

Applied Financial Economics >  
Volume 14, 2004 - Issue 12

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# Long run trends and volatility spillovers in daily exchange rates

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Pages 895-907 | Published online: 02 Feb 2007

Cite this article <https://doi.org/10.1080/0960310042000203037>

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## Abstract

Recent evidence has suggested that a model capable of capturing multiple volatility dynamics best describes daily exchange rate volatility. Estimation of a model that can capture long-run and short-run volatility movement also allows issues relating to financial and economic integration between countries to be examined. More specifically, the long-run component for comovement can be examined and spillover effects tested for in mean and volatility, the latter of which is suggestive of policy co-ordination. The paper reports of a long-run volatility series. Further, the European series in these economic

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# Notes

Whilst non-negativity constraints on the parameters of [Equation 4](#) are sufficient to ensure a non-negative GARCH variance, they are not necessary since weaker sufficiency conditions on the ARCH ( $\infty$ ) inversion of [Equation 4](#) also exist (Nelson and Cao, [1992](#)). For example, in the empirically relevant GARCH (1,2) case below,  $\omega > 0$ ,  $\alpha_1 \geq 0$ ,  $\beta_1 \geq 0$  and  $(\beta_1 \alpha_1 + \alpha_2) \geq 0$  are sufficient to ensure

, such that  $\alpha_2$  may be negative. For generalizations of this results see Nelson and Cao ([1992](#)) and Drost and Nijman ([1993](#)). However, it remains necessary and sufficient that the sum

in order for a finite unconditional variance to exist, that sum also providing a measure of the persistence of shocks to

, permitting the quantification of shock half lives as  $\lambda = [\ln(0.5)/\ln(\rho)]$ , and defining the limiting integrated-GARCH (IGARCH) case for  $\rho = 1$ ,  $\lambda = \infty$ .

See Engle and Lee ([1993](#)) for further details of stationarity and non-negativity conditions.

Nevertheless, it remains possible that long-run movements in these exchange rates are determined either by their own individual set of fundamentals, or by some common set of fundamentals. Given that all six currencies appear to be described by  $I(1)$  processes, the potential for common movement between them can be examined through testing for cointegration that is the presence of one or more long-run stationary relationships between these exchange rate series. The results of applying tests for up to five cointegrating vectors using the well known and widely applied framework of Johansen

([1991](#), 1995) to the six exchange rates, and the results of applying the Johansen (1991, 1995) test for one long-run equilibrium relationship to the six exchange rates, as outlined in Diebold and Mariano (1995), and Johansen (1995), test the null hypothesis that the long-run cointegration matrix is zero. The long-run cointegration matrix is zero if and only if the long-run cointegration matrix is zero for any subset of the exchange rates. The results of the Johansen (1995) test for cointegration from the results of the Johansen (1995) test for cointegration from the authors.

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All the estimation in this paper is executed using EViews 4.0.

Although the AR(1) coefficient for the Lira is statistically insignificant its inclusion was preferred on the basis of the BIC and residual tests.

These results are similar to those presented in Baxter ([1994](#)) for the level of quarterly real exchange rates.

A possible explanation for this difference lies in the fact that the continental European exchange rates have operated under a (semi-) fixed exchange rate regime for much of this period, such that volatility in their exchange rates will be subject to transitory movements within the currencies that were in the exchange rate mechanism, while sterling is determined by its long-run equilibrium value and therefore less prone to transitory movements.

The authors' are grateful to an anonymous referee for suggesting this approach.

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