

Long Memory and Volatility Dynamics in the US Dollar Exchange Rate

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This paper focuses on nominal exchange rates, specifically the US dollar rate vis-à-vis the Euro and the Japanese Yen at a daily frequency. In the paper both absolute values of returns and squared returns are modelled using long-memory techniques, being particularly interested in volatility modelling and forecasting. Compared with previous studies using fractional integration such as Granger and Ding (1996), a more general model is estimated, which allows for dependence not only at the zero but also at other frequencies. The results show differences in the behaviour of the two series: a long-memory cyclical model and a standard I(1) model seem to be the most appropriate for the US dollar rate vis-à-vis the Euro and the Japanese Yen respectively. (JEL: C22, O40)

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I. Introduction

The empirical literature analysing the statistical properties of exchange rates is vast. Most studies focus on the behaviour of real exchange rates in order to establish whether it is consistent with the theory of Purchasing Power Parity (PPP), which is one of the central tenets of the theory of exchange rate determination. In particular, they test the null hypothesis that the real exchange rate follows a random walk, the

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alternative being that PPP holds in the long run. However, such unit root tests are now well known to have very low power unless very long spans of data are used (see, e.g., Lothian and Taylor, 1996, and Cheung and Lai, 1994). Moreover, whilst in a flexible-price monetary model PPP is assumed to hold continuously, in a sticky-price model it holds only in the long run. Therefore the relevant issue to investigate is whether deviations from PPP are transitory or permanent.

As a result of the increasing awareness of the limitations of standard unit root tests as well as of possible frictions in foreign exchange markets, long-memory and fractional integration methods have been used much more frequently. For instance, applying R/S techniques to daily rates for the British pound, French franc and Deutsche mark, Booth et al. (1982) found positive memory during the flexible exchange rate period (1973-1979) but negative one (i.e., anti-persistence) during the fixed exchange rate period (1965-1971). Cheung (1993) also found evidence of long-memory behaviour in foreign exchange markets during the managed floating regime. On the other hand, the results obtained by Baum et al. (1999) estimating an ARFIMA model for real exchange rates in the post-Bretton Woods era do not support long-run PPP.

Other studies focus on the behaviour of nominal exchange rates. In this case, the main motivation is often building a model with better forecasting properties, rather than test theories of exchange rate determination, and in particular the financial modelling and forecasting of exchange rate volatility. This is because, from a dealer's perspective, what is of interest is not so much the ability to predict fluctuations in the exchange rate level, but rather in its volatility.

Some examples of recent studies analysing nominal exchange rate dynamics using fractional integration (looking at futures in particular) are those by Fang et al. (1994), Crato and Ray (2000) and Wang (2004). Volatility dynamics in foreign exchange rates (mainly the Deutsche mark vis-à-vis US dollar rate) have also been examined with the FIGARCH-model, introduced by Baillie et al. (1996), and subsequent papers using this approach are Andersen and Bollerslev (1997, 1998), Tse (1998 – examining the Japanese Yen-US dollar rate), Baillie et al. (2000), Kihc (2004) and Morana and Beltratti (2004 – analysing volatility).

The present study also focuses on nominal exchange rates, specifically the US dollar rate vis-à-vis the Euro and the Japanese Yen at a daily frequency. Both absolute values of returns and squared returns are modelled using long-memory techniques, being particularly

interested in volatility modelling and forecasting. Compared with previous studies using fractional integration such as Granger and Ding (1996), a more general model is estimated which allows for dependence not only at the zero but also at other frequencies.

The layout of the paper is the following. Section II describes the methodology. Section III presents the empirical results. Section IV examines the stability of the relationships over time. Section V examines the forecasting properties of the estimated models, while Section VI offers some concluding remarks.

II. Methodology

Given a covariance stationary process $\{x_t, t = 0, \pm 1, \dots\}$, with autocovariance function $E[(x_t - Ex_t)(x_{t-j} - Ex_{t-j})] = \gamma_j$, according to McLeod and Hipel (1978), x_t displays the property of long memory if

$$\lim_{T \rightarrow \infty} \sum_{j=-T}^T |\gamma_j|$$

is infinite. An alternative definition, based on the frequency domain is as follows. Suppose that x_t has an absolutely continuous spectral distribution, and therefore a spectral density function, denoted by $f(\lambda)$, and defined as

$$f(\lambda) = \frac{1}{2\pi} \sum_{j=-\infty}^{\infty} \gamma_j \cos \lambda j, \quad -\pi < \lambda \leq \pi.$$

Then, x_t displays long memory if this function has a pole at some frequency λ in the interval $[0, \pi]$. Most of the empirical literature has focused on the case when the singularity or pole in the spectrum occurs at the zero frequency. This is true in the standard fractionally integrated or $I(d)$ models of the form:

$$(1 - L)^d x_t = u_t, \quad t = 0, \pm 1, \dots, \tag{1}$$

with $x_t = 0, t \leq 0$, and where L is the lag operator ($Lx_t = x_{t-1}$), d is a positive real value, and u_t is an $I(0)$ process defined as a covariance stationary process with a spectral density function that is positive and

bounded at all frequencies.¹ As previously mentioned these processes are characterised by a spectral density function which is unbounded at the zero frequency.

However, a process may also display a pole or singularity in the spectrum at a frequency away from zero. In this case, the process may still display the property of long memory but the autocorrelations exhibit a cyclical structure that is decaying very slowly. This is the case of the Gegenbauer processes defined as:

$$(1 - 2 \cos w_r L + L^2)^d x_t = u_t, \quad t = 1, 2, \dots, \quad (2)$$

where w_r and d are real values, and u_t is $I(0)$. For practical purposes we define $w_r = 2\pi r/T$, with $r = T/s$, and thus s will indicate the number of time periods per cycle, while r refers to the frequency that has a pole or singularity in the spectrum of x_t . Note that if $r = 0$ (or $s = 1$), the fractional polynomial in (2) becomes $(1 - L)^{2d}$, which is the polynomial associated with the common case of fractional integration at the long-run or zero frequency. This type of process was introduced by Andel (1986) and subsequently analysed by Gray et al. (1989, 1994), Giraitis and Leipus (1995), Chung (1996a,b) and Dalla and Hidalgo (2005) among many others.

Gray et al. (1989, 1994) showed that the polynomial in (2) can be expressed in terms of the Gegenbauer polynomial, such that, denoting $\mu = \cos w_r$, for all $d \neq 0$,

$$(1 - 2\mu L + L^2)^{-d} = \sum_{j=0}^{\infty} C_{j,d}(\mu) L^j, \quad (3)$$

where $C_{j,d}(\mu)$ are orthogonal Gegenbauer polynomial coefficients recursively defined as:

$$C_{0,d}(\mu) = 1,$$

$$C_{1,d}(\mu) = 2\mu d,$$

1. The $I(0)$ class of models includes the classical white noise process but also other structures allowing a weak dependence structure, such as the stationary autoregressive moving average (ARMA) models.

$$C_{j,d}(\mu) = 2\mu \left(\frac{d-1}{j} + 1 \right) C_{j-1,d}(\mu) - \left(2 \frac{d-1}{j} + 1 \right) C_{j-2,d}(\mu), \quad j = 2, 3, \dots$$

(see, for instance, Magnus et al., 1966, Rainville, 1960, etc. for further details on Gegenbauer polynomials). Gray et al. (1989) showed that x_t in (2) is (covariance) stationary if $d < 0.5$ for $|\mu = \cos w_r| < 1$ and if $d < 0.25$ for $|\mu| = 1$.² The model just presented can be generalised to the case of more than one cyclical structure to consider processes of the form:

$$\prod_{j=1}^k (1 - 2 \cos w_r^{(j)} L + L^2)^{d_j} x_t = u_t, \quad t = 1, 2, \dots, \quad (4)$$

where k is a finite integer indicating the maximum number of cyclical structures, and $w_r^{(j)} = 2\pi/s_{(j)}$ where $s_{(j)}$ indicates the number of time periods per cycle corresponding to the j^{th} cyclical structure. Empirical studies based on multiple cyclical structures of this type (also named k -factor Gegenbauer processes) are Ferrara and Guegan (2001), Sadek and Khotanzad (2004) and Gil-Alana (2007).

In this paper a flexible specification is adopted that allows us to analyse long-memory models of the form (1) and (2) in a single framework. Specifically, it is considered processes of the form:

$$(1 - L)^{d_1} (1 - 2 \cos w_r L + L^2)^{d_2} x_t = u_t, \quad t = 1, 2, \dots \quad (5)$$

where u_t is again $I(0)$, d_1 indicates the order of integration at the long-run or zero frequency, and d_2 refers to the cyclical long-run dependence component.

A parametric approach developed by Robinson (1994) is employed that is very general in the sense that it allows to consider all the above specifications in a single framework. This method, based on the Whittle function in the frequency domain, has the advantage that it is valid for any real value d (or d_1 and d_2 in (5)), thus encompassing stationary ($d < 0.5$) and nonstationary ($d \geq 0.5$) hypotheses. Moreover, the limiting distribution is standard (normal, in the cases of equations (1) and (2))

2. Note that if $|\mu| < 1$ and d in (2) increases beyond 0.5, the process becomes “more nonstationary” in the sense, for example, that the variance of the partial sums increases in magnitude.

TABLE 1. Descriptive statistics

Series	Mean	Std. Deviation	Minimum	Maximum
US – Euro	1.17045	0.19554	0.82716	1.60100
US – Yen	112.63360	8.96991	87.843	134.776
Rtn: US – Euro	0.0000779	0.006506	–0.030031	0.04620
Rtn: US – Yen	–0.0000828	0.006871	–0.052156	0.0323608

and chi-square in the case of (5)), and this standard limit behaviour holds independently of the inclusion or exclusion of deterministic terms in the model and the modelling approach for the $I(0)$ disturbances. Moreover, Gaussianity is not a requirement, a moment condition of only 2 being necessary.

III. Empirical results

The time series data examined are the US foreign exchange rates with respect to the Euro and the Japanese Yen, daily, for the time period January 4rd, 1999 – October 2nd, 2009. These data were obtained from the Federal Reserve Bank of St. Louis database (DEXUSEU and DEXJPUS for the US-Euro and US-Yen rates respectively). Some descriptive statistics for the two variables are reported in table 1.

Plots of the two series are displayed in the upper half of figure 1, while their corresponding returns, obtained as the first differences of the logged values, are shown in the bottom half. First, the order of integration of the log-series is estimated to determine if they contain unit roots. For this purpose, initially standard unit root tests (Dickey and Fuller, ADF, 1979; Phillips and Perron, PP, 1988; Elliot et al., 1996; and Ng and Perron, NP, 2001) were carried out, finding evidence of unit roots (the results are not reported for brevity's sake) in the two series. However, it is well known that these procedures may have very low power if the true data generating processes are fractionally integrated. Therefore, other tests were also performed that, unlike the above, are not based on autoregressive alternatives but on fractional ones. In particular, it is considered a regression model of the form:

$$y_t = \alpha + \beta t + x_t; \quad t = 1, 2, \dots, \quad (6)$$

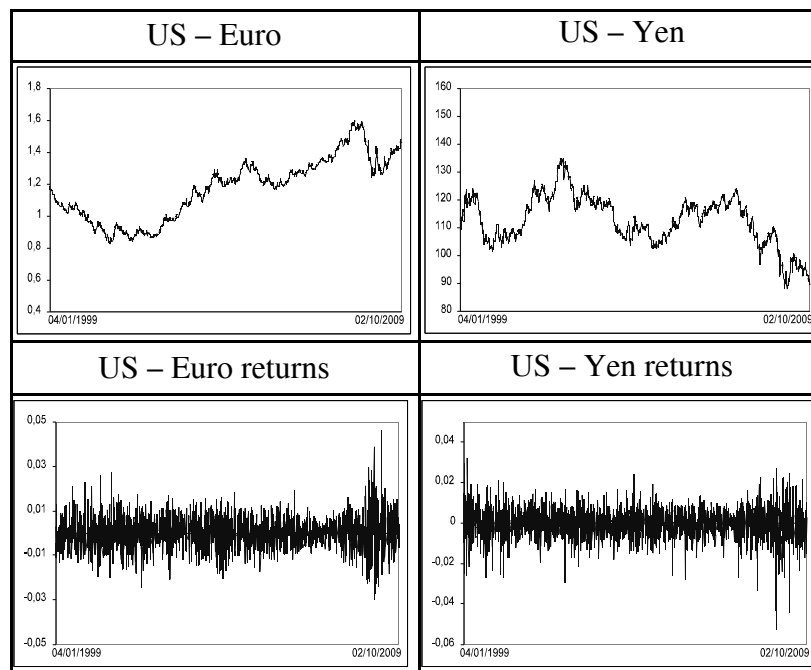


FIGURE 1.— Foreign exchange rate time series and their corresponding returns

where x_t is assumed to be fractionally integrated as in equation (1). Thus, if $d = 1$, the series follows a unit root process.³

Table 2 reports the estimates of d in (6) and (1) for the three standard cases of no regressors (i.e., $\alpha = \beta = 0$ a priori in equation (6)), an intercept (α unknown, and $\beta = 0$ a priori), and an intercept with a linear time trend (α and β unknown), under the assumption that the error term (u_t in (1)) follows a white noise process, an AR(1), and the exponential spectral model of Bloomfield (1973) in turn. The latter is a non-parametric specification that produces autocorrelations decaying exponentially as in the AR case and allows to approximate ARMA structures with a small number of parameters.⁴

3. The presence of outliers (towards the two ends of the sample) was also taken into account by applying standard procedures in this context. Their presence was found not to alter the main conclusions reported in the paper.

4. See Gil-Alana (2004) for the use of fractional integration with Bloomfield disturbances in the context of Robinson's (1994) tests.

TABLE 2. Estimates of d in the log exchange rates series

i) White noise disturbances			
	No regressors	An intercept	A time trend
Log of US-Euro	[0.973 (0.996) 1.022]	[0.985 (1.007) 1.032]	[0.985 (1.007) 1.032]
Log of US-Yen	[0.974 (0.997) 1.023]	[0.946 (0.969) 0.994]	[0.946 (0.969) 0.994]
ii) AR(1) disturbances			
	No regressors	An intercept	A time trend
Log of US-Euro	[0.927 (0.970) 1.017]	[0.971 (1.005) 1.043]	[0.971 (1.005) 1.043]
Log of US-Yen	[0.980 (0.999) 1.018]	[0.940 (0.976) 1.018]	[0.940 (0.976) 1.018]
iii) Bloomfield disturbances			
	No regressors	An intercept	A time trend
Log of US-Euro	[0.949 (0.992) 1.032]	[0.971 (1.008) 1.041]	[0.971 (1.008) 1.041]
Log of US-Yen	[0.953 (0.991) 1.032]	[0.943 (0.980) 1.022]	[0.943 (0.980) 1.022]

Note: In brackets the 95% confidence interval for the values of d . In parentheses, the Whittle estimates. We report in bold the cases where the unit root hypothesis cannot be rejected.

Table 2 displays the 95% confidence intervals formed by the non-rejection values of d , using Robinson's (1994) parametric approach in the frequency domain. It is also presented (in parentheses inside the square brackets) the Whittle estimates of d (Dahlhaus, 1989) in each case. It can be seen that the intervals almost always include the unit root, the only exceptions being the US dollar-Yen rate with an intercept and with a linear trend, where the estimated value of d is slightly below 1. In all other cases, the estimated d is around 1, hence supporting the unit root model and justifying the use of returns in the remainder of the paper.

In what follows the paper focuses on the variance of the return series and examines the squared and absolute returns, which are used as proxies for volatility. These two measures have been widely employed in the financial literature to measure volatility.⁵ Plots of these series are displayed in figure 2.

Figure 3 shows the first 1,000 sample autocorrelation values for the absolute and squared returns of the two series. It can be seen that the

5. Absolute returns were employed among others by Ding et al. (1993), Granger and Ding (1996), Bollerslev and Wright (2000), Gil-Alana (2005), Cavalcante and Assaf (2004), Sibbertsen (2004) and Cotter (2005), whereas squared returns were used in Lobato and Savin (1998), Gil-Alana (2003), Cavalcante and Assaf (2004) and Cotter (2005).

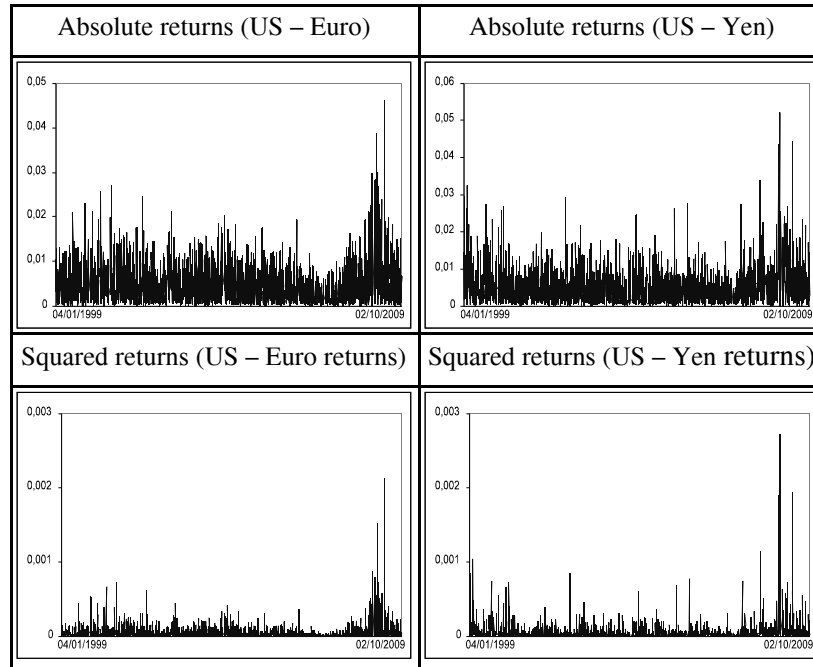


FIGURE 2.— Absolute and squared returns series

Note: The returns were obtained as the first differences of the logged transformed series.

four series display some degree of dependence with these values decaying very slowly, which may be consistent with fractionally integrated processes of the form given by equation (1). Moreover, there is some type of cyclical structure (especially for the Euro returns) which may imply that models of the form given by (2) or even (5) may also be plausible for these series. The periodograms, displayed in figure 4, have the highest values at the smallest frequencies, which is again an indication of possible $I(d)$ behaviour with $d > 0$, though this may be obscuring other peaks at non-zero frequencies.

First the results based on model 1 are presented, which is the one that displays long memory exclusively at the long-run or zero frequency, that is,

$$y_t = \alpha + \beta t + x_t; \quad (1 - L)^d x_t = u_t, \quad t = 1, 2, \dots, \quad (M1)$$

and, similarly to the results presented in table 2, the three cases of no

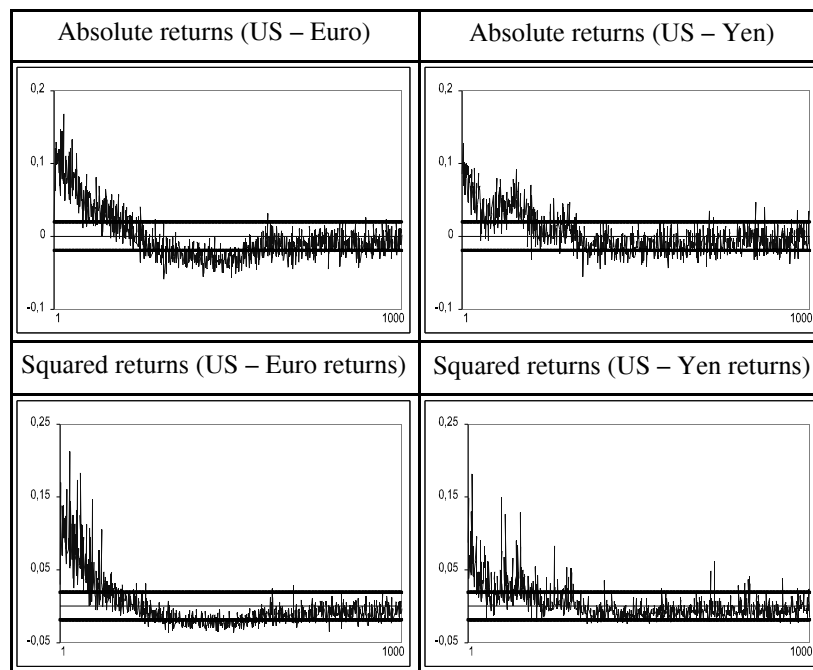


FIGURE 3.— Correlogram of the absolute and squared returns series

Note: The large sample standard error under the null hypothesis of no autocorrelation is $1/\sqrt{T}$.

regressors, an intercept, and an intercept with a linear trend are reported, assuming that the disturbances follow a white noise, an AR(1) and a Bloomfield-type process in turn.⁶ The results are displayed in tables 3 and 4 for the absolute and squared returns respectively.

Starting with the absolute returns (in table 3), the estimated values of d are in all cases strictly positive and smaller than 0.5, i.e. inside the stationary region, though with some degree of long-memory behaviour. When not allowing for autocorrelation the estimated value of d is around 0.10 for the US dollar-Euro rate, and is slightly higher for the US dollar-Yen one. If autocorrelation is allowed, in the form of either an AR process or of the Bloomfield model, the values of d are higher and close to 0.2 in the two series. Very similar results are obtained in table 4 for the squared returns, with values close to 0.1 with uncorrelated errors and close to 0.2 with weak autocorrelation. Finally,

6. When using higher AR orders very similar results were obtained.

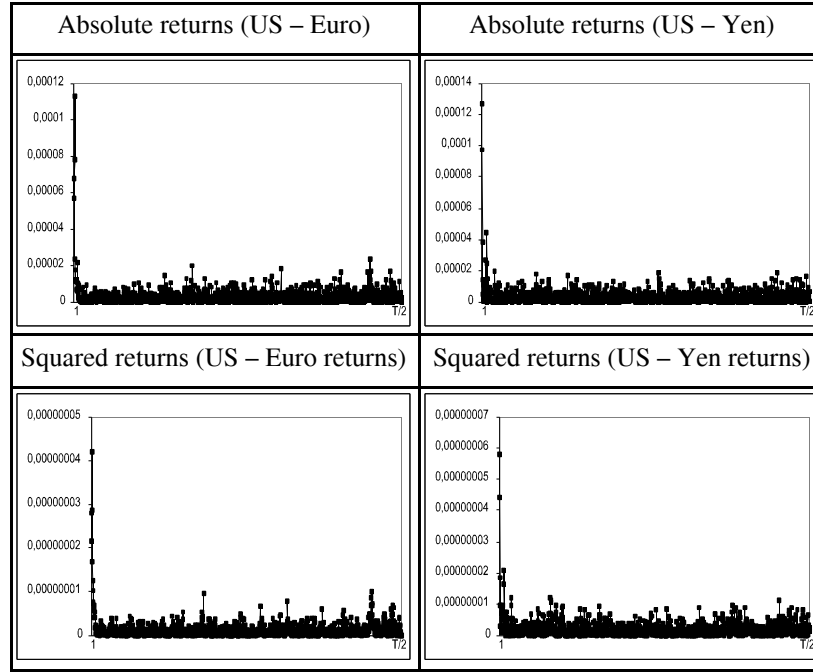


FIGURE 4.— Periodograms of the absolute and squared returns series

Note: The periodograms were computed based on the discrete Fourier frequencies $\lambda_j = 2\pi j/T$.

regarding the deterministic terms (not reported), the time trend coefficients were found to be insignificant in all cases, while the intercept was statistically significant at the 5% level, implying that the model including an intercept is the one that should be selected in all cases.

Because of the differences in the results depending on how the error term is specified, a semi-parametric method (Robinson, 1995) is also applied, in which the disturbances u_t are simply assumed to be $I(0)$ with no functional form required for them. This method is based on a “local” Whittle estimate in the frequency domain; it considers a band of frequencies that degenerates to zero, and the estimate of d is implicitly defined by:

$$\hat{d} = \arg \min_d \left(\log \overline{C(d)} - 2d \frac{1}{m} \sum_{j=1}^m \log \lambda_j \right),$$

TABLE 3. Estimates of d in model (M1) using the absolute returns

i) White noise disturbances			
	No regressors	An intercept	A time trend
US-Euro	[0.090 (0.103) 0.118]	[0.086 (0.098) 0.112]	[0.086 (0.098) 0.112]
US-Yen	[0.113 (0.130) 0.148]	[0.101 (0.116) 0.133]	[0.100 (0.115) 0.132]
ii) AR(1) disturbances			
	No regressors	An intercept	A time trend
US-Euro	[0.181 (0.201) 0.224]	[0.170 (0.188) 0.209]	[0.170 (0.188) 0.209]
US-Yen	[0.186 (0.212) 0.241]	[0.162 (0.185) 0.212]	[0.160 (0.184) 0.212]
iii) Bloomfield disturbances			
	No regressors	An intercept	A time trend
Log of US-Euro	[0.204 (0.230) 0.259]	[0.189 (0.209) 0.236]	[0.189 (0.209) 0.236]
Log of US-Yen	[0.198 (0.228) 0.259]	[0.169 (0.196) 0.226]	[0.168 (0.196) 0.226]

$$\text{for } d \in (-1/2, 1/2); \quad \overline{C(d)} = \frac{1}{m} \sum_{j=1}^m I(\lambda_j) \lambda_j^{2d}, \quad \lambda_j = \frac{2\pi j}{T}, \quad \frac{m}{T} \rightarrow 0,$$

where m is a bandwidth parameter.⁷

Figure 5 displays for each series the estimates of d based on the above procedure using the whole range of parameters for the bandwidth (displayed on the horizontal axis)⁸, including the 95% confidence interval corresponding to the $I(0)$ case. It is clear that the four series exhibit long-memory ($d > 0$) behaviour, consistently with the results based on the parametric approach outlined above and with other studies such as Granger and Ding (1996).

Next a cyclical long-memory model of the form given by equation (2) is considered. This is motivated by the periodograms of the series.⁹ Figure 6 displays the first 100 values of the periodogram for the Fourier frequencies $\lambda_r = 2\pi r/T$, ($r = T/s$), for $r = 1, \dots, 100$. It is noteworthy that

7. Further refinements of this approach can be found in Velasco (1999), Phillips and Shimotsu (2004, 2005), Abadir et al., 2007, etc. Applying some of these methods we obtain almost identical results to those reported here.

8. The choice of the bandwidth is crucial since it affects the trade-off between bias and variance; specifically, the asymptotic variance and the bias of this estimator are decreasing and increasing with m respectively.

9. Note that the periodogram is an asymptotic unbiased (though not consistent) estimate of the spectral density function.

TABLE 4. Estimates of d in model (M1) using the squared returns

i) White noise disturbances			
	No regressors	An intercept	A time trend
US-Euro	[0.092 (0.105) 0.118]	[0.093 (0.106) 0.120]	[0.091 (0.104) 0.120]
US-Yen	[0.010 (0.116) 0.135]	[0.097 (0.114) 0.132]	[0.095 (0.112) 0.131]
ii) AR(1) disturbances			
	No regressors	An intercept	A time trend
US-Euro	[0.190 (0.210) 0.236]	[0.190 (0.212) 0.237]	[0.188 (0.211) 0.235]
US-Yen	[0.163 (0.191) 0.224]	[0.158 (0.186) 0.218]	[0.156 (0.184) 0.217]
iii) Bloomfield disturbances			
	No regressors	An intercept	A time trend
US-Euro	[0.201 (0.228) 0.351]	[0.201 (0.228) 0.352]	[0.200 (0.227) 0.356]
US-Yen	[0.163 (0.193) 0.235]	[0.160 (0.189) 0.221]	[0.159 (0.188) 0.221]

for the US Dollar-Euro case the highest value of the periodogram does not occur at the smallest frequency ($r = 1$) but instead at $r = 4$, which should correspond to cycles with a periodicity of $T/4 \approx 677$ periods (days). By contrast, for the US Dollar-Yen case the highest value is found at the smallest frequency $r = 1$, followed by $r = 19$ ($T/19 \approx 142$ periods). Therefore, model 2 is specified as:

$$y_t = \alpha + x_t; \quad (1 - 2\cos w_r L + L^2)^d x_t = u_t, \quad t = 1, 2, \dots, \quad (M2)$$

with $w_r = 2\pi/677$ in case of the US Dollar-Euro absolute and squared return series and $w_r = 2\pi/142$ for the US Dollar-Yen values. The results using the above model are displayed in tables 5 and 6.

Two models, without regressors ($\alpha = 0$ in (M2)) and with an intercept, are considered. Another version of Robinson's (1994) parametric tests is employed here, testing the null hypothesis $H_0: d = d_0$, in (M2) for a range of values of d_0 from 0 to 1 with 0.001 increments, and s in w_r equal to 600, ..., 700 for the US Dollar-Euro case, and $s = 100, \dots, 200$ for the US Dollar-Yen one. The model that produces the lowest statistic in Robinson (1994) for different values for s and d is selected. It is noteworthy that the estimated values of s are equal to 677 and 142 respectively for the two series, which correspond to some of the highest peaks in the periodograms displayed in figure 6 (specifically, the highest peak for the US dollar-Euro rate, and the second highest for the

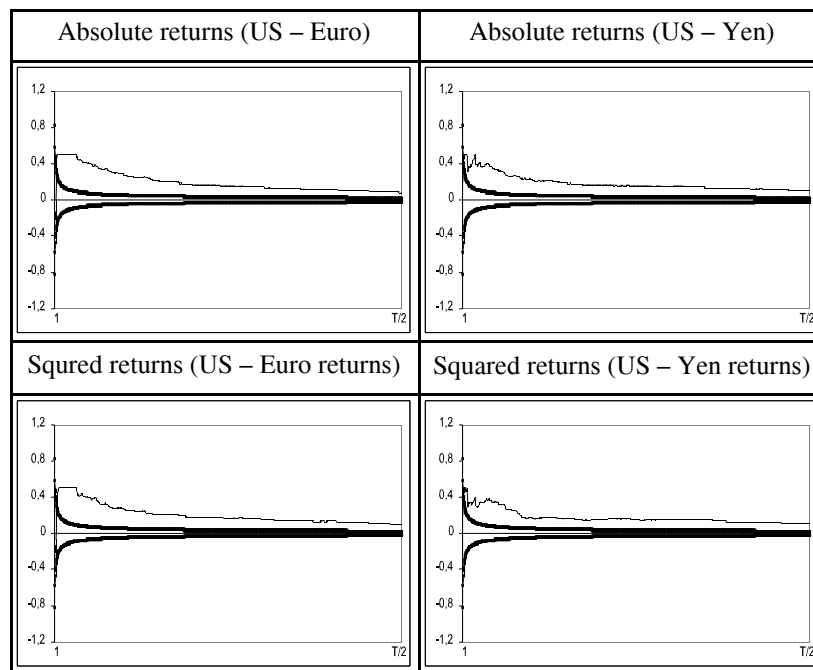


FIGURE 5.— Estimates of d based on the Whittle semiparametric method (Robinson, 1995)

Note: The horizontal axis refers to the bandwidth parameter while the vertical one displays the estimates of d .

US dollar- Yen rate).

Starting with the absolute values of the returns (see table 5), it is found that the differencing parameter is strictly positive and significant, though very close to 0 in all cases: the estimated values of d are 0.035 (US Dollar-Euro) and 0.049 (US Dollar-Yen) for the cases of white noise and Bloomfield disturbances, and 0.075 (US Dollar-Euro) and 0.080 (US Dollar-Yen) with AR(1) errors. For the squared returns (table 6) the values are again significant though slightly higher: 0.042 (US Dollar-Euro) and 0.050 (US Dollar-Yen) with uncorrelated and Bloomfield errors, and 0.092 (US Dollar-Euro) and 0.083 (US Dollar-Yen) with AR(1) disturbances. Once more, the intercepts are statistically significant in all cases.

TABLE 5. Estimates of model (M2) using the absolute returns

Series	i) White noise disturbances		
	No regressors		With an intercept
	j	d	μ
US-Euro	677	[0.029 (0.035) 0.043]	[0.029 (0.036) 0.043]
US-Yen	142	[0.040 (0.049) 0.059]	[0.040 (0.049) 0.059]
			0.00479 (41.358)
			0.00504 (42.230)
ii) AR(1) disturbances			
Series	No regressors		With an intercept
	j	d	μ
US-Euro	677	[0.064 (0.075) 0.087]	[0.065 (0.076) 0.088]
US-Yen	142	[0.064 (0.080) 0.097]	[0.067 (0.082) 0.099]
			0.00478 (28.773)
			0.00503 (34.515)
iii) Bloomfield disturbances			
Series	No regressors		With an intercept
	j	d	M
US-Euro	677	[0.032 (0.035) 0.040]	[0.032 (0.036) 0.040]
US-Yen	142	[0.043 (0.049) 0.054]	[0.044 (0.049) 0.055]
			0.00479 (41.358)
			0.00503 (42.230)

TABLE 6. Estimates of model (M2) using the squared returns

Series	No regressors		With an intercept	
	j	d	j	d
US-Euro	677	[0.035 (0.042) 0.049]	677	[0.036 (0.042) 0.049]
US-Yen	142	[0.040 (0.050) 0.060]	142	[0.040 (0.050) 0.060]
				μ
				0.000042 (16.661)
				0.000047 (15.897)
i) White noise disturbances				
ii) AR(1) disturbances				
Series	No regressors		With an intercept	
	j	d	j	d
US-Euro	677	[0.080 (0.092) 0.104]	677	[0.080 (0.092) 0.105]
US-Yen	142	[0.066 (0.083) 0.103]	142	[0.066 (0.084) 0.103]
				μ
				0.000041 (10.528)
				0.000047 (12.908)
iii) Bloomfield disturbances				
Series	No regressors		With an intercept	
	j	d	J	d
US-Euro	677	[0.038 (0.042) 0.046]	677	[0.038 (0.042) 0.046]
US-Yen	142	[0.044 (0.050) 0.056]	142	[0.044 (0.050) 0.056]
				μ
				0.000042 (16.661)
				0.000047 (15.897)

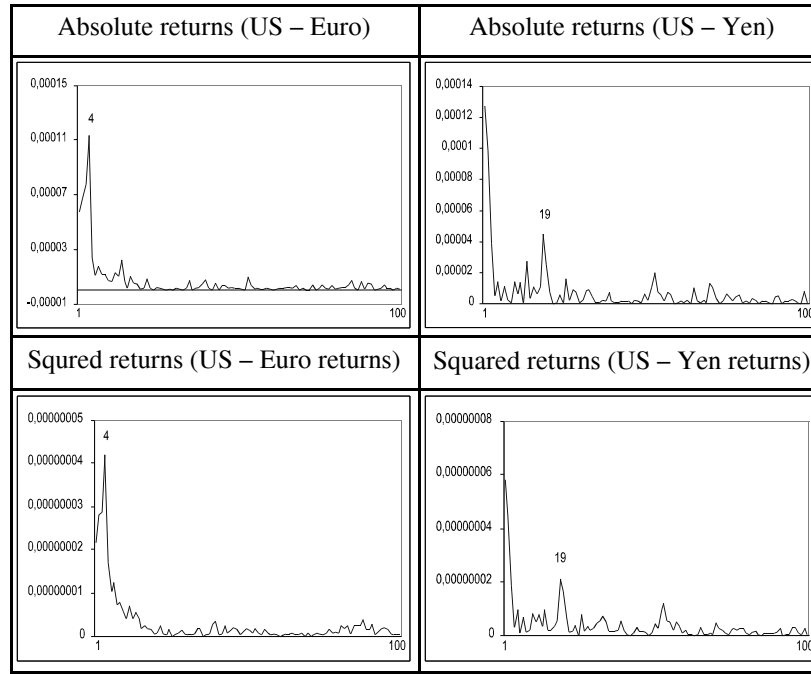


FIGURE 6.— First 100 values in the periodograms of the absolute and squared returns

Note: The periodograms were computed based on the discrete Fourier frequencies $\lambda_j = 2\pi j/T$.

Finally the case of a long-memory model that simultaneously takes into account the long-run and the cyclical structures is examined. Therefore, model 3 is specified as:

$$y_t = \alpha + x_t; (1 - L)^{d_1} (1 - 2 \cos w_r L + L^2)^{d_2} x_t = u_t, t = 1, 2, \dots, (M3)$$

once more focusing on the cases of no regressors ($\alpha = 0$ in (M3)) and an intercept, for uncorrelated and correlated (AR and Bloomfield) errors.

The results based on (M3) are displayed in tables 7 and 8. Interestingly, the selected models are once more those for the frequency r that corresponds to $s = 677$ for the US Dollar-Euro series case and to $s = 142$ for the US Dollar-Yen one. Concerning the estimates of the fractional differencing parameters, for the US Dollar-Euro d_1 is not significantly different from zero, and the same holds for d_2 in the case

TABLE 7. Estimates of model (M3) using the absolute returns

Series	i) White noise disturbances			
	No regressors		With an intercept	
	d ₁ (long run)	d ₂ (cyclical)	d ₁ (long run)	d ₂ (cyclical)
US-Euro (j = 677)	0.011 [-0.066, 0.098]	0.087 [0.048, 0.101]	0.007 [-0.059, 0.093]	0.078 [0.051, 0.093]
US-Yen (j = 142)	0.136 [0.108, 0.153]	0.009 [-0.017, 0.039]	0.131 [0.101, 0.148]	0.012 [-0.013, 0.027]
ii) AR(1) disturbances				
Series	No regressors		With an intercept	
	d ₁ (long run)	d ₂ (cyclical)	d ₁ (long run)	d ₂ (cyclical)
US-Euro (j = 677)	0.004 [-0.032, 0.066]	0.093 [0.050, 0.107]	0.006 [-0.036, 0.077]	0.088 [0.045, 0.099]
US-Yen (j = 142)	0.127 [0.101, 0.151]	0.004 [-0.032, 0.051]	0.127 [0.103, 0.155]	0.003 [-0.033, 0.057]
iii) Bloomfield disturbances				
Series	No regressors		With an intercept	
	d ₁ (long run)	d ₂ (cyclical)	d ₁ (long run)	d ₂ (cyclical)
US-Euro (j = 677)	0.014 [-0.061, 0.111]	0.092 [0.032, 0.104]	0.006 [-0.064, 0.097]	0.081 [0.049, 0.096]
US-Yen (j = 142)	0.142 [0.109, 0.166]	0.007 [-0.022, 0.051]	0.139 [0.097, 0.159]	0.014 [-0.016, 0.030]

TABLE 8. Estimates of model (M3) using the squared returns

Series	i) White noise disturbances			
	No regressors		With an intercept	
	d ₁ (long run)	d ₂ (cyclical)	d ₁ (long run)	d ₂ (cyclical)
US-Euro (j = 677)	0.007 [-0.036, 0.088]	0.071 [0.033, 0.094]	0.008 [-0.045, 0.043]	0.073 [0.035, 0.098]
US-Yen (j = 142)	0.117 [0.098, 0.136]	0.004 [-0.011, 0.024]	0.116 [0.095, 0.138]	0.003 [-0.017, 0.027]
Series	ii) AR(1) disturbances			
	No regressors		With an intercept	
	d ₁ (long run)	d ₂ (cyclical)	d ₁ (long run)	d ₂ (cyclical)
US-Euro (j = 677)	0.010 [-0.054, 0.103]	0.091 [0.038, 0.116]	0.009 [-0.055, 0.089]	0.086 [0.046, 0.111]
US-Yen (j = 142)	0.129 [0.114, 0.161]	0.005 [-0.028, 0.044]	0.129 [0.113, 0.155]	0.004 [-0.041, 0.036]
Series	iii) Bloomfield disturbances			
	No regressors		With an intercept	
	d ₁ (long run)	d ₂ (cyclical)	d ₁ (long run)	d ₂ (cyclical)
US-Euro (j = 677)	0.011 [-0.049, 0.091]	0.074 [0.031, 0.110]	0.008 [-0.045, 0.043]	0.075 [0.033, 0.096]
US-Yen (j = 142)	0.121 [0.100, 0.144]	0.006 [-0.015, 0.025]	0.120 [0.099, 0.142]	0.005 [-0.014, 0.025]

of the US Dollar-Yen. Therefore, model 2 and model 1 appear to be the most adequate ones for the US Dollar-Euro and the US Dollar-Yen cases respectively. We also perform LR tests to choose between models 1 and 3 for the US Dollar-Yen, and between models 2 and 3 for the US Dollar-Euro; these provide further evidence that model 2 (long-run cyclical dependence) is more appropriate for the US Dollar-Euro (absolute and squared) returns, and model 1 (standard $I(d)$) for the US Dollar-Yen values.

On the basis of this evidence as well as the t-values for the deterministic terms the models below are selected. For the US dollar-Euro series:

$$y_t = 0.00479 + x_t; \quad (1 - 2\cos w_4 L + L^2)^{0.036} x_t = u_t, \quad t = 1, 2, \dots, \quad (7)$$

in the case of the absolute returns, and

$$y_t = 0.000042 + x_t; \quad (1 - 2\cos w_4 L + L^2)^{0.042} x_t = u_t, \quad t = 1, 2, \dots, \quad (8)$$

for the squared returns.

However, for the US dollar-Yen values, a model with long memory only at the zero frequency seems to be more adequate, namely

$$y_t = 0.00526 + x_t; \quad (1 - L)^{0.185} x_t = u_t; \quad u_t = -0.144u_{t-1} + \varepsilon_t, \quad (9)$$

$$t = 1, 2, \dots,$$

for the absolute returns, and

$$y_t = 0.000051 + x_t; \quad (1 - L)^{0.186} x_t = u_t; \quad u_t = -0.139u_{t-1} + \varepsilon_t, \quad (10)$$

$$t = 1, 2, \dots,$$

for the squared values.

Clearly, both volatility series are characterised by long memory, but in case of the US dollar – Yen rate this affects the long run structure of the process, while in the case of the US dollar – Euro there is an underlying cyclical pattern.

IV. Stability tests and structural breaks

In this section it is examined whether the results reported in Section III are stable over the sample period or instead subject to structural change. For this purpose once more the versions of Robinson's (1994) tests employed in Section III are performed, using the specifications described above, starting with a sample of 1,500 observations and then adding recursively five observations each time till the end of the sample (with 2,710 observations). Figure 7 displays the estimated values of d for the absolute return series, for the Euro case (the upper plot) and for the Japanese Yen (in the lower part of the figure) respectively. In the former case, a model of a similar form to the one given by equation (8) is employed, i.e., using cyclical fractional integration,

$$y_t = \mu + x_t; \quad (1 - 2\cos w_t L + L^2)^d x_t = u_t, \quad t = 1, 2, \dots,$$

while in the latter case (Japanese yen absolute returns) we use a model similar to equation (10), i.e., based on a standard $I(d)$ model,

$$y_t = \mu + x_t; \quad (1 - L)^d x_t = u_t; \quad u_t = \rho u_{t-1} + \varepsilon_t, \quad t = 1, 2, \dots$$

As can be seen, for the US dollar-Euro absolute returns the estimated value of the (cyclical) fractional differencing parameter remains close to 0 (and statistically insignificant) for each subsample until the one ending at the observation 2035, which corresponds to February 5, 2007. If observations after that date are included, the estimate is above 0.010, becoming significantly different from 0 for each subsample till the end of the sample period, with another increase at observation 2460 (October 6, 2008). Focusing now on the US dollar-Yen case, the estimate of the fractional differencing parameter, d , is relatively stable till observation 2320 (March 20, 2008), with values around 0.12; there is then an increase (with values close to 0.15) till observation 2460 (October 6, 2008), and another one (d about 0.20) until the end of the sample. Similar results (not reported for reasons of space) were obtained for the squared returns.

Because of the instability in the estimated fractional differencing parameter (see figure 7) in what follows three different subsamples for each series are considered. These are: for the US dollar-Euro, [January 4, 1999 – February 5, 2007]; [February 6, 2007 – October 6, 2008] and

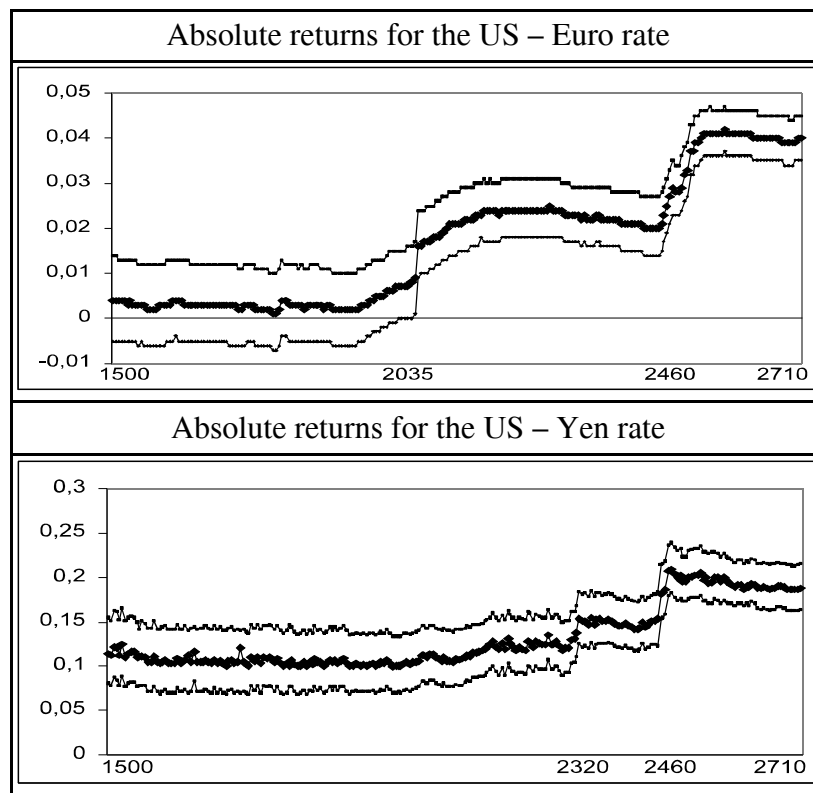


FIGURE 7.— Recursive estimates of the fractional differencing parameter

Note: The thin lines refer to the 95% confidence interval.

[October 7, 2008 – October 2, 2009], and for the US dollar-Yen [January 4, 1999 – March 20, 2008], [March 21, 2008 – October 6, 2008] and [October 7, 2008 – October 2, 2009].

Table 9 displays the estimates of the long-run and the cyclical fractional differencing parameters using model 1 and model 2 for each subsample and each series. The upper and lower half of the table concern the absolute and squared returns respectively. Considering the subsamples separately it can be seen that some of the estimates are statistically significant, especially in the case of model 1 (with long memory at the long-run or zero frequency). Also, the estimated value of d for model 1 is higher in the second subsample and lower in the third

TABLE 9. Estimates of models(M1) and (M2) for each subsample

Series	i) Absolute returns			
	US – Euro		US – Yen	
	Model 1	Model 2	Model 1	Model 2
1 st sub-sample	d = 0.109 (0.084, 0.137)	d = -0.001 (j = 1017) (-0.007, 0.009)	d = 0.155 (0.127, 0.186)	d = 0.034 (j = 1160) (0.027, 0.042)
2 nd sub-sample	d = 0.189 (0.135, 0.258)	d = -0.057 (j = 17) (-0.088, -0.024)	d = 0.097 (-0.087, 0.341)	d = -0.017 (j = 4) (-0.097, 0.078)
3 rd sub-sample	d = -0.174 (-0.281, -0.035)	d = -0.064 (j = 7) (-0.103, 0.011)	d = 0.129 (0.035, 0.247)	d = 0.043 (j = 19) (0.004, 0.086)
Series	ii) Squared returns			
	US – Euro		US – Yen	
	Model 1	Model 2	Model 1	Model 2
1 st sub-sample	d = 0.090 (0.065, 0.119)	d = -0.001 (j = 1017) (-0.013, 0.009)	d = 0.159 (0.127, 0.194)	d = 0.042 (j = 1160) (0.034, 0.053)
2 nd sub-sample	d = 0.239 (0.179, 0.311)	d = -0.045 (j = 17) (-0.073, -0.014)	d = -0.116 (-0.284, 0.351)	d = -0.001 (j = 4) (-0.094, 0.108)
3 rd sub-sample	d = 0.198 (0.112, 0.325)	d = -0.040 (j = 7) (-0.083, 0.007)	d = 0.106 (-0.022, 0.269)	d = 0.022 (j = 124) (-0.004, 0.053)

subsample for the US dollar-Euro rate (for both absolute and squared returns), whilst for the US dollar-Yen rate there is a decrease in the second subsample and an increase in the third one (see table 9).

The above approach assumes that the break dates are known. In what follows, it is used instead a procedure developed by Gil-Alana (2008) that endogenously determines the number of breaks and the break dates along with the parameters in the model. In what follows, this approach is briefly described which is based on minimizing the residuals sum of squares across the different subsamples. Gil-Alana (2008) considers the following model,

$$y_t = \beta_i^T z_t + x_t; \quad (1-L)^{d_i} x_t = u_t, \quad t = 1, \dots, T_b^i, \quad i = 1, \dots, nb, \quad (11)$$

where nb is the number of breaks (i.e., $nb = 0, 1, 2, 3$), y_t is the observed time series, the β_i 's are the coefficients corresponding to the deterministic terms; the d_i 's are the orders of integration for each subsample, and the T_b^i 's correspond to the dates of the unknown breaks. The method is based on minimizing the residuals sum of squares for a grid of values of the fractional differencing parameters and the time breaks.

The results using this approach indicate that there are two potential breaks for the US –Euro absolute returns, which coincide with the values obtained in figure 7 (i.e., February, 2007, and October, 2008). However, for the US – Yen absolute returns, only one break is detected, occurring in October 2008 (which is the second one of the two detected in figure 7). Evidence of a small degree of long memory ($d > 0$) is obtained across all the subsamples.

V. Forecasting performance

In this section the forecasting accuracy of the models presented in previous sections is examined. For this purpose, it is considered for each of the four series (i.e. the absolute and squared returns of the US dollar exchange rates against the Euro and the Japanese Yen) the three models that have been presented in Section 3, i.e., model 1 (M1): fractional integration at the zero frequency; model 2 (M2): fractional cyclical integration; and model 3 (M3): fractional integration at both the zero and the cyclical frequencies.

TABLE 10. Pairwise comparison using the modified DM statistic (RMSE, h = 50)

		Absolute returns						
		Series 3			Series 4			
\$/Euro		(M1)	(M2)	(M3)	\$ / Yen	(M1)	(M2)	(M3)
(M1)		XXXX	XXXX	XXXX	(M1)	XXXX	XXXX	XXXX
(M2)		2.45 (M2)	XXXX	XXXX	(M2)	-2.9 (M1)	XXXX	XXXX
(M3)		1.156	-2.0 (M2)	XXXX	(M3)	-2.3 (M1)	0.133	XXXX
		Series 3			Series 4			
\$/Euro		(M1)	(M2)	(M3)	\$ / Yen	(M1)	(M2)	(M3)
(M1)		XXXX	XXXX	XXXX	(M1)	XXXX	XXXX	XXXX
(M2)		2.71 (M2)	XXXX	XXXX	(M2)	-2.8 (M1)	XXXX	XXXX
(M3)		1.177	-2.2 (M2)	XXXX	(M3)	-2.1 (M1)	0.987	XXXX

TABLE 11. Pairwise comparison using the modified DM statistic (RMSE, h = 75)

		Absolute returns						
		Series 3			Series 4			
\$/Euro		(M1)	(M2)	(M3)	\$ / Yen	(M1)	(M2)	(M3)
(M1)		XXXX	XXXX	XXXX	(M1)	XXXX	XXXX	XXXX
(M2)		3.55 (M2)	XXXX	XXXX	(M2)	-3.1 (M1)	XXXX	XXXX
(M3)		1.77	-2.4 (M2)	XXXX	(M3)	-2.7 (M1)	1.437	XXXX
		Series 3			Series 4			
\$/Euro		(M1)	(M2)	(M3)	\$ / Yen	(M1)	(M2)	(M3)
(M1)		XXXX	XXXX	XXXX	(M1)	XXXX	XXXX	XXXX
(M2)		3.69 (M2)	XXXX	XXXX	(M2)	-3.1 (M1)	XXXX	XXXX
(M3)		1.68	-2.8 (M2)	XXXX	(M3)	-2.9 (M1)	1.606	XXXX

TABLE 12. Pairwise comparison using the modified DM statistic ($h = 100$)

		Absolute returns						
		Series 3			Series 4			
\$/Euro		(M1)	(M2)	(M3)	\$ / Yen	(M1)	(M2)	(M3)
(M1)		XXXX	XXXX	XXXX	(M1)	XXXX	XXXX	XXXX
(M2)		3.87 (M2)	XXXX	XXXX	(M2)	-3.5 (M1)	XXXX	XXXX
(M3)		2.08 (M3)	-3.4 (M2)	XXXX	(M3)	-3.2 (M1)	1.454	XXXX
		Series 3			Series 4			
\$/Euro		(M1)	(M2)	(M3)	\$ / Yen	(M1)	(M2)	(M3)
(M1)		XXXX	XXXX	XXXX	(M1)	XXXX	XXXX	XXXX
(M2)		3.94 (M2)	XXXX	XXXX	(M2)	-3.4 (M1)	XXXX	XXXX
(M3)		2.11 (M3)	-3.6 (M2)	XXXX	(M3)	-3.0 (M1)	1.239	XXXX

An in-sample forecasting experiment is performed to establish which of the three models (M1, M2 or M3) performs best for each series. First, the root mean squared errors are computed for the last 100 observations in the sample. Then, the modified Diebold and Mariano (M-DM, 1995) statistic as suggested by Harvey, Leybourne and Newbold (1997) is conducted.¹⁰

Using the M-DM test statistic, the relative forecast performance of the different models is performed by making pairwise comparisons. The root mean squared errors is used in the computations. The results are displayed in tables 10, 11 and 12 respectively for 50, 75 and 100-period ahead predictions.

For each prediction-horizon it is indicated in the tables in bold the rejections of the null hypothesis that the forecast performance of model (Mi) and model (Mj) is equal in favour of the one-sided alternative that model (Mi)'s performance is superior at the 5% significance level. The results for the three time horizons are consistent with the conclusions based on the estimation results of Section III: model 2 (M2), i.e., the cyclical fractionally integrated one, seems to be the most adequate specification for the US dollar- Euro absolute and squared returns, while model 1 (M1), the standard $I(d)$ model, is the preferred one for the two US dollar/ Yen returns series.

VI. Conclusions

This paper has applied long-memory methods to analyse the US dollar rate vis-à-vis the Euro and the Japanese Yen at a daily frequency, with particular attention being paid to volatility modelling and forecasting. Specifically, a more general fractional integration model compared with previous studies is estimated, allowing for dependence not only at the zero but also at other frequencies. The results show differences in the behaviour of the two series: a long-memory (Gegenbauer) process capturing the underlying cyclical structure and a standard $I(d)$ model seem to be the most appropriate for the US dollar rate vis-à-vis the Euro and the Japanese Yen respectively. Consequently, mean reversion with hyperbolic decay occurs in both cases in response to exogenous

10. Harvey et al. (1997) and Clark and McCracken (2001) show that this modified test statistic performs better than the DM test statistic in finite samples, and also that the power of the test is improved when p-values are computed with a Student t-distribution.

shocks to the volatility process, but in the former cyclical is present. The in-sample forecasting analysis also indicates that the cyclical fractional model outperforms other models in case of the Euro return series, while a standard $I(d)$ model outperforms other long memory models in the case of the Yen returns.

The analysis carried out in this paper can be extended to allow for non-linear structures and other procedures in the context of structural breaks as the one based on Markov-Switching models proposed by Tsay and Hardle (2009) could be applied. Work along these lines will be carried out in future papers.

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