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The Price Discovery and Volatility Transmission between Korean Won, Chinese Yuan, and Japanese Yen

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The globalization and integration of financial markets across border is an inevitable phenomenon, in line with which even emerging economies including Korea have opened their financial markets to international investors. With increasing globalization in capital markets, the cross border capital flow has become an important issue because it is directly related to vulnerability of small and open economies. In the past decades, the international financial economics literatures examine the effect in relation of the return of price and volatility transmission between stock markets (Hamao et al., 1990, Karolyi, 1995; Ng, 2000; Singh et al., 2010) or between index or commodity futures markets (Roope and Zurburegg, 2002; Xu and Fund, 2005; Liu and An, 2011). Although some studies examine the relation in currency markets, their focus is limited to price return and volatility transmission between major currencies such as Japanese Yen, Deutsch Mark, and British Pounds (Baillie and Bollerslev, 1991; Hong, 2001) or between European currencies (Baele, 2005; Bubak et al., 2011). No study so far has examined those between the currencies in the Asian region, so this paper is in fact the first of its kind to do so. As such, the purpose of this paper is to examine the dynamics of price discovery and volatility transmission between Korean Won (KRW), Chinese Yuan (CNY), and Japanese Yen (JPY). We use the US dollar, which has been used for payment and settlement in international trades, as the numeraire for evaluating the three currencies and gold. Historically, Japan has been the most influential economy for Korea next to the US. Korea and Japan have similar economic structure and geographical proximity to each other. Meanwhile, China's economy has grown rapidly since 1990's and has become the second largest economy in term of GDP in the world. Accordingly, its economic influence on Korea has also rapidly grown, and since 2006 it has been Korea's biggest trade partner, replacing Japan. Hence, we conjecture that some power shift must take place from Japanese yen to Chinese yuan in terms of these currencies' influence on Korean won. Subsequently, we conduct studies to understand how the three currencies are interrelated in term of the price discovery and volatility transmission. Our study period is from Aug. 1, 2005 to Nov. 7, 2012 since China was under the fixed exchange rate regime before Aug. 1, 2005. We also remove the period from Jul. 1, 2008 to May 31, 2010 from the above because China temporally enforced the fixed rate system during this global financial crisis (hereafter GFC) period. As a consequence, our sample period is divided into two sub-sample periods. The first one is from Aug. 1, 2005 to Jun. 30, 2008, which is before the GFC period. The other one is from Jun. 1, 2010 to Nov. 7, 2012, which is after the GFC period. To investigate the price discovery, we employ Hasbrock's (1995) information share measurement method. Our findings are follows: Before the GFC, the contribution of JPY for the price discovery of KRW is rather high while the contribution of CNY for the discovery of KRW is low. However, after the GFC, the price discovery contribution of CNY on KRW becomes quite significant whereas that of JPY diminish. To identify the volatility transmission, we use a multivariate volatility model, BEKK. However, since we should analyze four variables, we decide to employ the rotated multivariate GARCH model (hereafter MRARCH) of Noureldin et al. (2012) for numerical stability. Using this model, we find that there is no significant volatility transmission between JPY, CNY, and KRW before the GFC. However, the influence of CNY towards KRW and JPY in volatility transmission becomes apparent after the GFC. We suggest that increased role of CNY in volatility dynamics for Korea is caused both by the increase in the trade volume between China and Korea and by the rise of China's economic status in the world market. Although we can not get some strong evidences in terms of statistical significances, our empirical results support that there is a relative influence power shift from JPY to CNY before and after the GFC. This is the first systematic empirical work to find the linkage between the major currencies in Asia region. We hope that this study trigger further research on the multivariate currencies dynamics in the region.

Keywords:Price Discovery,Volatility Transmission,Financial Crisis,Information Share,Multivariate Rotated ARCH (MRARCH) Model Download List

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