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# The Impacts of the Political Uncertainty on the Currency Exchange Rate

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**Abstract.** This paper examines the impacts of political uncertainty on the currency exchange rate, taking the fluctuation of the LBP exchange rate against USD dollar in the black market as a practical case. It shed light on the most important political events and decisions that happened in Lebanon and the region during the period (2019-2021) and linked it directly to currency exchange rate, to show the impacts of the political instability on the LBP/USD exchange rate. We depend on the daily observations of LBP exchange rate in the central bank and black market to perform empirical tests and regression model and we gathered the political events and news from the National News Agency (NNA). The results show that the political uncertainty and instability has a direct impact on the currency exchange rate.

**Keywords.** Political Uncertainty; Exchange Rate; Lebanese Pound; USD dollar

## 1. Introduction

Politics considered as a set of activities and practices carried out by governments which helps in setting up the general frameworks for the economic, financial and social policies that serve the interests of states and their people. Politics is closely linked to these policies, where Gupta (2018) addresses that politics is closely related to the economic and financial policy of any country, considering that the nature of the political system and the ruling political class are the ones that set the general frameworks for economic policy. Also, Osterloh (2010) mention that the political environment of the country can affect its economic performance in different domains.

Economic prosperity has always been associated with political stability and security, as it is well known that unstable political environments contribute to weakening the national economy and alienating investors. As for Aisen and Veiga (2011), political instability considered as a serious condition harmful to the economic performance. Political instability reduces policymakers' prospects leading to suboptimal short-term in the macroeconomic policies. In addition, political uncertainty may lead to more frequent switching of policies, which leads to many fluctuations and negatively affects the local economy.

Political instability is the inability to resist internal and external shocks that disturb the socio-economic system as it defined by the World Bank (1997). Many researchers investigate the impact of the political uncertainty on the economic growth and exchange rate,

such as Easterly and Rebelo (1993); Benhabib and Spiegel (1992) who argued that political instability reduces the volume of investment which consequently hurts employment and productivity, decreases income, and eventually leads to inflation. In addition, Howell and Chaddick (1994) mention that the political risk which consists of political decisions and events affecting the business environment, which lead the investors to recall their investments where profit margin decreases.

During the past years, Lebanon has witnessed many internal political crises, the most important of which is the civil war, in addition to its exposure to many external attacks. Lebanon has also witnessed an economic crisis that began many years ago and continues to this day, followed by the spread of the COVID-19 epidemic and the explosion of the port of Beirut (Aug. 2020). In addition to the inability of successive governments during the last years to find appropriate solutions to the political and economic situation, and their fall in the street in front of the demands of the Lebanese protestors. These events contributed mainly to weakening the national economy, and lessen the value of the Lebanese pound against foreign currencies. The collapse of the Lebanese pound's exchange rate against the dollar began in the mid of 2019 until today, where the Lebanese pound has greatly lost its value, and affected negatively the purchasing power of citizens and their ability to access basic commodities, (NNA, 2021).

In this paper, we address the impacts of political uncertainty on the currency exchange rate, taking the LBP exchange rate against USD dollar in the black market as a practical case. The paper linked the political events with the fluctuation of the currency exchange rate over 3 years, where there are few studies about the topic. Therefore, this paper show how the political instability and uncertainty affects the exchange rate for Lebanese pound during the period [2019-2021].

According to the nature of the topic and the data collected in this study. This paper is useful for academics specializing in finance and economic field, as the study shows the impacts of political uncertainty on the currency exchange rate, taking the fluctuation of the LBP exchange rate in the black market as an example. The results of this study can be adopted in subsequent studies for those who interested in this field and can assist economic analysts by adopting the results of this study in analysing similar cases.

The rest of the paper is structured as follows. Chapter 2, addresses the theoretical background and hypothesis of the study. Chapter 3, describe the data and methodology, that include the empirical tests. Chapter 4 show the results and discussion of the study. Chapter 5 includes the conclusions and limitations.

## **2. Theoretical Background & Tested Hypothesis**

Political situations such as uncertainty and instability have a lot of impacts on the financial and economic sector especially on the currency exchange rate. So, to what extent can the recent Lebanese political atmosphere affect the exchange rate of the Lebanese Pound against USD dollar?

There are many studies and articles about the impact of politics on the economic sector, especially with regard to the national currency. There was a historical relationship between the political atmosphere and the valuation of the national currency for the countries. According to Blomberg and Hess (1997), the political factors play a key role in the exchange rate, where the political tensions contribute to weakening the currency's value. In turn, positive political indicators contribute to raising the currency's value. Lobo and Tufte (1998), mention that political factors such as elections, political system and political decisions have a lot of

impacts on the exchange rate of many currencies. They explained that the political environment effectively contributes in the fluctuation of the exchange rate.

Many authors around the world investigate about the relation between politics and currency exchange rate where they analyze the impacts of the political atmosphere on the exchange rate. For example, Frieden (2008), describe the pattern of domestic political conflict over currency values by analyzing the distributional impact of different currency regimes and levels, where he explains how political factors and events affect the exchange rate. In addition, Frieden et al. (2011) investigate about the impact of political economy factors on exchange rate policy in Latin America, with a special focus on political and interest group interpretations. Moreover, Kettell (2004), establishes a theoretical framework to analyze the exchange rate policy-making, where Exchange rate policy making is seen as a key component of a broader governance strategy designed by politicians with the aim of containing class conflict, securing favorable conditions for capital accumulation and providing an adequate degree of autonomy for governance in order to achieve high political goals.

Moreover, there are many studies about the political instability and economic growth which showed that political instability reduces economic growth. Barro (1991) determine that measures of political turmoil, such as the assassinations, the incidence of violent revolutions and military coups, greatly affect the average level of growth in a large sample of countries. In addition, Kormendi and McGuire (1985) find that a measure of the extent of political rights is positively correlated with economic growth. Also, Alesina and Rodrik (1994) found that politics has a direct impact on the economic growth, where the greater the inequality of authority and wealth, the lower the rate of growth. This makes politics plays a major role in the economic sector, which results in either boom or recession.

During the last years, political atmosphere in Lebanon leave its consequences on the financial and economic sector, which led to a noticeable deterioration in the economy. At the mid of 2019, the national currency (LBP) devaluated in face of foreign currencies which increase the economic crises. According to Mokalled (2019), the economic deterioration and the collapse of the national currency that we have reached, is the result of wrong political practices and ineffective financial policies over the past years. At the beginning of August 2019, the Lebanese pound began to collapse, as one dollar was equal to 1515 LBP, but it's value start decreasing, where the exchange rate of one dollar reached 23,000 LBP which means that the Lebanese pound were losing its value over the time.

Moreover, Lebanon witnessed a lot of internal and external political events that were accompanied by a state of political uncertainty, which left their impact on the financial and economic sector. According to Mokalled (2020), Lebanon has witnessed in the last years a series of political events that left their mark on our economy starting from October 17th which was the beginning of the popular demonstrations, then the resignation of Saad Al-Hariri Government which fail to meet the demands of the protesters and gaining the confidence of the international community down to the formation of a government of specialists headed by Hassan. Diab, which submitted its resignation after few months due to the inability to continue under pressures while Lebanon was going through an economic and financial crisis. Also, the explosion of the Beirut port on August 2020, which led to the damage of a large portion of the capital Beirut and contributed in deteriorating the national economy. In addition to the emergence of the global Covid-19, which lead to the closure of the country several times and affecting all the economic sectors.

### 2.1 Tested Hypothesis

Researchers have studied the impact of politics on economic performance over the years, particularly the impact of political events such as election results, the nature of the political system and the impact of government decisions on economic and financial policy. Drazen (2000) investigate about the impact of political decisions on the exchange rate, where different political factors lead to a currency crisis in many countries over the world. While Blomberg et al. (2004), mention that there are many factors that are involved in determining the exchange rate of a particular currency, as political factors are one of them, but there are many other economic factors that control the exchange rate.

Some researchers saw that political uncertainty have a lot of impacts on the economic sector especially the currency exchange rate, while others saw that such political events do not leave a significant impact. Moreover, others argue that the political uncertainty is only one factor where there are more economic factors that determine the exchange rate. According to the previous opinions, we can conclude that there are two main opinions. The first one assure that political uncertainty have a direct impact on the currency exchange rate, while the other believe that political uncertainty don't have much effect on the exchange rate where this depend on the political atmosphere of every country and the other economic factors. So, according to the above assumptions, we can build two hypotheses [H0 & H1] as below.

*H0*: The political uncertainty has no impact on the currency exchange rate.

*H1*: The political uncertainty has a direct impact on the currency exchange rate.

### 3. Data and Methodology

This paper analyzes the impact of political uncertainty and instability on the LBP exchange rate during the period [2019-2021]. The currency exchange rate was collected from the Lebanese Central bank and the black market on a daily basis during the studied period. Political events and news were provided from the National News Agency (NNA). About 100 political events and news were collected and had influence in the country for the three years. Therefore, the impact of these political factors and events on the LBP will be analyzed in terms of their impact on the exchange rate.

An empirical tests and regression analysis was adopted to analyse and interpret the ratios of the variables over the studied period, to analyze the impact of the political uncertainty on the exchange rate. In order to analyze the variables, it had to be mentioned the determinants of the exchange rate that we used in this study such as the official exchange rate of the LBP at the Central bank, the exchange rate at the commercial banks, and the exchange rate at the black market, in addition to the political factors influence over the studied period which effect on the exchange rate.

There are some models that used in this study to analyze the data and show the impacts of the political factors on the currency exchange rate. First we develop the regression model which will be help to determine the ratios of the variables, and how these variables will influence on each other. Equation 1 below show the regression model of the study.

$$OER_{it} = \beta_0 + \beta_1 CBER_{it} + \beta_2 BMER_{it} + \beta_3 PEI_{it} + \varepsilon_{it} \quad (1)$$

Where in eq. 1, the dependent variable is the official LBP exchange rate (OER) that determined by Lebanese Central bank over past years. However, the exchange rate usually decided by the market movement which reflect the real value LBP against foreign currencies. The independent variables are as follows: Commercial bank exchange rate (CBER), where the Central bank determined the exchange rate for dollar deposits in banks in case that customers decided to withdraw them in Lebanese pound after banks stopped withdrawals in dollars. The

Black market exchange rate (BMER) which determined by the informal exchangers in the black market. The political events influence (PEI) which gathered from the NNA over the studied period. Moreover,  $i$  represent number of observations;  $t$  represents the year;  $\beta_0$  represent the constant coefficient; while  $\beta_1, \beta_2, \beta_3$  represents the coefficients of the independent variables.

Also we studied and analyzed the impact of political events on the daily exchange rate by measuring the rate of change in the exchange rate in at the black market caused by these events.

A dummy variable equation was developed in order to capture the impacts of the political uncertainty on the currency exchange rate through mentioning for the political events that happened during the studied period in Lebanon. The following equation is as below:

$$R_t = \alpha_0 + \alpha_1 \sigma t^2 + \alpha_2 R_{t-1} + \alpha_3 NE + \alpha_4 PE + \epsilon_t \quad (2)$$

In equation 2, (PE) is a dummy variable that takes the value 1 in case of positive events and 0 otherwise, while (NE) is a dummy variable that takes the value 1 in case of negative events and 0 otherwise. It can be distinguished between the two types of events, where positive events (such as: formation of a new government, issuing an optimistic law, political agreement) are events that are likely to positively effect on the LBP exchange rate. While the negative events (such as: resignation of the government, revolution, political disputes) are events that are likely to have negatively effect on the LBP exchange rate.

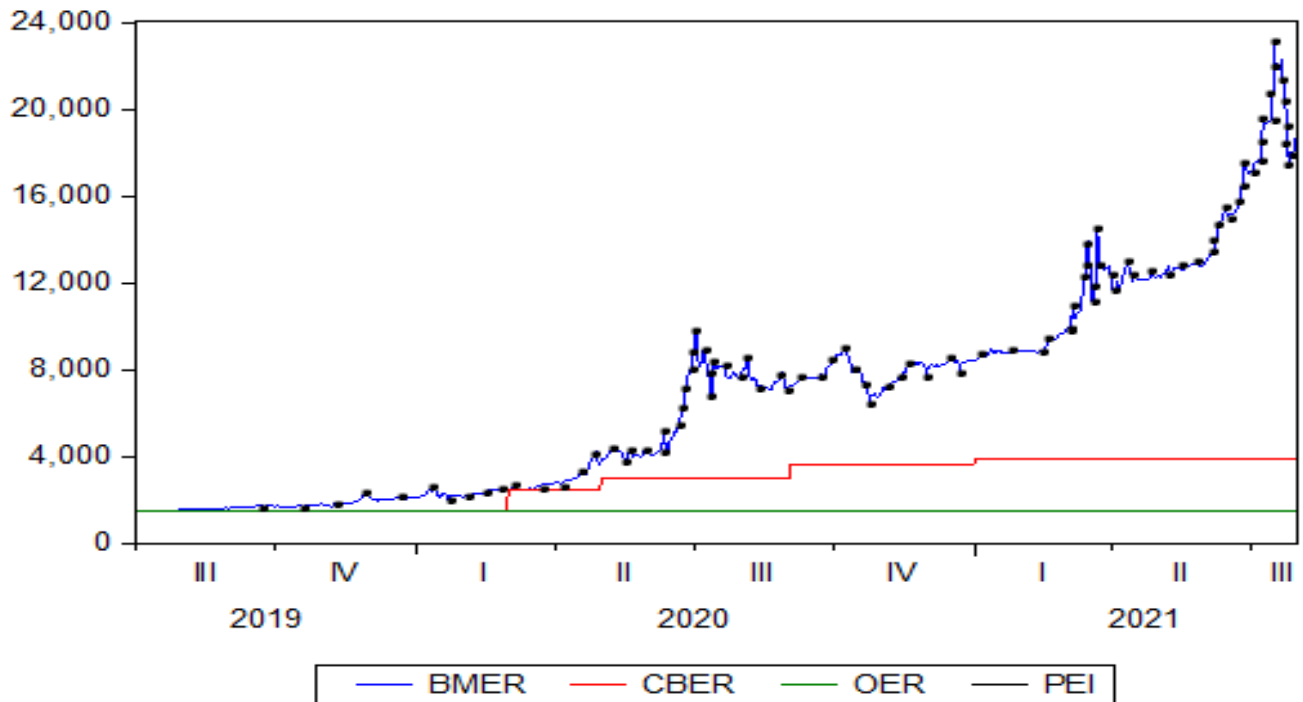
The variables of the regression model will help to determine the real exchange rate for the LBP at the market. Throughout the past years, the Governor of the Banque du Liban fix the exchange rate to a specific rate against the dollar, but in fact the determined exchange rate during those years did not reflect the real value of the exchange rate of the LBP. However, at the mid of 2019, and as a result of the deteriorating economic conditions in Lebanon, the LBP exchange rate versus USD dollar began to collapse and lose its value. The exchange rate was associated with many factors, but it was linked directly to the political atmosphere that played a prominent role in determining the exchange rate at the black market. Taleb (2021) addresses that the LBP exchange rate against dollar in the market is a political exchange rate. In addition, the New Arab website (2020), mention that the Lebanese political crises deepen the collapse of the Lebanese pound. The political atmosphere controls the exchange rate of LBP on the black market, with every positive or negative political event, we see an improvement or a decrease in the value of the Lebanese pound against USD dollar on the black market.

#### 4. Results and Discussions

We examine the variables of the study during the period [2019-2021] and apply the regression analysis depending on the collected data from the Central bank, black market and National News Agency in order to understand the impacts of the political uncertainty on the currency exchange rate. According to figure 1, we notice that the OER curve seems constant since its range between [1500 & 1524] where the Central Bank Governor fix the exchange rate at this level against the USD dollar over past years. According to CBER curve, the banks start to adopt the official exchange rate during the last period, until the beginning of 2020, where it began to increase the exchange rate against the dollar in parallel between the official exchange rate and the exchange rate in the black market. Nowadays, banks depend the exchange rate of 3,900 LBP against one dollar, and are still adopting it till now. As for BMER, we notice a high fluctuation in its curve, where the LBP exchange rate start rising at July 2019 from 1530 to reach about 23000 for one dollar at mid of beginning of 2021, and decrease later to become at the range of 19000 LBP for one dollar after this period. This means that the political uncertainty

contributes in the fluctuation of the exchange rate of the LBP against dollar in the black market during the whole period.

Figure 1. The fluctuation of LBP exchange rate against USD dollar during the period (2019-2021).



Source: Own work, 2021.

Table 1 below reports the descriptive statistics for the variables of the study during [2019-2021]. After applying the descriptive statistics for 762 observations, we can notice that the mean for OER=1512, CBER=2837, BMER=6658. If we look at BMER ratio we can notice that the real exchange rate of LBP against dollar at the market should be at the range of 7000 LBP for one dollar while its value now between [19000-20000 LBP] at the black market. The high difference in the exchange rate between the real market and the black market is due to the political instability and the loss of confidence of the Lebanese citizens in Government, financial institutions and banks. In addition, the median for OER=1513, CBER=3000 and BMER=7150. CBER exchange rate should be increased from 3900 to 7000 LBP for one dollar to be more realistic in the market. The minimum value for LBP exchange rate was 1500 while the maximum value was 23000 at the black market. The skewness measures the dataset's symmetry or lack of symmetry. Here, the skewness for OER= -0.14, CBER= -0.33, BMER= 0.86 and PEI= 2.13. Kurtosis used to describe distribution, it measures the combined weight of a distribution's tails relative to the center of the distribution. Here the Kurtosis for OER=3.84, CBER=1.42, BMER=3.24 and PEI= 5.55.

P-value = 0.0000 < 0.05 [  $\alpha=5\%$  (significant level)].

This means that there is a low probability that H0 is true. So, reject H0 and accept H1.

Hence the model is significant.

**Table 1.** Descriptive Statistics

	OER	CBER	BMER	PEI
Mean	1512.1	2837.1	6658.2	0.135
Median	1512.5	3000	7150	0.000
Maximum	1524	3900	23000	1.000
Minimum	1500	1503	1515	0.000
Std. Dev.	3.303	998.2	4807.8	0.342
Skewness	-0.144	-0.330	0.8667	2.134
Kurtosis	3.841	1.427	3.2425	5.554
Jarque-Bera	25.116	92.41	97.27	785.5
Probability	0.000	0.000	0.000	0.000
Observations	762	762	762	762

Source: Own work, 2021.

In addition, table 2 below show the results of the regression analysis and some additional tests. The political events influence (positive & negative) have significant impacts on LBP exchange rate at 95% confidence level. The magnitude impact of negative political events appears to be more influential than the impact of positive political events, where the magnitude of negative events is about - 0.23 while the magnitude for positive events is about + 0.021 in the model. It is obvious that the political uncertainty and instability have a significant impact on LBP exchange rate.

Moreover, R-squared ratio explain how much variation of a dependent variable is explained by the independent variables in a regression model where it's range usually between 0 and 1. The value of R-squared in the model equals to 0.52 which means that 52% of the variation in the LBP exchange rate against USD dollar are explained by the political uncertainty. Where the value of Adj. R-squared equal 0.51 which seems that the model fits the data of the study. Moreover, Log likelihood equals to 1905, highest log-likelihood value the better for the used model.

Furthermore, F-test assess multiple coefficients simultaneously, the P value for the F-test of overall significance test is less than the significance level, so we reject the null-hypothesis (H0) and accept H1 which means that our model provides a better fit. Akaike info criterion used for evaluating how well a model fits the data, AIC equals to 5.01 where a lower AIC score is better, the AIC value above seems the better-fit model which supported by the value of Schwarz criterion that equals to 5.03 and the value of Hannan-Quinn criterion which equals to 5.01.

**Table 2.** Regression Analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1507.96	0.38967	3869.81	0.0000
CBER	0.00275	0.00021	13.4394	0.0000
BMER	-0.00056	4.26605	-13.270	0.0000
PEI	0.33262	0.31361	1.06062	0.0289
R-squared	0.520321	Mean dependent var		1512.068
Adjusted R-squared	0.513801	S.D. dependent var		3.303414
S.E. of regression	2.955351	Akaike info criterion		5.010347

Sum squared resid	6620.447	Schwarz criterion	5.034683
		Hannan-Quinn	5.019717
Log likelihood	-1904.942	criter.	
F-statistic	64.26912	Durbin-Watson stat	1.81376
Prob(F-statistic)	0.000000		

Dependent Variable: OER

Sample: 01/07/2019 - 31/07/2021

Source: Own work, 2021.

In addition, table 3 below show the results of the correlations. The correlation matrix show that OER has a positive linear correlation with the CBER, BMER and PEI. The linear correlation between OER and CBER equals to .454 which considered a medium positive correlation with a significance level of .000. The linear correlation between OER and BMER equals to .472 which considered a medium positive correlation with a significance level of .000. The linear correlation between OER and PEI equals to .583 which considered a medium positive correlation with a significance level of .002. As for the study, it was important to find a relationship between these variables that prove the impacts of the political uncertainty and instability has a direct impact on the currency exchange rate.

**Table 3. Correlations**

	OER	CBER	BMER	PEI
OER	1	.454** (.000)	.472** (.000)	.583** (.002)
CBER	.454** (.000)	1	.924** (.000)	.095* (.015)
BMER	.472** (.000)	.924** (.000)	1	.716** (.003)
PEI	.583** (.002)	.095* (.015)	.716** (.003)	1

\*\* . Correlation is significant at the 0.01 level (2-tailed).

\* . Correlation is significant at the 0.05 level (2-tailed).

Source: Own work, 2021.

According to the above results and ratio's, we can notice that the political uncertainty and instability in Lebanon over the studied period [2019-2021] was contribute in the fluctuation of the LBP exchange rate against USD dollar. It seems clear that the exchange rate is closely linked to the political atmosphere, with every statement of political reassurance or a positive political events such as forming a new government or issuing of a new law, we notice an improvement in the exchange rate of the Lebanese pound and an increase in its value. On the other hand, with the increase in political tensions, convulsive rhetoric, and negative political events such as the resignation of the government or political disputes between political parties, we observe a deterioration in the exchange rate of the Lebanese pound against the dollar, and a decline in the value of the national currency. This means that LBP exchange rate is depends mainly on the political atmosphere, where the daily exchange rate for LBP at the black market still fluctuate with every political event. Note that the exchange rate on the black market does not reflect the real exchange rate of the Lebanese pound against the dollar and the difference in the exchange rate is due to political reasons.

## 5. Conclusions and Limitations

This paper examines the impacts of political uncertainty and instability on the currency exchange rate, taking the fluctuation of the LBP exchange rate against USD dollar as a practical case. It shed light on the most important political events and news that happened in Lebanon and the region during the last years and linked it directly to currency exchange rate. We use a 762 daily observations of LBP exchange rate collected from Lebanese central bank and black market during the period (2019-2021), also we gathered the political events from the National News Agency to perform empirical tests and regression models.

The results show that the political events and news have a significant impact on LBP exchange rate. The real exchange rate of LBP against dollar at the market should be at the range of 7000 LBP for one dollar while its value now between [19000 & 20000] LBP for one dollar at the black market. The high difference in the exchange rate between the real market and the black market is due to the political uncertainty and instability in addition to the loss of confidence of the Lebanese citizens in Government, financial institutions and commercial banks.

It's clear that the political atmosphere leave it's impacts on the LBP exchange rate in at the black market during the studied period. With every statement of political reassurance, we notice an improvement in the exchange rate of the LBP against USD dollar. While with the increase in political tensions, we observe a deterioration in the exchange rate of the LBP against USD dollar. So, according to the previous results of regression model we can conclude that the results reject the H0 and supports the H1 hypothesis, which assure that the political uncertainty has a direct impact on the currency exchange rate.

This paper has two main limitations. First, this paper required a lot of time and effort due to the collection of the political events which depend on objectivity in reporting news from reliable sources. Second, the studied period consists of 3 years which considered a small duration compared to other studies.

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