on the productivity character of industrial production, such as impact and growth machine theories, and the other on environmental damage and social

²⁰ Spruyt, 2002, P.127-149.

²¹ Schnellenbach & Schubert, 2015, P.395-417.

²² Erkan, Gurson & Özdemir, 2011, International Journal of Business and Management Studies, 3(1), p.373-380.

movements that challenge agents of destruction. Current debates center on the predictive power of these ideas, which might tilt towards catastrophe economics if climate change worsens²³.

Historically, economic conduct was centered on utility-maximizing transactions, whereas political activity entailed voting and forming interest groups. Institutions were distinct from economics and politics. However, a positive political economy employs an economic lens to analyze political processes, institutions, and public policy development. It stresses the political context of market phenomena and seeks to explain aggregate results such as production, resource allocation, and public policy²⁴.

Economists frequently subsidize natural resource-based economic transactions, hence influencing overall economic performance. To achieve long-term growth, each generation must leave a productive base equivalent to what it got. To quantify this, compute the productive base, including capital assets, and then utilize shadow prices to measure the net improvement in society. Ethical theories can assist detect Shadow Pricing, but evaluating them is difficult²⁵.

International trade agreements greatly enhance the economy, improve the currency and reduce inflation. They open markets for competitive products, prices and services, which increases productivity as well as growth of the local economy. Trade also increases supply, which reduces inflation²⁶. Foreign investment enhances the value of the local currency, and trade relations enhance confidence in the national economy and stimulate growth. Therefore, it is necessary to seek trade agreements that contribute to the stability of the currency and reduce fluctuations²⁷.

Immigrants contribute to economic growth in their home countries through a variety of ways, with the majority of evidence coming from case studies in Asia, specifically India, Taiwan, China, and Korea. Returning migrants bring new skills, capital, and ties with individuals in developed countries, which boosts tourism, transportation and

²³ Rudel, Roberts & Carmin, 2011, p.221-238.

²⁴ Altv& Alesina, 1996, p.645-674.

²⁵ Dasgupta, 2010, p.5-11.

²⁶ World Bank, 2021.

²⁷ World Trade Organization, 2024, *Regional trade agreements*.

telecommunications spending, and trade. Econometric research also points to the presence of immigrants in receiving nations and increasing commerce with exporting countries²⁸. We also emphasize state ownership of banks; while state-owned banks may not allocate credit effectively, the findings indicate that their impact on financial development and growth is less than previously anticipated. The article also proposes that state-owned banks may play an important role in lowering credit cyclicity, but their presence necessitates effective governance, clear missions, and accountability for assistance²⁹.

Agriculture's involvement in economic growth has developed across three periods. The first stage, based on Soviet industrialization strategies, called for considerable government intervention to mobilize labor and resources for investment. The second stage, which took place in the 1970s and 1980s, tried to strike a market-oriented balance between farm and industry. However, this strategy fails to adequately address agriculture's non-market contributions to economic growth, social reduction, and environmental conservation³⁰.

Policymakers see universities as critical participants in the knowledge-based economy, with research institutions in the United States at the center of studies on the commercial effect of university-based research on regional economies. Academic entrepreneurship and university-industry relationships have been studied, and the findings indicate that universities play an important role in their communities, where society gains from experience and knowledge, and the institution may provide work prospects for graduates³¹.

The role of education and human capital in economic development, and the impact of education and other institutional aspects. Economic growth is strongly influenced by workers' skills. Other factors such as well-functioning economic institutions and participation in international markets may also amplify the benefits of good education. Existing evidence suggests that the quality of education independently affects economic outcomes, and that a larger skilled population leads to stronger economic performance

²⁸ Lowell & Gerova, 2004, p.1-34.

²⁹ Levy-Yeyati, Micco & Panizza, 2004.

³⁰ Timmer, 1992, p.21-58.

³¹ Bagchi-Sen & Smith, 2012, *Geography Compass*, 6(7), p.439-453.

for countries³². Cross-border collaboration between local and state governments has evolved into a competitive economic development arena. Governments are increasingly referring to this cooperation as "collaboration," which improves their chances of winning a project by boosting their competitiveness through partnership with other governments. Collaboration is the result of the necessity to work together to boost competitiveness³³.

The debate over financing economic development centers on external resources, the liberalization of financially repressive regimes, and public sector deficits. However, the data supporting the benefits of financial repression is limited and risky. Latin America's budget deficits and reliance on external financing amplify these dangers. Realistic exchange rates, balanced budgets, and a good investment climate are all required to mobilize resources for growth³⁴.

Entrepreneurship is critical for economic development since it drives productivity and innovation. Its quality is determined by entrepreneurial ability, return rates, and impediments. Promoting high-quality entrepreneurship demands increasing both quantity and quality through education, culture, and hands-on learning. Institutional strengthening and an awareness of professional options can help to ensure long-term growth³⁵. Information and knowledge are critical to economic competitiveness in the modern economy. Developing countries should actively support the information economy through Government by facilitating market-led initiatives, strengthening capabilities, and increasing openness. Despite the hurdles, successful implementation is conceivable³⁶.

The developing world has tremendous energy challenges, with 90% of the population living without electricity and 2 billion reliant on conventional fuels. The inefficient production and uneven distribution of modern energy sources offer economic, environmental, and health risks. To solve these difficulties, governments should promote market-oriented initiatives that make the energy market more accessible and inexpensive to local investors, communities, and consumers. This would increase access to energy for

³² Hanushek & Wößmann, 2007.

³³ Lombard & Morris, 2010, *State and Local Government Review*, 42(1), p.73-81.

³⁴ Dornbusch & Reynoso, 1989.

³⁵ Naude, 2008.

³⁶ Ndou, 2004, p.1-24.

rural and low-income people by lowering energy prices and making the shift to sustainable energy more affordable³⁷.

Agriculture became automated and specialized following World War II, resulting in environmental and food challenges. Organic farming, which originated in Western countries, is being studied for sustainable development. In developing countries, low-input conventional systems continue to prevail. Proper production procedures, certifying organizations, and partnerships with overseas markets are all challenges. Government support is critical³⁸.

Resource-rich countries struggle to attract investors and finance investment, resulting in failures in developing areas. Common challenges include technological difficulties in managing unpredictable resource revenues and short-term spending pressures. However, recent decades have seen gains in governance, economic management, and growth, particularly in Africa, where annual growth averaged more than 5.5% between 2000 and 2014³⁹.

The tax reform in developing countries relies on politics rather than economics. Experts and aid agencies can help create necessary capacity to address tax challenges. Policy specific advice should be provided on request, and improving the institutional framework for discussing fiscal issues is crucial for sustainable fiscal reform. This may be the only feasible way for outsiders to assist in meaningful tax reforms⁴⁰.

The Sustainable Development Goals aim to achieve global environmental, social, and economic goals, but also present governance challenges such as promoting collective action, balancing equity, justice, fairness, and accountability. These challenges are interconnected and require integrative governance capabilities to progress beyond traditional approaches. Addressing these challenges requires a focus on fostering collective action and ensuring accountability for decision-making outcomes⁴¹. International political economy IPE is the interaction of politics and economics that

³⁷ Barnes & Floor, 1996, p.497-530.

³⁸ Rehber, & Turhan, 2002, British food journal, 104(3/4/5), p.371-390.

³⁹ Venables, 2016, Journal of Economic Perspectives, 30(1), 161-184.

⁴⁰ Bird, 2008.

⁴¹ Bowen, Craddock-Henry, Koch, Patterson, Häyhä, Vogt & Barbi, 2017, p.90-96.

involves the movement of commodities, services, money, people, and ideas across boundaries. It arose in the mid-1960s as a reaction to global economic concerns and slow progress in the Third World. The phrase refers to a variety of players and interactions, going back to antiquity with mercantilist texts pushing for state authority and national economic self-determination⁴².

International political economy IPE is a scientific discipline that combines theoretical and practical perspectives to better understand the global economic system. It promotes trust and solidarity, analyzes systemic transformations, establishes social legitimacy criteria, and creates conditions for individuals to realize their creative potential in global social capital. Further research could look into contradictions in the current stage of economic system development⁴³.

Industrial policy has become more prominent in European economic debates, particularly following the Great Recession and the COVID-19 pandemic. However, comparative political economy continues to pay little attention to industrial policy. Refocusing the comparative political economy debate on industrial policy, utilizing insights from heterodox economics and economic geography, aids in industrial policy integration⁴⁴.

Market competition is essential for the proper operation of a market economy because it fosters progress and transfers public goods to efficient agents. Globalization, on the other hand, poses a threat to regional economies, resulting in widespread unemployment, lower living conditions, and social instability. To meet these problems, new competitive economic directions are required⁴⁵.

Economic globalization presents both opportunities and challenges for workers. Multinational production can improve wages, training, and working conditions, while international trade can boost labor demand. However, competition in investment and product markets can pressure labor rights. Migration, involving workers transferring

⁴² Marlin-Bennett & Johnson, 2010.

⁴³ Kwilinski, Dalevska & Dementyev, 2022, *Journal of Risk and Financial Management*, 15(3), p.124.

⁴⁴ Bulfone, 2023, p.22-43.

⁴⁵ Markaryan, Yakovlevna, Yurevna, Alexandrovna, & Anatolyevna, 2020.

funds to relatives, can influence government policies. Workers can form unions or protest movements, and remittances can positively affect social welfare and political leaders⁴⁶.

Political economy suggests that conflicts of interest may underlie the emergence of deficits, opportunistic politicians generate deficits to win elections, even when doing so conflicts with the general welfare, conflicts of interest among politicians partisan preferences create incentives for some officeholders to run deficits, conflicts of interest among different social groups or regions create tensions in the allocation of government resources, leading to overspending⁴⁷.

This review discusses the political economy of deep integration agreements, highlighting the shift from trade liberalization to international policy coordination. The political conflict is shifting from exporter-gainer to import-competing interests, with popular backlash against these agreements. The welfare economics of these agreements has become more complex, making traditional gains from trade insufficient for evaluating their efficiency⁴⁸.

The political economy of fiscal policy, particularly the growth of public debt. Fiscal equilibria are determined by factors such as officials' opportunistic conduct, the diverse fiscal preferences of voters or legislators, and budgetary institutions. Less fragmented governments and greater voter control over fiscal policy are linked to reduced deficits, with the estimated impacts being stronger than when analyzed independently⁴⁹. Critical political economy addresses fiscal issues from two perspectives: opposition to interventionist measures and the commodification of social rights in contemporary capitalism. Austerity plays a key role in lowering spending and controlling public debt, ushering in a new age for social rights. Privatization and mercantilization indicate commercial logic's supremacy in social reasoning, as well as the unavoidable requirement for fiscal adjustment. But the austerity policy must be fair, balanced and guarantee the rights of the people without infringing on their rights⁵⁰.

⁴⁶ Mosley & Singer, 2015, *Annual Review of Political Science*, 18(1), p.283-301.

⁴⁷ Eslava, 2011, p.645-673.

⁴⁸ Maggi & Ossa, 2021, *Annual Review of Economics*, 13(1), p.19-38.

⁴⁹ Eslava, 2006.

⁵⁰ Toschi, Mendes & Carnut, 2024, *Modern Economy*, 15(01), p.1-22.

The Eurozone, which was made up of export-oriented northern European economies and demand-driven southern European economies, performed admirably from its formation until the Eurocrisis. However, except in banking, there has been minimal Eurozone-generated institution construction, with the European Central Bank becoming the de facto lender of last resort to fiscally stable member states as a result of Outright Monetary Transactions⁵¹.

1.2. The Impact of Political Factors on Economic Policy.

Saudi Arabia, the largest OPEC member, has a significant impact on oil prices. Economic variables such as market tightness and Western economic concerns do not correspond to Saudi action. The US government's limitations on Saudi oil policy, which has historically been negative, are also significant. The production capability of reserves is also significant in keeping global crude oil prices stable. Theoretical and empirical issues are ineffective for forecasting oil prices⁵².

Following Israel's frontal assault on civilians in Gaza, corporations that support the occupation have seen a decline in their financial standing due to the boycott of such enterprises. In Muslim-majority nations as well as in the US and Europe, McDonald's, Starbucks, Domino's Pizza, and Yum have all seen a fall in sales. In fact, McDonald's and Starbucks have seen a severe deterioration in their yearly sales growth projections⁵³.

Table 1

The company	Revenue (2023)	Change in revenue (%)	Sales in Middle East, Malaysia and Indonesia
McDonald's	\$6.41 billion	8%	Decline in sales
Starbucks	\$9.4 billion	8%	Weak sales

⁵¹ Iversen , Soskice & Hope, 2016, p.163-185.

⁵² Moran, 2016, p.94-130.

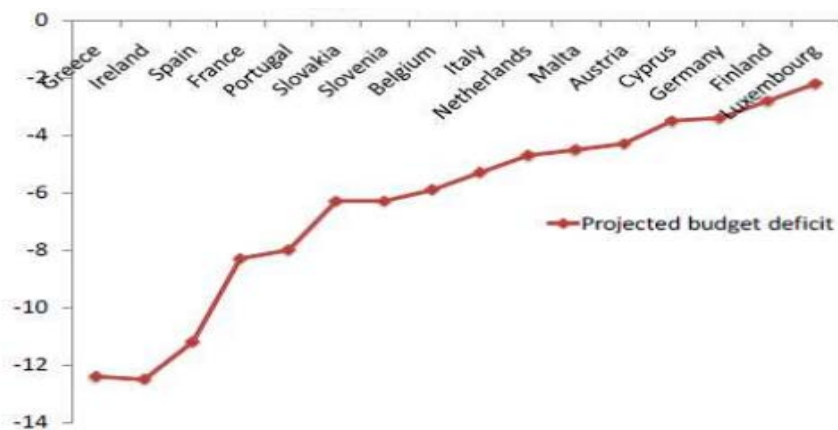
⁵³ Al Jazeera, (2024, February 12), The boycott hits the budgets of companies supporting Israel with a deficit. Al Jazeera, <https://2cm.es/LVkr>.

Domino's Pizza	Not specified	Decline of 8.9%	Direct impact on sales
Yum (KFC and Pizza Hut)	\$2.04 billion	1%	Decline of 5% (KFC) and 3% (Pizza Hut)

The impact of the boycott on the revenues of companies that support the Israeli occupation

Economic crises are structural occurrences in the capitalist economic system, not cyclical or recurring. The IPE examines economic crises utilizing classical and neoclassical tendencies. Economic variables are critical in societal development and politics, as governments prioritize growth, development, inflation, unemployment, and investment. Economic crises are dynamically renewed phenomena that provide the foundation for new economic concepts⁵⁴.

The US-caused global problems within the Euro Zone have resulted in public debt and budget deficits that fall well short of the Maastricht standards. Unresolved issues have been encountered by nations including Greece, Ireland, Italy, Portugal, and Spain. These crises can have an impact on Turkey, its biggest trading partner. Remaining at 55%, foreign debt is mostly owed to banks in Europe. New funding is needed to sustain expansion, and European banks may have to reduce their balance sheets⁵⁵.



⁵⁴ MIHOUB, 2021.

⁵⁵ Topcu, Gürson, Ülker & Erkan, 2011.

Figure 1: Budget Deficits (%/GDP) Source: Akram et al., 2011, p.122.

The impact of economic policy uncertainty on firms and economies around the world. It emphasizes the need of assessing and tracking uncertainty and its impact on financial decisions. Policy uncertainty has a considerable impact on firm financial policies and consumer spending, with firms acting more conservatively and reducing investments in production and employment⁵⁶. Economic and political factors influence government behavior, with administrations pursuing selfish interests in order to win reelection and achieve ideological objectives. However, government action is influenced by ideological factors as much as survival. Governments may not consistently pursue a political business cycle, necessitating a larger perspective to grasp macroeconomic effects and constitutional concerns⁵⁷.

The globalization of the world economy has had a substantial impact on domestic politics, eroding governments' autonomy in macroeconomic policy while creating political scope for big reforms. It has heightened susceptibility to exogenous shocks, precipitating economic crises and establishing new policy preferences. Institutions influence leaders' tactics for adapting to globalization, resulting in long-term resistance. To properly grasp these shifts, comparative politics and IR need to be modified⁵⁸.

The COVID-19 pandemic demonstrated the harmful consequences of economic policy uncertainty on individuals, firms, governments, and economies. Uncertainty in economic policy causes delayed financial decisions, decreased consumption, fewer investments, and increased unemployment. Political and regulatory uncertainty have an impact on commodity markets, cryptocurrencies, as well as banking, housing, and equities markets. The significance of economic policy uncertainty as a risk factor and risk management is emphasized, as is the need for cross-sector innovation to reduce its negative consequences⁵⁹.

⁵⁶ Al-Thaqeb & Algharabali, 2019.

⁵⁷ Schneider and Frey, 1988, p.239-275.

⁵⁸ Frieden & Rogowski, 1996.

⁵⁹ Al-Thaqeb, Algharabali & Alabdulghafour, 2022, p.2784-2794.

The key aspects of economic policy are just as important to accomplishing development goals as their content or orientation. The impact of policies on growth is determined by both direction and general aspects. Countries with policies that meet these criteria are more likely to achieve positive development outcomes. The extent to which polities receive significant policy aspects is determined by political institutions, areas of interaction, and socioeconomic groups. Economists should abandon the assumption that there are universally applicable policies, because what works in one country may not work in another⁶⁰.

The relationship between policy actions and national and regional economic dynamics. And how political context affects the investment environment, market regulation, trade ties, and other economic elements. The goal is to discover essential characteristics that cross the political and economic development domains and are critical for building effective management strategies. Understand the complex interactions between political upheavals and international trade trends⁶¹. Improved political relations do not often promote trade or trade dependency. As in the United States' relationship with emerging countries, the economy may be less significant than trade. The former Eastern Bloc countries benefited the most from improved relations, as capital inflows and foreign direct investment increased. However, improved ties do not always result in lower corruption, higher living standards, better human development, or faster economic progress⁶².

Turkey's political and economic hegemony has been reinforced by its stability in the Eastern Mediterranean. Reactions against the Greek Cypriot Administration of Southern Cyprus stem from its reliance on the TRNC for exploration of natural gas and power. Through initiatives like oil pipelines, hydroelectric power plants, and water transportation, Turkey hopes to economically bolster the TRNC. The Greek Cypriot Administration must exercise caution when it comes to any potential agreements that would jeopardize their long-term well-being⁶³.

⁶⁰ Ardanaz, Scartascini, & Tommasi, 2010.

⁶¹ Serbina, Daineko, Tsyrfa, Rozhkova & Lytvynenko, 2024, *International Journal of Religion*, 5(5), p.223-232.

⁶² Najafi & Askari, 2012, p.247-273.

⁶³ Ülker, Gürson, Topçu & Erkan, 2013, p.1027-1031.

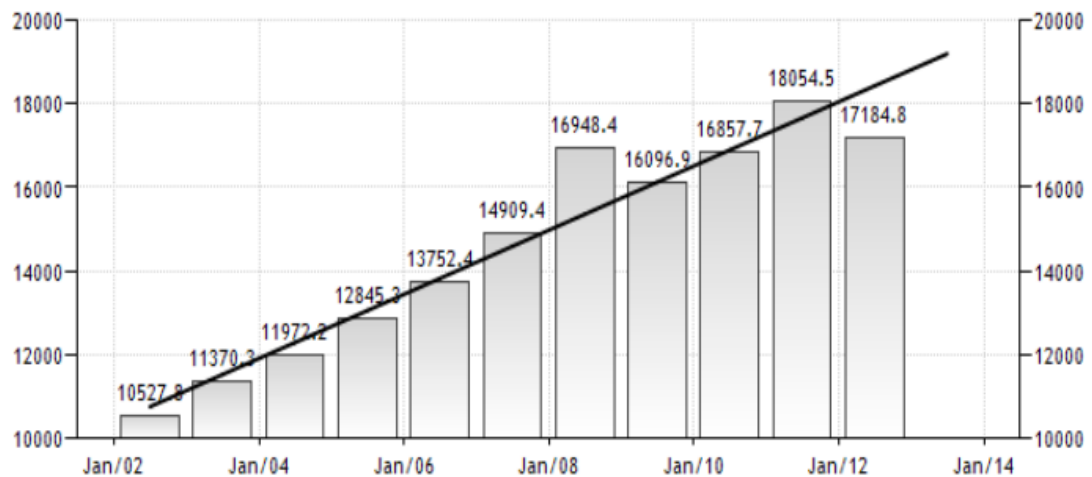


Figure 2 : GCASC GNP Source: GCASC Statistics Department.

Economic interests have a significant influence on political preferences, with the poor favoring redistribution, high earners opposing it, the working class voting for the left, capital owners supporting right-wing parties, and precarious workers supporting social insurance and welfare activation. Understanding how people respond to economic shocks is critical since financial crises and economic shocks have far-reaching repercussions for millions. According to Marx's critique of the capitalist system, economic crises and a shrinking middle class may lead to revolution⁶⁴. Democracies' policymakers have tremendous incentives to regulate economic policy activities, leading to assumptions that government control will result in predictable economic outcomes. However, empirical evidence demonstrates political fluctuations in real economic performance, as well as long-term shifts in specific policies. Later techniques incorporated rational expectations into individuals' and policymakers' economic and political conduct, but crucial anomalies and insufficiencies persisted. The framework in which elected party incumbents make policy influences policymakers' motives and capacities to manage economic policy for electoral and partisan advantage⁶⁵.

Economic interdependence refers to the value of economic transactions between countries or the world. It can be influenced by factors such as national output or financial assets. Responses to increased interdependence can range from disintegration to

⁶⁴ Margalit, 2019, 22(1), p.277-295.

⁶⁵ Franzese Jr, 2002, Annual review of political science, 5(1), p.369-421.

coordination, or seeking new policy instruments to capitalize on increased economic openness and mobility. And include barriers to foreign trade and international capital movement, which aim to reduce interdependence by increasing separation among national markets⁶⁶. Understanding the politics of evidence-based health policy is critical because it affects the legitimacy of decisions taken. Institutional frameworks should make it easier to employ evidence in varied political circumstances, and evidence-based guidelines can help to promote policy change across political and institutional boundaries. To further comprehend these difficulties, it is necessary to conduct in-depth case studies, analyze institutional and organizational arrangements, and engage with ideas and methodologies that go beyond public health and knowledge consumption studies⁶⁷.

The Politics of Growth examines the political economics determinants of economic growth, with a focus on the drivers. Determinants include human and physical capital accumulation, technological advancement, and productivity increase. However, institutions are seen as the primary source of economic growth because they stimulate enterprises to invest in productive activities and develop new commodities and technologies, for understanding the political pathways of economic growth, with a focus on growth acceleration and maintenance⁶⁸. Since the Cold War's end, international economic sanctions have grown in importance as an alternative to armed warfare. They can be used to express or demonstrate, with occasionally negative political consequences. Trade sanctions have a greater impact on the terms of trade than unilateral ones. Investment penalties initially increase the rate of return on capital in the target country, but they eventually limit expansion. The success of punishments is determined on conflict expectations and commitment levels⁶⁹.

The link between democracy and economic performance reveals how political involvement drives government spending behavior, allowing officials to select the best balance of rents and public goods to gain political support. As democracy grows, rents rise, but public goods become more efficient. This leads to higher per capita income growth rates. However, the favorable effects of democracy are only true for moderate

⁶⁶ Cooper, 1985, p.1195-1234.

⁶⁷ Liverani, Hawkins & Parkhurst, 2013.

⁶⁸ Sen, 2015, p.35-59.

⁶⁹ Kaempfer and Lowenberg, 2007, p.867-911.

levels of political participation⁷⁰. Political economic reforms should not be hidden from society and citizens, but their role is complex. Factors for reforming policy-makers include being truly reforms, supporting extensive technical evidence, and understanding special interests. If populist demand or mis-information hinders reform, reformers must communicate evidence better. Understanding information and communication's role in shifting beliefs, norms, and preferences is crucial for political economy research. Addressing credibility problems will not be durable, as citizens may still demand reforms in the future. Reformers may also need to examine other policy areas responsible for credibility and legitimacy issues⁷¹.

Several factors influence the relationship between investment, political instability, and government transfers, including sociopolitical, executive, and legislative instability. These factors can have an impact on inflation and the share of transfers in gross domestic product. The impact of these factors varies according to a country's wealth level and democratic state, and the positive relationship between government transfers and investment is contingent on certain assumptions⁷². The influence of party makeup on public policy in democratic countries. It claims that differences in government composition have a major impact on public policy under constitutional democracies. However, the style of democracy and the restrictions of central state administration all have an impact on party influence. Majoritarian democracies and states with sovereign legislatures and executive branches are distinguished by strong partisan effects. Consensus democracies and nations that share governance with opposition parties are more complex and difficult to recognize. In political systems with counter majoritarian institutional pluralism or semi-sovereignty, incumbent parties have little wiggle room⁷³.

The Islamic economy emphasizes fair and equitable economic distribution, encouraging people to consume halal food and pursue diverse life pleasures in accordance with their skills. Islamic economics' distribution plan includes both direct and indirect processes, with the former focused on security, education, and health. The Islamic

⁷⁰ Plümpert, & Martin, 2003, p.27-50.

⁷¹ Khemani, 2017.

⁷² Alesina & Perotti, 1992.

⁷³ Schmidt, 1996, European journal of political research, 30(2), p.155-183.

solution for achieving food security includes offering jobs. The Islamic economy protects people's rights and assets, allowing them to prioritize education, health, and safety⁷⁴.

Economic empowerment programs in low-income countries are increasingly focusing on economic interventions, with the theory of change anticipating favorable "spillovers" into social and political domains. However, these interventions frequently do not increase economic empowerment and rarely result in "spillovers." Empirical research is required to better understand the context and political economy dynamics that can either facilitate or impede the development, sustainability, and survival of effective economic empowerment programs⁷⁵.

The use of state and local public policy as an economic development tool is becoming increasingly contentious because of technical and political developments, rising demand for public services, and prospective cuts in federal funding. The Federal Reserve Bank of Boston hosted a conference in 1996 to analyze the effectiveness of state and municipal tax, spending, and regulatory policies. Participants agreed that state actions have an impact on economic development inside their borders, but the effects are often minimal. State regulations' ability to significantly impact corporate location and growth is limited, and competitive forces have reduced variations between states⁷⁶. The economic voting notion implies that voters react to economic situations, with booms increasing government assistance and busts decreasing it. This voting can take several forms, including retrospective, prospective, and sociotropic voting. These voting strategies are popular in Western Europe and the United States, where socioeconomic concerns frequently trump pocketbook votes. Voters frequently blame the government for the country's financial plight⁷⁷.

Since the 1980s, the Middle East and North African region has experienced low and volatile economic growth due to bad policies such as excessive government interventions, large public sectors, restrictive trade policies, inefficient mass subsidies, and poorly managed fiscal policies. as well the political economy factors that have shaped these

⁷⁴ Marlina, Juliana, Adila & Robbani, 2019, Review of Islamic Economics and Finance, 2(1), p.47-55.

⁷⁵ Cheema, 2017.

⁷⁶ Bradbury, Kodrzycki & Tannenwald, 1997.

⁷⁷ Lewis-Beck & Stegmaier, 2008, p.303-323.

policies and their outcomes, offering a framework based on recent political economy literature to explore the deeper forces behind growth variations in the region⁷⁸.

According to the ideology of imperialism and colonialism, the West's prosperity is the result of robbery, extortion, and exploitation. Indonesia, formerly an agricultural country, was the world's greatest spice producer. However, dissatisfaction with Western colonization resulted in the rise of colonialism and imperialism. These phrases are inextricably linked, as colonizers control riches and acquire it by force. This practice has persisted for generations, influencing people's behavior and the economy. The colonized mentality has been instilled in regional officials and continues to influence human thought⁷⁹.

The global acquisition of farmland for foreign investment is a relatively new topic, inspired by the global food crisis and the desire for greater control over food supplies. This has serious consequences for food security, especially in lessor states. Shortfalls in development aid, the global food crisis, the increasing middle class, and biofuel acceptance are all factors pushing this trend. However, risk mitigation may result in unparalleled development potential for lessor states⁸⁰. Fiscal decentralization is implemented using a political economics method that simulates government behavior at the national or local level, taking into account institutions such as elections and legislative bodies. It differs from the traditional paradigm, which regards each government level as a social planner. Decentralization aims to improve allocation efficiency and government accountability by matching goods to citizens' desires. Also Decentralization's preference-matching and accountability benefits cannot be rigorously accounted for using the usual technique⁸¹.

Open Economy Politics is a research paradigm that uses political science and economics to examine international institutions and policies. It filters interests through international prices and economic theory, giving us a clearer grasp of how these institutions influence politics. Open Economy Politics has provided insights into how international institutions strengthen accords, impact state negotiations, and shift interests.

⁷⁸ Esfahani, 2006, p.61-102.

⁷⁹ Naimah, 2022, p.39-48.

⁸⁰ Robertson and Pinstrup-Andersen, 2010, p.271-283.

⁸¹ Lockwood, B. (2005). Fiscal decentralization: A political economy perspective.

However, there is ongoing disagreement about the usefulness of international organizations, particularly in security concerns⁸².

1.3. Political Institutions and Economic Decision-Making.

The competing interests over imports that have shaped trade and development policies in developing nations, as well as the economic theory that underpins them, have been influenced by political and economic pressures. Politicians' answers to interest group demands have changed governments' monetary and exchange rate policies through the techniques they have employed to maximize advantages from foreign direct investment while limiting costs⁸³.

Insofar as it pertains to voters' rationality, conduct, political party motivations, economic structure, shocks, and power dynamics, the party theory provides some answers. It says that in order to get support, politicians should first disclose their ideology during the first mandate time and then adopt moderate policies. It is challenging to forecast the cycle's movements, though, because no model can predict the cycle's movements with any degree of accuracy⁸⁴. Russia, the leading energy producer and exporter in the world, is regarded as an example of how other nations could use energy to gain more influence and investment. In Russian foreign policy, energy is a strategic tool that is employed through energy diplomacy. Russia wants to take control of the world's critical infrastructure, curtail the power of the West, and increase its influence in the Middle East, Asia, Eastern Europe, and Latin America⁸⁵.

Defense spending has a big effect on state budgets and economic expansion. This study looks at the relationship between national income per capita and defense spending in nations with significant military spending. France, Japan, and the United States were chosen for examination. The US spends more on defense than France or Japan,

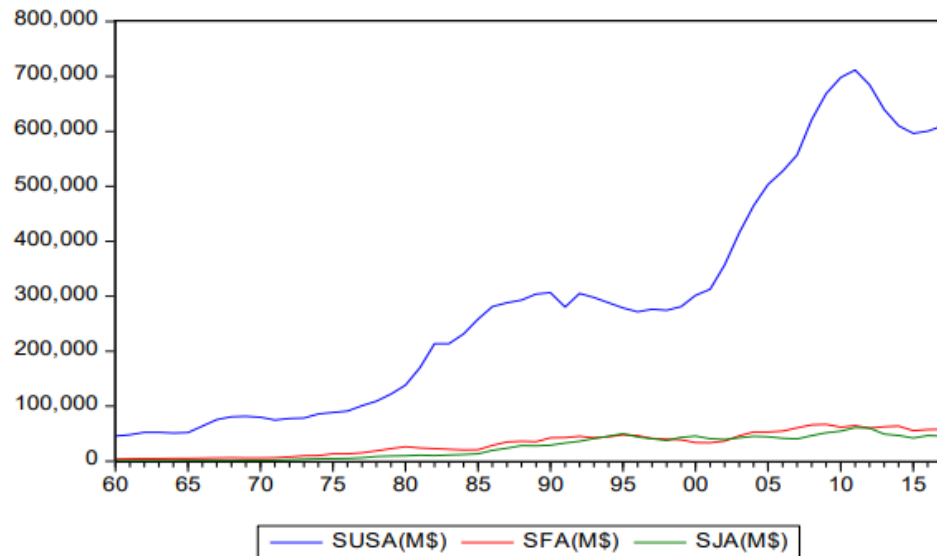
⁸² Lake, D. A. (2009). Open economy politics: A critical review. *The Review of International Organizations*, 4, 219-244.

⁸³ Oatley, T. (2022). *International political economy*. Routledge.

⁸⁴ Tiganas & Peptine, 2012, p.853-865.

⁸⁵ Rashad & Suzy, 2022, *Journal of Politics and Economy*, 14(13), 1-26.

notwithstanding their increases. In France, a 1% rise in defense spending translated into a 0.92% increase in national income per capita in France and a 0.94% increase in Japan⁸⁶.



Graph 3 : Defense Industry Expenditures Trend Graphs
Research on Defense Expenditure and Economic Growth: USA, Japan, France

When the World Bank and the International Monetary Fund intervened in 1999 to fight inflation, Turkey's economic crisis got underway. The Turkish economy had its poorest performance in more than 50 years during the course of the next three years. The fact that all resources were focused on repaying the loans made by the Fund suggests that the US exerted political influence over Turkey by dominating and controlling its economy. The nation's economic environment has significantly changed as a result of this intervention⁸⁷. Political institutions, interconnections, and structural factors all influence taxation systems. In contrast to premodern systems, which were regressive and low-income, modern systems have expanded quickly as a result of globalization, economic expansion, and democratic institutions. Rate ceilings, the end of progressive taxation, the emergence

⁸⁶ Yantur & Gürson, 2019, p.163-182, <https://doi.org/10.15869/itobiad.480114>.

⁸⁷ Zaki & Roaa, 2008, p.55-88.

of revenue-neutral taxes, and the difficulty of worldwide taxation are possible developments in the field of taxation in the future⁸⁸.

The decision-making process is a vital part of administrative leadership and senior management, encompassing competences, financial, material, and human resources. It serves as the cornerstone for all organizational operations and relationships with the outside world. Robust, well-thought-out decisions are essential to a functioning government. In contrast to accountants, financial managers gather and display data, assess financial statements, create supplementary data, and make financial choices⁸⁹.

Information now plays a crucial role in management, aiding in decision-making and administrative procedures. Systems for financial information are vital for institutions since financial managers depend on them. Education systems have strengthened beneficiary parties and responsibility by moving from hierarchical to horizontal partnerships. As a result, there is now a dynamic link between the national and sub-national levels, with government authorities working with stakeholders like parents and teachers to make decisions⁹⁰.

Decision-makers in political institutions must have the skills to use evidence effectively and be more effective in systematically evaluating, summarizing, and assessing the credibility and relevance of evidence. Knowledge governance plays a crucial role in making evidence available, integrating it into decision-making processes, and promoting a shared understanding of evidence that is fit for purpose⁹¹. Refining political power, continuity, and existence depends on political institutions. They are a form of authority without containing people, and their stability is predicated on the rule of law and its absolute authority over all people. Since the establishment of a modern state is difficult and required for societal and international developments, the rule of law is

⁸⁸ Kiser and Karceski, 2017, p.75-92.

⁸⁹ Nabil & Halimi. 2020.

⁹⁰ Mahmoud & Einas, 2022, Journal of the Faculty of Education in Educational Sciences, 46(3), p.15-197.

⁹¹ Mahmoud & Einas, 2022, p.15-197.

vital to the modern state. Given the difficulties in creating a state of institutions, understanding political institutions and the rule of law is especially important⁹².

The political climate is influenced by a multitude of elements, making political decision-making intricate. Institutions, like states, are dynamic, cohesive communities of ideals and regulations that endure long after their creators pass away. The constitution lays out the prerequisites for rulers to wield their power, giving them the freedom to do as they like and the authority that comes with upholding the law⁹³.

Political institutions are not the same as judicial or local political institutions; the former apply the law in cases of disagreement. Administrative institutions apply basic decisions, general positions, and comprehensive orientations to citizens, whereas political institutions relate to these things. The distinction between administrative and political institutions lies not in the individual or objective character of decisions, but rather in their relative significance. Political institutions are considered at the upper level, whereas administrative institutions are at the intermediate and lower levels. Senior officials do occasionally have distinctly political duties, particularly in nations with substantial state administrative operations in the social and economic spheres. Nevertheless, there is overlap between the two⁹⁴.

Encouraging local communities and stakeholders to actively participate in decision-making processes is the aim. This entails working with a variety of stakeholders, establishing reliable channels for intercommunication, drafting laws to support the development of societal capacity, educating the public about the governance of education, offering technical assistance to stakeholders, and opening channels of communication with the media. These initiatives seek to establish a network of collaborations, guarantee information exchange, and promote a thorough comprehension of the intimate connection between stakeholders and society. The objective is to strengthen societal capacities and

⁹² Khairi, 2015.

⁹³ Khairi, 2015.

⁹⁴ Burayo, & Linda, 2024.

encourage openness and involvement by creating a conducive atmosphere, institutions, structures, and organizations⁹⁵.

Three crises have been brought about by the COVID-19 pandemic: social, health, and economic. Decision-making teams, such as political, health, social, and economic teams, as well as communications and local government/party branch teams, should be established to handle these. These groups ought to be in charge of keeping an eye on the healthcare system, offering social assistance, handling financial fallout, and making sure that everyone is communicating clearly. They ought to advise lower echelons of the administration and political parties as well⁹⁶. Ministers, government representatives, and a presidential body comprise the political decision-making framework. Organizations that represent different groups, local governments, politics, society, communications, health, and the economy are examples of external stakeholders. There are also representation from a variety of sectors inside the framework⁹⁷.

General, applied, administrative, crisis, tactical, strategic, and executive decisions can all be made in politics. The state's general policy is reflected in daily actions by the executive branch; general decisions help future decision-making processes; applied decisions are issued by the executive branch; administrative decisions deal with procedural matters; crises involve emergency interactions; strategic decisions involve initiative; tactical decisions implement supreme policies⁹⁸. The process of making political decisions is impacted by both internal and external variables. External factors include variables and circumstances that are beyond the state that makes decisions, such globalization and the political climate of the state. Internal elements include material, political, and social effects. To make well-informed decisions, the decision-maker must weigh these variables while taking into account their consequences and long-term effects⁹⁹.

⁹⁵ Al-Aidi & Ahmed, 2024, p.695-719.

⁹⁶ Mahmoud & Einas, 2022, *Journal of the Faculty of Education in Educational Sciences*, 46(3), p.15-197.

⁹⁷ Nabil and Halimi. 2020.

⁹⁸ Mahmoud & Einas, 2022, p.15-197.

⁹⁹ Akdouch, 2010.

Any political system must have a political decision-making process, which is impacted by both internal and external variables. When it reflects the democracy of the state and is in line with the desires of the public, it is effective. Special decisions are taken in emergency situations without public input. By addressing societal and global changes, studying political institutions helps clarify authority and its continuity¹⁰⁰.

1.4. Fiscal and Monetary Policy.

We emphasize the importance of distinguishing between fiscal and economic policies, focusing on the role of fiscal policies in economic growth, economic development and social development. It also explores how fiscal policies affect economic growth, economic development and social development¹⁰¹. The US government has lowered its spending on foreign aid by 6% and 14% over the previous year, resulting in a substantial economic downturn in the US. This has resulted in a huge rise in US foreign assistance spending, with the government paying \$700 million to support the current fiscal year's budget. This has lowered both the quantity of help received and the amount of aid offered to the US government, lowering the country's financial burden¹⁰².

Greece's national debt to European banks and the International Monetary Fund exceeded €300 billion, and there was a liquidity gap that prevented Greece from repaying its debt to the IMF. Capital flows were restricted, and the country's population rejected the concessions offered, leading to a "technical default." The issue was removed from the agenda on July 17, when Eurozone members agreed to provide Greece with €86 billion over three years. However, Greece's final withdrawal from the Eurozone is uncertain¹⁰³. Greece's economic concerns have been examined in a variety of publications, with different causes proposed. However, the scientific approach must extend beyond standard economic theory. According to Hyman Minsky's financial instability hypothesis, the capitalist system encourages financial linkages that lead to debt crises. This article discusses Minsky's thesis, compares it with alternative approaches, and relates it to the

¹⁰⁰ Khairi, 2015.

¹⁰¹ Abu Jamea & Nasim ,2020, p.123-152.

¹⁰² Jawad, 2012.

¹⁰³ Beshenov & Rozmainsky, 2015, Russian Journal of Economics, 1(4), p.419-438 .

current Greek debt crisis. According to Minsky, classical Keynesians misinterpreted and rejected Keynes's insights¹⁰⁴.

Minsky's 1975 insights focus on key elements of Keynesian theory that had been lost in traditional Keynesianism, such as decision-making under uncertainty, the cyclical nature of the capitalist process, and financial relations in an advanced capitalist economy operating in an uncertain future¹⁰⁵. Keynes' theory holds that cyclical uncertainty in capitalist economies is a result of the cyclicity of the economy. These fluctuations are exacerbated by complex financial interconnections that allow for increased investment during a boom while imposing huge debt burdens during a recession. This cyclicity was lost in traditional Keynesian macroeconomic theory, which evolved into a subset of neoclassical theory. Minsky argued that both systems were based on a trade-off model, but his own approach was based on a speculative financial model¹⁰⁶.

The continued economic growth crises has resulted in a considerable increase in the number of people living in developing nations, creating major economic and social changes that have an impact on research and government institutions¹⁰⁷. In developed countries, the financial system is an essential economic tool that strikes a balance between social objectives, economic growth, and government spending to advance both social harmony and economic advancement. It employs financial resources to study economic expansion, forecast future national incomes and social spending, and make use of a range of economic indicators and social interactions¹⁰⁸. The fiscal policies of the Islamic Republic are divided into two categories: contractionary fiscal policy, which is being pursued in reaction to inflation and the current economic crisis, and expansionary fiscal policy, which tries to boost GDP or cut inflation¹⁰⁹.

A nation's financial system has a significant impact on social objectives and financial stability. The banking industry has a major impact on the nation's financial stability notwithstanding its stability. As evidenced by the current tensions between the US and

¹⁰⁴Beshenov, 2015.

¹⁰⁵ Beshenov, & Rozmainsky, 2015

¹⁰⁶ Beshenov, & Rozmainsky, 2015, Russian Journal of Economics, 1(4), 419-438.

¹⁰⁷Tawhari & Borara, 2022.

¹⁰⁸Boukhrouba & Razika, 2014.

¹⁰⁹Herak & Krouani, 2012.

China, political developments and fluctuations in currency rates also have a major impact on the circumstances¹¹⁰. A nation's political system, rate of economic expansion, and political ideology all have an impact on the political decisions that are made, which are shaped by its past, present, and future. A nation's economy, political choices, and social and economic components are all greatly impacted by its political economy, which can be changed by military or political operations. Thus, a nation's economic system is greatly influenced by its political economy¹¹¹. The financial system is characterized by numerous financial issues, such as financial crises and financial crises, which pose significant financial risks to those suffering from various types of financial crises, which are not found in areas where financial crises are common due to economic factors¹¹².

By effectively allocating resources and responding to shifts in the economy, fiscal policy seeks to promote economic growth. Its goal is to bring about economic stability, highlighting how crucial significant economic changes are in the current economic environment. Achieving these objectives requires economic growth and development in order to ensure adaptation and efficient use of resources¹¹³. The importance of economic forecasting in predicting future economic trends should be emphasized. It also emphasizes the need for a broad forecasting system that takes into account various economic factors, including the use of financial instruments, and the potential for a significant increase in the country's future economic growth. The article also highlights the need for a comprehensive understanding of the economic environment, noting that the current economic situation may be affected by various factors¹¹⁴.

The importance of social and economic development which includes setting aside money for long-term national economic growth—is emphasized by the UN. Economic development is the process of implementing policies and improvements that have a major impact on a nation's real GDP and cause it to change quickly and considerably over time¹¹⁵. The capitalist financial system is characterized by its focus on individual investment and risk management and the idea that the company pays the wages of all its

¹¹⁰ Boukhrouba, & Razika, 2014, The role of fiscal policy in achieving economic development.

¹¹¹ Ait Sahad, 2023, The financial policies of the institution.

¹¹² Abila, 2020.

¹¹³ Gajati, Sissawi & Ryan, 2023.

¹¹⁴ El-Sherbini & El-Helali, 2018, p.271-296.

¹¹⁵ Tawhari & Borara, 2023.

employees and customers to ensure the highest level of investment and risk management. This system is a natural continuation of the capitalist financial system and its decisions, which ensures the protection of the company's interests¹¹⁶.

This social welfare system is based on the belief that the government's principal objective is to provide for all citizens, regardless of nationality, and that the government's role in economic development is more than just a means to an end, but also a means to a brighter future. The aim of socialist work is to satisfy common needs, not to generate profit. The state, through its public apparatus, exploits the available productive labor force to satisfy the needs of the majority of the people. Comprehensive planning supervises the methods of production and distribution, with the basic structure serving as a general framework to which all economic units adhere¹¹⁷.

Fiscal policy in the mixed system: When we talk about a mixed economy, we are talking about a system characterized by a distinctive pattern of economic performance that attempts to reconcile private and collective tendencies, that is, it attempts to coordinate public economic activity with private economic activity so that the latter can contribute its financial and technical capabilities and potential to driving the wheel of development, but within the framework of taking into account the interests of individuals and groups. One of the most important objectives of this system is to find a balance between individual interests and the public interest and to address the repercussions of the market system's inability to meet some needs¹¹⁸.

Achieving price stability, full employment, economic growth, and national currency stability are among the goals of monetary policy. Central banks can raise the legal reserve ratio, rediscount rate, and buy securities to close inflationary and deflationary gaps. By affecting employment levels, prices, and national income, fiscal policy is essential to establishing economic stability, particularly in periods of prosperity and recession. Two types of financing are available for fiscal policy: surplus financing, which lowers excess

¹¹⁶ Metwally 2024, p.868-927.

¹¹⁷ Mohammed, 2005.

¹¹⁸ Bouchdaq & Zraoulia, 2023.

monetary demand and aggregate demand, and deficit financing, which increases aggregate demand in order to attain full employment¹¹⁹.

2. The Exchange Rate Puzzle: Bridging Economic and Political Powers.

2.1. The Impact of Exchange Rates on the Global Economy.

Remittances and the currency rate are related, but there is no evidence of a long-term effect. Particularly when implementing a fixed exchange rate, suggesting a detrimental effect in the short run. Further disclosed a sizable time variable that negatively affected exchange rates. There is a negative long-term association between exchange rate fluctuations and remittances. Remittance volume rises in response to an improvement in the exchange rate. Remittances might rise by 48.1% in response to a 1% change in the exchange rate¹²⁰.

The appreciation of the Chinese Yuan can simplify international trade, but it relies on price elasticity of foreign demand, which may not accurately represent foreigner income. The single exchange rate model treats the world as a single entity, limiting the ability to model complex exchange rate policies. The effects of a RER devaluation and increased rebates of export taxes include two types of firms, three types of imports, and two types of labor. A 30% increase in export rebate rate restores China's export competitiveness to 5%. However, a RER shock results in a 4% decrease in China's trade balance¹²¹.

Interest in how exchange rates affect global commerce has increased as a result of the discussion surrounding trade imbalances and unconventional trade restrictions. The most researched part of this relationship is exchange rate volatility since it has the potential to reduce international trade because of increased risks and transaction costs. The relationship between trade flows and actual exchange rate changes is probably fueled by

¹¹⁹ Bouchdaq & Zraoulia, 2023.

¹²⁰ Hijaj & Hamed, 2023, p.157.

¹²¹ Meng, 2015, p.223-231.

reverse causality and long-term policy credibility. But because financial tools are more widely available, exporting has sunk costs, and businesses choose to insure against exchange rate risk, volatility is less significant¹²².

Exchange rates were changed from fixed to variable during the financial revolution of the 1970s in an effort to increase economic policy flexibility and better accommodate a global economy. Countries were able to implement more customized policies as a result of this shift, but there were drawbacks as well, such as more exchange rate volatility brought on by the growth of global financial markets. The shortcomings of conventional economic models were brought to light by this new era, which also underlined the necessity for stronger controls to deal with the world's financial instability¹²³.

The competitiveness of a sector is greatly impacted by exchange rates; a decline in value of a currency lowers production costs and increases the competitiveness of items on the international market. The US dollar has declined due to the country's strong currency, which might provide US firms a competitive advantage. The US wood industry, however, faces competition from overseas due to variables such as labor and capital costs, environmental constraints, and other considerations, and future patterns in exchange rates are unpredictable. For the next fifty years, production is expected to stagnate, according to a recent national timber assessment¹²⁴.

Following the global financial crisis, there has been a decline in the correlation between RER levels and trade volume. The factors influencing trade include changes in import product structure, exposure to short-term external debt, and regional and global value. Trade is unaffected by fluctuations in exchange rates, but it is greatly impacted by currency misalignment, which results in undervaluation, export promotion, and import restrictions. Real effective exchange rate levels have a greater impact on exports than on volatility¹²⁵.

The effect of exchange rate fluctuations on different economic indicators, with a focus on the relationship between exchange rates and the economy of the euro region, as a result

¹²²Nicita, 2013, p.47-61 .

¹²³Challoumis, 2024, p.164-179 .

¹²⁴ Daigneault, Sohngen & Sedjo, 2008, *Forest Policy and Economics*, 10(3), p.108-116.

¹²⁵ Kang & Dagli, 2018, p.84-105.

of globalization. During the first half of the 2000s, exchange rate fluctuations had no effect on the activity of the euro area; but, after 2000, foreign demand has been a major driver of growth. Additionally, while the quantitative effects of globalization are generally small, their influence is more evident in the way that prices and exchange rates are related¹²⁶. Up until 2004, the effect of increased volatility has been the main focus of the relationship between exchange rates and trade. But from the middle of the 2000s, researchers have also looked into the connection between commerce and exchange rate level. There is conflicting evidence in the literature about the impact of exchange rate volatility on commerce; some authors support and others refute the hypothesis. Trade and currency level have a complicated and diverse relationship, with short-term trade consequences based on particular economic factors¹²⁷.

Financial systems are crucial in global economies, influencing investment decisions and reducing foreign trade deficits. Foreign exchange rate policies affect countries' economies, regardless of geographical boundaries. Trade transactions involving multiple regions often require currency conversion, making real effective foreign exchange rate a dependent variable. Analyzing the effect of foreign exchange rates on imports and exports separately is essential¹²⁸.

The Executive Directors of the World Bank stressed how crucial it is for developed and emerging market economies with substantial participation in international financial markets to select an exchange rate regime. They underlined how difficult it is to gauge when an economy is sufficiently interconnected to make a decision between significant exchange rate freedom and hard pegs. They also emphasized the range of workable substitutes that existed between the two extreme regimes. They urged employees to keep developing sensible rules and thinking through the implications of inflation targeting for Fund conditionality¹²⁹.

Exchange rates are crucial in economic life, and understanding their political economy is essential. Scholars have made progress in understanding regional and international currency regimes and their origins. Internationally, global and regional monetary regimes

¹²⁶Di Mauro, Rüffer & Bunda, 2008.

¹²⁷ Auboin & Ruta, 2011.

¹²⁸ Genc & Artar, 2014, European Scientific Journal, 10(13), p.128-141.

¹²⁹ Mussa, 2000.

have evolved through international coordination and cooperation. Domestically, economic interests and political institutions influence currency policy choices. Future research should integrate international and domestic sources of exchange rate policy, clarify theoretical and empirical uncertainties, and incorporate trade and financial policy's impact on international monetary affairs¹³⁰.

Penetration rates are impacted by market integration and organization, with non-tradable goods being essential to customers. System targeting can lessen the permeability of the monetary system, which is susceptible to changes in policy. Economy relying on the dollar usually move toward higher rates. The type of commercial goods and services determines how exchange rates move; energy, agricultural, and service items are particularly interdependent¹³¹.

The money supply, unemployment, inflation, and other economic variables all have an impact on a nation's foreign exchange rate. The foreign exchange market may be impacted by political choices, including those made by the Central Bank. Countries may see slower growth and higher unemployment rates as a result of rising interest rates and foreign currency prices. It results in the influx of hot money into Turkey, raising the value of the Turkish lira. Due to increased costs for commodities, this has a negative impact on international trade¹³².

The problems with globalized finance in today's world economy necessitate the abandonment of standard international economic theory, including trade and finance. Without an automatic trade balance adjustment mechanism, the division of these branches becomes problematic. 'Washington Consensus' policy-abiding nations risk trade disputes, economic instability, and inequality in the absence of efficiency increases. Different countries should have different ideal policies, and careful currency rate management is crucial¹³³.

The stability of the world economy has fluctuated significantly since the 1970s due to fluctuating exchange rates. Currency misalignments have the ability to create

¹³⁰ Frieden, Weingast & Wittman, 2006.

¹³¹ Karakostas, 2021, p.1628-1647.

¹³² Korkmaz, 2013.

¹³³ Blecker, 2005, p.183-209.

protectionist pressure by undermining a nation's growth and competitiveness. Exchange rate misalignments and global imbalances have a complicated relationship, with the potential of a currency war rising in the wake of subprime crises¹³⁴.

The Reserve Bank of South Africa's effect on inflation rates, with particular attention to depreciation in 2007 and 2009. Whereas the large RER depreciation appreciation in 2009 caused a fall, RER depreciation depreciation raised inflation. Significant drops in the repo rate, real economic activity, lending rate margins, factory production, retail sales, housing price growth, and private sector credit extension were all brought on by the unanticipated increase¹³⁵.

The effects of unpredictable foreign economic policies on foreign economic growth and South Africa. It concludes that has short-term implications on policy rate responsiveness and growth, with a drop in the US Federal Reserve funds rate suggesting a loosening of monetary policy to avert negative consequences. Unexpected increase has a major effect on macroeconomic indicators in South Africa¹³⁶.

The Contemporary Open Economy Economics has undergone a revolution thanks to macroeconomics' new concepts and instruments. Exchange rates' significance in international adjustment has been called into question, nevertheless, as some models contend that changes in exchange rates have no influence on shifting foreign spending. the Exchange rate movements shouldn't be restricted by using overly simplistic modeling techniques and regulatory frameworks. In open economies or with variable nominal wages and prices, the conclusions may not hold true¹³⁷.

Current account disequilibria at the international level have refocused RER distortions on international debates. To assess if a currency is fundamentally misaligned, several institutions publish indicators using more or less sophisticated measures. Institutions have developed more sophisticated measures that rely on the real effective exchange rate,

¹³⁴ Allegret & Sallenave, 2014, p.149-163 .

¹³⁵ Ndou, Gumata & Ncube, 2018.

¹³⁶ Ndou, Gumata & Ncube, 2018.

¹³⁷ Obstfeld, 2002.

allowing for the equilibrium value of the exchange rate to vary over time, reflecting changes in economic fundamentals¹³⁸.

The policy brief shows that Asian currencies need a significant appreciation since they are undervalued, especially the Chinese yuan. The value of other currencies relative to the dollar should also increase, such as the Korean won and the New Zealand dollar. However, because of the dollar's significant loss in the ensuing year, these changes against the currency are smaller than originally reported. Depreciation versus Asian currencies should have an impact on the euro's depreciation, with effective appreciations being less than bilateral ones¹³⁹.

Economic growth is more likely to be caused by financial integration than affected by it in emerging nations with greater per capita incomes and lower output and consumption volatility. Measurable benefits, however, have been restricted for these nations due to recent crises. Integration is hampered by insular nations, fixed currency rates, and institutional shortcomings¹⁴⁰.

Important areas include the effectiveness of different exchange rate regimes, the long-term behavior of real exchange rates, and the evaluation of RER misalignment are the focus of attention in emerging economies. The absence of practical experience with floating exchange rates hinders emerging nations' ability to implement the best exchange rate regime. Thus, short time series and dubious data quality constrain gaps in our understanding of the long-term dynamics of real exchange rates in emerging economies¹⁴¹.

Governments and businesses are compelled to monitor the global economy and use financial derivatives to hedge against foreign exchange risks due to the throughput of cargo loaded at South Korean ports, the rate of global net economic activity, and the volatility of the freight price index, all of which are positively impacted by an increase in

¹³⁸ Couharde, Delatte, Mignon & Morvillier, 2018, p.206-230.

¹³⁹ Cline & Williamson, 2008.

¹⁴⁰ Obstfeld, 2004.

¹⁴¹ Edwards and Savastano, 1999.

the rate of global net economic activity. Subsequent research ought to focus on diverse economies or countries within a region¹⁴².

The argument over monetary policy's response to currency depreciation has been triggered by the Asian financial crisis, which has increased inflation and caused an economic recession. While some economists contend that monetary policy tightening is required to stabilize exchange rates and boost confidence, others worry that increasing interest rates could devalue national currencies and the banking system. Three years after the crisis, this argument is still unresolved, leaving the field of economics divided on what monetary policy is suitable in times of crisis¹⁴³. With China and the US being the biggest outliers, most currencies were near their original effective exchange values. Because China keeps its exchange rate pegged at a low level and sends a significant portion of its revenue to the US, the dollar gains value relative to other currencies that are free to fluctuate. This implies that genuine efforts are still being made to persuade Chinese officials to reap the rewards of a more realistic value for the renminbi¹⁴⁴.

The interplay between business cycles and terms-of-trade shocks significantly affects economic activity in industrialized nations, primarily by raising the relative cost of energy; in developing nations, however, this effect is amplified by reliance on imported capital goods and commodity export specialization. By funding trade deficits, accessibility to global financial markets is also essential for balancing consumption¹⁴⁵. Three major economies China, the euro area, and the United States—have minimal sectoral effects on bilateral trade as a result of exchange rate variations. With smaller economies or developing nations without functional currency pegs, this might alter. While the long-term effects are greater for the US than for the euro area, the short-term effects are not as great. The kind of items that are traded in each region may account for the greater influence on US-China trade¹⁴⁶.

¹⁴² Kim, 2016, *The Asian Journal of Shipping and Logistics*, 32(4), p.243-248.

¹⁴³ Gould & Kamin, 2001, p.384-420.

¹⁴⁴ Cline & Williamson, 2010, *Estimates of fundamental equilibrium exchange rates*, May 2010 (No. PB10-15). Peterson Institute for International Economics

¹⁴⁵ Mendoza, 1995, p.101-137.

¹⁴⁶ Huchet-Bourdon & Korinek, 2011.

Latin American central banks have been actively addressing constraints on currency appreciation by routinely intervening in foreign exchange markets. With smaller effects in areas with more capital account openness and larger effects where currencies have appreciated significantly, these measures reduce the pace of exchange rate appreciation. It's still unclear, though, how these initiatives will affect the exchange rate¹⁴⁷. Both direct and indirect trade activities are greatly impacted by exchange rate variations, which are a major impediment to international trade. They have an impact on the nation's liabilities and trade balance. The connection between currency devaluation and inflation, using the example of Azerbaijan as a case study. It caused notable variations in exchange rates, which had an impact on the trade balance, rendering it a non-trade barrier and influencing international trade¹⁴⁸.

Changes in exchange rates have not garnered the same level of attention for the travel and tourism sector as they have for the manufacturing sector. Still, American tourism has to contend with global economic competition for travelers, just as automakers do. When the value of the dollar rises, American citizens find traveling abroad more appealing while foreigners find traveling within the country less appealing¹⁴⁹. Exchange rate movements have a big impact on the Canadian economy, with manufacturing jobs being significantly impacted by a rise in the Canadian currency. The currency rate that is export-weighted rather than import-weighted is mostly to blame for this. Since that just 10% of jobs are in manufacturing, the overall impact is negligible¹⁵⁰.

2.2. Political Factors Affecting Exchange Rates.

Macroeconomic trends have a greater influence on currency policy decisions than efficiency reasons. It is not true that weak coalition governments or left-wing administrations are less competent to maintain stable currency rates. Membership in regional monetary accords and central bank independence both lessen short-term currency volatility, but they have little to no effect on longer-term exchange rate fixing.

¹⁴⁷ Adler & Tovar, 2014, Foreign exchange interventions and their impact on exchange rate levels. *Monetaria*, 2(1), p.1-48.

¹⁴⁸ Mehtiyev, Magda & Vasa, 2021.

¹⁴⁹ Day, 1986, *International Journal of Hospitality Management*, 5(3), p.115-119.

¹⁵⁰ Huang, Pang, & Tang, 2014, *Canadian Public Policy*, 40(4), p.339-352 .

Governments in nations with high inflation postpone devaluations in anticipation of elections¹⁵¹.

Executive performance surveys, election outcomes, and government survival all have an impact on currency-market equilibrium switching. Electoral institutions mitigate political consequences, with proportional representation voting systems having a less noticeable impact. Consensual corporatist regimes, the independence of central banks, and "political coherency" as mitigating factors against political impact on currency markets are less well supported¹⁵².

In Latin America, exchange rate policies are heavily influenced by the political economy. Price competitiveness and macroeconomic credibility are weighed by policymakers. Moderately inflationary nations are more likely to keep their flexible rates in place, whereas hyperinflation makes fixing more likely. Currency policy is also influenced by exporters and special interests. Elections and stronger governments have an impact on currency policy¹⁵³. In every economy, the exchange rate is a key component that affects all other prices and is impacted by governmental policies. The most important economic policy of a government is its currency policy, particularly in an open economy. Decision-makers need to balance costs and benefits, as well as winners and losers. Nominal exchange rate policy influences politicians' and socioeconomic groups' motivations, whereas RER policy represents the impact on commerce and payments inside a nation¹⁵⁴.

Decades of discussion have focused on whether exchange rate regime is best for Latin America; the import substitution era, the foreign debt problem, and financial crises have all brought attention to this issue. Local, national, and international political situations have an impact on the regime's choice¹⁵⁵.

Global economic integration has an impact on currency value fluctuations. Along with examining the distributional effects of various regimes and levels, also internal political

¹⁵¹ Frieden, 1998.

¹⁵²Freeman, Hays & Stix, 2000, p.449-468 .

¹⁵³Frieden & Stein, 2000.

¹⁵⁴Frieden, 2016.

¹⁵⁵ Rodriguez, 2016, p.1-26.

disputes over currency values. The debate is extended to the ongoing European monetary unification process and the political struggle in America over the gold standard¹⁵⁶. The influence of political economy on Latin American exchange rate policy. It demonstrates that while hyperinflation raises the possibility of fixing, nations with low indexing and moderate inflation are more likely to retain flexible exchange rate systems. Elections, special interests, and exporters all have an impact on currency policy¹⁵⁷.

The structure of the economy, political concerns, and real exchange-rate misalignment all affect governments' decisions to remain on a peg. The choice of exchange-rate regime is influenced by openness and awareness, and the likelihood of leaving a peg rises with growing trade concentration. There are political considerations as well. Early in the year, there is a significant rate of exit races; by the seventh month, one-third had ended, and by the first year, more than half have¹⁵⁸.

Bangladesh's exchange rate is heavily influenced by both economic and non-economic factors, such as the proportion of debt to money, the foreign exchange reserve, and political unrest. The budget deficits and development projects funded by the government's borrowing have caused the Bangladesh Taka to weaken in value relative to the US dollar. Policy measures to lower deficits and debt loads should be put in place in order to preserve currency stability¹⁵⁹.

Political risks are influenced by a host country's economic development and industry, altering financial, business, and risk environments. Studies indicate that political instability has a detrimental effect on immigration; yet, some contend that industry and economic expansion are important considerations when selecting a location. International businesses have the option to invest in developing countries with greater political stability or in industrialized countries with less stability¹⁶⁰.

The pursuit of a political economy of stable exchange rates in developing market nations, with an emphasis on the function of economic factors in policy. Shows how,

¹⁵⁶ Frieden, 1994, p.81-103.

¹⁵⁷Frieden, 2001.

¹⁵⁸Klein & Marion, 1994.

¹⁵⁹Uddin, Quaasar & Nandi, 2013, 18(1), p.1-12 .

¹⁶⁰Deseatnicov & Akiba, 2016, p.16-30 .

assuming reasonable expectations, a common agency game can be used to justify concern of currency swings. Sectors such as producers and bankers, currency mismatches, and welfare costs related to exchange rate volatility are important characteristics¹⁶¹.

Nations have had the freedom to select their own exchange-rate arrangements ever since the collapse of the Bretton Woods system. Exchange-rate arrangements are chosen based on the motivations of politicians, which are influenced by domestic political institutions. Politicians are less inclined to embrace fixed exchange rates when there are high electoral costs and exogenous timing, but fixed regimes are encouraged by low costs and endogenous time¹⁶².

A nation's foreign exchange rate plays a vital role in maintaining financial stability, increasing purchasing power, and promoting international trade. It varies as a result of supply and demand for currencies being determined by the market. Exchange rates are influenced by a number of factors, including inflation, interest rate variances, income disparities, governmental regulation, and shifts in public expectations. Foreign exchange rate fluctuations and currency demand are also influenced by terms of trade, political stability, and market judgment¹⁶³.

The variables influencing the volatility of Sri Lanka's exchange rate, with a focus on terms of trade, inflation, interest rates, net foreign purchases, government intervention, and remittances. The factors affecting exchange rate volatility, the relationship between these factors and the exchange rate, and the impact of these factors are explored. the significance of exchange rates in influencing domestic price behavior, particularly in light of the growing liberalization-induced integration of domestic markets with international markets¹⁶⁴.

The main cause of Pakistan's exchange rate volatility, which results in currency devaluation, is inflation. Orders for imports and exports are the most important determinant, then economic growth. The balancing of monetary and fiscal policies to

¹⁶¹ Faia, Giuliadori & Ruta, 2008, of Applied Economics, 11(1), p.1-32.

¹⁶² Bernhard & Leblang, 1999, p.71-97.

¹⁶³ Akter, 2021.

¹⁶⁴ Rajakaruna, 2017, Journal of South Asian Studies, 5(2), p.101-115.

promote economic growth and lower inflation while closing the gap between the creation and application of policy¹⁶⁵.

When it comes to determining policy, institutional and political variables frequently take precedence over economic ones. A more comprehensive institutional and political framework, comprising sector-specific taxes and subsidies, is necessary to implement undervaluation-friendly RER policies. The paper also emphasizes the necessity for more investigation into the connection between RER undervaluation and external debt. It is preferable to take a nuanced stance on real RER policies¹⁶⁶.

Exchange rate regimes and fiscal restraint have a complicated relationship that is supported by conflicting empirical data. While variable exchange rate regimes are compatible with sound state finances, fixed rate regimes have been linked to better fiscal discipline. The political environment in which decisions on fiscal policy are made, which influences party cohesion and election timing, is the cause of the contradictory results. Comprehending these variables is crucial in comprehending the interplay between substitute exchange rate regimes and fiscal consequences¹⁶⁷.

Tanzanian political unrest is negatively correlated with currency value, indicating the necessity for distinct economic and political measures. This value, imports, and exports have no discernible link; this could be because central banks are not independent. The results cast doubt on Tanzania's buying power and interest rate parity connections' validity¹⁶⁸.

Political economy of exchange rates examines the factors that lead countries to change the value of their currencies, fix or fluctuate exchange rates, and concur or disagree on international norms. Theories on economic models, international relations, domestic exchange rate regimes, and exchange rate valuation have been produced via research that started in the 1970s. Mercantilist valuation policies and de jure vs. de facto exchange rate regimes are subjects of future investigation¹⁶⁹.

¹⁶⁵ Khan & Ismail, 2012.

¹⁶⁶ Ugurlu & Razmi, 2023, p.918-940 .

¹⁶⁷ Jalles, Mulas-Granados & Tavares, 2016.

¹⁶⁸ Proti, 2013, Scholarly Journal of Business Administration, 3(1), p.12-19.

¹⁶⁹ Hall, 2010.

Fixed exchange rates, used to attract foreign investment and stabilize high inflation economies, have been successful in short-term economic growth but can lead to undesirable long-term outcomes. The governments may choose policies that are self-defeating due to electoral cycle incentives. Therefore, it makes sense that reelection times would see swings toward fixed exchange rates more frequently than previous elections cycles¹⁷⁰.

Systemic issues have less of an impact on exchange rate policy than domestic politics. It implies that in situations when they are unable to obtain alternative compensation policies, tradable industries desire devalued exchange rates. In nondemocratic regimes, interest groups have more influence over exchange rate policy because autocrats choose policies that suit their own agendas¹⁷¹.

In the Middle East and North Africa, a number of elements, such as economic traits, political risk, institutional quality, elections, government strength, and central bank independence, influence the choice of exchange system. The possibility of selecting a fixed regime is increased by elements such as substantial reserves, government spending, low inflation, trade openness, financial openness, and foreign direct investment¹⁷².

The effect of daily returns on the Renminbi central parity rate under political pressure. Furthermore, political pressures from the US and other countries have a major impact on the conditional volatility of the Renminbi but not on its daily returns¹⁷³. In nations with high levels of political instability, corruption, or investment risk, the RER depreciates in reaction to political risks and non-economic determinants. Additionally, a threshold effect on the correlation between political instability, corruption, and investment profile is found by the study¹⁷⁴.

While the relative foreign exchange reserve is adversely and considerably correlated with the foreign currency reserve, the relative stock of money and debt is positively and significantly correlated with the exchange rate. Currency values in Pakistan are adversely

¹⁷⁰ Schamis & Way, 2003, p.43-78.

¹⁷¹ Steinberg & Shih, 2012, p.1405-1434 .

¹⁷² Maraoui, Hadj, Khefacha & Rault, 2022.

¹⁷³ Liu & Pauwels, 2012, *Journal of International Money and Finance*, 31(6), p.1800-1818.

¹⁷⁴ Bahmani-Oskooee, and Hadj, 2019, p.741-762.

affected by political unrest. The ratio stock of nominal money in each currency has a high correlation with the exchange rate, and rising relative debt is a significant factor influencing the nominal exchange rate. Political stability is necessary for stability, as is a well-thought-out monetary and fiscal policy¹⁷⁵.

Changes in exchange rates can have a detrimental effect on welfare, governments' credibility, and economic actors. Stable equilibrium exchange rates represent the best possible political and economic situation. Successful governments are able to control policies to prevent policy misalignments, particularly frequent devaluations. Governments with limited authority are less effective at implementing political interventions than those with greater authority¹⁷⁶.

The Economic Community of West African States' political economy significantly influences exchange rate policies. The agricultural sector and manufacturing companies have no strong preference for a specific regime, while service businesses promote fixed currency regimes due to a bias against weak currencies and investment finance. Political factors explain significant variation in exchange rates, with right-wing governments fixing rates and left-wing governments favoring flexible arrangements¹⁷⁷.

When political unpredictability affects Lebanon's currency exchange rate, attention should be paid to the LBP's black market fluctuations against the USD dollar as well as current affairs and news from the National News Agency. Additionally The currency exchange rate is directly impacted by political unpredictability and volatility. Because it limits the opportunities available to policymakers and results in less-than-ideal short-term macroeconomic policies, political instability is thought to be detrimental to economic performance¹⁷⁸.

Reexamining growth and trade policy, with an emphasis on the long-term connection between trade orientation and increases in productivity. Productivity growth is faster in economies with greater openness than in nations with more external sector distortion.

¹⁷⁵ Saeed, Awan, Sial & Sher, 2012, International Journal of Business and Social Science, 3(6), p.184-196.

¹⁷⁶ Arbetman, 1995, International Interactions, 21(2), p.127-153.

¹⁷⁷ Exchange, H. B. I. S. The Political Economy of Exchange Rates.

¹⁷⁸ Youness, 2022, p.414.

This viewpoint is supported by recent reforms in Latin America, however Mexico contends that extensive deregulation and reforms are necessary for significant gains in productivity¹⁷⁹.

Controls on capital movement, which some advocate for fixed exchange rates and others for lessening the volatility of floating rates, might not have a big effect on the global economy. Evasion has gotten easier as interdependence has grown. Rather, authorities ought to encourage the development of a global supervision system that permits the safe growth of derivatives as a means of mitigating exchange-rate risks¹⁸⁰.

Developing nations are usually in support of flexible par values as the foundation for the global exchange rate system, as demonstrated by their responses to recent events and attitudes toward reforming the international monetary system. A group of developing country ministers declared that stable currency rates based on flexible par values are necessary for a satisfactory international monetary system after the 1973 shift to global floating. The majority of developing nations keep their exchange rates set against a single intervention currency¹⁸¹.

The real interest rate uncertainty directly impacts Mexican real exchange rates and has a small positive effect on the conditional variance of the real interest rate. It also shows that appreciated real interest rates are positively correlated with economic growth, while undervalued real interest rates do not promote growth and are less predictable. Therefore, all the factors we mentioned previously affect the exchange rate¹⁸².

An economy's exchange rates are mostly determined by its trade components and macroeconomic indices. Nonetheless, by downplaying the significance of inflation and interest rates, it runs counter to previous research. It also emphasizes how significant unobservable factors, such as political developments and outside shocks, have been in shaping historical patterns of currency rates. Governments can use this information to

¹⁷⁹Edwards, 1995, Trade policy, exchange rates, and growth. In *Reform, recovery, and growth: Latin America and the Middle East* (pp. 13-52). University of Chicago Press.

¹⁸⁰Obstfeld and Rogoff, 1995, *Journal of Economic perspectives*, 9(4), p.73-96.

¹⁸¹Crockett & Nsouli, 2013.

¹⁸²Grier & Hernández-Trillo, 2004, p.1-25.

lessen market uncertainty in foreign exchange markets and make more accurate predictions about the results of trade policies¹⁸³.

The connection between exchange rates and political actions, as well as how political uncertainty affects forecast mistakes and expectations. Taking into account that announcements and ambiguity over the direction of economic policy have an impact on expectations. Forecast mistakes are significantly impacted by political uncertainty as well, suggesting that market expectations are not adequately taken into consideration. Nonetheless, the yen is projected to appreciate due to the heightened political unpredictability in the US¹⁸⁴.

Monetary policy responses to the Asian financial crisis have been the subject of discussions. Raising interest rates may damage domestic currencies and the financial system, according to some, while others contend that tighter monetary policy is required to stabilize the exchange rate and rebuild trust. Based on past experiences, monetary authorities tend to tighten their policies when there is downward pressure¹⁸⁵. The value of a nation's currency in relation to other currencies is determined by its nominal exchange rate. For exports, trade balance, and foreign investment, stable currency rates are essential. Although there are many factors that affect exchange rates, the money supply, trade balance, foreign exchange reserves, inflation, and interest rate all have a long-term impact on the rupee exchange rate in Pakistan¹⁸⁶.

Significant shifts have occurred in interest rates, exchange rates, fiscal policies, and private sector spending in the global economy. Concern over global policy measures, the international transmission of fiscal policies, and their implications on real exchange rates and interest rates has intensified as a result of the United States' expansionary track and the contractionary courses of other major economies. It gave the world economy a generally lopsided effect¹⁸⁷.

¹⁸³ Atif and Sauytbekova, 2012.

¹⁸⁴ Beckmann & Czudaj, 2017, p.148-162.

¹⁸⁵ Gould & Kamin, 2001, p.384-420.

¹⁸⁶ Khattak, Tariq & Khan, 2012, p.421.

¹⁸⁷ Frenkel & Razin, 1986, *The Economic Studies Quarterly*, 37(2), 99-113.

2.3. Government Policies and Exchange Rates.

The Bangkok Central no Filipina's uses legislation, monetary policy actions, and market involvement to maintain market stability in the foreign exchange market. It works in tandem with the Development Budget Coordination Committee to ensure that monetary and fiscal policies are consistent. To prevent budget deficits, the government tightens tax exemptions, boosts income, manages spending, and enhances foreign exchange liberalization initiatives¹⁸⁸.

The Great Depression had an impact on Keynes' employment theory, which contends that export- and investment-friendly policies boost output and employment. This doctrine, however, may be implemented without question in nations where there is no central bank that controls foreign exchange rates since flexible exchange rates preserve the equilibrium of the balance of payments¹⁸⁹.

High approval ratings for US government policies are predictive of a drop in the dollar risk premium and a sustained acceleration of economic development, and they are closely correlated with changes in the value of the US currency. According to the model, when policy uncertainty is low and growth expectations are high, policy values rise, suggesting a strong dollar and a low risk premium¹⁹⁰. Daily exchange rates that are flexible are those that are set by supply and demand without interference from the government. They are not the same as the system of the International Monetary Fund, which upholds fixed currency values. The ability of national monetary authorities to intervene depends on their skill and efficiency as speculators, which are frequently correlated with political beliefs¹⁹¹.

Western countries are used to an inflexible international payment system with fixed exchange rates between their respective national currencies. International economic policy, the European Payments Union, and the International Monetary Fund all exhibit

¹⁸⁸ Mariano, Sablan, Sardon & Mae, 2015, Review of Integrative Business and Economics Research, 5(4), p.171-202.

¹⁸⁹ Mundell, 1961, p.509-517.

¹⁹⁰ Liu & Shaliastovich, 2022, p.303-331.

¹⁹¹ Johnson, 2013, p.198-228.

this structure. However, given the current political and economic climate, which calls for flexible exchange rates, this approach is not appropriate. It is difficult to encourage rearmament, liberalize commerce, and prevent allocations under the strict exchange rate regime¹⁹².

The impact of tax and spending decisions of governments on the global economy, with a particular emphasis on interest rates and real exchange rates. The intertemporal distribution of government expenditure in relation to the domestic private sector and the commodity mix of government purchases are the two biases that determine these impacts. also emphasizes the significance of time substitution effects and wealth impacts¹⁹³. A strong dollar is linked to favorable opinions of U.S. government policies and is connected with expectations of declining volatility, rising economic growth, falling exchange rates, and rising currency returns in the future. The effects on other asset classes, global regulations, and more intricate economic processes must also be taken into account¹⁹⁴.

Standard dynamic general equilibrium models and the Mundell-Fleming-Dornbusch framework both imply that an unanticipated rise in a nation's public spending causes its currency to appreciate. However, the shock of the expansionary government expenditure causes a significant devaluation of the real exchange rate. To explain this, we need a tiny, open economy with stable prices, imperfect financial markets, and a non-aggressive monetary policy¹⁹⁵.

In the popular "elasticity approach" model of international commerce, the non-traded products sector and clearly defined government policy can be used as an explanation for the devaluation. The model's detractors argue that it is devoid of implicit assumptions and general equilibrium qualities. Different hypotheses regarding absorption policies are explored in the sub-issues brought up by shifting terms of trade. It is a helpful tool for policy talks and contemporary international economics textbooks because of its simplicity and emphasis on core qualities¹⁹⁶.

¹⁹² Friedman, 1953.

¹⁹³ Frenkel & Razin, 1986.

¹⁹⁴ Liu, & Shaliastovich, 2017.

¹⁹⁵ Bouakez & Eyquem, 2015, p.178-201.

¹⁹⁶ Dornbusch, 1975, p.859-871.

The correlation between COVID-19, currency rate volatility, and government intervention actions suggests that an increase in confirmed cases will exacerbate volatility. Exchange rate swings are regulated by economic support programs, containment and health measures, and government response indicators. While economic support programs may increase private consumption, non-pharmaceutical treatments might lessen anxiety and uncertainty¹⁹⁷. Exchange rate depreciation affects the Nigerian economy because of the money supply, interest rate, and budget deficit. The government should address this by concentrating on these elements and removing interest rate caps in order to promote savings and lessen speculative fever. It is also advised to practice fiscal indiscipline and transparency, which entail high taxes, modest government spending, moderate interest rates, and strict monetary policy¹⁹⁸.

Monetary policy responses to the Asian financial crisis have been the subject of discussions. Raising interest rates may damage domestic currencies and the financial system, according to some, while others contend that tighter monetary policy is required to stabilize the exchange rate and rebuild trust. Three years after the catastrophe, there is still disagreement on this issue¹⁹⁹.

The contribution of RER policies to economic growth, emphasizing the necessity of competitive and stable RER policies to address market imperfections and spur expansion in industries where learning spillovers occur. To further improve the impact of real exchange rate, a system of various exchange rates and conventional industrial policies are also used²⁰⁰.

The free economy proposed by Keynes under flexible exchange rates has perfect international capital mobility. It examines the impact of changes in fiscal and monetary policy as well as an increase in the global price of imported intermediate inputs. Further shows that, in contrast to the Fleming-Mundell model, fiscal policy can affect the level of real income²⁰¹.

¹⁹⁷ Feng, Yang, Gong & Chang, 2021, what is the exchange rate volatility response to COVID-19 and government interventions?. *Economic Analysis and Policy*, 69, p.705-719.

¹⁹⁸ Asinya & Takon, 2014, *The Business & Management Review*, 4(3), p.161.

¹⁹⁹ Gould & Kamin, 2001, p.384-420.

²⁰⁰ Guzman, Ocampo & Stiglitz, 2018, p.51-62.

²⁰¹ Findlay & Rodriguez, 1977, p.208-217.

Selecting between flexible and stable currency rates is essential for creating adaptable policies that can release auto money from relatives in BOP disputes. While inflexible rules may have suicidal effects, flexible policies can improve commercial balances and domestic revenue. Macroeconomic factors should be taken into account when deciding between fixed and flexible exchange rates since they are essential to creating flexible alterations that free up rival families²⁰². The relationship between national monetary systems and the ways in which exchange-rate regimes affect national policy has long been the main emphasis of international monetary theory. But the topic has been nationalized, with governments being ranked from the perspective of a particular nation. A more constrained paradigm, emphasizing the relationships between internalization and national policies, has also been adopted by policy coordination. This limited perspective is insufficient to explain the real behavior of governments²⁰³.

The government actions and external disruptions can affect the RER and resource distribution. Policies that impact domestic expenditure in relation to income and those that impact the distribution of domestic spending between domestic and imported goods fall into two major groups. These policies, which might include capital controls or a combination of measures that set the course of the nominal exchange rate and the nominal money supply in the country, can have obvious or subtle consequences²⁰⁴. The efficiency of monetary and fiscal policy is at the center of the discussion around floating exchange rates. While detractors contend fiscal policy is more effective at fixed rates, supporters of monetary policy contend that monetary policy is more effective at floating rates. According to Mundell (1963), the effectiveness of both approaches can vary based on sterilization²⁰⁵.

The significance of perfect capital mobility in influencing the transmission of disruptions under fixed or floating exchange rates as well as the efficacy of monetary and fiscal interventions. Monetary policy is not responsible for shifting output; fiscal policy is. Fixed rates are. This is not always the case, though, as many nations sterilize surpluses

²⁰² Dernburg, 1970, *The Canadian Journal of Economics/Revue canadienne d'Economie*, 3(1), p.1-13.

²⁰³ Kenen, 1989.

²⁰⁴ Mussa, M. L. (1986, p. 43-88.

²⁰⁵ Bahmani-Oskooee & Pourheydari, , Exchange rate sensitivity of demand for money and effectiveness of fiscal and monetary policies. *Applied Economics*, 22(7), p.917-925.

or deficits in their BOP during times of fixed exchange rates²⁰⁶. The global economy depends heavily on currency regulations, which have an impact on finance, commerce, investment, migration, and travel. The Bretton Woods monetary regime, the post-World War I period, and the classical gold standard era all had a role in the interwar world economy's collapse. With the Eurozone serving as a pillar of global economic integration, exchange rate policies now influence practically every economy²⁰⁷. Paul Volcker talks about exchange rate policy; he agrees with Mussa that sterilized intervention is a good idea but has low expectations. He rejects the legal justification for market intervention by the Federal Reserve. Volcker fears depreciation but wants a strong dollar. He thinks that stable currency rates should be facilitated by monetary policy²⁰⁸.

When their currencies are overpriced, emerging nations are hesitant to alter their exchange rates. By connecting the terms of trade in the manufacturing sector with the real exchange rate, a state of disequilibrium can be maintained that can foster welfare and structural change. Increased welfare and industrial growth may result from this²⁰⁹.

China is accused of manipulating its currency by the US, but its officials are hesitant to admit it. The main causes of the economic interconnectedness between developed and developing market nations are spillovers, global imbalances, exchange-rate pressures, and coordinated policies. The US suggests internationally recognized current account imbalance targets²¹⁰.

While the gross domestic product, inflation, and exports have negative, positive, and negative influences on the exchange rate, the lag of the exchange rate has a positive and significant effect on the exchange rate. To keep the foreign currency market stable, policymakers should concentrate on liquidity and other variables that affect exchange rates. Reducing reliance on oil and gas exports, implementing expansionary monetary policies, and maintaining optimal control over liquidity are among the recommendations²¹¹. The immediate macroeconomic impacts of fiscal policy, with a

²⁰⁶ Branson & Buiter, 1982.

²⁰⁷ Frieden, 2016.

²⁰⁸ Monacelli and Perotti, 2010, *The Economic Journal*, 120(544), p.437-461.

²⁰⁹ Rodrik, 1986, p.89-106.

²¹⁰ Portes, 2012, p.157-163.

²¹¹ Khordehfrush & Tehranchian, 2015, p.177-191.

particular emphasis on the two channels of transmission—the exchange rate channel and the cost channel. Since the labor market affects non-government sectors, it is a crucial conduit for the consequences of fiscal policy. Additionally fixed pricing or salaries also affect the general state of the economy²¹².

Political parties frequently support policies that reflect their ideologies; for example, right-wing governments seek somewhat low inflation, while left-wing governments embrace strong inflation and low unemployment. The choice of exchange rate regimes reflects this ideological split in the role of government in the economy. Government ideology shapes policy decisions, fostering a range of viewpoints and being a major factor in monetary policy decisions²¹³.

The link between real currency rates and government spending, as well as the pathways that cause consumption to fluctuate and resources to be removed. It estimates the structural and reduced-form equations of the model using data from the Organization for Economic Co-operation and Development and the United Nations International Comparisons Program. The empirical findings imply that, in the medium term, government spending affects equilibrium real exchange rates, with the resource-withdrawal effect about equaling the consumption-tilting effect²¹⁴. Exchange policies that are flexible encourage inflation and devaluations, which hurts public opinion of the government. Conversely, fixed exchange rate regimes lessen this trade-off, which increases the need for "opportunistic" fiscal expansion before to elections. The findings lend credence to the theory that fiscal policy cycles are limited to nations with stable exchange rates and adequate reserves²¹⁵.

Different industries' businesses and individuals have varying political stances about the level and stability of the exchange rate. Compared to non-tradable sectors, producers of tradable goods are more likely to favor more stability and to be dissatisfied with an

²¹² Lane and Perotti, 2003, p.2253-2279.

²¹³ Berdiev & Chang, 2012, *European Journal of Political Economy*, 28(1), p.38-53.

²¹⁴ Balvers & Bergstrand, 2002, *Journal of International Money and Finance*, 21(5), p.667-692.

²¹⁵ Schuknecht, 1999, p.569-580.

increase in the real exchange rate²¹⁶. Shocks to government spending and their implications on trade balance, real exchange rate, production, and consumption in four developed nations. Positive government expenditure shocks devalue the RER while increasing output and consumption, defying the popular belief that higher domestic absorption raises prices²¹⁷.

Combining fiscal policy with spending cuts results in several exchange rates, which function as a differentiated tariff. They can be applied to deal with short-term disruptions like trade deficits and improvements in terms of trade. Since they don't resemble a tax-subsidy program like direct taxes and subsidies, they can be exploited, though. Both the political costs of transition and the duration of disruptions determine the best way to react to global prices²¹⁸. Countries must select an exchange rate regime that will link their domestic and global economies. In the near term, policymakers have the power to determine the nominal exchange rate; however, the RER is influenced by other factors such as tariffs, capital controls, and monetary and fiscal policies²¹⁹.

Low debt is the outcome of fixed exchange rates, which are even lower in times of investor turbulence. An effectively functioning government would minimize debt if it were excessively high, guaranteeing the continuation of stable rates. The question of when fixed exchange rates are indeed fixed is addressed by this method²²⁰.

2.4. Geopolitical Events and Exchange Rates.

The Israeli aggression on Gaza has cost over 60 billion dollar, affecting Israel's GDP by 1.4% in Q1 2024 and per capita GDP by 3.1%. The war has also lowered Israel's credit

²¹⁶Broz, Frieden & Weymouth, 2008, p.417-444.

²¹⁷Ravn, Schmitt-Grohé & Uribe, 2012, *Journal of Monetary Economics*, 59(3), p.215-234.

²¹⁸Dornbusch, 1986, p.143-174.

²¹⁹Ito & Krueger, 2007.

²²⁰Velasco, 1997, p.5-25.

rating to "A2" by Moody and Standard & Poor's, leading to increased borrowing costs, a deterioration in the shekel, and an annual increase in sovereign debt costs of 1.2 billion²²¹.

Economic stability, commodities functioning, and financial markets can be impacted by geopolitical risks, which encompass uncertainties and disturbances in international relations, politics, and global security. These dangers have been made worse by the Russia-Ukraine conflict, which has an impact on food security, agricultural output, and energy markets. Market reactions were unfavorable for corporations exposed to Russia, Ukraine, or the region, and stock markets saw volatility. Safe-haven currencies like the US dollar, Swiss franc, and Japanese yen rose in value as a result of the fighting²²².



Graph 4: Israeli New Shekel to US Dollar for Five Years (2020-2024).

Natural catastrophes, political unrest, and wars are examples of geopolitical hazards that have a big effect on the currency rate market as well as other financial and economic markets. Currency value is often positively impacted by a healthy economy, but it can

²²¹ Al Jazeera. (2024, August 9). Study: How the Al-Aqsa flood impacted the economy. <https://2cm.es/Ogq9>

²²² Hossain, Masum & Saadi, 2024, p.104750.

sometimes depreciate due to unforeseen dangers. As a result, companies and investors should think about how currency changes can affect profit margins²²³.

The post-war low for the dollar against the Japanese yen is not accurate. Before World War II, the yen was pegged at 3.6 yen to the dollar. In 1945, the U.S. occupation forces adopted an exchange rate of 15 yen to the dollar. As inflation soared, the rate changed to 50 yen to 1, 270 yen to 1, and finally 360 yen to 1 in 1949²²⁴. Japan's postwar recovery was largely driven by the Japanese people's spirit of togetherness, investment in education, and focus on domestic industries such as automobiles and electronics²²⁵. The Japanese government played a pivotal role in economic planning, supporting strategic industries, extracting and exporting raw materials, and encouraging small and medium-sized enterprises. Traditional Japanese values such as community solidarity and sacrifice also contributed to the country's rapid recovery²²⁶.

Turkey's geopolitical position and associated requirements have created significant challenges and opportunities for its international relations. Turkey now relies on energy for 72% of its needs, and this dependence is increasing due to the growing demand for energy, especially in the manufacturing sector, as well as imports. Turkey's growing energy needs mean that renewable energy is essential, and that domestic generation and integration into conventional systems are crucial for reserves, security, and reducing dependence on external sources²²⁷. Ensuring territorial integrity and equitable resource distribution are the goals of Turkey's policies towards Iraq. Although Kurdish forces in northern Iraq have gained strength, the hostilities that are currently occurring still mostly concern Turkey. As a strategic defense endeavor, the US and Israel might think of creating a Kurdish state in northern Iraq; nevertheless, this could go against Turkey's national interests and result in rapprochement with Russia and Iran²²⁸.

Energy costs have surged because to the turmoil in Ukraine and Russian export limitations in 2022, which has affected currencies such as the Australian dollar. An

²²³ Kiswani & Elia, 2021.

²²⁴ Kristof, 1986, the postwar dollar bought fewer yen. The New York Times.

²²⁵ Journal of East Asian Studies, 2018, 18(1):1-21.

²²⁶ Flath, David, 2022, the Japanese Economy, Oxford Academic.

²²⁷ Topcu & Gürson, 2016, Energy supply security and renewable energy policies in Turkey. Journal of Defense Resources Management, 7(1), p.53-61.

²²⁸ Çağlar & Gürson, 2013, p.125-152.

Australian mining boom may be revived by the strong correlation seen between changes in energy prices and currency exchange rates. Subsequent investigations may delve deeper into commodity currencies, trade agreements, political stability, and machine learning methodologies²²⁹. Increased tensions worldwide brought dangers and uncertainty to the crude oil and foreign exchange markets because of the Russia-Ukraine war. High risk and uncertainty resulted from the conflict's impact on trade patterns and economic sanctions. Dangers related to geopolitics that influenced market activity both before and after the conflict while currency devaluation has a short-term negative effect, geopolitical risk has a negative influence. Economic policy is beneficial, particularly when it supports the travel and tourism sector. Though the growth rate has slowed recently, tourist arrivals have generally increased over time in the BRICS economies. In addition, governments ought to control currency volatility, reduce geopolitical risk, create stable economic policies, and improve marketing tactics²³⁰.

The Economists cannot in developing nations is unable to predict changes in stock prices, exchange rates, or oil prices. On the other hand, it can accurately predict gold prices. Because of the transient nature of geopolitical conflicts, governments and economic agents ought to exercise caution when it comes to first price changes. Political risk is what determines the price of gold because historically investors have used it as a safe haven to offset risk and uncertainty²³¹.

The null hypothesis, which states that general interest rates have no causal influence on foreign exchange leaps, is rejected by the geopolitical risks, which produce jumps over a broad range of quantiles. This data is especially significant for jump risk premia for investors during geopolitical risk oscillations and diversification strategies for currency risk managers²³².

²²⁹ Sokhanvar, 2023, p.405-427.

²³⁰ Reivan-Ortiz, Cong, Wong, Ali, Thu & Akhter, 2023, Environmental Science and Pollution Research, 30(32), p.78339-78352.

²³¹ Plakandaras, Gogas, & Papadimitriou, 2018.

²³² Gillas, Gupta, Konstantatos, & Vortelinos, 2021.

Three financial market measures exist: equity, currency options, and spot market. It shows that while the impact on the equities market is large and takes time, the currency market responds quickly to favorable news and outperforms them. Market performance may be fundamentally impacted by geopolitical concerns²³³.

The Great Recession and COVID-19 have influenced the relationship between currency rates and WTI crude oil log-returns. Following the 2008 financial crisis, oil prices declined, creating advantageous correlations for countries that export oil. With oil-importing countries having stronger concordance due to their larger monetary bases and expectation of future global currency supply, correlations can, however, be positive over time. The majority of correlations are negative, most likely as a result of oil-importing central banks' precautionary monetary base emission or withdrawal²³⁴.

Exchange rates are subject to asymmetric and currency-specific effects from geopolitical threats, especially at low and high extremes. The Swiss franc and the euro exhibit notable resilience to geopolitical uncertainties, providing a means of potential protection against such shocks. To allocate money effectively, currency investors should keep an eye on market patterns and the degree of geopolitical risk. In order to maintain financial stability, policymakers should try to avoid geopolitical risks from going too far²³⁵.

Geopolitical risks are an important economic concern because they have a substantial impact on asset markets and conflict dynamics. Geopolitical instability has increased due to recent events such as the Paris attack, Brexit, and tensions between North Korea and the US. Geopolitical risks have affected empirical studies on wars and their economic effects, which makes asset resilience analysis essential²³⁶.

The U.S. Energy Information Administration asserts that historical political and military conflicts, such as the Suez Crisis, Iran-Iraq War, and Libyan Revolution, have had a significant impact on crude oil production, in contrast to conventional wisdom, which maintains that oil price shocks are only indicators of a robust global economy.

²³³ Hentov, Petrov & Zumbo, 2018.

²³⁴ Candila, Maximov, Mikhaylov, Moiseev, Senjyu & Tryndina, 2021, p.8046.

²³⁵ Bossman, Gubareva & Teplova, 2023.

²³⁶ Bouoiyour, Selmi, Hammoudeh & Wohar, 2019.

Conversely, conflicts invariably result in the annihilation of nations and their financial systems²³⁷. While currency devaluation has a short-term negative impact, geopolitical risk has a negative effect. Favorable policies, in particular, have a good effect on the economy. In order to preserve visitor safety and security, the report advises governments to reduce geopolitical risk, control exchange rate swings, create stable economic policies, and improve marketing tactics²³⁸.

Rising geopolitical concerns have an impact on imports and exports, decrease energy trade, and hurt emerging economies. Time-lag, mediating effects, and national characteristics all have an impact on this. They should put regulatory rules into place, enhance response mechanisms, stabilize global energy market cooperation, and uphold long-term geopolitical peace in order to reduce risks. This involves encouraging internal energy usage and increasing domestic consumption²³⁹.

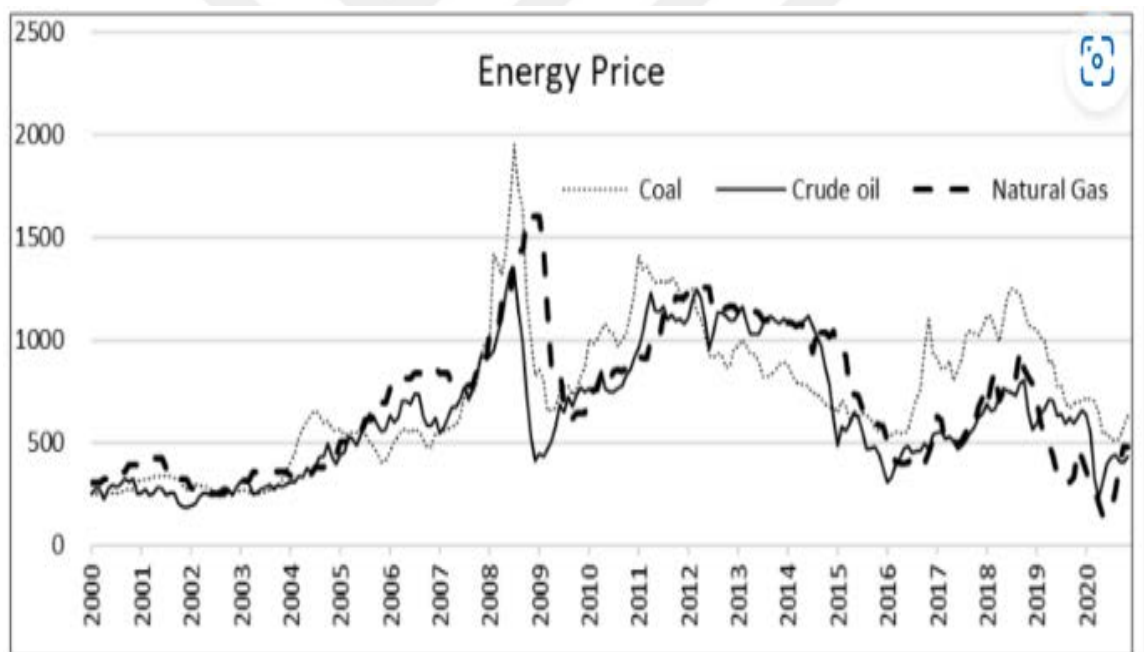


Figure 5 . Energy price trend line.

When geopolitical risk is high, there is a relationship between oil prices and financial liquidity in the time domain, and there are correlations in the frequency domain that are both short- and medium-term. According to the study, one way to lessen the impact of

²³⁷ Monge, Gil-Alana & de Gracia, 2017, p.79-91.

²³⁸ Akhter.

²³⁹ Li, Yang, & Failler, 2021, Sustainability, 13(9), p.5199.

volatility in oil prices is to establish a policy of resource income diversification and allocate unneeded government spending to investment initiatives²⁴⁰.

Energy and food costs have surged as a result of the conflict between Russia and Ukraine, and the sanctions imposed by the West on Russia have disrupted the sale of commodities. Currencies related to commodities, such as the Canadian dollar, have been affected by this, even as rising prices have helped. Shocks to commodity prices may also have an impact on foreign exchange markets, influencing traders, investors, and decision-makers. To maintain the best macroeconomic policies, central banks must take risk-mitigating measures into consideration²⁴¹.

Geopolitical risk and the price of precious metals, and economic policy uncertainty and all other prices save gold, are not causally related. The time-varying causality test, however, suggests that these conclusions are erratic and that the causal relationship is only evident during specific times. Given that there is typically no correlation between precious metals and the stock and bond markets, this emphasizes how crucial it is to evaluate the performance of precious metals during times of market crisis brought on by growing uncertainty²⁴². The trilateral relationship between oil prices, changes in exchange rates, and stock market returns in China and the United States was studied between 1991 and 2015. Important findings included the following: the trade-weighted US dollar index was consistently impacted by oil prices, the Chinese stock market was negatively impacted by them, and there was a notable parallel inverse relationship between the two markets. Oil prices also responded favorably to shocks to aggregate demand²⁴³.

The fixed and flexible exchange rate regimes facilitate the flow of products between nations. However, outcomes vary depending on the anchor currency, and indirect agreements have little effect on global trade. Trade flows between nations are adversely impacted by systemic banking crises. Depending on the anchor currency and whether the

²⁴⁰ Su, Khan, Tao & Nicoleta-Claudia, 2019.

²⁴¹ Sokhanvar & Bouri, 2023, *Borsa Istanbul Review*, 23(1), p.44-54.

²⁴² Yilanci & Kilci, 2021.

²⁴³ Bai & Koong, 2018, *The North American Journal of Economics and Finance*, 44, p.12-33.

crisis is in the exporting or importing nation, exchange rate regimes can have a significant impact on trade during times of crisis²⁴⁴.

The COVID-19 epidemic and the worldwide financial crisis of 2008 have had a major effect on the Indian stock, oil, and foreign exchange markets. Additionally, while exchange rates are out of step with oil prices, stock returns are in line with them. Also, the Indian market is impacted by economic shocks that occur in industrialized countries. Investors, portfolio managers, and risk assessors can benefit from the findings²⁴⁵. High inflation, with varied degrees of intensity across nations and time periods, is predicted by geopolitical threats. This increase is correlated with reduced economic activity, higher defense spending, public debt, money growth, disturbances in the supply chain, and a drop in global trade. Higher commodity prices and currency depreciation more than offset deflationary impacts when geopolitical uncertainties cause inflation to rise²⁴⁶.

3. The Puzzle of Exchange Rate Movements.

3.1. Exchange Rate Determination Challenge.

Knowing the differences between fixed and floating exchange rates is essential to choosing the right strategy. Which strategy is better relies on how each country's economy is doing and how best to handle exchange rates. Although managing foreign currency exchange rates within a state is one benefit of floating exchange rates, they may also deter foreign investment²⁴⁷.

Richard Cooper and Susan Strange drew attention to the shifts occurring in intrastate politics, economy, and international politics in the late 1960s. IR scholars have endeavored to elucidate the "new" phenomena of the global political economy. The epistemological foundations of logical positivism in IR and IPE theory, however, have

²⁴⁴ Santana-Gallego & Pérez-Rodríguez, 2019, p.85-95.

²⁴⁵ Das, 2021, Journal of Business Cycle Research, 17(2), p.129-149.

²⁴⁶ Caldara, 2022.

²⁴⁷ Belhouchi, 2020.

left room for few explanations that adequately convey the complexity, ambiguity, and uncertainty of the field of international political economy²⁴⁸.

The Branson model, in particular, and the investment portfolio method highlight the significance of maintaining portfolio balance in the face of exchange rate fluctuations. Exchange rates are identified by the model as factors that affect the current account balance and the growth of foreign assets. It also describes how exchange rates move and adjust to different price points²⁴⁹. Due to its exchange rate management strategy, which depreciated its currency and boosted the export industry, South Korea's economy recovered substantially. With the percentage of manufactured items in exports increasing from 27% in 1962 to 95.4% in 1991, this policy resulted in a quicker rise of exports than GDP. But the 1997 crisis made the Korean won internationally convertible. The nation now has the authority to control fiscal policy and exchange rates²⁵⁰.

Exchange rates have an impact on resource allocation, economic development, and local and worldwide economies. Budgets, the balance of payments, and indicators are all affected by changes in exchange rates. International exchange markets and commercial banks have an impact on the economic conditions of nations. Economic interactions are impacted by Algeria's socialist regime and reforms' failure to bring about progress. Although devaluing currencies can aid in the removal of imbalances, inflation and deficits still affect emerging nations²⁵¹.

An overvalued currency lowers a nation's competitiveness and foreign exchange reserves by increasing export prices and domestic inflation. Although Algeria has undergone economic reforms since the 1986 oil crisis, excessive borrowing costs and a reliance on foreign organizations have made this problem worse. The goal was to lessen imbalances and external shocks. More exchange rate flexibility, higher productivity, and monetary policy management are among the recommendations²⁵². Liberalizing the exchange rate is an essential policy for preserving the value of the currency, drawing foreign direct investment, and bolstering domestic industry. This supports the

²⁴⁸ Tooze, 1987,. Millennium, 16(3), p.523-528.

²⁴⁹ Ali, 2001.

²⁵⁰ Meqash & Mbareki, 2021, Journal of Social and Human Sciences, 22(02), p.623-638.

²⁵¹ Kadour, 2022.

²⁵² Yacoub and Darwish.

maintenance of the trade balance deficit, the exchange rate, and the economy's defense against speculative activity²⁵³.

Foreign exchange, especially in French francs, is Algeria's biggest illegal market. Even when it's illegal, the market operates sensibly since it's hard to monitor and regulate. Algeria is now a market economy thanks to the government's implementation of measures to limit transactions and permit free trade based on supply and demand principles²⁵⁴. Algeria's equilibrium exchange rate is not a fixed amount; rather, it depends on macroeconomic factors. A parallel market emerged as a result of the planned economy's adoption of a fixed exchange rate regime. A controlled floating mechanism was implemented in the market economy, bringing the dinar closer to its actual value. Real oil prices, inflation, trade openness, and production differentials all affect the equilibrium exchange rate²⁵⁵.

Economic growth depends on stable exchange rates, yet unstable policies can lead to instability. In the short term, using the exchange rate as a tool for policy may be helpful, but it is meaningless in the long run. Comprehending the rationale behind government apprehension is crucial since linking currencies to one another can impede economic growth²⁵⁶. Inflation and the shortage of local resources must be addressed by foreign direct investment. Stability in the political and security sphere, exchange rate stability, and internal economic balance are important characteristics that draw investment. The range of 5.92 pounds to the dollar to 5.42 pounds to the dollar is good for Egypt's exchange rate. Negotiating investment projects, preserving pricing stability, and putting fiscal policy measures into action are among the recommendations²⁵⁷.

In order to handle exchange risk in financial and commercial operations, the International Accounting Standards Board has created the twenty-first international accounting standard. This standard offers techniques for handling currency rate fluctuations, classifying them as either gains or losses. This aids in the improvement of mission decisions, efficiency gains, treatment clarification, ease of reading financial

²⁵³ Abu Amira & Salem, 2020, Studies and Research, 6(1), p.43-76.

²⁵⁴ Benaini, 2014.

²⁵⁵ Bourahli.

²⁵⁶ Ahmed, 2024, the impact of exchange rate changes on economic growth. Journal of Research and Commercial Studies, 38(1), p.621-661.

²⁵⁷ El-Ghaish & Massad, 2022, p.1-37.

statements, and ease of comparison with other comparable institutions for economic institutions²⁵⁸.

According to the study, the parallel exchange rate has a major short-term impact on the trade balance; a 1% decline in the value of the lira leads to a 1.36% improvement in trade balance. Long-term, however, this effect reverses, resulting in a 0.8% decline in the trade balance. This defies the economic theory, which holds that an increase in exports and imports results in a better trade balance when the local currency depreciates. This could be caused by the low elasticity of imports and exports. The analysis also shows that the parallel exchange rate and trade balance have a unidirectional causal link, with the biggest trade balance shortfall occurring ten months following abrupt shocks²⁵⁹.

Egypt's economy is impacted by the depreciation of the native currency in both good and bad ways. Poverty and inflation rates are inversely correlated with the value of the pound. The Egyptian government should create a social security system, activate the Consumer Protection Agency, and offer microloans to the underprivileged in order to lessen these consequences. They will be able to raise their income and close the wealth gap as a result²⁶⁰. The macroeconomic variables of national income, inflation, growth, and unemployment are all impacted by exchange rates. By comparing local market prices with their international counterparts, they also establish ties between the local and global economies. In order to address structural imbalances and restore the true value of the national currency, the Algerian dinar exchange rate was liberalized in 1986. To convey the competitive condition of the Algerian economy, the exchange rate index is insufficient²⁶¹.

Reducing the official US dollar-Iraqi dinar exchange rate from 1,450 to 1,300 dinars per dollar could have an impact on the country's economy. This might result in a 15 trillion dinar annual drop in government revenue, a 15 trillion dinar increase in the budget deficit for 2023, and a 15 trillion dinar increase in domestic debt. Additionally, speculation, financial instability, and a decline in trust in Iraq's monetary authority could result from

²⁵⁸ Abbas & Ibrahim, 2012.

²⁵⁹ Bitar, 2021.

²⁶⁰ El-Barbary and Hend, 2021, *Journal of Politics and Economics*, 10(9), p.1-37.

²⁶¹ Roubi & Bakri, 2014.

the shift. The government's capacity to close the deficit determines whether the official price of the dinar will drop²⁶².

Different currency rate systems have different effects on foreign financial investments; fixed or semi-floating systems are more restrictive. However, as the experience in Iraq has shown, exchange rates are essential monetary policy channels for addressing inflation. Monetary policy is not the only factor driving growth in investments; laws, rules, and financial policies also have a role. The foreign investor indicators are directly impacted by exchange rates, and the Central Bank aims to achieve financial stability in the national economy through maintaining stable exchange rates²⁶³.

Export flows and exchange rate volatility have a long-term negative correlation. When fluctuations in exchange rate volatility lead to changes in real exports, and exchange rate volatility has a short-term impact on export flows. This result supports earlier research on export behavior in LDCs and emphasizes the significance of taking exchange rate volatility into account in export demand models²⁶⁴. The connection between growth and exchange-rate regimes. The impact of exchange rates on growth may be attributed, theoretically, to the uncertainty presented by flexible rate options. Empirical research, however, has produced a range of findings. Some claim that growth is stimulated by pegged exchange rates, while others find the opposite. Exchange rates may also have a short-term impact on economic growth rather than a long-term one, similar to inflation²⁶⁵.

Exchange rate regime preferences shift periodically; prior to the fall of the Bretton Woods system, flexible exchange rates were promoted. But the results have fallen short of expectations, and fixed exchange rates are now viewed as a useful instrument for maintaining monetary stability. The volatility of fixed rates and the necessity of solid arrangements have been brought to light by recent currency crises²⁶⁶. The impact of exchange rate stabilization on a nation's currency and businesses is explained by a risk-based perspective. According to the approach, governments can make their currency a

²⁶²Al-Marsoumi, 2023, *Iraqi Journal of Economic Sciences*, 21(76), p.1-2.

²⁶³ Al-Tamimi and Al-Shammari, 2022, p.47-65.

²⁶⁴ Deltas & Zilberfarb, 1993, p.641-647.

²⁶⁵ Petreski, 2009.

²⁶⁶ Hefeker, 2000, p.20, 159.

more secure investment for foreigners. In comparison to larger economies, small economies can enhance domestic capital accumulation, wages, and wealth by stabilizing their bilateral exchange rate. Larger economies anticipate an equilibrium pattern that is consistent with the evidence by floating their exchange rates²⁶⁷.

The ROM was implemented by Turkey's Central Bank in 2011 with the aim of stabilizing the currency rate and safeguarding the economy against transient, unstable capital flows. During periods of inflow, the ROM assists banks in internalizing the social advantage of foreign currency accumulation. The USD/TL exchange rate has demonstrated less volatility and depreciation probability in contrast to other currencies²⁶⁸.

An effective place to start when examining the dynamics of nominal exchange rates is with the fundamental monetary model of exchange rate determination. Its features include robust microeconomic foundations, easy model dynamics handling, optimal money growth, and exchange rate depreciation. It is based on intertemporal optimization²⁶⁹. The return transmission rate in developing nations, as well as the low rate resulting from low inflation and asymmetric behavior brought on by fluctuations in exchange rates, unstable economic situations, and inflation. Policymakers should not assume that return transmission would continue or use a general rule to predict it because past return transmission measures may not accurately predict future trends²⁷⁰.

The connection between foreign exchange risk, default risks on both domestic and foreign securities, interest rate parity, and anticipated exchange rate fluctuations. Furthermore, even for risk-averse investors, the forward premium is very nonlinear and not a fair indicator of changes in exchange rates. The forward premium is impacted by forward market intervention based on the covered and speculative arbitrage schedules' slopes²⁷¹. It is critical to recognize that foreign exchange market participants play a significant role and that currencies are assets in order to comprehend the long-term drivers of real exchange rates in developing and emerging nations. The significance of the

²⁶⁷ Hassan, Mertens & Zhang, 2023, *The Review of Economic Studies*, 90(2), p.879-911.

²⁶⁸ Değerli & Fendoğlu, 2015, p.166-179.

²⁶⁹ Piersanti, 2012, *the macroeconomic theory of exchange rate crises*. Oxford University Press.

²⁷⁰ Tunç, 2017, p.205-233.

²⁷¹ Kouri, 1975.

international monetary system's hierarchical structure in comprehending fluctuations in exchange rates²⁷².

Nigeria has managed its foreign exchange market inconsistently, with the initial naira overvaluation mostly eradicated but the Central Bank's strict monetary policy undermined by a significant comeback of the fiscal deficit. As a result, the currency rate and foreign exchange resources are continuously under demand pressure. High external reserves and additional deregulation have nevertheless helped to rebuild trust. To maintain consistency with macroeconomic stability, fiscal constraint and coordination between monetary and fiscal policy activities are required²⁷³.

The THB/USD currency rate is heavily influenced by international reserves and terms of trade. The value of the Thai baht reacts to other currencies in diverse ways, with terms of trade showing the largest correlation. Due to Thailand's export-focused economy, the exchange rate can be impacted by the relative costs of imports and exports. Thailand's investment position is reflected in its international reserves, which also support a steady exchange rate²⁷⁴.

3.2. Exchange Rate Risks.

In order to mitigate currency volatility, banks and the state employ strategies including signing sales contracts and invoicing in local currency and making cash payments. They can also decide to divide the losses brought on by fluctuations in exchange rates, with a percentage going to each side. Risk can also be decreased by drafting contracts and making payments in several currencies. In order to minimize losses in the event that the value of the local currency drops, another tactic is to pay off debt faster to nations with strong currencies. These techniques lessen the effect that exchange rate changes have on transactions²⁷⁵.

²⁷² Barbosa, Jayme & Missio, 2018, *International Review of Applied Economics*, 32(1), p.62-83.

²⁷³ Mordi, 2006.

²⁷⁴ Bouraoui & Phisutthiwatcharavong, 2015, p.137-145.

²⁷⁵ Salouh.

Because it handles the impact of exchange rate volatility and rationalizes financial results, exchange risk management is essential for economic entities. It is intricate and has to be reviewed often. Developing nations ought to create committees to oversee financial performance and stay up with technological advancements. Strategies for managing treasury risk should receive extra consideration²⁷⁶. Changes in exchange rates make international transactions more difficult for economic operators. The Algerian Foreign Bank controls exchange rate paths through the use of a controlled floating mechanism. The study discovered that there is a substantial correlation between changes in exchange rates and exchange returns, with fluctuations having little effect on international transactions. Net income is a key metric for the bank's profitability indicators, and statistical techniques are a useful tool for analyzing bank-related variables²⁷⁷.

Two foreign financial portfolios were compared; one had exchange risk insurance, and the other did not. The second portfolio was judged to be less hazardous. Exchange rate variations have an impact on the value of financial assets, which in turn affects the risks and return of a portfolio. In order to mitigate currency rate risk, it is advised to choose suitable insurance and carry out research on financial derivatives²⁷⁸.

International investments are more risky due to exchange rate risks, particularly when there are significant currency swings. Returns on investment and the efficiency of the financial markets are key factors in the management of stock portfolios. The enhancement of portfolio characteristics through international diversification is contingent upon the interconnectedness of markets. Risk identification, best-selection of securities, currency market diversification with stronger correlations, avoidance of foreign assets with extreme volatility, globalization promotion, and weak correlations with local markets are some of the recommendations²⁷⁹.

²⁷⁶ Kifani & Bellahreche, 2020, p.166-181.

²⁷⁷ Kouthar, 2017.

²⁷⁸ Khribash.

²⁷⁹ Karmit.

The foreign exchange rate was impacted by the monetary upheaval brought about by the fall of the Bretton Woods system. A study recommends gradually liberalizing and floating currency rates in developing nations as a solution to this problem. The expansion of Algeria's foreign exchange market, streamlined control processes, and the creation of risk prediction methods are all recommended by the report, which emphasizes the importance of profitability in assessing the performance of banking institutions²⁸⁰. Exchange rate risk arises from changes in exchange rates that impact international corporations such as Saudi Almarai Company. The business uses a combination of conventional and contemporary risk management strategies, such as financial derivatives hedging for options, futures, and swaps. Forwards, futures, and swaps are used in modern procedures, whilst invoicing processes are used in traditional methods²⁸¹.

The exchange rate is crucial for economic institutions as it impacts the economy and foreign currency transactions. To control currency rate risks, institutions should use modern hedging techniques like futures, forward, and options contracts. Recommendations include establishing an office to oversee exchange risks, maintaining income and expense balances, enhancing output, assessing diminishing returns, cutting debt, and lowering needs. These actions strengthen resources utilization and help organizations achieve their profit objectives²⁸².

Changes in exchange rates are a major problem for economic actors, particularly in developed countries like Iraq and Egypt. Unlike gold and silver, currency has conventional worth as well as legal dependability. With consistent time series for both, the price index reacts to lagged exchange rates more favorably. Prices are stabilized by government policy, but the value of the currency is not reflected in the official exchange rate. The price index and exchange rate have a one-sided relationship that affects the price index²⁸³.

Under the capitalist system, developing countries have been reluctant to entice foreign direct investment because of worries about the objectives of multinational corporations. Nonetheless, these countries have put in place incentives to attract investment,

²⁸⁰ Bahloul & Khebbab, 2018.

²⁸¹ Abd al-Nasser, 2019.

²⁸² Mokhtari and Khalifawi, 2019.

²⁸³ Mousa, 2024.

emphasizing cutting-edge technology and potent administrative capacities. By improving its financial system, utilizing indirect monetary instruments, issuing licenses to foreign banks, and carrying out privatization procedures, Algeria has made an effort to draw in foreign direct investment²⁸⁴. In emerging nations, the exchange rate between local and foreign currencies is essential for maintaining financial and economic stability. Governments frequently step in to stabilize exchange rates; one example is the liberalization of the value of the Egyptian pound relative to other currencies. Because it has an effect on discount rates, projected cash flows, and the true asset worth of corporations, this choice may have an effect on the stock market. The purpose of this study is to examine how the announcement affected the risks and returns of the Egyptian stock market²⁸⁵.

Due to the absence of a single monetary unit and the ongoing search for an international payment method, money is employed in international economic transactions. The exchange rate, which is based on changes in supply and demand, is essential to economic activity. Exchange rate systems use internal features such as billing currency, payment terms, and clearing to link currencies and handle exchange rate risks²⁸⁶.

Changes in the foreign exchange rate have a big effect on banks and local companies in Iraq. By detecting changes in the value of financial instruments, financial derivatives reduce risk. Although futures contracts necessitate a substantial initial investment and accounting labor, they are comparable to trading in Iraqi markets. Although they need a substantial initial investment and regular reevaluation, option contracts are preferable. In the Iraqi environment, inadequate financial reporting is caused by a dearth of tools to manage price volatility and a multitude of risks²⁸⁷.

Because of the Bretton Woods system's breakdown, currency exchange rate swings have a considerable impact on overseas businesses through their transactions and operations. Hedging strategies are employed by businesses to preserve long-term

²⁸⁴ Nassri, 2014.

²⁸⁵ Al-Mughni, 2021, Arab Journal of Management, 41(1), p.127-144.

²⁸⁶ Larab, 2014.

²⁸⁷ Salman, 2018, Journal of Economics and Administrative Sciences, 24(104), p.404-404.

exchange positions, and the share price of Anatolia Automotive Company is directly impacted by the Turkish lira exchange rate. Creating a risk management division, documenting procedures, and funding human competency training are among the suggestions²⁸⁸. Ensuring that financial statements appropriately represent the impact of exchange rate changes depends on how they are presented. Since exchange rates translate profits and returns into local currency, they have a direct impact on foreign investment flows. However, political, economic, social, and cultural factors all have an impact on the flow of wealth across national borders. Exposure to foreign currency rate risks is also influenced by factors including industry type and activity. Furthermore, the quality of earnings may be adversely affected by financial statements that contain inadequate disclosures about foreign exchange risks²⁸⁹.

To lessen a company's exposure to exchange rate risk, currency exposure is essential. To manage this risk, multinational corporations employ a variety of hedging techniques that cover economic, translation, and transactional risks. The conventional forms of exchange rate risk, contemporary methods, and optimal approaches for managing currency risk are all covered in this study. Derivatives are used by US multinational corporations as a hedge against exchange rate risk, mainly to lessen the volatility in cash flows and profits accounts²⁹⁰.

Complete hedging is possible since genuine exchange rate volatility affects the exchange risk. One important consideration in portfolio composition is the volatility of the nominal consumption rate. The difference between the predicted consumption rate and the interest differential is how the risk premium is calculated. Additionally, money demand which is determined by the average return on securities rather than by domestic interest rates affects the integration of the portfolio and macro models²⁹¹.

Direct investment is encouraged by a reduction in foreign capital expenses brought about by a risk-adjusted predicted real foreign currency appreciation. But this effect might

²⁸⁸ Khroubi.

²⁸⁹ Hussein and Farghali, 2024, of Financial and Administrative Studies and Research, 16(4), p.30-38.

²⁹⁰ Papaioannou, 2006.

²⁹¹ Dornbusch, 1980.

be countered by additional input expenses, which would lower investment. The combined estimate of annual bilateral US direct investment flows to five developed nations indicates significant drops linked to anticipated real foreign exchange rate appreciation and significant rises linked to risk, indicating a decrease in exports by multinational corporations to other nations²⁹².

Exchange rate regimes have an effect on global trade; bilateral trade flows are stronger when exchange rates are floating than when they are fixed. Although trade volume is decreased by exchange rate uncertainty, the effects of this phenomenon are not as strong as those of trade restrictions imposed by countries with fixed exchange rates²⁹³. The argument concerning exchange rate risk's effects on global trade is that it raises the possibility of trade gains and discourages traders who are risk averse from engaging in trade. Finding a large influence of risk on trade is challenging since exchange rate risk can only account for a small portion of the export development over time. Since businesses can completely eliminate exchange risk through hedging, the impact of exchange rate risk on commerce may likewise be nonexistent²⁹⁴.

Industry-specific differences in dollar value and stock returns are shown by the US stock market's use of bilateral and multi-factor arbitrage pricing models to price exchange rate risk. Exchange risk is not, however, implied to be priced into the stock market by empirical findings, since the risk premium for exposure to foreign exchange is negligible²⁹⁵. Bonds and stocks are affected by changes in real exchange rates differently; bonds only show an interest-rate effect, but stocks show both an interest-rate and cash-flow effect. Even if earlier research failed to uncover a correlation between stock returns and exchange rates, long-horizon returns and exchange-rate fluctuations paint a clearer picture of exchange exposure, which may mean that short horizons do not adequately capture it²⁹⁶.

Between 1974 and 1984, the United States' trade volume was restricted by the actual exchange rate risk, but only slightly in certain sectors. Changes in resource allocation

²⁹² Cushman, 1985, p.297-308.

²⁹³ Brada & Méndez, 1988.

²⁹⁴ Klaassen, 2004, p.817-839.

²⁹⁵ Jorion, P. (1991, *Journal of financial and quantitative analysis*, 26(3), p.363-376.

²⁹⁶ Chow, Lee & Solt, 1997, p.105-123.

might have resulted from this. Policies such as fixed exchange rates, foreign exchange market intervention, limitations on financial capital flows, and macroeconomic policies may be put into place to lessen uncertainty. Trade benefits from reduced exchange risk are probably small, though, and they should be balanced against market manipulation of the real exchange rate²⁹⁷. The euro has reduced non-financial companies' exposure to market risk while simultaneously increasing stock return volatility for non-financial companies in the US, Japan, and 18 other European nations. The corporations in the euro region and those with a significant percentage of overseas sales or assets in Europe have been the main targets of the reductions²⁹⁸.

The returns of nation stock indices are significantly impacted by currency fluctuations. Currency risk is also highly influenced by imports, exports, credit ratings, and tax receipts, which is in line with certain economic theories. Also, lag-related explanatory variables might be helpful in predicting exposure to currency risk. The outcomes hold up well to different alternative requirements²⁹⁹. Exchange, interest rates, and stock returns are related both through a volatility spillover relationship and a causal-in-mean relationship. Long-term interest rates affect the financial services and insurance sectors, even if short-term interest rate effects are more prevalent in banking and insurance. As such, investors may find it helpful to regularly watch monetary policies in order to make well-informed investment decisions³⁰⁰.

Because the Turkish economy is vulnerable to shocks from the outside world as well as from inside, exchange rate and macroeconomic instability are worries. Recession, soaring inflation, and financial instability have been brought on by the lira's collapse and the heightened default risk. In order to counteract this, the government wants to fortify domestic macroeconomic frameworks and policy frameworks through cutting back on short-term foreign debt, raising domestic savings, and decreasing its dependency on outside funding³⁰¹.

²⁹⁷ Maskus, 1986, *Economic Review*, 71(3), p.16-28.

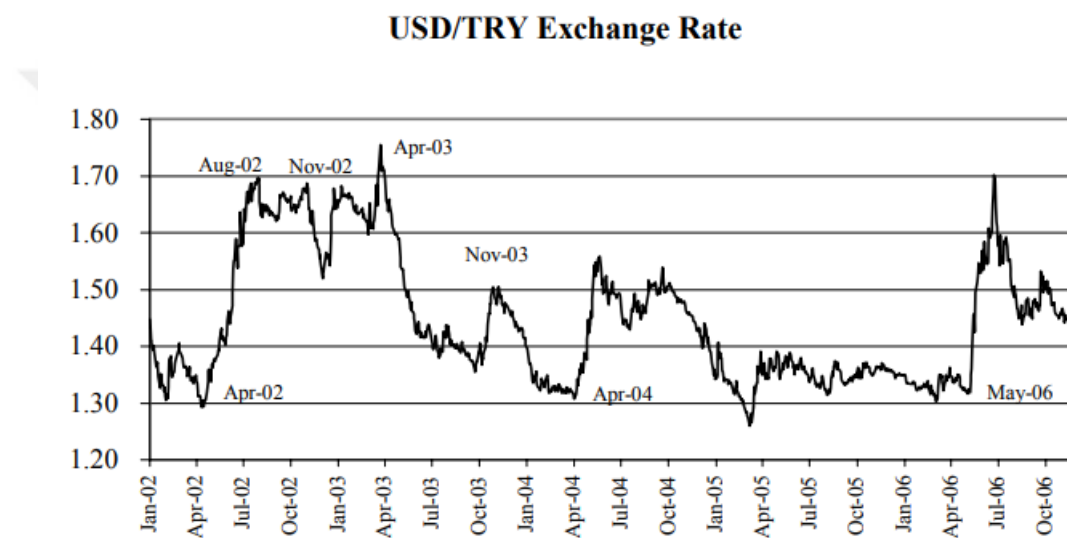
²⁹⁸ Bartram & Karolyi, 2006, *Journal of empirical finance*, 13(4-5), p.519-549.

²⁹⁹ Patro, Wald & Wu, 2002, *Journal of banking & finance*, 26(10), p.1951-1972.

³⁰⁰ Mouna & Anis, 2016.

³⁰¹ Yıldırım, 2020, *İstanbul İktisat Dergisi*, 70(1), p.73-112.

Compared to the volatility of foreign exchange prices, government banks are more susceptible to changes in interest rates. Due to their size and ease of borrowing from the European financial system, foreign banks are more susceptible to fluctuations in the volatility of the TL/US dollar exchange rate³⁰². Variations in exchange rates are influenced by a number of variables, such as national circumstances, market dynamics, and economic fundamentals. In contrast to economic theory, the Turkish lira depreciates when the price of benchmark Turkish government bonds rises. The USD/TRY parity is raised by buying actions and announcements of auction suspension or reduction³⁰³.



Source: Central Bank of the Republic of Turkey

Figure 6 :USD/TRY Exchange Rate

Increases in exchange rates cause the CPI to rise during periods of both low and high volatility. Productivity is not as important to consumer prices as economic uncertainty is. To reach more advantageous trade and price targets, authorities should also keep a careful eye on the various business cycle phases and areas³⁰⁴. Changes in "safe haven" portfolios are frequently cited as the cause of nominal exchange risk, which is a major consideration

³⁰² Karasoy, 1996, Management of Exchange Rate Risk in Turkish Banking Sector: A Model and Tests. Central Bank of the Republic of Turkey.

³⁰³ Öztürk, 2006.

³⁰⁴ Bilgili, F., Ünlü, F., Gençoğlu, P., & Kuşkaya, S. (2022). Modeling the exchange rate pass-through in Turkey with uncertainty and geopolitical risk: a Markov regime-switching approach. Applied Economic Analysis, 30(88), 52-70.

in the study of international economic policy. Nevertheless, not much focus has been placed on the analytical underpinnings of these phenomena, where decisions about setting prices, short-term interest rates, and asset values are influenced by risk³⁰⁵.

3.3. Exchange Rate Theories and Mechanisms.

The value and circulation of currencies are influenced by economic variables like speculation, shifts in demand, and relative price changes. Exchange rates are also impacted by political variables like rumors and conflicts. Rumors and misleading information can cause stress and unrest, which can have an impact on trade, financial markets, and economies. Wars, on the other hand, can boost demand for military goods and money circulation³⁰⁶. Exchange rate theories provide an explanation for the fluctuations and advancements in exchange rates. Gustav Cassel devised the three versions of the buying power parity theory: monetary, relative, and absolute. It is predicated on the idea that money's purchasing power is constant between nations. Monetary models and interest rate parity are two examples of financial techniques that relate exchange rate changes to financial variables³⁰⁷.

A record of economic exchanges between a country and the rest of the world, the BOP Theory focuses on how a country's BOP influences exchange rates. Foreign exchange rates increase, signifying a deficit, when demand for foreign currency exceeds supply. Although it incorporates exchange rate determination within the larger theory of value and permits minor revisions, this theory is unable to explain the genesis of particular exchange rate assumptions³⁰⁸. There are four periods for contemporary exchange-rate theories: short, medium, long, and extremely long. Only capital flows are significant over the short term; both the current and capital accounts are in balance over the long term. Models of cash-in-advance are handled individually. Because of news, speculative

³⁰⁵ Obstfeld and Rogoff, 2003, p.74-120.

³⁰⁶ Aouil & Mhaieni, 2023, March, Femfest International Conference on Economics, Management, and Business, 1, p.695-709.

³⁰⁷ Belhouchet & Lounis, 2016.

³⁰⁸ Weib, 2023.

bubbles, and the peso issue, many models fail econometric testing and fail to take currency exchange into account. No "true" model exists³⁰⁹.

The majority of writers adhere to the antiquated PPP hypothesis, which is generally acknowledged to be no more accurate in the short and medium term than stochastic forecasts. These textbooks, however, propose theories about exchange rates that are mostly devoid of empirical evidence and diverge greatly from the dominant theoretical framework. Changes in exchange rates have the potential to cause employment, output growth, financial crises, and economic development³¹⁰.

Three exchange rate regimes exist: collaboratively pegged, unilaterally pegged, and floating. Consumption levels determine welfare levels. Allocating to Pareto-efficient equilibrium is guaranteed by optimal insight. Under a floating system, a costless barter economy and the equilibrium allocation coincide. If parity is reached in the currency rate fixing authority of the pegged country, the equilibrium allocation in a unilateral peg is different. Conflicts between desirable monetary policies and policy coordination are also covered in the paper³¹¹.

The two countries' economic fundamentals, such as stock prices and the growth rates of their respective currencies, determine the nominal exchange rate, which is fixed. A nominal exchange rate that differs from the relative prices of the two currencies in the goods markets is required for direct currency exchanges³¹².

A balanced approach that emphasizes macroeconomic fundamentals and long-run PPP is necessary to comprehend exchange rates. Long-term PPP is prioritized over short-term price stability in traditional macroeconomic interpretations. The dispersion of the global commodity market and enduring deviance from the "law of one price" offer a dynamic general equilibrium model that replicates the volatility characteristics of actual exchange rates. Exchange rates are thought of as prices that shift to balance supply and demand in foreign exchange markets. They can be identified by making simplifications and are a part of the intricate global economy. The suitability of these simplifications

³⁰⁹ Visser, 1989, p.16-46.

³¹⁰ Priewe, 2017, *European Journal of Economics and Economic Policies*, 14(1), p.32-47.

³¹¹ Helpman, 1981, p.865-890

³¹² Head & Shi, 2003, *Journal of Monetary Economics*, 50(7), p.1555-1591.

varies with the evolution of the global economy and is contingent upon the time horizon for forecasting exchange-rate changes³¹³.

Exchange rates' dynamic nature, how they react to external shocks, and how they relate to endogenous variables like output, current account, nominal and relative prices, and interest rates. In order to analyze endogenous production variations, models that are compatible with observable correlations and market frictions are presented by the stochastic processes that influence exchange rates and other economic variables³¹⁴. Exchange rate pass-through and endogenous markups in the economy are explained by the sticky-wage model. It shows that after an exchange rate shock, aggregate import prices are prone to composition bias and low levels of pass-through coexist with high trade flows. Exogenous shocks are more persistent when firms reallocate³¹⁵.

The establishment of the equilibrium exchange rate can be achieved by effectively managing monetary policy. The pursuit of monetary policy rules, speculative attacks, price stability, "beggar thy neighbor" disputes, trade balance, current account, balance of payments, and other definitions of the equilibrium exchange rate make this difficult. Variations in exchange rates have both short- and long-term effects on output and employment, indicating that money is not neutral over the long term³¹⁶.

A consistent and long-term decrease in depreciation, interim reductions, fiscal contractions, and permanent contractions with fixed nominal wages or continuous inflation are only a few of the parameters on which the various scenarios perform well. But when it comes to boom-bust cycles and recessions in the tradables industry, these scenarios function differently. Subsequent investigations have to concentrate on comprehending the function of non-tradables in actual economies and designing efficacious stabilization strategies for transition economies³¹⁷.

The RER and PPP measurements, It indicates that while it is challenging to compare the prices of commodities in two nations using absolute PPP, it can be somewhat achieved

³¹³ Devereux, M. B. (1997). Real exchange rates and macroeconomics: evidence and theory. *Canadian Journal of Economics*, 773-808.

³¹⁴ Isard, 1978.

³¹⁵ Obstfeld & Stockman, 1985, p.917-977.

³¹⁶ Canale, 2002, <https://mpira.ub.uni-muenchen.de/3086/>.

³¹⁷ Rebelo & Vegh, 1995, p.125-174.

by utilizing price indices connected by the nominal exchange rate. The ratio of tradable to non tradable prices, on the other hand, represents the opportunity cost of transferring resources to produce GDP and is known as the real exchange rate³¹⁸.

When discussing international economic circumstances and policy, equilibrium exchange rates are essential because they provide insight into future exchange rate movements and can be used to calculate the cost of maintaining a particular entry price or modifying inflation rates. It is crucial to comprehend the reasoning behind observed fluctuations in exchange rates, particularly in open economies such as the UK where inflationary results can be influenced by trade effects. Determining which shock is most likely to account for observed fluctuations in exchange rates might aid in choosing the appropriate course of action³¹⁹.

UIP-based theories have replaced the monetary theory of exchange rate determination, which was prominent in the 1970s and 1980s. The theory can be saved by developing hybrid models that combine the most important ideas from the two theories. Based on this hybrid model, the monetary UIP (MUIP) model takes into account the relative supply and demand of various currencies as co-determinants of exchange rates. The empirical performance of open economy macroeconomic models may be enhanced using this model³²⁰.

The goal of exchange-rate determination theory is to comprehend the behavior of rational maximizing agents in a neoclassical setting. It highlights the need for excess supply in one market to meet excess demand in another. This theory emphasizes two key components: modeling a single market as dependent and examining how changes in exchange rates affect excess demand. It also serves as the foundation for analyses of expenditure-switching and expenditure-reducing measures taken in response to a payments deficit³²¹. International risk sharing, goods market clearing, and the intertemporal budget constraint all have an impact on the RER , which is a critical

³¹⁸ Yotopoulos, 1996, Exchange rate parity for trade and development: theory, tests, and case studies. Cambridge University Press.

³¹⁹ Driver & Westaway, 2013.

³²⁰ Cesa-Bianchi, Kumhof, Sokol & Thwaites, 2019.

³²¹ Krueger, 1983, Exchange-rate determination. Cambridge University Press.

component of international macroeconomic models. These factors influence its equilibrium dynamics, which in turn dictates future alterations and surprise level jumps. The intertemporal budget restriction shapes the long-run behavior of the real exchange rate, which is typically nonstationary. To comprehend how it spreads, more investigation is required.³²²

The transition from the perspective of trade flows to one of contemporary financial assets; the effects of exchange rate movements on macroeconomic conditions and how these effects affect monetary policy; the rationale behind exchange rate volatility; the selection of a regime; the benefits and drawbacks of capital flows; financial crises; and the responses of monetary policy under flexible regimes. While no single theory can account for exchange rate movements in all nations or historical times, it does have implications for how policy might be put into place to eventually address the primary drivers of exchange rate volatility³²³.

When comparing various exchange rate regimes, the effect of exchange rate risk on trade volume has garnered attention. It has been stated that because of unforeseen changes in currency rates, the 1973 floating regime decreased international commerce transactions. Nevertheless, the actual data on this effect is conflicting, with the majority of studies failing to uncover a meaningful correlation between trade volume and exchange rate variations³²⁴.

4.4. Mandel-Fleming Model and Exchange Rate Forecasts.

The Mundell-Fleming model is predicated on the idea that trade and finance flows work together to determine pricing. It also uses the use of monetary policy and fiscal policy, which essentially affect the exchange rate and the amount of capital circulation, to explain the internal and external balance in a way that provides an expected value for

³²² Itskhoki, 2021, *Annual Review of Economics*, 13(1), p.423-455.

³²³ Warjiyo, 2005, *Bulletin of Monetary Economics and Banking*, 8(3), p.1-17.

³²⁴ Dellas & Zilberfarb, 1993, p.641-647.

the currency. The exchange rate of the local currency is determined by supply and demand, which is also the underlying premise of this model³²⁵.

Table 2: Summary of the Following Theories

Theory	Promoter	Argument	Relevance
Mundell-Fleming Approach	Mundell & Fleming (1962)	The theory explains the relationship among exchange rates, interest rates, and output in an open economy. It clarifies that a nation cannot have unrestricted capital flows, an independent monetary policy, and a fixed exchange rate simultaneously.	The Mundell-Fleming approach is relevant for understanding the policy trilemma and the challenges faced by countries in managing their exchange rates and monetary policies.
Balassa-Samuelson Model	Balassa & Samuelson (1964)	The model predicts that differences in productivity growth between tradable and non-tradable sectors will lead to an appreciation of the real exchange rate in countries with higher productivity growth.	The Balassa-Samuelson effect model helps explain long-term trends in real exchange rates and the impact of productivity differentials on a country's competitiveness.
Productivity Effects Model	Balassa & Samuelson (1964)	This theory emphasizes the influence of productivity growth on economic growth and development, arguing that raised productivity levels lead to higher living standards and economic prosperity.	The model is relevant for understanding the importance of productivity-enhancing policies and investments in fostering long-term economic growth.

Source: Author, 2023

One important finding in open economy macroeconomics, the Mundell-Fleming model, indicates that the sort of shock that affects the economy determines the appropriate exchange rate regime. Flexible exchange rates are ideal when shocks are mostly monetary, whereas fixed exchange rates are ideal when shocks are primarily monetary. But this presumption isn't always accurate, particularly in underdeveloped nations³²⁶.

³²⁵ Ben Brika, 2007.

³²⁶ Lahiri, Singh & Vegh, 2008.

When coupled with a Keynesian-Hicksian model, the classical Mundell-Fleming exchange-rate determination model may explain how macroeconomic events and policies affect exchange rates. It offers a framework for looking at other global macroeconomic issues despite its limitations. The Mundell model provides clarity in the complicated debate around the behavior of exchange rates and the factors that influence foreign currency fluctuations³²⁷. The changes in Venezuela's real effective exchange rate using the Newey-West technique and the Mundell-Fleming model. The bolivar is predicted to devalue due to a number of factors, including an increase in the real money supply, a reduction in deficit spending, an increase in global interest rates, an increase in country risk, and an increase in anticipated inflation. To preserve the value of the bolivar, Venezuela must lower country risk through governmental stability, economic expansion, and a robust financial system³²⁸.

Regardless of whether the devaluation takes place under an IMF program, political leaders in developing nations have a nearly twofold increased risk of losing their positions within the six months that follow a currency fall. Because devaluations have contractionary implications, especially on the balance sheet, they are expensive. Instead of waiting to switch to short-term dollar loans, governments should make the necessary adjustments as soon as inflows stop in order to lessen this production decline. Increased trade openness can lessen a country's susceptibility to abrupt pauses and currency crashes³²⁹.

According to the Mundell-Fleming model, an open economy with a flexible exchange rate and mobile capital is resistant to shocks from outside sources, with the exception of fluctuations in interest rates. While rises in interest rates weaken the value of the home currency and increase output, gains in foreign income or prices balance net exports. Fiscal policy is useless if domestic prices are fixed³³⁰. Expansive monetary policies are contractive, raising country risk and raising domestic interest rates, according to the Mundell-Fleming model. Growing government deficits and stifling private spending make fiscal measures less effective. According to the model, Argentina's expansive

³²⁷ Johnson, Zuber & Gandar, 2005, *Journal of Economics and Finance Education*, 4(2), p.22.

³²⁸ Hsing, 2006.

³²⁹ Frankel, 2005, *IMF staff papers*, 52(2), p.149-192.

³³⁰ Sarantis, 1986, *of Post Keynesian Economics*, 9(1), p.138-148.

monetary policies between 1991 and 2000 would have resulted in lesser reserves, higher interest rates, and reduced output³³¹. The best exchange rate plan to use the MF framework when Eastern European nations join the common European currency zone. A rigorous modeling experiment demonstrates that a float regime would improve overall welfare and function as a more effective short-term shock absorber. For nations with less solid macroeconomic foundations and less credibility, harsher regimes are advised. The welfare outcomes withstand the preferences of policymakers³³².

Both expansionary monetary and fiscal policies can be used to boost economic growth, albeit each policy's efficacy varies depending on the exchange rate system in place. Fiscal policy affects growth in nations with fixed exchange rates by increasing government expenditure, whereas monetary policy affects growth in nations with variable exchange rates by increasing the money supply³³³. A two-sector growth model based on a regulated capital account, tight credit and monetary policies, and a pegged exchange rate can explain the East Asian crisis and its success. In the 1990s, liberalizations brought about by the end of the Cold War increased real wages and created asset price imbalances. East Asia, like Taiwan, has an opportunity to go back to its roots as a result of the currency crisis³³⁴.

In light of local currency pricing, the Friedman-Feldstein argument for flexible exchange rates is reexamined since it implies that the stabilizing effect of flexible exchange rates may not be as powerful when producers set prices in consumer currency. Additionally, not all producers or items in all nations experience the same level of exchange rate transmission; in fact, simple homogenous goods experience a higher exchange rate transmission than complex goods³³⁵. Monetary shocks to the money supply and demand for real money balances account for a sizable portion of the variation in real exchange rates with respect to the dollar for Germany and Japan. Supply shocks account

³³¹ Ortiz & Rodriguez, 2002, *Journal of Applied Economics*, 5(2), p.327-348.

³³² De Souza, 2002.

³³³ Nenkova and Kovachevich, 2022, p.141-149.

³³⁴ Fabella, 1999, *The Manchester School*, 67(5), p.475-495.

³³⁵ Engel, 2000, *European Economic Review*, 44(8), p.1449-1472.

for very little of the variance, but demand shocks account for most of it. The short-run dynamics of the model agree with the predictions of the Mundell-Fleming model³³⁶.

The analysis concludes that the most significant factor in influencing expectations for exchange rates is predicted gross domestic product. When it comes to the DM/US dollar expectations, the Mundell-Fleming type model fits the data well, although high predicted interest rates are a sign of a weak currency³³⁷. Trade volume and exchange rate volatility have a negative connection, indicating that trade volume and volatility are causally related. Any nation's ability to improve its economic performance depends on having suitable exchange rates and effective exchange rate regulations. Among the suggestions include putting measures into place to strengthen economic stability and diversify the economy, as well as keeping an eye on exchange rate fluctuations to lower uncertainty and boost domestic output³³⁸.

The Mundell-Fleming model describes price stability, gradual output adjustment, and durable equilibria in asset markets as the relationship between exchange rates and output. When output volatility rises, exchange rate target areas also lessen asset market volatility. Speculative activity and the collapse of the target area may result from real shocks that force the equilibrium RER outside of the currency range³³⁹. Positive reactions to productivity and private consumption are produced by Spain's government expenditure, and rising housing prices and persistent nominal appreciation account for real appreciation. External competitiveness remains largely unaffected by financial shocks even after the unified currency is adopted. Primary and trade budget deficits result from public expenditure shocks because private agents fail to account for the potential long-term effects of public spending³⁴⁰.

A comparative static mechanism for examining discretionary monetary policy under various exchange-rate regimes was first presented by Mundell in a 1963 work. He compared the efficacy or inefficacy of capital mobility for monetary and fiscal policy under fixed and flexible rates, conceptualizing it as complete or "perfect". Analysis and

³³⁶ Clarida & Gali, 1994, December.

³³⁷ Schröder & Dornau, 2002, *Applied Financial Economics*, 12(8), p.535-543.

³³⁸ Danladi, 2015

³³⁹ Kempa & Nelles, 1998, p.603-619.

³⁴⁰ De Castro and Fernández, 2013, p.151-180.

policy have been greatly impacted by Mundell's vision in foreseeing future changes in financial markets and international monetary arrangements³⁴¹. Impacts of government expenditure using the Mundell-Fleming model in fixed and variable exchange rate regimes. The short- and long-term effects of debt-financed and tax-financed increases in government spending in an environment with fully linked global capital markets and no active monetary policy. Changes in exchange rates have an impact on debt revaluation, which affects short-run output multipliers³⁴².

Exchange rate prediction is a difficult task. Large data sets are being used more often in econometrics research to integrate data from several factors. With mean-square prediction errors slightly lower than those of random walk predictions, Bayesian mean models are helpful for out-of-sample exchange rate forecasting. However, the improvements are minor³⁴³. There is no exchange risk premium to account for the forward discount bias in future spot exchange rate forecasts. Trading volume and exchange rate volatility are impacted by forecasters' tendency to extrapolate current trends over short time horizons while anticipating a reversal over long time horizons³⁴⁴.

Financial markets employ the non-parametric NN forecasting technique to anticipate high-frequency data. NN forecasts, which can be thought of as a generalization of technical trading principles, are predicated on the notion that historical time series may resemble future ones. Similar patterns of activity are used by NN to construct forecasts, and the temporal evolution of these NN approaches is utilized to provide the intended prediction NN, however, have not been found to be as successful in enhancing point prediction in exchange-rate markets by earlier research³⁴⁵.

Order flow, or net cash transactions started by a seller and a buyer, is closely related to the daily fluctuations in exchange rates. This method proposes that order flow has a direct and indirect impact on exchange rates due to macroeconomic knowledge. Although order flow has a stronger ability to explain exchange rate behavior than macro variables,

³⁴¹ Boyer, 2002, Nobel Laureate in Economic Sciences, p.119.

³⁴² Exposition, 1987, Staff Papers-International Monetary Fund, 34(4), p.567-620.

³⁴³ Wright, 2008, p.329-341.

³⁴⁴ Frankel & Froot, 1990.

³⁴⁵ Fernandez-Rodriguez, Sosvilla-Rivero & Andrada-Felix, 1999, International Journal of forecasting, 15(4), p.383-392.

this does not imply that order flow is the main factor³⁴⁶. Can exchange rates be predicted by structural models in a short amount of time? To a certain degree, the answer is affirmative, although overestimation has resulted from test misinterpretation, over-reliance on asymptotic test statistics, and neglect to verify robustness in alternate time windows. The methods required to provide reliable forecasts for the majority of exchange rates have not been created in the literature on exchange rate forecasting³⁴⁷.

Foreign exchange rates can be accurately predicted by artificial neural networks, and their performance can be enhanced by adjusting elements that influence it. New prospects for using neural network technology to predict exchange rates will arise with the development of artificial intelligence and computer-based systems³⁴⁸. Making financial and managerial decisions depends on forecasting financial data, such as interest rates, currency rates, stock markets, and bankruptcies. People purchase and sell currencies at exchange rates, and they make investments in nations depending on their potential for profit. Forecasting models, economic calculations, and factors influencing currency valuation are crucial. For a robust economy, nations must keep a careful eye on these variables and advance their forecasting techniques³⁴⁹.

³⁴⁶ Rime, Sarno & Sojli, 2010, p.72-88.

³⁴⁷ Rogoff & Stavrakeva, 2008, the continuing puzzle of short horizon exchange rate forecasting (No. w14071). National Bureau of Economic Research.

³⁴⁸ Juhn and Mauro, 2002.

³⁴⁹ Patel, Patel & Patel, 2014, International Journal of Application or Innovation in Engineering & Management, 3(3), p.53-56.

Conclusion

In order to improve the quality of life in contemporary states and devise methods for sustainable development, the interaction between politics and economics is essential. The purpose of this research is to clarify the interplay between political and economic issues and how it impacts state stability and the accomplishment of national objectives. The main variables influencing these dynamics were found using a thorough analytical approach, and the outcomes were consistent with recently published research in the area. Because they establish the laws and guidelines that direct economic policies, political institutions play a crucial role in the process of making economic decisions. The findings demonstrate that the ability of governments to carry out economic policies in a way that promotes stability and growth is improved by the existence of robust and functional institutions. In this particular context, the findings show that nations with robust democratic institutions—such as accountability and transparency—achieve superior economic results in comparison to those with weaker institutions.

Economic policy is also greatly influenced by pressure organizations, which include powerful corporations and special interests. These organizations frequently prioritize their personal interests over the good of the public, which results in competing political and economic objectives.

These groups have the potential to obstruct the adoption of new policies, which emphasizes how crucial it is to include them in economic models in order to comprehend the dynamics that exist in democracies today. The success of economic policy is also significantly impacted by issues of poverty and inequality.

The public and decision-makers in high poverty and inequality countries lack trust in each other, which makes it difficult to put policies in place that are essential for sustainable development. In order to address these issues, economic policy must encourage inclusivity and close social divides. As a result, since sustainable development is a fundamental component of the modern period, governments ought to prioritize it in their economic strategies. Political institutions must collaborate with business and civil society in order to attain sustainability. This will increase their capacity to accomplish shared objectives, which will raise living standards and improve people's quality of life.

The formation of national economic policies is significantly influenced by international interactions. The findings demonstrate that international collaboration, particularly economic alliances, improves nations' capacity to share resources and expertise, which promotes economic growth. But nations also need to be mindful of the political and economic pitfalls that might result from depending too much on foreign allies. As a result, emphasis should be on fiscal and monetary policy as well as economic performance.

The management of interest rates and the money supply are two key components of monetary policy, which greatly affects investment and inflation. However, fiscal policies—that is, government choices on taxes and spending—are crucial for fostering economic expansion. The findings imply that achieving economic stability may be facilitated by coordinating these two categories of measures.

In the global economy, exchange rates have a significant impact on the value of both domestic and foreign currencies. Changes in exchange rates have an impact on inflation rates, foreign investment flows, and international trade. This study attempts to clarify the ways in which fluctuations in exchange rates impact economic performance, with particular attention to the political and economic aspects of this relationship. enhanced international trade and enhanced investor confidence are two benefits of stable currency rates. Companies may plan more effectively and lower the costs of price-related hazards when exchange rates are steady.

Studies indicate that nations with more stable exchange rate regimes have seen faster economic growth than those with more volatility. Consequently, changes in exchange rates raise the cost of imports, which has a detrimental impact on regional businesses that rely on imported raw materials. Local prices are impacted by this, which raises the rate of inflation.

The findings also show that because of their limited capacity for adaptation, small and medium-sized businesses are the most impacted by these variations. In order to predict the future and prevent possible losses and damages, businesses must thus keep a careful eye on both domestic and international markets and take note of any recent developments in the political and economic spheres. Exchange rates are thus directly impacted by

political stability. Stronger currencies are the result of higher foreign investment in nations with stable political systems. On the other hand, a substantial drop in the value of the currency can result from geopolitical unrest or political unrest, which has an impact on the entire economy.

A significant factor in the volatility of exchange rates is geopolitical conflicts. Investors often shift their money into safer currencies during times of turmoil, which causes the value of the affected currency to decline. This emphasizes how important it is to comprehend the geopolitical setting when examining exchange rate volatility. Government statistics and political remarks have a significant impact on market expectations as well. Investor confidence in the local currency tends to increase when governments reveal data demonstrating economic stability, therefore increasing the value of the currency. Statements that are unclear or negative may contribute to the currency's depreciation. As a result, political stability boosts investor confidence and promotes monetary stability.

Furthermore, the importance of fiscal policies—such as taxation and government spending—in influencing exchange rates has been highlighted. Governments that implement expansionary fiscal policies run the risk of making the local currency weaker as a result of rising public debt. Conversely, carefully considered fiscal policies could help to improve currency stability and draw in foreign capital. Contextual factors influence economic growth even when it comes to the exchange rate regime chosen by the government. Fixed regimes may increase volatility during times of crisis, whereas flexible regimes may help economies respond more effectively to external shocks. Countries must carefully weigh their alternatives in light of their unique political and economic situations.

Government policies have a significant impact on exchange rates, which are a critical factor in determining the value of both local and foreign currencies. These policies, whether monetary or fiscal, have an impact on the balance of payments, investment trends, and the state of the economy. With an emphasis on the intricate relationships between these components, this study attempts to examine how governmental policies impact exchange rates and overall economic performance. Fiscal policies, such as tax and spending reductions, have a direct impact on the demand for local currency. The

stimulation of economic activity through increased government spending on exports and manufacturing results in more demand for the currency. In order to prevent inflation, these policies must be balanced.

The data show that increasing manufacturing, exports, and government spending can all help to narrow the trade imbalance, which in turn strengthens the value of the local currency. Therefore, the central bank's monetary policy, which regulates interest rates and the money supply, has a significant impact on exchange rates. The findings indicate that lowering interest rates may attract both foreign and domestic investment, raising the value of the currency. On the other hand, higher interest rates may draw in foreign capital, but they can cause erratic and illogical financial flows, which in turn cause exchange rate volatility.

Furthermore, we observe that trade regulations like tariffs and quotas have an impact on exchange rates as well as the balance of payments. Import limitations could strengthen the balance of payments and boost the local currency. But these approaches could also provoke unfavorable responses from allies, which would damage trade ties. As a result, we advise using greater caution while making decisions and keeping in mind that the government ought to treat other nations equally. That being said, since strengthening connections with neighboring countries can lead to shared political and economic objectives, the government is still free to show love and friendliness by lowering customs taxes on certain items.

Research indicates that democratic political occurrences like elections and the establishment of governments raise market uncertainty. But these occurrences cannot account for all of the volatility in the currency market. The results imply that investors would find it challenging to predict changes in currency prices during these times, which heightens volatility. One instance of how governmental policies impact exchange rates is the situation surrounding the Chinese yuan. While the renminbi's depreciation has boosted economic growth and job creation in China, it has also increased the nation's susceptibility to financial threats. The results imply that political goals could occasionally take precedence over economic efficiency.

A small, open economy's best monetary strategy should be to keep interest rates as low as possible. The advantages of sustainable growth and future consumption must be weighed against this strategy, keeping in mind any potential negative effects of low real cash balances. Given the emphasis on low interest rates, the dangers involved must be carefully considered. Expansionary monetary policies may cause inflation or financial market volatility in an unstable economic climate, which would be detrimental to exchange rates.

Exchange rates have a significant impact on the world economy and are strongly correlated with developments in geopolitics. The purpose of this study is to investigate how political upheaval and crises impact currency rates and the world economy as a whole. We'll talk about the research on the effects of geopolitical events and how markets and governments respond to these factors.

The findings demonstrate that regional conflicts and other geopolitical events have a direct impact on currency values. For instance, the Israeli occupation of the Gaza Strip and other regional tensions in the Middle East have made financial markets more volatile. The depreciation of currencies linked to the region is caused by investors withdrawing their funds when tensions escalate.

An examination of currency rate data during turbulent times, when currencies associated with hostilities saw notable drops, supports this. Exchange rate markets and geopolitical developments are also causally related in both directions. For instance, during the times when they occurred, the COVID-19 pandemic and the conflict between Russia and Ukraine had a major effect on exchange rate markets.

These benefits started to fade as the conflict went on, indicating that geopolitical concerns might affect market expectations for particular time periods. Reactions to crises by the international community have a significant impact on economic expectations. The response of the international community, such as humanitarian relief, has an impact on the stability of exchange rates.

In times of crisis, higher levels of international assistance can also raise the value of a local currency, indicating the significance of international contact in fostering economic stability. Not to be overlooked are the oil markets, which are heavily impacted by news

on geopolitical developments. Uncertainty and increased trade volume are caused by news about political disputes. The real-time impact of economic data on oil prices further muddies the connection between geopolitical developments and financial markets.

Empirical evidence indicates that political risks heighten market uncertainty. Political upheaval has a significant impact on investors' strategy, which in turn affects their investment selections. As a result, businesses and investors might want to stay away from erratic markets, which makes local currencies more vulnerable. Several other factors, such as the supply and demand for currencies, also have an impact on exchange rates. An increase in investment or trade leads to a rise in the demand for a specific currency, which in turn drives up its exchange rate. The value of the currency diminishes when demand declines as a result of political unrest or crisis. This emphasizes how crucial it is to have a thorough grasp of both political and economic aspects in order to evaluate changes in exchange rates.

Governments can impose fixed exchange rates, which might not accurately represent the value of the market. Although economic instability may result from allowing exchange rates to fluctuate, the deliberate process of determining exchange rates necessitates a detailed examination of political and economic factors. Since uncertainty is measured as a percentage change in real exchange rates, it represents a significant risk in international trade.

The findings demonstrate that considerable fluctuations in exchange rates might have unfavorable consequences on trade volumes, necessitating the implementation of suitable risk management policies by governments. Exchange rate increases may also result in higher import prices, which lowers business profitability. Furthermore, investors' judgments may be impacted by volatility as they steer clear of uncertain markets, which makes it more difficult for multinational companies.

Effective tools for controlling exchange rate risks are hedging strategies. Research indicates that companies with hedging instruments have more consistent financial results than those without. This illustrates how crucial risk management is to preserving competitiveness and financial performance. Trade is adversely affected by exchange rate volatility, with the degree of this impact varying according to production structure and

hedging instruments. This link highlights the need for countries to take action to improve exchange rate stability in order to promote international trade.

An important component affecting both national economies and international trade is exchange rates. The value of currencies in financial markets is determined by many valuation techniques and market mechanisms, which influence the structure of the world economy. The various theories surrounding exchange rates, the possible outcomes of monetary policy, and the significance of economic projections in managing uncertainty are all highlighted in this paper. The findings support the theory that supply and demand dynamics reacting to shifts in economic activity control exchange rates. An increase in trade or investment leads to a rise in demand for a specific currency, which in turn causes the exchange rate to appreciate. The examination of economic data, which demonstrates how exchange rates fluctuate in response to demand around the world, makes this clear.

Forecasts of exchange rates are influenced by a number of variables, such as shifts in the economy and interest rate differentials. According to the idea of "changing time patterns of risk," investors should reevaluate their projections in light of fresh economic information. Different models, like the "front-end price gap," have been put out to explain discrepancies in expectations. As a result, forecasts are not wholly scientific and instead depend on judgment, gut feeling, and data analysis. Forecasts can be a useful tool for assessing risk, but their accuracy is not always guaranteed. This shows how crucial it is to use a variety of analytical techniques when creating forecasts since doing so can help to lower uncertainty.

Grasp the relationship between exchange rates and monetary policy in open economies requires a grasp of the Mundell-Fleming model. The findings demonstrate how changes in interest rates and fiscal policy have an impact on exchange rates and capital flows. Under fixed exchange rates, where the fiscal policy multiplier eventually rises, the effect is most pronounced. Both fixed and flexible exchange rate regimes have an impact on output; however, the impact of fiscal policy is greater in fixed regimes. These findings contribute to our understanding of economic dynamics and the ways in which policies influence economic growth. The Mundell-Fleming model has drawbacks despite its advantages. When applying the model to actual economic settings, researchers should be

aware of these limitations as political and international economic considerations may have an impact on the model's outcomes.

This does not, however, lessen the need of examining projections, as they are essential in converting uncertainty into controllable risks. Economic data can be systematically analyzed to assist lower uncertainty and encourage evidence-based decision-making. Forecasts are a crucial tool for identifying future trends for investors and decision-makers. Forecasts that are accurate help investors make well-informed judgments about their investments. Price projections are used by businesses as a component of their investment strategy, which affects how they react to shifts in the market. Based on the findings, currency rates have a direct impact on international trade. Volatility in exchange rates raises uncertainty, which may cause trade volume to drop. Research indicates that a stable exchange rate encourages trade expansion, necessitating currency protection measures on the part of nations.

As a result of the search, Politics and economics have a multifaceted, intricate interaction. When creating and executing policies, policymakers need to consider political, social, and economic aspects. The public's trust in decision-makers is increased by transparency and accountability, and this helps to improve the efficacy of economic policies and the accomplishment of national objectives. Achieving sustainable growth and economic stability requires collaboration between nations and between political and economic institutions. To gain a deeper understanding of the evolving interactions between politics and economics, it is imperative to keep investigating the existing gaps in the literature.

We stress how crucial it is to comprehend the intricate interactions that exist between political, economic, and exchange rate concerns. The different aspects of this relationship need to be considered by policymakers when creating plans for economic development. In order to guarantee sustainable growth, stable political conditions, responsible budgetary measures, and knowledge of the geopolitical environment are all necessary for enhancing exchange rate stability.

It is critical to comprehend how exchange rates, governmental policies, and economic success are interconnected. In order to ensure that economic goals are met without

jeopardizing monetary stability, policymakers must consider both political and economic concerns while developing development strategies. In order to guarantee sustained economic growth and financial stability, this calls for a thorough examination of the effects of fiscal and monetary policy.

The global economy, exchange rates, and geopolitical developments are all intricately entwined. To maintain the stability of the national economy, policymakers must consider both political and economic factors while developing development policies. Improving exchange rate stability necessitates a coordinated approach between well-considered monetary and fiscal policies and a strong ability to handle any geopolitical obstacles that a nation may encounter.

It is crucial to comprehend the mechanics underlying various economic models and the establishment of exchange rates. When making decisions, investors and policymakers need to consider the intricate relationships between economic growth and currency rates. In a changing global context, attaining economic stability and sustained growth requires improving forecasting and risk management techniques.

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