The relationship between Foreign Currency trading and Economic Development
A case Study of Pakistan

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ABSTRACT
In order to determine the relationship between few factors whom not calculated or evaluated by central bank is a tough job. The researcher tried to accumulate such secondary factors which are directly combined together and form very important primary factors. The researchers have reviewed many international researches in order to enhance the accuracy and focus of the research data and their variables. These researches has provided many new variables which are not very commonly used in our monetary research paradigm. This is a descriptive research where the researchers identified some new dimensions of usage of secondary variables into the formation of primary variables. There are many limitations researchers have during the course of the research. The most important and notable is the unavailability of the statistical data regarding many important statistical aspects of the economy. In the conclusion the researchers have found that the inflation, interest rate and exchange rates are highly correlated with currency trading. By manipulating such factors, inflation and exchange rates are exert influenced by central banks and varies impact currency and inflation. The valuation of foreign currency trading needs high attention from capital formation, determinants of inflation rate and proper utilization of supply of money in economy. The growth rate of GDP is essential factor for both economic development and foreign currency trading.

Keywords: Economic development, Foreign Currency Trade.

1. INTRODUCTION
In the modern economic times the foreign currency trade is a common site all over the world. There are hundreds of currency dealers trading in Dollars, Pounds, Yen, Euro, and many other currencies all around the world. In Pakistan it is also a common site, central bank issue licenses of different categories of currency dealership. These dealers perform as a currency trader but also deal in remittances as well.
In this paper we will going to discuss the relationship between the currency market and the economic development of a country, because each and every business has a negative or positive effect on Economy. The currency trading does have a special impact on the economy that is the opening of an extra window for trading a conservative and closed item. 50 years back people can’t even think about the concept that the foreign currency would sell on shops.
We will try to determine the factors creating positive impact of opening currency market on to the economic development, and the impact of negative relationship between the business and the economy. Then the next stage where we test the different factors and the economic development indicators combine in a model to find the true sense of relationship and its reasons. This will going to help us to understand the analysis of different new monetary moves of State bank policies as well.

2. RESEARCH QUESTION
● What are the basic type of relationship between the currency market and the economic development?
● How relationship does plays a role in Economic Development?
3. RESEARCH OBJECTIVES

- To find out the major factors of relationship between the currency dealership and economic development.
- To determine the impact of these factors on the Economic development.
- To find out the problem areas in this relationship.
- To put forward some solutions of all these problems.

4. LITERATURE REVIEW

The impact of foreign currency trading has wide magnitude and among them most significant is currency union increases trade. Rose and Stanley (2005) after going through the research came to this conclusion that the impact of currency trading is very vast throughout the world Currency trading is affected by several factors such as the real exchange rate and the level of output. Economist are doing research to find out the relationship between these two variables i.e. (real exchange rate, level of output) because currency devaluation is the most use full tools in flourishing the economy of any country. When there is currency devaluation or depreciation the price of the imports increases as compared to the prices of the export and this results in the improvement of the trade balance and hence improvement has a positive relationship with the foreign sector of economy. (AGHION, Philippe et al., 2009)

History of Pakistan’s economy provides information about its openness as the time is going by. Trade openness of Pakistan’s economy is a gradual process and is increasing with time. Openness is attained by increasing the number of imports and exports of any country. Economic growth of a country can improve by increasing its number of export. It also becomes the source of increase in earnings of a country as reflected in foreign currency. Export demand for products of any country depends upon several factors. Those factors include price of its products, quality of its products and economic conditions of importing country. An old time view favors devaluation as it increases its ability to increase competitiveness and exports value of that country’s products. It increases demand for domestic products and thus increases the production of goods which can be traded in the domestic and foreign market. It has also been noticed that devaluation has other implications also as it frequently decreases the output of any country and ultimately becomes the source of starting recession in that country. Imports have always added value as it increases well-being of people of a country but it may affect the domestic output adversely. It also has negative effect on foreign exchange reserves of the country. Any change in imports prices will also affect the exchange rates. Total import of Pakistan is concentrated in few items. More than 75% imports of Pakistan were consisting of only eight items during the fiscal year 2002-2003. There is an increasing trend in Pakistani import with the passage of time. This import figure consists of both consumer goods capital goods, but consumer goods import is increasing faster than the imports of capital goods. (MAHMOOD, Iqbal et al., August 2011)

Total import and export of Pakistan in 1975 were 53,185 million rupees and it increased to the level of 212,019 million rupees at the end of 1985 within a short span of ten years. Although, Pakistan’s economy was not closed one, but it was not so open. In these ten years, total of imports and exports showed growth of about 300 percent. This figure became 619,882 million rupees in 1995 and 2,130,061 million rupees at the end of 2005. The figure shows that within a span 1985 to 1995 growth rate of openness was high as compared to previous ten years span which further increased during 1995-2005.

In the developing countries like Pakistan the exchange rate plays its role as it solve some of the important problems that are faced by the economy of our country such as volatile exchange rate, unbalanced financial circumstances and frustration of government and to have control over domestic money market. “Exchange rate” shows that how much unit of one nation’s currency can be purchased with one unit of domestic currency. More precisely, exchange rate is a conversion factor that determines rate of change of currencies. While exchange rates volatility shows that exchange rate is settled on demand and supply of one nation’s currency, it may turn out fastest moving price of currency and bring all the foreign capital in the economy. Exchange rate volatility can affect the policy maker decision as well as it has some influence on the volume of exports and imports. Exchange rate volatility is a platform for different domestic investors as they can invest in the foreign market and obtain profits and at the same time the home currency gets depreciate on the other hand foreign currency gains value. Whenever there is less difference between the actual and the expected value of the exchange rate that is more likely by the traders and the supporters as they get benefit from it, but there are some traders and the investors that like the volatile exchange rate because it results in the maximization of their earning. (HUSSAIN JAVED, Zahoor and Farooq, Muhammad, 2009)

Sengupta and Sfeir (1995) states that exchange rate volatility has gained a remarkable output in the international trade because of the two reasons firstly it improves the balance of payment as the volume of export
increases and secondly asset market gets diversified. It is considered as one of the macroeconomic variables as it has major role in domestic and foreign currency. Economists have come to this conclusion that there exists a relationship between these variables such as exchange rate volatility appreciates positively with exports, manufacturing goods, money reserves and affects negatively on imports and at the same time depreciation of exchange rate will have vice versa reaction Theoretically, if depreciation of Pakistani currency exists (Pak Rupees/US$ increase in value), then this will raise competitiveness of the domestic goods and hence encourage exports. By the same way, appreciation of the Pak Rupees is expected to reduce imports and to improve trade balance. Frankel and Rose (2002) estimate the effect of currency unions on Gross Domestic Production in comparison with trade. That analysis was carried out under the assumption that the unique effect that currency unions have on growth is via promoting international trade flows. However, the effect of sharing a common currency on tourism has been neglected. After dividing the sample into three groups according to the level of income, in the first stage of our study a considerable effect of common currency on tourism is obtained. For that reason, a single currency not only promotes trade but also tourism. In fact, for the high income economies, the effect of common currency on tourism is greater than on trade. The effects for three different groups of countries according to their level of income are estimated. In that sense, the concerns that Frankel and Rose (2002) have about extended their results to large and/or rich countries in some way overcome. Results obtained in the last stage of our analysis reveal how important who else is in the currency union and how open is the economy not only in terms of trade but also in terms of tourism. The effect on trade, tourism and GDP per capita will be greater if a country share a single currency with a trading partner or a traditional origin of tourists.

Keeping in view the fact of adoption of volatile exchange rates in the developing countries such as Pakistan, does it have any effect on imports, exports, reserves and manufacturing goods or not. (SANTANA-GALLEGOS, María et al., 2009) To find the answer to this question various studies have been conducted and according to them Akhtar and Hilton (1984), Kenen and Rodrik (1986), Rogoff (1998), Persson and Svensson (1989), the exchange rate volatility has negative impact of two different variables such as imports and exports. Rogoff (1998) importers and exporters can face problems due to flexibility in the exchange rate. Arize (1998) negative relationship exists between exchange rate and imports and exports in both the long run and the short run. De Grauwe (1988) the relationship between the exchange rate volatility and the trade can be positive only in one situation if there is accurate fabrication of the model otherwise it will not have the positive impact. Qayyum and Kemal (2006) there is a positive relationship between volatility returns in the stock market and the volatility of the foreign market. (MCCAULEY, Robert and Scatigna, Michela, 2010) Khan and Sajid (2005) with reference to Pakistan over the period of 1982:Q2 to 2002:Q4 it is concluded that there is a positive relationship in both the long and the short run between real money balances, real income, inflation rate, foreign interest rate and real effective exchange rate. They use ARDL and estimated results indicate that the long run real income, inflation rate, foreign interest rate and real effective exchange rate have a significant impact on real money balances in Pakistan. Khair-uz-Zaman (2005) due to the problems faced by the Iranian exporters in the trading of carpets it has positively affected the export market of Pakistan. Abeysinghe and Yeok (1998) suggested that exchange rate depreciation stimulates and increases the exports and decreases imports, while exchange rate appreciation would result in the vice versa situation as it decreases the exports and increases the imports. Aizenman (1992) and Goldberg (1993) find that increase in exchange rate volatility has a negative impact on the level of investment as it results in reductions in the level of investment expenditure. Esquivel et al. (2002) described exchange rate volatility has certainly played a role in reducing level of exports in developing countries such as Pakistan. The impact of exchange rate volatility is examined on macroeconomic variables in Pakistan using quarterly data from 1982:1 to 2007:IV. The findings of this study show positive relationship between these two variables, which contradict with the theoretical model but these values are insignificant. The manufacturing product (MP) and economic growth show positive relationship. This shows that 1% rise in manufacturing product will increase economic growth by 32%. (FRIEDEN, Jeffry, 2009) Reserve money has negative impact on economic growth: An increase in domestic reserve money may reduce the international of reserve and decrease economic growth. Results shows that over the sample period of study a 1% increase in imports will bring about a 0.2 % decrease in economic growth. Moreover, manufacturing sector and economic growth have positive relationship with each other. The overall conclusion of this research is that exchange rate volatility, reserve money, exports have long-run positive relationship with economic growth, but the statistical value of exports, and imports are insignificant. Notwithstanding, in the short run, exports, imports, manufacturing production, exchange rate volatility, economic growth and reserve money in various regressions have positive or negative relationship to economic growth at lags 1 and 2 correspondingly. The explanatory
variables are insignificant except imports in the short-run. From this conclusion, we can find that domestic economic performance is very sensitive to the change in exchange rate volatility in the long-run period. (RODRIK, Dani, 2008)

In Pakistan the exchange rate has gained a lot of importance ever since there has been the acceptance of the floating exchange rate patterns. Economic growth of a country can improve by increasing its number of export. It also becomes the source of increase in earnings of a country as reflected in foreign currency. Export demand for products of any country depends upon several factors. Those factors include price of its products, quality of its products and economic conditions of importing country. An old time view favours devaluation as it increases its ability to increase competitiveness and exports value of that country’s products. It increases demand for domestic products and thus increases the production of goods which can be traded in the domestic and foreign market. It has also been noticed that devaluation has other implications also as it frequently decreases the output of any country and ultimately becomes the source of starting recession in that country. Imports have always added value as it increases well-being of people of a country but it may affect the domestic output adversely. It also has negative effect on foreign exchange reserves of the country. Any change in imports prices will also affect the exchange rates. Total import of Pakistan is concentrated in few items. This study has been conducted to know about any such relationship between exchange rate volatility and some of the macroeconomic variables like foreign direct investment, Gross Domestic production, and trade openness and growth rate in Pakistan. Adubi et al. (1991) evaluated the effect of price volatility and exchange rate volatility on agricultural trade flow which is an important sector in Pakistan. Bleany et.al. (1999) analyzed through a model that if exchange rate of developing countries is pegged to exchange rate of developed countries, the inflationary expectations in developing countries may be decreased. Frey (1999) investigated the impact of short run volatility of exchange rates on the volume of exports. Cooper (1999) compared the scope of different exchange rate choices availed by the developed and the developing countries. Liwang (2000) studied the impact of exchange rate volatility on flow of international trade. Kawai et al. (2000) discussed conceptual and empirical issues relevant to exchange rate policies. Larrain et al. (2001) put light on the question of which exchange rate arrangement middle income countries should adopt. Frydman et al. (2001) argued that the standard Rational Expectation Hypothesis (REH) assumption is the primary reason for the growth empirical failure of the monetary models of the exchange rates. Esquivel et al. (2002) described the exchange rate volatility of G-3 countries. Rollemberg et al. (2002) emphasized the relationship between alternative exchange rate regimes and the different concepts of money and the role of the market as an economic regulator. Zhang (2002) reviewed China’s foreign exchange reforms and analyzed their impact on the balance of trade and inflation. Maskey (2003) reviewed the patterns of economic shocks affecting the SAARC member countries.


Impact of exchange rate volatility on macroeconomic variable is analysed through application of regression techniques. Exchange rate volatility is measured using GARCH model. The results indicate the presence of positive impact of exchange rate volatility on GDP, growth rate and trade openness. While negative impact of exchange rate volatility on foreign direct investment is found. When there is currency devaluation or depreciation the price of the imports increases as compared to the prices of the export and this results in the improvement of the trade balance and hence improvement has a positive relationship with the foreign sector of economy. Economic growth of a country can improve by increasing its number of export. It also becomes the source of increase in earnings of a country as reflected in foreign currency. Export demand for products of any country depends upon several factors. Those factors include price of its products, quality of its products and economic conditions of importing country. It increases demand for domestic products and thus increases the production of goods which can be traded in the domestic and foreign market. It has also been noticed that
5. METHODOLOGY

As we already mention that this is a descriptive research defining the relationship between new and old variables. The test which is considered as most authentic in this relationship identification process is co-integration test. This test gives us the long run relationship but for only those variables which has same order relationship for integration. But the problem is that the data available for the currency trade is about 18 years. As we have mentioned above that the most suitable test for such relationship is co-integration but the lack of long run data force us to use multiple regression model to check the relationship.

6. EMPIRICAL ANALYSIS

In this part the first requirement is the selection of variables for our analysis.

Economic Development (Real GDP) = ED
Real Effective Exchange Rate = RER
Capita Growth Rate = CGR
Real Interest Rate = RIR
Remittances in $ = R

We have to design the variables in the most effective economic variable propositions due to the lack of accurate data. There are few other variables which plays a vital role in the foreign currency trade such as devaluation of local currency. But the unavailability of long term data sequence limits our working in this variable selection.

7. DATA ANALYSIS

Correlation Analysis

<table>
<thead>
<tr>
<th>Descriptive Statistics</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>CurrencyTrade</td>
<td>3496.4939</td>
<td>3276.00114</td>
<td>31</td>
</tr>
<tr>
<td>RealGDP</td>
<td>3347289.0422</td>
<td>1313754.37607</td>
<td>31</td>
</tr>
<tr>
<td>IntRate</td>
<td>.0172</td>
<td>3.04283</td>
<td>31</td>
</tr>
<tr>
<td>RealEffExcRate</td>
<td>133.9110</td>
<td>43.39054</td>
<td>31</td>
</tr>
<tr>
<td>CapitalFormation</td>
<td>586220.2371</td>
<td>181445.29009</td>
<td>31</td>
</tr>
</tbody>
</table>

The descriptive statistics illustrates the effectiveness of given variables that indicates the mean and standard deviation of variables. It is indicating the distribution of points in data sets. In above table, Currency trade (3496.49), Real GDP (3347289.04), Interest Rate (.0172), Real Effective Exchange Rate (133.911) and Capital Formation (586220.23) respectively. Moreover, these data sets are likely estimated by Standard Deviation which specifies that how data are spread out around points. The low standard deviation indicates most of the data points are centre around average and vice versa.
Under the correlation analysis, the data of currency trade have measured with different factors of analysed variables, that is, Interest Rate, Real GDP, Real Effective Exchange Rate and Capital formation which are related to currency trade. The idiosyncratic assumption of foreign currency trading varies consistently due to stagnant economic growth. However, we have analysed the degree of association through correlation model on below data.

<table>
<thead>
<tr>
<th>Correlations</th>
<th>CurrencyTrade</th>
<th>RealGDP</th>
<th>IntRate</th>
<th>RealEffExcRate</th>
<th>CapitalFormation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pearson</strong> Correlation</td>
<td>1</td>
<td>.726**</td>
<td>-.113</td>
<td>-.308</td>
<td>.719**</td>
</tr>
<tr>
<td><strong>N</strong></td>
<td>31</td>
<td>31</td>
<td>31</td>
<td>31</td>
<td>31</td>
</tr>
<tr>
<td><strong>RealGDP</strong> Pearson Correlation</td>
<td>.726**</td>
<td>1</td>
<td>-.029</td>
<td>-.820**</td>
<td>.957**</td>
</tr>
<tr>
<td><strong>N</strong></td>
<td>31</td>
<td>31</td>
<td>31</td>
<td>31</td>
<td>31</td>
</tr>
<tr>
<td><strong>IntRate</strong> Pearson Correlation</td>
<td>-.113</td>
<td>-.029</td>
<td>1</td>
<td>-.026</td>
<td>-.036</td>
</tr>
<tr>
<td><strong>N</strong></td>
<td>31</td>
<td>31</td>
<td>31</td>
<td>31</td>
<td>31</td>
</tr>
<tr>
<td><strong>RealEffExcRate</strong> Pearson Correlation</td>
<td>-.308</td>
<td>-.820**</td>
<td>-.026</td>
<td>1</td>
<td>-.806**</td>
</tr>
<tr>
<td><strong>N</strong></td>
<td>31</td>
<td>31</td>
<td>31</td>
<td>31</td>
<td>31</td>
</tr>
<tr>
<td><strong>CapitalFormation</strong> Pearson Correlation</td>
<td>.719**</td>
<td>.957**</td>
<td>-.036</td>
<td>-.806**</td>
<td>1</td>
</tr>
<tr>
<td><strong>N</strong></td>
<td>31</td>
<td>31</td>
<td>31</td>
<td>31</td>
<td>31</td>
</tr>
</tbody>
</table>

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

The correlation analysis were conducted to examine the relationship between dependent variable and independent variables, it is resulting to perceive an economic factors that are relevant each other. Subsequently, the Pearson Correlation define the strength or degree of association between variables that measure how each variable relates. In above table, the correlation of ‘Currency Trade’ is highly related with ‘Real GDP’ which is (.726**) and resulting that GDP factor helps to increases foreign currency deposits with perception of GDP growth. Although the growth rate of GDP (Gross Domestic Profit) can pull stagnant condition of economic growth deliberately. Likewise, the ‘Interest Rate’ is another significant factor that influence on Currency Trade. The correlation of Interest Rate with Currency trade has negative relation which is (-.113) that is not exemplify much higher, it is effective but not propelled the currency trade variable. The real effective exchange rate has negative relation with Currency Trade which is (-.308) and this negative value represent the variation stability in currency trade change but in negative therefore exchange rate could be affected in order to negative impact. Capital Formation is highly correlated with Currency Trade which is (.719**) that specify the strengthen relation with dependent variable. It is
good sign for currency trading that capital formation ascertain the economic growth and enhance foreign currency deposits.

**Multiple Regression Analysis**

**Model Summary**

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.897&lt;sup&gt;a&lt;/sup&gt;</td>
<td>.804</td>
<td>.774</td>
<td>1558.63543</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), CapitalFormation, IntRate, RealEffExcRate, RealGDP

In Model summary of multiple regression, the R indicates the strength of overall variables showing great effectiveness each other, by the way, R-square define the independent variation of predictor variable and that how independent variables explained well. The R-square value is (.804) which is 80.4% variation of dependent variable explained by predictor variables. The Adjusted $R^2$ is overestimated population of $R^2$ resulting that 77.4% high collinearity or may be said subject ratios. Particularly, the equation of regression is very useful for making expected results since $R^2$ nearer to 1.

**ANOVA**<sup>a</sup>

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>258802549.417</td>
<td>4</td>
<td>64700637.354</td>
<td>26.633</td>
<td>.000&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>Residual</td>
<td>63162954.631</td>
<td>26</td>
<td>2429344.409</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>321965504.048</td>
<td>30</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Dependent Variable: CurrencyTrade
b. Predictors: (Constant), CapitalFormation, IntRate, RealEffExcRate, RealGDP

c. Dependent Variable: CurrencyTrade

In above Table, multiple regression were conducted and examined to analyze the linear relationship with variables. Moreover, the multiple regression equation is expresses the immediate determination of statistics significantly. However, the equation is likely to create descriptive results and indicating economic predictions from observatory variables.
The regression equation is follows:

\[
\text{Currency Trade (y)} = -19199.617\beta_0 + \text{RealGDP (.002)} - \text{IntRate (-45.559)} + \text{RealEffExcRate (68.364)} + \text{CapitalFormation (.009)}
\]

This equation shows the rate of currency trade according to several factors, if any variable find any variations thus, currency trade would vary. In this equation, the Real GDP would change by (.002) that’s means the 0.2% variation would effect on currency trade, likewise Interest Rate (-45.559), Real Effective Exchange Rate (68.364) and Capital Formation (.009) respectively would varies on currency trade.

The statistical measure were summarize the multiple regression model to accumulate the results of T-test of each variable explained in above table. That is, Real GDP (B) is (.002), T-test (3.174) and significance level is (.000) which is (p<0.01) its means the null hypothesis is rejected and accepted alternate one due to evidence of rejection level of significance and T-test value is greater than (T>2.4). Furthermore T-test implied on Interest Rate (B) is (-45.559), T-test (-.485) and significance level is (.632) therefore, the null hypothesis is accepted due to evidence of greater the value of significance and T-test is less than (T<2.4).

Now comes on, Real Effective Exchange rate (B) is (68.364), T-test (5.888) and level of significance (.000), hence, the null hypothesis is rejected due to rejection level of T-test is greater than (T>2.4) and also evidence of significance level is less than (p<0.01). Capital Formation (B) is (.009), T-test (1.640) and level of significance (.113) that showing the rejection of alternate hypothesis and accept null one due to lesser the value of (T<2.4) and significance level is crossing the (p>0.01).
Graphical Analysis
8. Conclusion
There are several relationships we have found during the course of research. Generally, the research study conducted an old and new variables that could be emboss prominently for foreign currency trading and initialize the yardstick of foreign investment with sustainability. Aside from variables, like inflation and interest rate of borrowing and lending that meant for keep growing in future aspects and make valuable foreign currency trading. In order to conducted examination of available variables that analysed through multiple regression which were varied the results of growing factors of foreign currency trading. Particularly, the important consideration of exchange rate plays vital role in depreciation or appreciation of the currency, almost the sustainable GDP growth rate is directly effect on foreign deposits. Likewise, understanding the central bank policies and regulations of investment are meant to be for growth in foreign currency deposits. There are six factors also circulating around the foreign currency trading are determinants of interest rate, differentials of inflation, current account deficits and public debts are made extension of sustainable economic development
by analysis of these factors including foreign direct investment rapidly. Inflation rate are exhibited by consistent lowering currency rate cause to high exchange rate of foreign currency.

In the meanwhile, we can say that inflation, interest rate and exchange rates are highly correlated with currency trading. By manipulating such factors, inflation and exchange rates are exert influenced by central banks and varies impact currency and inflation. Moreover the conclusive statement of defining the valuation of foreign currency trading needs high attention from capital formation, determinants of inflation rate and proper utilization of supply of money in economy. The growth rate of GDP is essential factor for both economic development and foreign currency trading.
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