International Journal for Multidisciplinary Research (IJFMR)

E-ISSN: 2582-2160 ● Website: www.ijfmr.com ● Email: editor@ijfmr.com

Examining the Relationship Between Geopolitical Events and Currency Market Dynamics

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Abstract

This paper delves into the intricate relationship between geopolitical events and exchange rates, aiming to provide a comprehensive understanding of how geopolitical factors influence the currency dynamics of a country and strategies to mitigate their impact. Geopolitical events, ranging from political tensions and conflicts to trade disputes and diplomatic relations, have profound implications for exchange rate stability and volatility. Through a multidimensional analysis integrating economic, political, and social perspectives, this study examines the mechanisms through which geopolitical events transmit their effects onto currency markets. Drawing on empirical evidence, theoretical frameworks, and historical trends, the paper elucidates the channels through which geopolitical risks influence exchange rate movements, offering insights for policymakers, investors, and market participants. Additionally, the study explores strategies to mitigate the impact of geopolitical risks on exchange rates, including prudent policy measures, risk management techniques, and hedging strategies. By enhancing our understanding of the interplay between geopolitics and exchange rates, this paper aims to empower stakeholders to navigate the challenges posed by geopolitical events effectively and safeguard against potential adverse effects on currency stability and economic well-being.

Keywords: Geopolitics, exchange rates, currency valuation, economy

Introduction

The intricate interplay between geopolitics and exchange rates remains a subject of profound interest and scrutiny in the realm of international finance and economics. Geopolitical events, encompassing political tensions, conflicts, diplomatic relations, trade agreements, and other geopolitical factors, exert a significant influence on the stability and fluctuations of a country's exchange rates. These dynamics reflect the intricate balance between domestic policies, global economic trends, and geopolitical developments that shape the trajectory of exchange rate movements.

The exchange rate of a country's currency serves as a pivotal indicator of its economic health and standing in the global market. It plays a crucial role in determining the competitiveness of a nation's exports, the attractiveness of foreign investments, and the overall stability of its economy. Geopolitical factors, however, introduce a layer of complexity that can disrupt the conventional forces of supply and demand in currency markets.

Geopolitical events can trigger abrupt shifts in investor sentiment, leading to heightened volatility and uncertainty in currency markets. Political turmoil, armed conflicts, trade disputes, sanctions, and geopolitical alliances can all impact the perceived risk associated with holding a particular currency, thereby influencing its exchange rate vis-à-vis other currencies. Moreover, geopolitical developments may prompt policymakers to implement monetary policies or interventions aimed at stabilizing exchange rates, further complicating the relationship between geopolitics and currency values.

Understanding the impact of geopolitics on exchange rates requires a multidimensional analysis that integrates economic, political, and social factors. Academic research, empirical studies, and real-world observations offer valuable insights into the mechanisms through which geopolitical events transmit their effects onto currency markets. By unraveling these complexities, policymakers, investors, and market participants can better navigate the challenges posed by geopolitical risks and devise strategies to mitigate their impact on exchange rate dynamics.

In this context, this paper seeks to explore the nuanced relationship between geopolitics and exchange rates, shedding light on the mechanisms through which geopolitical events influence currency movements. By examining historical trends, theoretical frameworks, and empirical evidence, this study aims to contribute to a deeper understanding of how geopolitical factors shape the exchange rate dynamics of a country, offering valuable insights for policymakers, investors, and researchers in the field of international finance and economics.

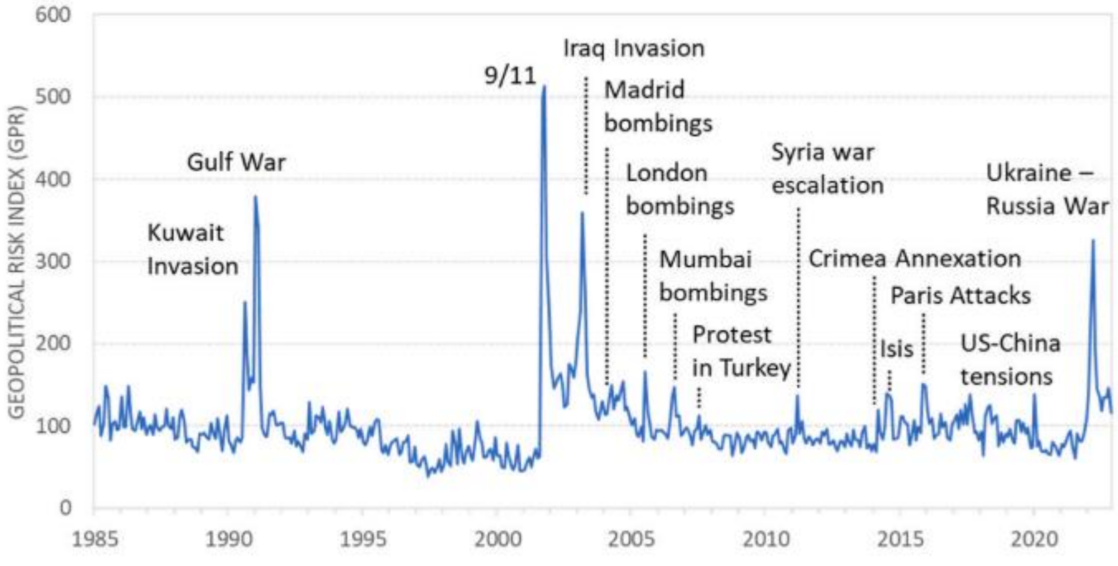

Fig. 1. The geopolitical risk index (from 1985 to 2022). Source: Reference [9].

Literature Review

Paresh Kumar et. al. (2014), the graph depicting currency trading in India has experienced a significant surge in recent years, necessitating the development of more effective methods for analyzing currency movements. Currency, being a highly uncertain and unpredictable instrument, is influenced by numerous factors. As a result, people are increasingly turning to currency futures as an investment avenue, enabling them to trade various currencies based on the prevailing economic conditions of the country. Prior to making investments, it is crucial to discern the impact of different factors on the currency's index value. The objective of this paper is to outline the primary factors influencing currency rates, with a focus on economic formulas derived from economic theory to assess the currency's health, along with useful prediction models for currency exchange rates. [1]

Y. V Reddy (2002), The paper delves into several key inquiries: What exactly are forex reserves, and what prompts the decision to maintain them? How has this policy evolved over time? What constitutes an optimal level of reserves? And how does the current situation measure up in terms of indicators of reserve adequacy? Additionally, the author directs attention towards various facets of forex management, including its ramifications on quasi-fiscal deficit and the communication policy of the RBI. The intricacies surrounding the policy formulation and management of forex reserves in India are scrutinized in depth. Finally, the concluding section offers some speculative musings from a futuristic standpoint.[2]

Hon Chung Hui (2022), The primary objective of this paper is to analyze the long-term association between geopolitical risk and exchange rates within four ASEAN countries. We enhance existing theoretical models of nominal exchange rates found in literature by incorporating the geopolitical risk index developed by Caldara and Iacoviello (2019). Subsequently, we estimate these augmented models utilizing the ARDL approach to Cointegration. The findings of this research hold implications for various stakeholders including entrepreneurs, central banks, portfolio managers, and arbitrageurs engaged in active trading within financial markets. A deeper comprehension of how geopolitical events impact the portfolio of financial assets across different nations can offer financial market participants significant advantages. Additionally, entrepreneurs can develop effective hedging strategies based on these insights. This study contributes to the examination of the connections between political risk and foreign exchange markets, representing the initial endeavor to apply the geopolitical risk index formulated by Caldara and Iacoviello (2019) to the analysis of foreign exchange markets within ASEAN countries.[3]

Wenqi Duan (2021), The Venezuelan economy, heavily reliant on oil, is significantly impacted by geopolitical instability, leading to hyperinflation and devaluation of the national currency. Therefore, this study aims to investigate the interplay among geopolitics, exchange rates, and oil prices using Wavelet analysis for the period spanning from 2008 to 2019. The findings indicate a bidirectional causal relationship between oil prices and exchange rates from 2017 to 2019, as well as a mutual causality between geopolitics and oil prices during the same period. Furthermore, a medium-term co-movement between geopolitical risk and exchange rates is observed from 2015 to 2019. Notably, there is evidence of a causal relationship between oil prices and exchange rates from 2008 to 2011 and again from 2018 to 2019. These results align with theoretical models and reflect the actual economic dynamics. Drawing from our findings, we speculate that Venezuela must reduce its reliance on oil, given its vulnerability to geopolitical risks, steer clear of regional conflicts, and effectively manage exchange rates to foster sustainable economic growth.[4]

Afees A. Salisu (2021), This study investigates the predictability of exchange rate volatility in the BRICS nations in response to geopolitical risks (GPR), utilizing both historical and recent GPR data. Employing the GARCH-MIDAS-X model with available data frequencies, our findings reveal that BRICS exchange rates are more sensitive to recent GPR data compared to historical data. Further analysis indicates divergent outcomes between recent global GPR data and country-specific GPR data, suggesting that BRICS exchange rates are more influenced by global rather than domestic GPR. Moreover, we uncover some out-of-sample economic benefits associated with incorporating GPR into the assessment of foreign exchange portfolios.[5]

Bernard Njindan Iyke (2022), We formulate the hypothesis that geopolitical risk is a significant predictor of exchange rate returns. By analyzing data from 17 countries, we provide evidence that the information contained within geopolitical risk indicators holds economic value and enhances the accuracy of exchange rate return forecasts. Our findings indicate that geopolitical risk predicts the returns of 10 out of 17 (59%)

exchange rates in in-sample tests, while in out-of-sample tests, predictability is observed for 88% of currencies. Utilizing buy and sell signals generated by our model results in higher returns compared to those generated by a historical average model. Furthermore, our model outperforms the benchmark model, yielding excess profits relative to the benchmark in 11 out of 17 (65%) currencies.[6]

Manuel Monge (2023), The necessity for enhanced statistical modeling in response to the influence of geopolitical risk on energy markets, particularly in the crude oil markets and the shipping industry, has garnered significant attention. This study examines the behavior of the West Texas Intermediate crude oil price and the Baltic Dry Index under the influence of geopolitical risks, utilizing monthly data spanning from January 1985 to May 2021. Employing fractional integration methods, the findings suggest that geopolitical risk and the Baltic Dry Index series tend to revert to their initial trends following an exogenous shock, contrasting with the behavior observed in West Texas Intermediate prices. These conclusions are further supported by analyzing the long-term relationship of the time series through the Fractional Cointegration Vector AutoRegressive approach. Additionally, we utilize Bai and Perron (2003) and wavelet transform methodologies to identify disruptions in maritime transport prices and crude oil prices triggered by geopolitical risks.[7]

Conclusion

In conclusion, this paper has shed light on the significant impact of geopolitical events on exchange rates and provided valuable insights into strategies for mitigating such effects. By comprehensively analyzing the complex relationship between geopolitics and currency dynamics, we have deepened our understanding of the mechanisms through which geopolitical risks influence exchange rate movements. Moreover, the exploration of various mitigation strategies, including policy measures and risk management techniques, underscores the importance of proactive approaches in safeguarding against potential adverse consequences. As geopolitical uncertainties continue to shape the global economic landscape, the findings of this study hold relevance for policymakers, investors, and market participants seeking to navigate the challenges posed by geopolitical risks effectively. By incorporating these insights into decision-making processes and adopting prudent strategies, stakeholders can better position themselves to manage the impact of geopolitical events on exchange rates and promote stability in the international financial system. Ultimately, the pursuit of a deeper understanding of the interplay between geopolitics and exchange rates is essential for fostering resilience and enhancing economic prosperity in an increasingly interconnected world.

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