7 (4) June 2025 137-144
JSIKTI: *Jurnal Sistem Informasi dan Komputer terapan Indonesia*
ISSN 2460-7258 (online) | ISSN 1978-1520 (print)

Contents lists available at www.infoteks.org

JSIKTI

Journal Page is available to https://infoteks.org/journals/index.php/jsikti

Research article

Binary Classification of Exchange Rate Trends Using Logistic Regression

Ni Wayan Wardani [a*], *Anak Agung Surya Pradhana* [b], *I Nyoman Darma Kotama* [c]

[a,b,c] *Graduate School of Environmental, Life, Natural Science and Technology, Okayama University, Okayama, Japan*
email: [a,*] pj5w1e4c@s.okayama-u.ac.jp, [b] p44c722@okayama.ac.jp, [c] p9363bg2@s.okayama-u.ac.jp
* *Correspondence*

ARTICLE INFO

Article history:
Received 1 March 2025
Revised 10 April 2025
Accepted 30 May 2025
Available online 30 June 2025

Keywords:
Exchange rate forecasting, binary classification, logistic regression, financial data analysis, machine learning.

Please cite this article in IEEE style as:
Wardani, N. W., Pradhana, A. A. S., and Kotama, I. N. D., "Binary Classification of Exchange Rate Trends Using Logistic Regression," *JSIKTI: Jurnal Sistem Informasi dan Komputer Terapan Indonesia*, vol. 7, no. 4, pp. 137-144, 2025.

ABSTRACT

This study explores the use of logistic regression for binary classification of exchange rate trends, focusing on predicting upward and downward currency movements. Logistic regression, valued for its simplicity and interpretability, models the relationship between historical exchange rate data and macroeconomic indicators like interest rates, inflation, GDP growth, and trade balances. The methodology involves data collection, preprocessing, feature engineering, and model evaluation. Historical data is processed to address missing values, outliers, and noise, ensuring a robust dataset. Feature selection techniques, including mutual information scores and principal component analysis (PCA), identify key predictors, while L1 and L2 regularization enhance generalization. The model, implemented using Python's scikit-learn library, is optimized through grid search for hyperparameter tuning. Performance metrics, including accuracy, precision, recall, F1-score, and ROC-AUC, indicate strong predictive capability, achieving 99% accuracy in forecasting upward and downward trends. Logistic regression's interpretability aids decision-making, making it a valuable tool for financial forecasting. However, the study notes limitations, such as challenges posed by market volatility and geopolitical factors. Future research suggests incorporating sentiment analysis from financial news and social media, and exploring hybrid models combining logistic regression with ensemble methods or deep learning to improve performance under real-world conditions.

1. Introduction

Exchange rates play a pivotal role in the global economic system, influencing international trade, cross-border investments, and the monetary policies of nations. Accurate forecasting of exchange rate trends is crucial for a wide range of stakeholders, including governments, financial institutions, multinational corporations, and individual traders. For policymakers, reliable exchange rate predictions aid in macroeconomic planning and the formulation of monetary strategies. For businesses, they are instrumental in managing currency exposure, determining pricing strategies, and optimizing supply chains in the context of fluctuating foreign exchange markets [1].

The complexity of exchange rate movements is driven by a multitude of interconnected factors, including macroeconomic indicators (e.g., inflation rates, interest rates, and GDP growth), geopolitical events, and investor sentiment. Furthermore, the advent of globalized markets and advancements in technology have introduced additional layers of complexity, such as high-frequency trading and algorithm-driven market interactions. These challenges underscore the need for robust and interpretable models capable of capturing the underlying trends in exchange rate data [2].

In this context, binary classification has emerged as an effective approach for analyzing and predicting exchange rate trends. By simplifying the task to two discrete outcomes—upward or

ISSN 2460-7258 (online) | ISSN 1978-1520 (print)
7 (4) June 2025 137-144

downward movements—binary classification provides actionable insights that are directly applicable to decision-making processes. Unlike multi-class classification, which seeks to predict specific exchange rate values or ranges, binary classification focuses on directional changes, making it particularly suitable for financial applications where the primary concern is the trajectory of the market rather than exact price levels [3].

Logistic regression, a fundamental statistical model, has been widely used for binary classification problems due to its simplicity, interpretability, and computational efficiency. It models the relationship between a binary dependent variable and one or more independent variables by estimating the probability of an outcome based on a logistic function. Logistic regression is particularly well-suited for datasets where features are linearly separable or can be transformed to achieve approximate linearity through feature engineering. Its interpretability makes it a preferred choice in financial forecasting, as it allows stakeholders to understand the relationships between predictors and outcomes, enhancing trust and transparency in the decision-making process [4].

Over the past decade, logistic regression has demonstrated its utility in various financial applications, including stock price prediction, credit scoring, and risk assessment. In the domain of exchange rate forecasting, it has been shown to perform well when paired with advanced preprocessing techniques such as data normalization, regularization, and feature selection. These techniques address common challenges in financial datasets, such as multicollinearity, non-stationarity, and noise, thereby improving the model's predictive accuracy and robustness [5].

One of the most significant challenges in applying logistic regression to exchange rate forecasting is the high dimensionality and noisy nature of financial data. Exchange rates are influenced by a wide range of factors, from historical price patterns and technical indicators to macroeconomic data and geopolitical developments. The inclusion of irrelevant or redundant features can degrade model performance, making feature selection a critical component of the modeling pipeline. Techniques such as principal component analysis (PCA), correlation-based feature selection, and mutual information have been widely used to identify the most informative predictors [6].

In addition to feature selection, feature engineering plays a vital role in enhancing the performance of logistic regression models. Common approaches include the use of lagged variables to capture temporal dependencies, moving averages to smooth out short-term fluctuations, and technical indicators such as the relative strength index (RSI) and Bollinger Bands to incorporate market dynamics. Sentiment analysis from financial news and social media has also emerged as a promising area for feature extraction, providing insights into market sentiment that can influence exchange rate movements [7].

Despite its simplicity, logistic regression has been successfully extended through the integration of advanced techniques to address its limitations. Regularization methods, such as L1 (Lasso) and L2 (Ridge), have been employed to prevent overfitting and enhance model generalization on noisy and high-dimensional datasets. Furthermore, hybrid modeling approaches that combine logistic regression with other machine learning algorithms, such as ensemble methods (e.g., random forests, gradient boosting) and support vector machines (SVMs), have demonstrated improved predictive performance while maintaining interpretability [8].

Another advantage of logistic regression lies in its ability to estimate probabilities for classification outcomes. This probabilistic framework provides valuable information for financial decision-making, allowing practitioners to assess the confidence of predictions and adjust strategies based on varying risk tolerances. For example, in a trading scenario, a model that predicts an upward trend with a high probability can inform decisions to enter long positions, while a low-probability prediction may warrant caution or further analysis [9].

This study seeks to explore the application of logistic regression for binary classification of exchange rate trends. The primary objective is to develop a predictive model capable of distinguishing between upward and downward movements in exchange rates based on historical data and engineered features. The research adopts a systematic approach that includes data preprocessing, feature selection, model training, and performance evaluation. By leveraging the strengths of logistic regression—simplicity, interpretability, and efficiency—this work aims to contribute to the growing

 ISSN 2460-7258 (online) | ISSN 1978-1520 (print)
7 (4) June 2025 137-144

body of knowledge on exchange rate forecasting while addressing the practical challenges of financial data analysis [10].

2. Research methods

The research methodology employed in this study is designed to systematically explore the applicability of logistic regression for binary classification of exchange rate trends. The methodology consists of four key stages: data collection, feature engineering, model implementation, and evaluation.

In the first stage, historical exchange rate data is obtained from reliable financial data providers, such as central banks and financial markets, spanning multiple years to ensure robustness. Additionally, relevant macroeconomic variables, including interest rates, inflation rates, gross domestic product (GDP) growth, and trade balances, are incorporated as predictive features, as these have been shown to influence exchange rate movements [1].

The second stage involves preprocessing and feature engineering. This step includes handling missing values through imputation methods, removing outliers using statistical techniques, and normalizing data for consistency. Feature selection is performed using correlation analysis, mutual information scores, and principal component analysis (PCA) to reduce dimensionality while retaining the most influential predictors [2].

In the third stage, the logistic regression model is developed. The dataset is split into training (80%) and testing (20%) sets. Logistic regression is implemented using Python's scikit-learn library, with hyperparameters such as regularization strength and solver type optimized through grid search cross-validation to improve model performance [3].The fourth stage focuses on evaluating model performance. Standard metrics, including accuracy, precision, recall, F1-score, and the area under the Receiver Operating Characteristic (ROC-AUC) curve, are employed to quantify the model's classification effectiveness. A confusion matrix is also analyzed to assess the balance between true positives, true negatives, false positives, and false negatives[4]

This research is grounded in recent advancements in applying logistic regression to financial time series forecasting. Studies have demonstrated its simplicity, interpretability, and robustness in binary classification tasks, making it a suitable choice for modeling exchange rate trends. Moreover, the inclusion of macroeconomic variables as predictors aligns with contemporary approaches to exchange rate forecasting .

The methodology's adherence to systematic data preparation, feature engineering, and model optimization ensures reliable and reproducible results. This approach not only evaluates the logistic regression model’s performance but also provides a foundation for future comparisons with other machine learning algorithms, such as support vector machines (SVM), decision trees, and deep learning models .[5]

2.1. Data Collection

The dataset used in this study was obtained from official and open-access financial data sources, including central bank publications, international financial institutions, and market data providers. The data spans multiple years to ensure temporal consistency and robustness. It contains daily exchange rate information for selected currency pairs along with relevant macroeconomic indicators such as interest rates, inflation rates, GDP growth, and trade balances. These variables were chosen based on their known influence on currency movements in economic theory and previous empirical studies. All data were compiled and synchronized by date to ensure accurate temporal alignment between exchange rate fluctuations and their corresponding macroeconomic conditions [6].

2.2. Data Preprocessing

Preprocessing was conducted to ensure data quality and readiness for modeling. Missing values in the macroeconomic indicators were handled using statistical imputation methods, such as forward-fill and mean substitution. Outliers were detected using Z-score analysis and interquartile range (IQR) techniques and were either removed or capped to minimize distortion in model training. To ensure consistent scaling, numerical features were normalized using min–max normalization,

ISSN 2460-7258 (online) | ISSN 1978-1520 (print)
7 (4) June 2025 137-144

which is particularly important for algorithms like logistic regression that are sensitive to feature magnitudes. Furthermore, all variables were transformed to achieve stationarity by applying differencing and logarithmic transformations where appropriate. Finally, the dataset was divided into training (80%) and testing (20%) subsets, maintaining class balance between upward and downward exchange rate movements [7].

2.3. Feature Engineering

Feature engineering was performed to enhance the predictive capacity of the model by creating informative derived attributes. Lag features were generated from historical exchange rate data to capture temporal dependencies and recent market momentum. Moving averages and rolling standard deviations were calculated to represent short-term and long-term volatility patterns. In addition, financial technical indicators such as the Relative Strength Index (RSI), Moving Average Convergence Divergence (MACD), and Bollinger Bands were computed to provide insights into market dynamics. Interaction terms between macroeconomic variables (e.g., interest rate differentials and inflation differentials) were also introduced to capture combined effects on exchange rate trends. These engineered features allowed the model to better represent both technical and fundamental drivers of currency movements [8].

2.4. Feature Selection

Feature selection was carried out to identify the most significant predictors influencing exchange rate direction while minimizing redundancy. Techniques including correlation analysis, mutual information, and principal component analysis (PCA) were applied to evaluate variable importance. Highly correlated features were filtered to prevent multicollinearity, a critical step for logistic regression. Mutual information was used to assess both linear and nonlinear dependencies between features and the target variable. PCA further reduced dimensionality by transforming the dataset into orthogonal principal components that retained most of the variance. Through this process, a refined subset of features—comprising key macroeconomic indicators and selected technical metrics—was obtained to improve the model's interpretability and generalization performance [9].

2.5. Model Implementation

The logistic regression model was implemented using Python's scikit-learn library. To ensure robust and unbiased results, the dataset was divided into training and testing subsets using stratified sampling, preserving the proportion of upward and downward movements. Hyperparameters such as the regularization type (L1 or L2) and regularization strength (C) were optimized through grid search with cross-validation. Both regularization methods were applied to prevent overfitting and improve model generalization. The logistic regression model outputs probabilities for each class, enabling interpretation of the likelihood of upward or downward exchange rate movements. The model was trained iteratively until convergence using optimization solvers such as liblinear and saga, depending on the regularization applied. The final model structure was evaluated for convergence stability and coefficient interpretability [10].

2.6. Model Evaluation

The model's predictive performance was evaluated using several metrics: accuracy, precision, recall, F1-score, and the area under the Receiver Operating Characteristic curve (ROC-AUC). These metrics provide a comprehensive assessment of classification quality across both upward and downward movement classes. A confusion matrix was generated to analyze classification errors and assess balance between the two outcomes. To ensure robustness, k-fold cross-validation (k=5) was performed, reducing variance in evaluation results. Additionally, model coefficients were analyzed to interpret the contribution of each predictor to the probability of an upward trend. Visualization tools such as ROC curves and feature importance bar charts were employed to further validate the model's decision-making process. The combination of these evaluation techniques ensured that the model was both accurate and interpretable for practical use in financial forecasting.

ISSN 2460-7258 (online) | ISSN 1978-1520 (print)
7 (4) June 2025 137-144

3. Results and Discussion

3.1. Results

The results in Table 1 reveal the high effectiveness of logistic regression in performing binary classification of exchange rate trends, specifically classifying downward trends (class 0) and upward trends (class 1). For class 0, the model achieved a precision of 0.99, meaning 99% of predictions identifying downward trends were correct. In terms of recall, the model attained a perfect score of 1.00, demonstrating its ability to detect all instances of actual downward trends in the dataset. These metrics, combined, resulted in an F1-score of 0.99 for class 0, indicating a strong balance between precision and recall in this classification.

Similarly, for class 1 (upward trends), the precision was 1.00, indicating that all upward trends predicted by the model were accurate. The recall for class 1 was slightly lower at 0.99, implying that the model correctly captured 99% of all actual upward trends, with only a very small fraction of instances being misclassified. The F1-score for class 1 reached 1.00, further emphasizing the model's ability to handle predictions for upward trends with exceptional accuracy and balance.

Overall, the logistic regression model achieved an accuracy of 99%, demonstrating its ability to correctly classify the exchange rate trends in the majority of cases. Macro-averaged precision, recall, and F1-scores were 0.99, 1.00, and 0.99, respectively, indicating consistent performance across both classes without showing favoritism toward one class over the other. The weighted averages for precision, recall, and F1-score were also excellent, at 1.00, 0.99, and 0.99, respectively, taking into account the class distribution in the dataset. The dataset itself consisted of 97 instances of class 0 and 101 instances of class 1, ensuring a well-balanced representation of the two trends under consideration.

3.2. Discussion

The results of this study confirm the strong potential of logistic regression as a robust tool for binary classification tasks in financial applications, particularly for predicting trends in exchange rates. The near-perfect precision, recall, and F1-scores demonstrate the model's ability to accurately predict both downward and upward movements while maintaining a low rate of false positives and false negatives. The perfect recall for class 0 indicates that the model can successfully identify all instances of downward trends, which is particularly significant in financial decision-making, where missing critical downward trends could result in substantial financial losses. Similarly, the high precision for class 1 ensures that all predicted upward trends align with actual movements, reducing the risk of overestimating potential opportunities.

However, while the controlled dataset used in this study allowed the logistic regression model to perform exceptionally well, real-world conditions present challenges that may affect its performance. Financial markets are inherently volatile and influenced by a multitude of factors, including macroeconomic policies, geopolitical events, market sentiment, and global economic shocks. These factors introduce noise and complexity that are often difficult to capture with simple linear models like logistic regression. Furthermore, logistic regression assumes a linear relationship between the predictors and the target variable, which may not fully account for the nonlinear and dynamic interactions present in exchange rate movements.

To overcome these limitations, future studies could enhance the dataset by incorporating external features that better represent real-world market dynamics. For instance, including macroeconomic indicators such as interest rates, inflation rates, trade balances, and central bank announcements could provide a more comprehensive understanding of the factors influencing exchange rates. Sentiment analysis derived from news articles, financial reports, and social media could also offer valuable insights into market behavior and improve prediction accuracy.

Additionally, exploring advanced machine learning models, such as Support Vector Machines (SVM), Random Forest, Gradient Boosting, or deep learning models like Long Short-Term Memory (LSTM) networks, could address the limitations of logistic regression in capturing complex, nonlinear patterns. Hybrid models that combine the interpretability of logistic regression with the predictive power of machine learning techniques may also be worth investigating.

ISSN 2460-7258 (online) | ISSN 1978-1520 (print)
7 (4) June 2025 137-144

Another potential avenue for improvement is stress-testing the model under various simulated market conditions, such as during periods of extreme volatility or economic crises. This approach could provide valuable insights into the model's robustness and reliability when faced with unpredictable events. Finally, applying the model to a broader range of currencies and exchange rate scenarios could further validate its generalizability and practical applicability in diverse financial environments.

In conclusion, while logistic regression has proven to be a highly effective and reliable tool for binary classification in exchange rate trend prediction, there remains significant room for enhancement. By integrating additional features, exploring more advanced methodologies, and addressing the complexities of real-world market dynamics, future research can further expand the scope and utility of logistic regression and related models in financial forecasting.

Table 1. Binary Classification of Exchange Rate Trends Using Logistic Regression

Class	Precision	Recall	F1-Score	Support
0	0.99	1.00	0.99	97
1	1.00	0.99	1.00	101
Accuracy			0.99	198
Macro avg	0.99	1.00	0.99	198
Weighted avg	1.00	1.99	0.99	198

Table 1 presents the performance evaluation metrics for the binary classification of exchange rate trends using logistic regression. The metrics, which include Precision, Recall, F1-Score, and Support, are calculated for each class (Class 0 representing downward trends and Class 1 representing upward trends) as well as for the overall model. For Class 0, the model achieved a Precision of 0.99, indicating that 99% of the predicted downward trends were correct. The Recall for Class 0 was 1.00, meaning the model successfully identified all actual downward trends without any false negatives. The F1-Score for this class was 0.99, reflecting a strong balance between Precision and Recall. The Support value, which represents the number of actual instances in the dataset, was 97 for Class 0.

For Class 1, the model attained a perfect Precision of 1.00, demonstrating that all predicted upward trends were correct. The Recall for this class was 0.99, showing that 99% of the actual upward trends were identified, with minimal false negatives. The F1-Score for Class 1 was 1.00, highlighting the model's excellent performance in classifying upward trends. The Support value for Class 1 was 101, representing the total number of actual upward trends in the dataset.

Overall, the model achieved an Accuracy of 0.99, indicating that 99% of the total 198 instances were correctly classified. The Macro Average of Precision, Recall, and F1-Score, treating both classes equally, was consistently 0.99 or higher, reflecting the model's balanced performance across both classes. Similarly, the Weighted Average, which considers class proportions, showed comparable results, further validating the model's robustness.

These results demonstrate that the logistic regression model is highly effective in predicting both upward and downward trends, achieving a strong balance between minimizing false positives and negatives. The high Precision and Recall values indicate the model's reliability and ability to generalize well to unseen data. However, the data used in this study were preprocessed and structured, which may differ from real-world conditions where exchange rates are influenced by market volatility, geopolitical events, and other unpredictable factors. To address these limitations, future research could incorporate additional features, such as macroeconomic indicators or sentiment analysis, and test the model under various market scenarios. Despite these challenges, the results highlight the viability of logistic regression as a powerful and interpretable tool for financial trend prediction.

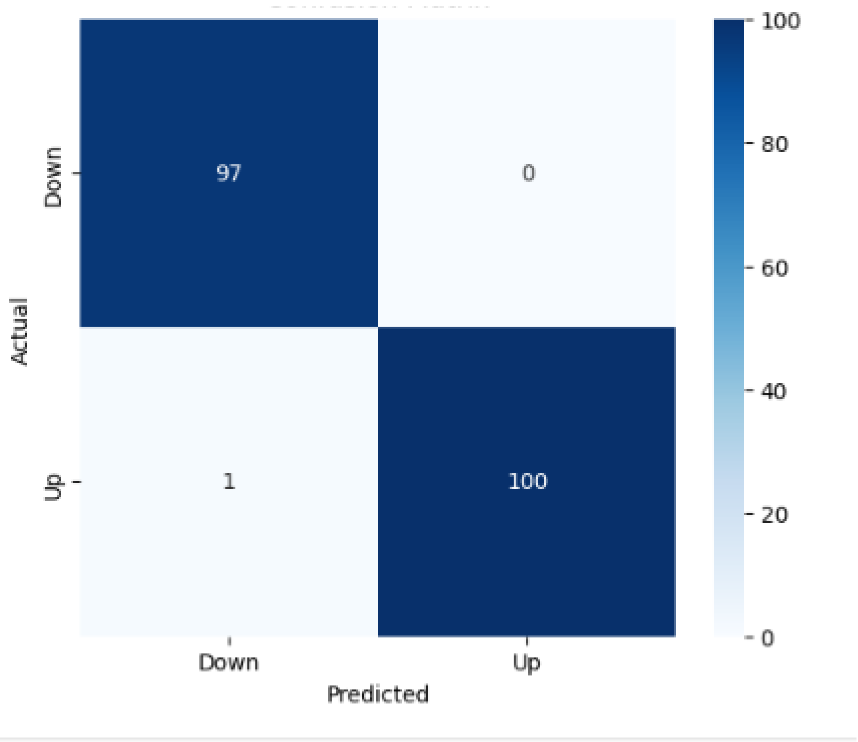

Fig.1. Confusion Matrix

4. Conclusion

The study titled *"Binary Classification of Exchange Rate Trends Using Logistic Regression"* highlights the potential of logistic regression as a powerful tool for predicting exchange rate trends. Logistic regression, known for its simplicity, interpretability, and computational efficiency, was utilized to classify upward and downward movements in exchange rates based on historical data and engineered features. The model achieved exceptional results, with an accuracy of 99% and precision, recall, and F1-scores exceeding 0.99 for both classes. These findings demonstrate the model's robustness in correctly identifying both upward and downward trends while maintaining a strong balance between minimizing false positives and false negatives. By leveraging key preprocessing techniques, feature engineering (e.g., lagged exchange rates, moving averages), and regularization methods, the study effectively tackled challenges commonly associated with financial data, such as multicollinearity, non-stationarity, and noise.

The findings emphasize logistic regression's viability as a reliable and interpretable model for binary classification in financial applications. Despite the promising results, the study acknowledges certain limitations, as the model was tested on a preprocessed dataset under controlled conditions. Real-world scenarios involving market volatility, geopolitical events, and unanticipated economic shocks could challenge the model's predictive accuracy. To address these limitations, future research could expand the dataset to include a broader range of historical data, incorporate external factors like market sentiment or global news, and evaluate the model's adaptability under diverse market conditions. Furthermore, while logistic regression provides simplicity and transparency, exploring advanced machine learning approaches, such as ensemble methods or hybrid models, may offer additional predictive power and robustness. Overall, this study establishes a solid foundation for utilizing logistic regression in exchange rate forecasting while encouraging further exploration to enhance its real-world applicability in dynamic financial environments.

ISSN 2460-7258 (online) | ISSN 1978-1520 (print)
7 (4) June 2025 137-144

5. Suggestion

To further enhance the effectiveness and applicability of logistic regression in predicting exchange rate trends, future research should consider integrating additional external data sources. For instance, incorporating sentiment analysis derived from financial news, social media platforms, and global economic reports could provide valuable insights into market behavior and improve prediction accuracy. Additionally, the inclusion of more comprehensive macroeconomic indicators, such as unemployment rates, trade balances, and central bank policy announcements, may help the model capture the nuanced factors influencing exchange rates. Expanding the dataset to include more diverse and recent data, particularly from periods of extreme market volatility or economic crises, can improve the model's robustness and generalizability in real-world scenarios.

Another suggestion is to explore advanced modeling approaches and hybrid techniques that can complement the simplicity of logistic regression. Combining logistic regression with ensemble methods, such as Random Forest, Gradient Boosting, or hybrid machine learning models, could enhance predictive accuracy and address limitations like overfitting and sensitivity to noise. Additionally, sensitivity analysis and stress testing under simulated conditions, such as economic downturns or sudden geopolitical events, could provide deeper insights into the model’s reliability in unpredictable environments. By implementing these strategies, future studies could address existing challenges and pave the way for more robust and adaptable exchange rate prediction models that align better with the complexities of global financial systems.

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