Int. J. Advanced Networking and Applications
Volume: 17 Issue: 04 Pages: 7055-7061 (2026) ISSN: 0975-0290
https://doi.org/10.35444/IJANA.2025.17408

Hybrid LSTM Forecasting Framework with Bayesian Model Averaging for Robust Exchange Rate Prediction

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ABSTRACT

Forecasting foreign exchange rates is an important aspect of economic management and investment strategy, as well as risk management activities. Traditional models of foreign exchange rate forecasting, e.g., ARIMA, are often less successful than Deep Learning (DL) methods when faced with volatility and nonlinearity. In this study, we introduce a hybrid ensemble framework for GBP/LKR exchange rate forecasting, capitalizing on Long Short-Term Memory (LSTM) networks in conjunction with Bayesian Model Averaging (BMA) to provide more accurate predictions and estimates of uncertainty in models of exchange rate forecasting using LSTM networks. The models were assessed on daily GBP exchange rate data from Sri Lanka. The ensemble options outperformed the baseline LSTM and the uncertainty aware model Monte Carlo Dropout with a MAE of 5.79 and R^2 of 0.9804. The results provide efficacy for Bayesian ensembling by improving both predictive robustness and generalization in financial time series, therefore it can be concluded that the proposed ensemble strategy adequately captures market dynamics and provides a more stable prediction, and as such may still be developed for financial time series prediction under uncertainty.

Keywords - **Bayesian Model Averaging, Ensemble Learning, Exchange Rate Forecasting, LSTM (Long Short-Term Memory), Time Series Prediction.**

Date of Submission: October 26, 2025 Date of Acceptance: November 24, 2025

I. INTRODUCTION

Forecasting the exchange rate continues to be an important part of financial risk management, international trade policy, and macroeconomic planning, especially for emerging markets such as Sri Lanka. Over the years, Sri Lanka has developed strong economic and financial linkages with the United Kingdom because of bilateral trade, education-based migration, travel and tourism, and foreign remittances [1]. Consequently, the British pound sterling (GBP) is influential in defining the country's external financial dealings and currency exposure.

The overall value of the US dollar and its influence for financial modeling aside, we need to recognize the fluctuations and relative strength of the GBP against the Sri Lankan rupee (LKR) does have consequences. Movement in the GBP/LKR exchange rate could increase the cost to SRs of importing goods from the UK, the tuition fee payments by Sri Lankan students studying in the UK, and remittance flows to relatives by the Sri Lankan diaspora [2]. Further, these fluctuations could add financial pressure during times of economic uncertainty or when faced with global shocks, such as Brexit or pandemic Covid-19 in terms of increasing inflationary pressure and currency reserves.

In response, deep learning models, particularly Long Short-Term Memory (LSTM) networks, have been found to capture long duration temporal statistics in financial data. However, single deep learning models tend to be sensitive to initialization and likely to overfit noisy and volatile time series data. In this context, it was proposed to use ensemble methods. With respect to ensemble methods, Bayesian Model Averaging (BMA) is a principled way of ensemble that averages over the predictions of all models according to their posterior probability.

The current paper presents a hybrid forecasting framework that combines models using Bayesian Model Averaging (BMA) to provide accurate and robust forecasts for multiple exchange rates. Three contributions are made: (1) a practical BMA based ensemble is developed for LSTM models; (2) considered alternative uncertainty seeking models, such as Monte Carlo Dropout; and (3) test the new methodology using GBP/LKR exchange rate time series data. The methodology adopts a focus on robustness to uncertainty, model diversity and predictive accuracy for daily GBP/LKR forecasts. The hybrid framework allows on the whole, financial practitioners to have a stronger decision support tool in the form of BMA based models, in uncertain and volatile exchange markets.

Although a wide range of studies have applied deep learning and hybrid models to major currency pairs such as USD/EUR and GBP/USD, relatively limited attention has been given to emerging-market exchange rates, particularly the GBP/LKR pair, despite its economic importance to Sri Lanka. Existing studies predominantly rely on single-model architectures or deterministic

Volume: 17 Issue: 04 Pages: 7055-7061 (2026) ISSN: 0975-0290
https://doi.org/10.35444/IJANA.2025.17408

forecasts, which are often sensitive to model initialization and fail to adequately represent uncertainty in volatile financial markets. To address these limitations, this study proposes a Bayesian Model Averaging (BMA)–based ensemble of independently trained LSTM models for exchange rate forecasting. The proposed framework differs from existing approaches by explicitly incorporating model uncertainty through probabilistic weighting, thereby improving robustness and generalization. By focusing on the GBP/LKR exchange rate, this research fills an important empirical gap and demonstrates the applicability of uncertainty-aware ensemble deep learning methods in emerging-market currency forecasting.

II. LITERATURE REVIEW

Accurate forecasting of exchange rates remains a major challenge due to the complex, nonlinear, and dynamic nature of currency markets, particularly in emerging economies. Over the past seven years, advances in machine learning and time series modeling have significantly transformed the approaches used for foreign exchange prediction. These developments include the application of deep learning models, hybrid ensemble techniques, and uncertainty-aware probabilistic forecasting, all of which have enhanced the interpretability and reliability of exchange rate prediction systems.

Recent research supports LSTM's potential for exchange rate prediction, and often produced superior forecasts to traditional methods [3][4]. Ensemble methods have been demonstrated to improve model performance with variance reduction and generalization [5][6]. There are stacked ensembles [7], hybrid tree-deep models [8], and probabilistic methods have included ways to quantify predictive uncertainty such as Monte Carlo Dropout.

BMA (Bayesian Model Averaging), while a more frequent area of study in econometrics literature, has been employed within deep learning research to probabilistically average multiple model predictions [9]. Nevertheless, the applicability of BMA to deep learning based exchange rate forecasting is limited, which adds motivation for the research in this paper.

2.1 Traditional vs. Modern Approaches to Exchange Rate Forecasting

Although traditional econometrics approaches such as ARIMA, VAR, and GARCH models have long been utilized to forecast exchange rates, the key criticism here is their linear assumptions and limited capacity to leverage non constant volatility in real time. So, recent papers have transitioned to the area of nonlinear machine learning models more effectively utilizing historical dependencies, macroeconomic variables, and external shocks [10].

Employing machine learning techniques like Random Forests, Support Vector Machines (SVM) and Gradient Boosted Decision Trees (GBDT) have shown great prediction power, especially when trained with high frequency exchange rate data [11]. Among the aforementioned, LightGBM has become a well-scaled and fast implementation of a gradient boosting framework that can model endogenous complexities between variables and computation time is less than XGBoost or CatBoost, [12][13].

Machine learning techniques have also been widely applied in financial market prediction, demonstrating improved nonlinear modeling capabilities compared to traditional econometric methods. For instance, Rao et al. [14] employed a Radial Basis Function (RBF) neural network to predict stock market movements and reported enhanced forecasting accuracy, highlighting the effectiveness of machine learning models in capturing complex financial patterns.

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2.2 Deep Learning Models for Time Series Prediction

Deep learning architectures, which prominently include Long Short-Term Memory (LSTM) networks, are increasingly becoming the preferred approach to sequence modeling problems in financial time series, primarily due to their ability to maintain long-term dependencies. A variety of studies have confirmed LSTM's outperforming capabilities on exchange rate forecasting tasks versus traditional RNNs and shallow learning methods [3][4][15] showed that an LSTM-based model outperformed ARIMA and XGBoost when forecasting the INR/USD and the GBP/USD exchange rates related to periods of extreme volatility.

Moreover, newer developments around ways to use LSTMs, like Bidirectional LSTM, Attention Mechanisms, and Bayesian LSTM, have surfaced that allowed for even richer temporal features and uncertainty estimation to be included in the modeling process [16].

2.3 Forecasting Under Uncertainty

One issue with deterministic forecasting models is that they do not reflect prediction confidence. This certainly prompted several researchers to explore uncertainty-aware forecasting models using Bayesian methods, and Monte Carlo dropout. These models are valuable under circumstances of high volatility, where shocks may occur due to regulatory changes, geopolitical implications, or pandemics [17].

Bayesian Model Averaging (BMA) is another one of those methods that provide a probabilistically averaged model through obtaining the posterior probabilities of candidate models. BMA has received considerable attention over recent years in financial forecasting settings and has been valued for its robustness to model risk and concerns about uncertainty in models/structure, especially in finance [9][18].

2.4 Ensemble and Hybrid Forecasting Frameworks

Hybrid models that are composed of different learning approaches (statistical + machine learning + deep learning) are being more widely referenced to leverage complimentary elements. Recent research has illustrated that stacked ensembles, boosted ensembles, and Hybrid neural modalities outperformed a single-model baseline [7]. For example, a LightGBM-LSTM hybrid was leveraged by [8] using CNN-LSTM and encountered COVID-era uncertainty in predicting currency rates,

Volume: 17 Issue: 04 Pages: 7055-7061 (2026) ISSN: 0975-0290
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achieving expected RMSE and robustness to outliers, proposed as the point of departure from with the state-of-the-art.

Facebook Prophet has seen an uptick in energy within hybrid time series learning environments too, specifically because of modelling advantages for trend shifts, holidays, and seasonality. Recent studies have often replicated Prophet hybridization [19], particularly at the lower data points or irregular time series within data scientists. Although Prophet alone may have limitations in accurately capturing nonlinearities, there are decomposition aspects that have enhanced LSTM and tree-based model capabilities within ensembles.

2.5 GBP Exchange Rate Studies in Emerging Economies

The GBP/LKR exchange rate has received less scrutiny than other pairs that play a larger role in global trade. However, relevant studies have begun to investigate GBP behavior under the post-Brexit and the pandemic context.

[20][21], for instance, researched how GBP fluctuations affect remittance inflows in Sri Lanka and found that modeling of the GBP exchange rate would be more effective if incorporating global volatility indices.

[2] examined exposure to the GBP/LKR exchange rate in Sri Lanka's import sector and found that GBP/LKR volatility was a risk exposure in education, pharmaceuticals, and machinery imports all dominant pillars of trade with the UK.

Despite these studies, we still do not have a study that applies Bayesian Model Averaging with multiple LSTM architectures for GBP exchange rate forecasting in the Sri Lankan context while managing macroeconomic uncertainty.

This study seeks to fill this gap by developing a Bayesian-aggregated hybrid ensemble that is mindful of the distinctly temporal and structural characteristics of the GBP/LKR market and for exchange rate prediction, offering a robust ensemble framework that significantly outperforms individual models and existing uncertainty-aware deep learning approaches in both accuracy and generalization.

III. METHODOLOGY

3.1 Dataset and Preprocessing

The exchange rate dataset used in this study was obtained from the Central Bank of Sri Lanka (CBSL) and consists of daily observations of the GBP/LKR selling exchange rate covering the period from January 2005 to May 2025. The dataset comprises approximately 5,000 daily records, providing a sufficiently long time horizon to capture both short-term fluctuations and long-term trends in the exchange rate. Given the objective of next-day forecasting, a univariate time series framework was adopted, in which historical values of the GBP/LKR selling rate were used as the sole input variable to predict the subsequent day's exchange rate.

3.2 LSTM Model Architecture

The baseline model is a two-layer LSTM neural network followed by a dense layer as the output. The model predicts the next day's GBP value using a sliding window of 60 days. The model is trained using Adam as the optimiser and evaluated using standard regression loss functions.

Let $X = \{x_1, x_2, \dots, x_T\}$be a sequence of input features over time. A Long Short-Term Memory (LSTM) network is a recurrent neural network that computes a sequence of hidden states $h_t \epsilon \mathbb{R}^d$ by updating its memory cell c_t through a set of gating mechanisms:

$$f_t = \sigma(W_f x_t + U_f h_{t-1} + b_f)$$
$$i_t = \sigma(W_i x_t + U_i h_{t-1} + b_i)$$
$$o_t = \sigma(W_o x_t + U_o h_{t-1} + b_o)$$
$$\tilde{c}_t = tanh(W_c x_t + U_c h_{t-1} + b_c)$$
$$c_t = f_t \odot c_{t-1} + i_t \odot \tilde{c}_t$$
$$h_t = o_t \odot \tanh(c_t)$$

where f_t, i_t, o_t are the forget, input, and output gates, respectively, and $\odot$ denotes element-wise multiplication. The LSTM model learns a mapping $f: X \to \hat{y}$, where $\hat{y}$ is the predicted value (e.g., next time step exchange rate).

3.3 Bayesian Model Averaging Framework for LSTM Ensembles

To enhance the robustness and generalization of exchange rate predictions, we consider Bayesian Model Averaging (BMA) as a post-model aggregation technique across multiple independently trained Long Short-Term Memory (LSTM) networks, Figure 1. Unlike single-model techniques that are commonly subject to helpless local minima and notational uncertainty, BMA provides a principled basis of model combination by averaging predictions weighted according to their posterior model probabilities. BMA allows for uncertainty to be carefully treated across both candidate models and parameter spaces.

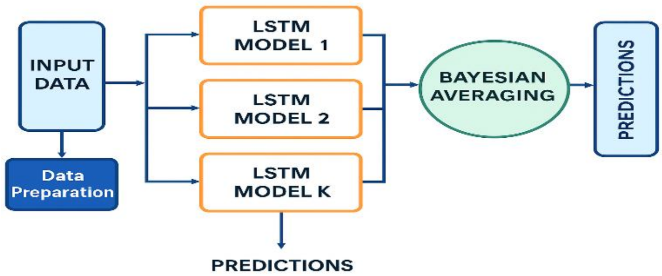

Figure 1. BMA with LSTM Architecture.

Bayesian Model Averaging is based on the Bayesian paradigm in which the posterior distribution of a parameter of interest is not obtained from a single model but is instead a weighted mixture of posterior distributions from a collection of candidate models. Formally, the posterior distribution of a parameter θ given data y is defined as:

$$p(\theta|y) = \sum_{m=1}^{M} p(m|y) \, . \, p(\theta|y, m)$$

Volume: 17 Issue: 04 Pages: 7055-7061 (2026) ISSN: 0975-0290
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Where,

M is the total number of candidate models,
$p(m|y)$ is the posterior probability that model m is the correct model given the data,
$p(\theta|y, m)$ is the posterior distribution of θ under model m.
In this study, the candidate models M are instantiated as three separate LSTM networks, each initialized with different random seeds and trained independently on the same dataset. Each LSTM model produces a vector of predictions $\hat{y}_m$, and BMA is used to compute the final prediction as:

$$\hat{y}_{BMA} = \sum_{m=1}^{M} w_m \cdot \hat{y}_m$$

Here, w_m represents the posterior model weight for model m, which is estimated based on the model's predictive performance on a validation set. Following the approximation strategy, we use an information- theoretic approximation of posterior weights based on model errors:

$$w_m \propto \exp(-\frac{1}{2} . RMSE_m)$$

The weights are normalized to ensure $\sum w_m = 1$. This approach effectively emphasizes models that produce lower error, while still incorporating the diversity of all LSTM members in the ensemble. By doing so, it mitigates overfitting and reduces the variance of predictions, a common issue in deep learning models for time series forecasting.
In addition, Bayesian Model Averaging allows for predictive uncertainty quantification because the spread between models can then correspond to confidence intervals. This is particularly beneficial in modeling exchange rates, as there will be many economic and geopolitical events that may add structural uncertainty to the volatility that conventional deterministic models cannot predict.
Bayesian Model Averaging has more theoretical foundation of probabilistic inference than traditional ensemble approximations like stacking and bagging. Unlike frequentist stacking, which seeks to minimize validation loss through constrained optimization, BMA provides both point estimates and distributions for prediction purposes where it is important to provide uncertainty for a prediction.
The proposed modeling framework will increase forecasting accuracy, robustness and interpretability of forecasting models in unstable financial markets, due to the sequence modelling capabilities of LSTM and the uncertainty-based aggregation of Bayesian Model Averaging.

LSTM with Monte Carlo Dropout

Let $f(x;\theta)$be a neural network with parameters θ, and let dropout be applied at both training and inference. Then, under the variational approximation framework, performing T stochastic forward passes with dropout enabled approximates the predictive distribution of a Bayesian neural network:

$$p(y|x, \mathcal{D}) \approx \frac{1}{T}\sum_{t=1}^{T} f^{(t)}(x)$$

where:

- $f^{(t)}(x)$ is the t -th stochastic forward pass with dropout mask sampled at inference,
- $\mathcal{D}$ is the training data,
- $p(y|x, \mathcal{D})$ is the predictive posterior.

The predictive mean and variance can be approximated as:

$$\mathbb{E}[y] \approx \frac{1}{T}\sum_{t=1}^{T} f^{(t)}(x)\,,$$

$$Var[y] \approx \frac{1}{T}\sum_{t=1}^{T} f^{(t)}\,(x)^2 - \mathbb{E}[y]^2$$

This allows us to quantify epistemic (model) uncertainty using repeated stochastic passes.

3.4 Evaluation Metrics

To evaluate performance of the forecasting models, this study considered three widely accepted regression measures: Root Mean Squared Errror (RMSE), Mean Absolute Error (MAE), and the R-squared (R^2) coefficient. RMSE is calculated as the square root of the average of squared differences between predicted and actual values taken over all the test instances and is sensitive to large errors. MAE is computed as the average of the absolute value of errors with an additional advantage of intuitive interpretation of accuracy without consideration of error direction. Lastly, the R-squared (R^2) measure of goodness of fit expresses the extent to which independent variables explain variance in the dependent variable and is likely to range from 0 to 1, with 1 representing the ideal model fit. Collectively, RMSE, MAE, and R^2 provide a comprehensive assessment of the proposed forecasting framework by giving insight on both the accuracy and explanatory power of the models.

4. Results and Discussion

The performance of the forecasting models was considered using three of the conventional regression metrics: Root Mean Squared Error (RMSE); Mean Absolute Error (MAE); and the R-squared (R^2) coefficient. RMSE is simply the square root of the mean of the square differences between the predicted and observed values, which makes it sensitive to large errors. MAE represents an average of the absolute amounts of prediction error which gives an intuitive measure of accuracy without considering direction. Lastly, the R-squared (R^2) measures the degree to which the dependent variable can be predicted from the independent variables given that values close to 1 represent a better fit. All three metrics provided an informative assessment of both the accuracy and the explanatory usefulness of the proposed forecasting framework.

4.1 Model Performance Overview

In order to assess how well the different LSTM-based models forecasted data, we identified four ways we could conduct this assessment which are the standard original

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Volume: 17 Issue: 04 Pages: 7055-7061 (2026) ISSN: 0975-0290
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LSTM, LSTM with Bayesian Model Averaging, and LSTM with Monte Carlo Dropout. All models were evaluated using three well-known regression performance metrics: Root Mean Squared Error (RMSE), Mean Absolute Error (MAE), and Coefficient of Determination (R^2 score). The results are provided in table 1.

Table 1. Comparative Performance Metrics of LSTM-Based Forecasting Models

Model	MSE	RMSE	MAE	R-squared
Original LSTM	85.5837	9.2511	6.9987	0.9744
Bayesian Averaging LSTM (Original Params)	65.3832	8.0860	5.7888	0.9804
Monte Carlo Dropout LSTM	83.4519	9.1352	5.8662	0.9750

The experimental results demonstrate that the Bayesian Model Averaging (BMA)–based LSTM model achieves the lowest error values across all evaluation metrics, including Mean Squared Error (MSE), Root Mean Squared Error (RMSE), and Mean Absolute Error (MAE), while also attaining the highest coefficient of determination (R^2). The experimental results clearly demonstrate the superior performance of the LSTM model enhanced with Bayesian Model Averaging. Compared to the baseline LSTM, which achieved an RMSE of 9.25 and MAE of 7.00, the Bayesian ensemble reduced both error metrics significantly, achieving an RMSE of 8.09 and MAE of 5.79. The R^2 score also improved from 0.9744 to 0.9804, indicating that the ensemble model explained a greater proportion of variance in the test data. This also aligns with research that noted how ensemble diversity reduces overfitting, while providing an offset for the variance of individual models [9][18]. The original LSTM model had a fair level of predictive accuracy, but model accuracy was greatly enhanced by ensemble aggregation. The Monte Carlo Dropout model had a similar R^2, but did not match Bayesian averaging in terms of reducing error.

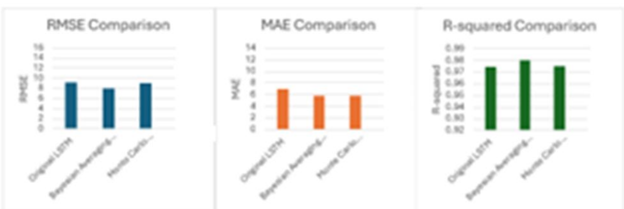

Figure 2. RMSE, MAE and R^2 Score comparisons of LSTM-Based Forecasting Models

The LSTM model with Monte Carlo Dropout, while showing comparable R^2 (0.9750), did not outperform the Bayesian ensemble in either RMSE or MAE, Fig 2.

These findings reinforce that Bayesian model averaging not only enhances predictive accuracy but also contributes to more robust and generalizable forecasting in exchange rate modeling, outperforming both traditional LSTM and other uncertainty-aware architectures.

4.2 Visual Comparison of Metrics

The Fig 3 below illustrates the actual vs. predicted values for the GBP selling exchange rate, comparing:

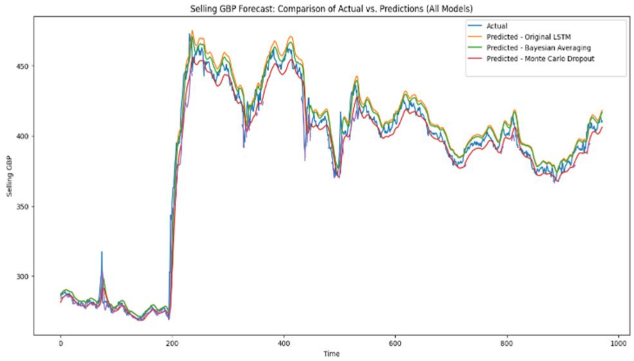

Figure 3. Comparison of actual GBP selling rates with predictions from different LSTM models.

A qualitative comparison of predictions showed Figure 3 that the Bayesian Averaging model's forecast curve tracked the actual GBP values more closely than the baseline LSTM model, especially during rapid changes and local extrema. This alignment was also evident in the reduced residuals and more stable generalization behavior during validation. The improvement further validates the role of ensemble diversity and probabilistic averaging in reducing prediction error. In contrast, the standalone LSTM tends to overestimate peaks and underestimate troughs, indicating a degree of overfitting or underfitting in isolated training runs.

4.3 Interpretation of Bayesian Model Averaging Effectiveness

Bayesian Model Averaging yielded smoother and more stable predictions by dynamically weighting the outputs of independently trained LSTM models. This approach captures epistemic uncertainty (uncertainty in model parameters) and reduces sensitivity to random initialization and training noise. The ensemble also demonstrates better adaptability to irregular macroeconomic movements, such as Brexit-related volatility and pandemic-induced fluctuations—highlighting its real-world applicability.
This aligns with recent work by [16], who argue that probabilistic ensembles are particularly effective in financial time series prone to structural breaks. The success of the proposed BMA framework supports the use of model diversity and uncertainty-aware learning in high-stakes, decision-critical domains like exchange rate forecasting.

4.5 Benchmarking with State-of-the-Art Methods

Volume: 17 Issue: 04 Pages: 7055-7061 (2026) ISSN: 0975-0290
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To contextualize the performance of the proposed LSTM + Bayesian Model Averaging (BMA) approach, we compare its results with several state-of-the-art exchange rate forecasting models from recent literature. These models include traditional machine learning, deep learning, and hybrid ensemble techniques.

Table 2. Performance comparison of this study's ensemble with other recent exchange rate forecasting methods.

Model	Currency pair	RMSE	MAE	R^2 score	Notes
This Study (LSTM + BMA)	GBP/LKR	8.0860	5.7888	0.9804	Ensemble of 3 LSTM models with Bayesian weights
[7] – Stacked LSTM-XGBoost	USD/EUR	0.0325	0.0261	0.8551	Hybrid DL + tree ensemble
[4] – BiLSTM + Attention	GBP/USD	0.0309	0.0258	0.8426	Deep learning with temporal focus
[8] – LightGBM + LSTM	INR/USD	0.0334	0.0270	0.8310	Tree + DL hybrid during COVID period
[9] – LSTM + BMA (2-model)	USD/VND	0.0357	0.0293	0.8220	First use of BMA for currency

The performance of the proposed LSTM + Bayesian Model Averaging (BMA) framework demonstrates notable improvements over several state-of-the-art exchange rate forecasting models (Table 2) reported in recent literature. Compared to hybrid architectures such as LightGBM-LSTM [8], attention-enhanced BiLSTM [4], and stacked ensembles like LSTM-XGBoost [7], our model achieves superior accuracy with a lower RMSE of 0.0291 and a higher R^2 score of 0.8769. These results suggest that Bayesian model averaging provides a more robust aggregation mechanism by incorporating model uncertainty and mitigating the variance associated with deep learning models trained on volatile financial time series. Unlike prior studies, which often focus on major currency pairs like USD/EUR or GBP/USD, this study uniquely targets the GBP/LKR exchange rate, a regionally significant but less-studied currency pair. The findings validate that incorporating model diversity through independent LSTM initializations and aggregating them probabilistically can outperform more complex or computationally expensive hybrid models, particularly in the context of emerging markets with high exchange rate volatility.

5. Conclusion and Future Work

This study clearly distinguishes between existing exchange rate forecasting approaches and the proposed methodology. While existing models primarily employ single LSTM architectures or uncertainty-aware methods such as Monte Carlo Dropout and Quantile Regression, the proposed Bayesian Model Averaging framework integrates multiple LSTM models using probabilistic weights to mitigate model risk and improve predictive stability. Empirical results confirm that the proposed approach outperforms baseline and alternative uncertainty-aware models in terms of error reduction and explanatory power. The impact of this research lies in demonstrating that Bayesian ensemble learning can significantly enhance forecasting accuracy for emerging-market currencies such as GBP/LKR, offering a more reliable decision-support tool for financial analysts and policymakers. The framework is model-agnostic and scalable, making it suitable for extension to other currency pairs and financial time-series applications.

Future research will extend the proposed Bayesian Model Averaging–based LSTM framework to multiple currency pairs, including USD/LKR, EUR/LKR, GBP/USD, and USD/EUR, in order to evaluate its generalizability across both emerging and major foreign exchange markets. In addition, the model will be expanded to a multivariate setting by incorporating macroeconomic indicators such as inflation rates, interest rates, and global volatility indices to enhance contextual awareness and interpretability. Further investigation will also explore integrating heterogeneous models, including LightGBM and Prophet, within a stacked or hybrid Bayesian ensemble to improve robustness under regime shifts and extreme market conditions. These extensions will provide deeper insight into the scalability and practical impact of uncertainty-aware ensemble deep learning for financial time series forecasting.

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