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Does Budget Deficit and Political Stability Effect Real Exchange Rate in South Asian Countries?

Abstract *The study investigates the effect of political stability and budget deficit on the real exchange rate. We used a panel data set of south Asian countries, including Pakistan, China, Bangladesh and India. We applied the panel unit root test, Kao's panel Cointegration and fully modified the least square in the study to reach robustness of findings. Findings reveal that real exchange rate(RER) and political stability are positively related. It supports the argument that political stability attracts foreign investment, appreciates local currency, and leads to higher RER. However, results reveal that the budget deficit is not related to RER. This study provides new empirical evidence to policymakers and government officials that political stability encourages foreign investors and appreciates exchange rate.*

Key Words: Budget Deficit, Political Stability, Exchange Rate

Introduction

In a competitive international market, a real exchange rate (RER) is a measure of the cost competitiveness of an economy. So, any government body should comprehend the macroeconomic factors impacting the real exchange rate. This can help maintain real equilibrium in RER. Devaluation can make domestic products cheaper and foreign goods expensive and ultimately can affect the price of domestic and foreign goods.

Marshal in 1980 first gave the idea of the law of demand and supply. It can be applied to currencies like other commodities. For example, if the demand for a specific currency rises, then its value is also increased in economies. If the demand of any specific currency fall, it leads to a decrease in that currency's value and leads to deprecation. In case of the higher budget deficit, some developing countries are accumulating more foreign debt, which can reduce the demand for local currency and increase the demand for the US dollar. Ultimately it can depreciate the domestic currency and reduce RER. We argue that political stability can attract foreign investors; this can create demand for domestic currency, hence appreciation of the local currency.

Some previous empirical evidences support the argument that RER fluctuations have either a negative or positive association with economic growth, so it is worthwhile to study the factors that influence exchange rate fluctuations from the regulatory authorities' point of view. A number of studies focus on understanding the factors that determine the RER (Gula and Glenness, 1993; Edwards, 1989). Previous studies provide mixed evidence on how real exchange rate fluctuations affect the outcome of economic activity. Aguirre

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and Calderon (2005) argue that the higher real exchange rate appreciation and depreciation are inadequate for the economy, although low depreciation levels are positive for economic performance.

The exchange rate policy faced by Bangladesh and India has recently changed from fixed policies to more market-based policies in the past. Despite the total fluctuations in India's exchange rate regime, Bangladesh continues to practice a managed floating system. As a result, these countries have made some progress in protecting their economies from the RER's impulsive movements. On the other hand, the evidence from Srilanka and Pakistan, unlike those of Bangladesh and India, has been unable to control their respective RER strictly. Therefore, it is relatively difficult to protect those two countries from the macroeconomic problems associated with fluctuations in the RER.

The choice of the best exchange rate regime remains an area of debate and controversy, as each system has its advantages and disadvantages, and specific economic, institutional and political conditions must be taken into account when assessing the desirability of a particular system (Corden, 2004). There is no simple correlation between economic indicators and exchange rate regimes. The single currency's direct economic interests in the region, the ultimate form of monetary cooperation, stem from the fundamental fact that the abolition of numerous currencies and related exchange rate fluctuations can lead to lower transaction costs and higher trade and investment.

The budget deficit occurs when a country spends more than its income, indicating the country's financial health. If a country's expenditures surpass its income, it may affect the economy negatively. To finance deficits, the government need to raise taxes and look for other sources of funding, such as debt. Therefore the unclear association of decrease in deficit and exchange rate should be not surprising due to the different behavior of exchange rate at different contexts. There are several effects of a decrease in deficit on exchange rates; in some contexts decrease in budget deficit cause a currency to devalues. In other contexts, it appreciates the currency. Interest rates are directly affected by a decrease in the budget deficit, as it reduces demand for loans. If the government has a budget deficit, it usually borrows more loans from the market and increases taxes. If in budget deficit reduces, it can reduce demand for loans and ultimately decrease the interest rates.

Investors prefer to sell low return domestic securities and buy high return foreign securities. The decrease in domestic securities demand and the increase in foreign securities demand affect the exchange rate market. When investors plan to buy foreign security and sell local security, they don't trade it for foreign security. Instead, investors sell domestic security in the national currency, buy foreign currency in exchange for national currency. Eventually, buy foreign security using foreign currency use foreign currency. Interim transactions - the sale of national currency and foreign currency purchase - lead to the exchange rate's devaluation. In other words, lower interest rates reduce the demand for the national currency and lead to a devaluation of the local currency.

In South Asia, the continued high deficit over the past two decades and the strategy to finance the deficit have had a negative impact on all macro indicators. Excessive domestic debt, financing the deficit, absorbs all available internal and external resources. The resulting debt trap has led to an increase in external borrowing at a high short-term repayment rate. This, combined with the higher depreciation of the exchange rate over the past two decades, has led to a rapid build-up of debt.

It is now widely accepted that the RER is an economy's relatively significant price. RER changes affect the flow of foreign trade, resource allocation, production structure, the balance of payments, etc. The RER is an endogenous variable, both as an external means and to respond to political instruments. To formulate policies effectively, it is important to understand the factors associated with RER. At the same time, it is generally accepted that the impact of

several foreign exchange rate shocks is spread through interest rates, income, absolute prices, and relative prices. It has been determined that the relative importance of these channels varies from country to country. In general, this depends on the relative efficiency of monetary and fiscal sectors and the economy's openness.

Political stability can qualitatively represent social development, and it is defined as a social order that dominates the social systems and represents the legacy of social values and goals and methods to achieve these goals (Sidamor, Lemtaouch, Bensouici and Science, 2016). Political instability is therefore not resistant to external and internal shocks. As regards corruption, the World Bank (1997) and UNDP (1999) defined corruption as the use of public office for personal purposes, exacerbating the inflation of individuals or groups. Thus, political instability is unable to withstand internal and external shocks affecting the economic system. Previous studies have overlooked the impact of the budget deficit and political stability on RER. There is a gap to examine how to budget deficit and political stability affect the exchange rate. We are therefore filling this gap by examining the impact of the budget deficit and political stability on RER.

The overall objective of the study is to conduct scientific research through the use of appropriate econometric models and examine the association of budget deficit and political stability with RER. To examine the relationship between independent and dependent variables, the current study has the following objectives.

1. To investigate the impact of political stability on the real exchange rate.
2. To investigate the impact o budget deficits on the real exchange rate.

The study fills the gap in the literature by examining the association of budget deficits with the real exchange rate, and it also examines how political stability affects the real exchange rate. The findings may be useful for regulatory bodies to incorporate them in decision making. It will also help managers of MNCs in their financial decisions.

The findings provide several policy implications. The first one is that it provides policy initiative that political stability increases real exchange rate, and it can help developing economies to stabilize the real exchange rate. Further, it recommends managers of MNCs consider political stability in the financial decisions regarding emerging countries, particularly in the case of South Asian countries.

Literature Review

Law of One Price

One price assumption is that the price of a homogeneous marketable raw material is the M, M. as that of international trade, and the logic behind it is arbitration intervention, which is equally expensive because of demand and supply factors in the global market, in other words, we can say that arbitration opportunities make countries equal in the price level. On the contrary, in the real world, the literature endorses the argument that a short-term pricing law does not apply because of transport costs and other obstacles.

Specialization Tradable Goods Model

This model assumes that the national country, like the rest of the world, specializes in a product that is sold internationally, and these products on the market are not ideal substitutes. This model applies to countries contributing to the production of manufactured goods, not to countries whose contributions are made through raw materials since only manufactured products are presumed to be imperfect substitutes for each other. The model does not describe the clear views of developing countries.

Salter-Swan Dependent –Economy Model

It is known as the tradable and non-tradeable model, which analyzes two items, one tradable, and the other is non-tradable. Where tradable goods are exported and consumed in a foreign country rather than goods sold only in a domestic country, RER may represent the number of non-

traded goods required to purchase each unit of tradable good.

Exportable-Importable-Nontra dable Three-good Model

It explains about three kinds of goods, including goods for import, export, and non-commercial. The model indicates that both exportable and importable can be produced at home. Trading conditions are determined in the model from different points of view. The first definition of a real exchange rate in line with three good models, maybe the price ratio for domestic and non-marketed exports, also known as the real export exchange rate. Another definition is the relationship between domestic prices between imported and unsold goods, also known as the actual exchange rate of imports. Within this model range, trading conditions would be defined as the relationship between the price of goods exported in local currency and the domestic price of imported goods.

Overview of Real Exchange Rate in South Asian Countries

The exchange rate policy faced by Bangladesh and India has recently changed from fixed policies to more market-based policies in the past. Despite the total fluctuations in the exchange rate regime in India, Bangladesh continues to practice a managed floating system. As a result, these countries have made some progress in protecting their economies from impulsive movements of the RER; on the other hand, the evidence from Srilanka and Pakistan, unlike those of Bangladesh and India, has been unable to strictly control their respective RER. It is, therefore, relatively difficult to protect those two countries from the macroeconomic problems associated with fluctuations in the RER.

The choice of the best exchange rate regime remains an area of debate and controversy, as each system has its advantages and disadvantages, and specific economic, institutional and political conditions must be taken into account when assessing the desirability of a particular system (Corden, 2004). There is no simple correlation between economic indicators and exchange rate regimes. The direct economic interests of the single currency in the region, the ultimate form of monetary cooperation, stem from the fundamental fact that the abolition of numerous currencies and related exchange rate fluctuations can lead to lower transaction costs and higher trade and investment.

In a comprehensive study of some 200 countries, Frankel and Rose (2002) estimated that trade between the countries of monetary union was three times higher than that of the countries that the countries outside the union controlled all other relevant factors. It is important to note that this is a clean expansion of trade, not only through trade transfers from third countries (Rose and Stanley, 2005). Since per capita income will typically increase by at least one-third of the country's total trade growth (relative to gross domestic product), this leads to significant overall economic benefits. By strengthening trade, investment and political ties can strengthen deeper economic integration between partner countries, promote trade relations, mobility, mutual trust and friendship. Given that South Asia is currently suffering from mistrust, tensions and even armed conflicts between neighboring countries, this is perhaps the most compelling argument to consider monetary union in the region today. Despite the independent monetary policy of the South Asian countries, it is surprising that all currencies have been experiencing a downward trend against the US dollar for more than 20 years.

Budget Deficit and Real Exchange Rate

Budget Deficit

The budget deficit occurs when a country spends more than its income, indicating the country's financial health. If a country's expenditures surpass its income, it has negative effects on the economy. To finance the deficit, governments need to raise taxes and look for other sources of funding, such as debt.

Therefore the unclear association of decrease in deficit and exchange rate should be not surprising that as a result of different behavior of

exchange rate at different contexts. There are several effects of a decrease in deficit on exchange rates; in some contexts decrease in budget deficit cause the currency to devalues, and in other contexts, it appreciates the currency. Interest rates are directly affected by a decrease in the budget deficit, as it reduces demand for loans. In case the government have a budget deficit, it usually borrows more loans from the market and also increases taxes. If the budget deficit reduces, it can reduce demand for loans and ultimately decrease the interest rates.

Investors prefer to sell low return domestic securities and buy high return foreign securities. The decrease in domestic securities demand and the increase in foreign securities demand affect the exchange rate market. When investors plan to buy foreign security and sell local security, they don't trade it for foreign security. Instead, investors sell domestic security in the national currency, buy foreign currency in exchange for national currency. Eventually, buy foreign security using foreign currency use foreign currency. Interim transactions - the sale of national currency and foreign currency purchase - lead to the exchange rate's devaluation. In other words, lower interest rates reduce the demand for the national currency and lead to a devaluation of the local currency.

There are several empirical studies, which provides empirical support for the association of macroeconomic variables and fiscal deficit as Ekeocha and Ikenna-Ononugbo (2017) suggest that economic growth, population and inflation are major factors affecting fiscal deficits. Moreover, Okoye *et al*. (2016) noted that exchange rate is positively associated with budget deficits; Safdar and Padda (2017) noted that institutional and economic factors are associated with fiscal operations. Umoh, Onye and Atan (2018) reported that the government present fiscal behavior is related to its past fiscal behavior. In Addition, Okoye et al. (2020) suggest that money supply and external debt have a negative effect on fiscal deficits.

Reducing the deficit would strengthen the exchange rate. Although deficit reduction only reduces the need for public funding, it also indirectly increases the demand for funds from private investors. Increased capital demand may be one of three effects: 1) higher expected returns for national securities, 2) lower exchange rate risk premiums and 3) lower expected inflation. Exchange rates tend to rise as investors move from foreign to domestic securities. Reducing the deficit could reduce expected inflation. Many analysts believe that an increase in the budget deficit will eventually lead to higher inflation. Thus, if the country reduces the budget deficit, inflation may fall (Greenspan, 1995). Moreover, some developing countries have faced a balance of payments crises and have huge amounts of foreign debt. In the face of rising budget deficits, some developing countries are accumulating more foreign debt, reducing demand for local currencies and increasing demand for US dollars. Ultimately, this can lead to currency devaluations and real exchange rates. Based on the preceding discussion, we have developed the following hypothesis.

H1: Budget Deficit is Negatively Associated with Real Exchange Rate

Political Stability and Real Exchange Rate

Political Stability

Political stability carries great significance in an economy's evolution, which also attracts private investment. It is used to measure the Government effectiveness and quality of public and civil service, its policies and implementation. Several macroeconomics variables affect exchange rates, including money supply (Junttila and Korhonen 2011), economic growth (Papanikos 2015), oil prices (Basher, Haug, and Sadorsky 2016; Beckmann, Czudaj, and Pilbeam 2015). terms of trade (Chowdhury 2012), capital flows (Jongwanich and Kohpaiboon 2013; Bouraoui 2015), oil prices (Beckmann, Czudaj, and Pilbeam 2015; Basher, Haug, and Sadorsky 2016). Asteriou and Sarantidis (2016) noted that political uncertainty has a negative effect on stock returns. Bonfiglioli and Gancia (2018) show that economic uncertainty has positive and significant effects on the adoption of reforms. Culiuc and

Kyobe (2017) found that several structural reform indicators exhibit a strong correlation to the real exchange rate. Moreover, Bouraouri and Hammami (2017) noted that political instability has a strong association with the exchange rate.

Political stability can qualitatively represent social development, defined as a social order that governs the system of associations that reflects the legacy of community values, goals and methods to achieve these goals (Sidamor, Lemtaouch, Bensouici and Science, 2016). Political instability is therefore not resistant to external and internal factors that weaken the social, economic system. As regards corruption, UNDP (1999) and World Bank (1997) defined corruption as the use of public office for personal purposes, exacerbating the inflation of individuals or groups. In fact, many studies have investigated the influence of political instability on some macroeconomic variables. Some economists, such as Benhabib and Spiegel (1992), Easterly and Rebelo (1994), and Barro (1996), argue that political instability declines investment, thereby undermining employment and productivity, reducing income and ultimately increases inflation. Edwards and Santaella (1993) study this view and argue that a corrupt country would have an inefficient economic system.

In addition, Alessina, Ozler, Rubini and Swagger (1996), Alessina and Perotti (1996), and most recently Ali, Hashemi and Hassan (2013) all agree that non-economic factors such as political instability and corruption have contributed to uncertainty in public policy and could encourage potential investors to invest in a country having political stability. Such capital outflow can cause reduce in investment and a decrease in economic growth. Barrow (2013) Chung stressed the importance of incorruptible government. And it will raise the standard of living of the masses.

Recent studies have shown that there is more interest in the way political factors work together to define common exchange rate policy (Steinberg, Walter, Theory and Models, 2013). Studies by Bamani-Oskui, Nasir and Change (2002) suggest that political instability can drive out foreign investors and ultimately lead to a loss of government revenue. To compensate for the loss of income, the government can again adopt various forms of policies that could be the reason for inflation. They also indicate that countries with high levels of corruption or poor public order depreciated currencies. We assume that political stability will attract foreign investment, creating demand for local currencies and valuing the local currency. Based on the previous discussion, we have developed the following assumptions.

H2: Political Stability is positively associated with real exchange rate

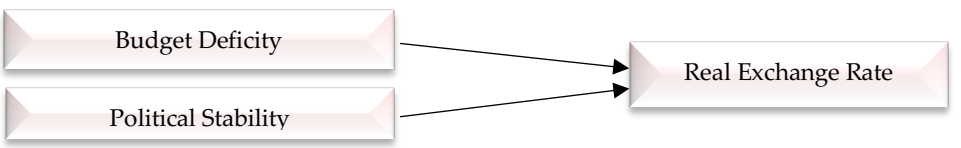

Figure 1: Conceptual Framework

Research Methodology

In this study, we are going to examine the association of budget deficit and political instability with RER in the South Asian countries which include, Pakistan, India, Bangladesh, and Srilanka. We collected data of 19 years over the period 1998 to 2016. Data sources are Onanda.com and World Bank.

An econometric Equation is given below:

$RER_{i,t} = \beta 0 + \beta 1 DEFGDP_{i,t} + \beta 2 PS_{i,t} + ut,$

Table 1. Data Sources and Variables Measurement

Variables	Measurement	Data Source
RER: Real Exchange Rate	Nominal Exchange Rate*(CPI Foreign)/(CPI Domestic)	www.oanda.com World Bank
DEFGDP	Deficit per GDP(Domestic)	World Bank
PS: Political Stability	Political stability index	World Bank
Ut: Error Term	Error term	

Real Exchange Rate

To calculate RER, we multiply the nominal exchange rate with adjusted foreign and domestic inflation factor. We retrieve the data of customer price index from World Bank. CPI represents that average change in the price of goods and services, which are known as a customer price index, which is not constant; it means it varies according to time, for example, yearly. The proxy we used to calculate real exchange in the current study has been used in a previous study (Kia, 2012).

Budget Deficit

A budget deficit occurs when the expenses of a country exceed its revenue which reveals the economic health of a country. It is not beneficial for an economy if a country's total expenditure exceeds its revenues. And to fund the deficit government need to burden people with more taxes and look for other sources of finance like debt.

Political Stability

Political stability carries much importance in any economic system, which also attracts private investment. It is used to measure the Government effectiveness and quality of public and civil service, its policies and implementation.

Econometric Analysis

Correlation Analysis and Multicollinearity Test

We conduct correlation analysis in the study to investigate the association between independent and dependent variable. Perfect multicollinearity between the independent variables can produce spurious results. To detect perfect multicollinearity, we conduct the multicollinearity test to know whether there is perfect multicollinearity between the variables or not.

Unit Root Test

It can further help us understand that the level of stationary of a particular variable(Dimitris & Stephen). We applied several panel unit root tests in the study, following some previous studies, for instance, Carrera & Restout (2008).

Kao's Panel Cointegration Tests

Several previous studies have used Kao's panel co-integration to examine the long-run relationship among variables, for instance, Carrera & Restout (2008).

Fully Modified Ordinary Least Square (FMOLS)

We applied FMOLS to overcome the limitation of Kao's co-integration. Kao's panel integration has certain limitations for example; it does not determine the relationship of variables separately. So, this is why fully modified ordinary least square (FMOLS) is used to identify and examine the causal relationship of variables separately. It is also used by researchers in previous studies.

Results and Discussion

Descriptive Statistics

Table 2

Variables	Observations	Mean	Std. Dev.	Minimum	Maximum
RER	76	0.016	0.0071	0.004	0.035
DEFGDP	76	4.444	2.465	0.121	9.341
PS	76	15.973	12.436	0.000	48.000

RER refers to the real exchange rate, DEFGEP refers to the ratio of budget to total GDP in percentage, PS refers to the index of political stability

The table reports descriptive statistics of the variable being used in the study. The mean value of the real exchange rate (RER) is 0.016, which suggests that, on average, the real exchange rate of 1 rupee in South Asian Countries is 0.016. The mean value of deficit to GDP ratio is 4.44, which suggests that the average percentage of budget deficit in south Asian countries is 4.4 % of GDP. The mean value of political stability is 15.9, which suggests that the average rank of political stability in South Asian Countries is 15.9.

Correlation Analysis and Multicollinearity Test

Table 3

	RER	DEFGDP	PS	VIF
RER	1			
DEFGDP	-0.295	1		1.096
PS	0.205	-0.512	1	1.096

RER refers to the real exchange rate, DEFGEP refers to the ratio of budget to total GDP in percentage, PS refers to the index of political stability

Table 3 reports the findings of correlation analysis and multicollinearity test. The correlation coefficient of the ratio of deficit to GDP (DEFGDP) is -0.295, which suggests that the ratio of budget deficit to GDP is positively related to the real exchange rate. The correlation coefficient of political stability (PS) is 0.20, which suggests that their political stability is positively correlated with the real exchange rate.

Unit Root Analysis

Table 4

Real Exchange Rate		
Method	**Statistic**	**Prob.****
Levin, Lin & Chu t*	-7.709	0.000
Im, Pesaran and Shin W-stat	-5.718	0.000
Budget Deficit		
Levin, Lin & Chu t*	-7.665	0.000
Im, Pesaran and Shin W-stat	-4.399	0.000
Political Stability		
Levin, Lin & Chu t*	-6.696	0.000
Im, Pesaran and Shin W-stat	-4.081	0.000

Table 4 report the findings of the panel unit root test (I, P & S) and (L, L & C). Findings reveal that the probability value is 0.05. Results suggest that the real exchange rate is stationary at first difference. The findings of the panel unit root test of budget deficit to GDP ratio reveal that probability value is 0.00. The results demonstrate that the budget deficit to GDP ratio is stationary at first difference. Findings of the panel unit root test of political stability reveal that the probability value is 0.00. Results demonstrate that political stability is stationary at first difference.

Kao's Cointegration

Table 5

Series: RER DEFGDP PS		
	t-Statistic	Prob.
ADF	-2.027	0.021

Table 5 reports the findings of Kao's panel Cointegration. The findings suggest that t-statistics is -2.02, and probability is 0.02, which supports the long run Cointegration (Dimitrios & Stephen, p, 452). The limitation of Kao's panel Cointegration is that it does not examine the independent variables separately, and it does not reveal the deterministic movement of variables.

Fully Modified Ordinary Least Square

Panel Cointegrating Regression

Table 6

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DEFGDP	-0.0004	0.0005	-0.828	0.410
PS	0.0003	0.0001	2.101	0.039
R-squared	0.364	Adjusted R-squared		0.316
SE of regression	0.0057	Sum squared residuals		0.002

RER refers to the real exchange rate, DEFGEP refers to the ratio of budget to total GDP in percentage, PS refers to the index of political stability

Table 6 reports the findings of (FMOLS). FMOLS overcomes the limitation of Kao's panel Cointegration. It provides the results of independent variables separately, and it also shows the deterministic trend. The findings reveal that t-statistics of deficit to GDP ratio(DEFGDP) is -0.823, and the p-value is 0.41, which reveals that budget deficit is negatively associated with the real exchange rate, but the p-value suggests that the relationship between budget deficit and the real exchange rate is not significant. Probably limited availability of observations can be the reason for the insignificant relationship (Dimitrios & Stephen, p, 416).

The findings reveal that t-statistics of deficit to political stability (PS) is 2.10, and the p-value is 0.03, which reveal that political stability is positively associated with the real exchange rate, and it is significant at less than 5% significance level. The results support our hypothesis 2.

Result Discussion

Budget Deficit

Results show that the sign of the association of budget deficit with the real exchange rate is negative, but it is found insignificant. The sign of coefficient supports the argument that in the face of rising budget deficits, some developing countries are accumulating more foreign debt,

reducing demand for local currencies and increasing demand for US dollars. Ultimately, this can lead to currency devaluations and real exchange rates. However, the association of budget deficit with the real exchange rate is not statistically significant; therefore the hypothesis one is not accepted. However, the findings of a previous study support our results (MacDonald, 1998).

Political Stability

The findings suggest that political stability is positively associated with the real exchange rate, and the relationship is significant at the first percent significance level. Therefore the results support our hypothesis 2. A possible explanation is that political stability reveals a stable political environment, which attracts foreign investors who feel that their investment is safe in a less risky environment. Therefore, the demand for local currency increase, and higher the real exchange rate. The findings support the argument that that non-economic factors such as corruption and political instability have contributed to uncertainty in public policy and could encourage potential investors to invest in a country having political stability (Hashemi and Hassan 2013). It also provides evidence that political stability is an indicator of a better political and economic system, which attract foreign investors, hence appreciate the domestic currency.

Conclusion and Recommendations

The study investigates the effect of political stability and budget deficit on the real exchange rate. And we used data panel data set of south Asian countries, including Bangladesh, Pakistan, Srilanka and India. We collect data from a word bank and oanda.com and run analysis in Eviews 9. Our data is comprised of 76 observations and four cross-sections.

We did a detailed analysis to produce robust results. We conduct descriptive analysis, correlational and multicollinearity analysis, stationary test, Panel Cointegration, and (FMOLS). Descriptive analysis reveals the descriptive nature of the variables, including mean values, standard deviation, minimum and maximum values. Findings collinearity analysis reveals the association between independent and dependent variables, and it is found in line with our hypothesis. The multicollinearity test examines whether there is perfect multicollinearity between independent variables; however, findings suggest that there not multicollinearity problem between the independent variables. The unit root test examines either variables are stationary or not; the findings reveal that all the variables are stationary at first difference. Kao's Cointegration examines either there is long-run Cointegration among the variables, the results are in favor of Cointegration of variables, but it has the limitation that it cannot produce the results separately for all variables and does now show a deterministic trend. To overcome the limitations of Kao's panel integration, we used the fully modified ordinary least square in the study. Findings suggest that budget deficit is negatively associated with the real exchange rate, but the association of budget deficit with the real exchange rate is statistically insignificant. Further, the results reveal that political stability is positively associated with the real exchange rate, and its association is significant at a five percent significance level.

The negative sign of the association of budget deficit with the real exchange rate is in line with our hypothesis 1, but the association is statistically insignificant. Hence hypothesis 1 is rejected. Probably limited availability of observations is the reason for insignificant relation. However, the positive and significant association of political stability with real exchange rate are in line with hypothesis 2, and hypothesis 2 is accepted, and it supports the argument that political stability attracts foreign investment, appreciates domestic currency, and leads to a higher real exchange rate.

Recommendation

The findings provide several policy implications. The first one is that it provides policy initiative

that political stability increases real exchange rate, and it can help developing economies to stabilize the real exchange rate. Further, it recommends managers of MNCs consider political stability in the financial decisions regarding emerging countries, particularly in the case of South Asian countries.

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