Modelling exchange rate volatility in The Gambia using dynamic conditional correlation model

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Received November 11, 2019; Accepted February 10, 2020; Published online May 24, 2020

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Abstract. (Short abstract) The relationship between different international stock markets is of importance for both financial practitioners and academicians in order to manage risks. Especially after the financial crisis, the pronounced financial contagion draws the public attention to look into such associations. However, measuring and modelling dependence structure becomes complicated when asset returns present non-linear, non-Gaussian and dynamic features. This paper examines the time-varying conditional correlations to the weekly exchange rate returns for the USD, EURO and GBP against The Gambian Dalasi (GMD) during the period 2000 to 2017. (to be continued in page 806)

Key words: Exchange rate; returns; volatility; DCC-GARCH; EGARCH; GJR-GARCH

AMS 2010 Mathematics Subject Classification Objects : 62P20; 62M10; 62M20.
Full Abstract The relationship between different international stock markets is of importance for both financial practitioners and academicians in order to manage risks. Especially after the financial crisis, the pronounced financial contagion draws the public attention to look into such associations. However, measuring and modelling dependence structure becomes complicated when asset returns present non-linear, non-Gaussian and dynamic features. This paper examines the time-varying conditional correlations to the weekly exchange rate returns for the USD, EURO and GBP against the Gambian Dalasi (GMD) during the period 2000 to 2017. We use a dynamic conditional correlation (DCC) multivariate GARCH model. This model can be simplified by estimating univariate GARCH models for each return series, and then, using transformed residuals resulting from the first stage, estimating a conditional correlation estimator. DCC-GARCH model was implemented for two different assumptions of the error distribution; assuming Gaussian and Student t-distribution. Empirical results show substantial evidence of significant increase in conditional correlation. It is also clean that, the Student t-distributed errors better forecast the conditional correlation.

Résumé: (French) L’évaluation des interactions entre différents marchés financiers est d’une importance particulière en gestion de risque aussi bien pour les chercheurs que pour les praticiens de la finance de marché. En effet, après une crise financière, à cause de l’effet contagion, cette association est particulièrement étudiée. Cependant, la non-linéarité et les queues épaisse généralement observées sur les séries de rendements financiers rendent la modélisation de cette structure de dépendance très compliquée. Dans ce papier, nous examinerons les corrélations conditionnelles dynamiques sur les rendements de taux de change hebdomadaires USD/Gambian Dalasi (GMD), EURO/GMD, et GBP/GMD sur la période allant de 2000 à 2017. Nous utiliserons un modèle GARCH multivarié à corrélations conditionnelles dynamiques. L’estimation du modèle peut se faire en deux étapes : d’abord estimer un modèle GARCH univarié sur chaque série, puis estimer la corrélation conditionnelle sur les résidus. Une application du modèle avec bruit Gaussien et Student-t est considérée. Les résultats ont mis en évidence une significativité substantielle de la corrélation conditionnelle. En terme de prévision, le modèle avec bruit student-t est plus performant.

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1. Introduction

Volatility is a concept that helps us measure the uncertainty of a particular market or financial value (stocks, bonds, currencies, commodities, etc.) In other words, one can say that the volatility in finance is a measure of fear or instability of returns Abdalla and Zakaria (2012). From the point of view of any investor, when it is said that the price of a stock or exchange rate is very volatile, it often refers to as "violent" fluctuations outside what is commonly recorded. It is widely known that volatility varies over time and tends to cluster in periods of large volatility and periods of tranquility (May and Farrell (2017)). This phenomenon is what we called heteroskedasticity.

Over the last few decades, exchange rate movements and fluctuations have become an important subject of macroeconomic analysis and have received a great deal of interest from academics, financial economists and policy makers, particularly after the collapse of the 1994 Bretton Woods agreement of fixed exchange rates among major industrial countries. Since then, there has been an extensive debate about the topic of exchange rate volatility and its potential influence on welfare, inflation, international trade and degree of external sector competitiveness of the economy and also its role in security valuation, investment analysis, profitability and risk management (Bosnjak et al. (2016)). Consequently, a number of models have been developed in empirical finance literature to investigate this volatility across different regions and countries. Well known and frequently applied models to estimate exchange rate volatility are the autoregressive conditional heteroskedastic (ARCH) model by Engle (1982) and generalized (GARCH) model developed by Bollerslev (1986).

Empirical researches have been carried out in the area of estimating and forecasting using GARCH models. Sengupta and Sfeir (1996) studied the exchange rate volatility of the US dollar against the British pound, the yen, the German mark, and the French franc; Baille et al. (1996) analyzed the volatility of the exchange rate of the German mark against the dollar; Tse (1998) studied the volatility of the yen-dollar exchange rate. More recent work has also followed this line of modeling: Longmore and Robinson (2004) analyzed the behavior of the Jamaican dollar against the US dollar. Sandoval (2006) analyzed the exchange rate volatility of the currencies of some emerging financial markets. Siddiqui (2009) analyzed the volatility of the exchange rate of the Pakistani rupee in relation to the currencies of Canada, the United States, Japan, United Kingdom and the European Monetary Union. Sarno et al. (2004) and McMillan and Speight (2010) studied the dynamics of exchange rates intraday data. Bawwens and Sucarrat (2010) studied the volatility of the Norwegian krone; Olowe (2009) analysed the exchange rate volatility of the Nigerian currency against the US dollar. Other scholars have chosen to analyze the exchange rate volatility using stochastic volatility models. MacDonald and Taylor (1994) studied the daily exchange rate of the German mark in respect of applying various stochastic volatility models. Mahieu and Schotman (1998) analyzed the volatility of bilateral exchange rates.
of the currencies of US, Japan, Germany, and the United Kingdom. Taylor (1986) uses a stochastic volatility model to study the volatility of the exchange rate of sterling against the US dollar. Arranz and Iglesias (2005) analyzed the behavior of the peso-dollar, compared with the exchange rates of Venezuela, South Africa, Norway and the UK, using the stochastic volatility model proposed by Taylor (1986). Abdalla and Zakaria (2012) estimated from a Panel of nineteen Arab countries occurrence or nonoccurrence and degree of asymmetry of the exchange rate series which provide evidence of leverage effects for the majority of currencies. Peters (2008) evaluated how forecasts of the Dynamic Conditional Correlation model of Engle and Sheppard (2001) performs compared to the traditional one (sample covariance). His results shown that the dynamic conditional correlation tend to out perform the covariance matrix based on historical data in the short run, while in the long run the reverse relationship holds. Hartman and Sedlak (2013) examined the performance of two multivariate GARCH models BEKK and DCC, applied on ten years exchange rates data. Their results indicated that the BEKK model performs relatively better than the DCC model, and both these models perform better than the univariate GARCH(1,1) model. May and Farrell (2017) examine the key nominal exchange rates of the South African rand using various GARCH models. Their results provide evidence of leverage effects, indicating that negative shocks imply a higher next period volatility than positive shocks.

To our knowledge, (Marreh et al. (2014)) modeling of exchange rate is the only work done on modeling exchange rate volatility in the Gambian market and thus helping to fill the knowledge gap. In their study, they model the USD and EURO against GMD using ARMA-GARCH models. Their empirical results revealed that the distribution of the return series was heavy-tailed and volatility was highly persistent in The Gambian foreign exchange market.

The objective of this study is to investigate the volatility and conditional relationship of exchange rates in The Gambia and to construct a model using a multivariate DCC-GARCH model. The DCC-GARCH is mainly a generalization of the CCC-GARCH model developed by (Bollerslev (1990)). This model, to the best of our knowledge has not been used in The Gambian context of exchange rate. This model estimates the parameters in two steps that makes it relatively easy to use in practice. The first step uses the univariate GARCH model to estimate the conditional variance for each asset. In the second step, the parameters of the conditional correlation given the parameters of the first step are estimated. In this study the implementation of the DCC-GARCH model will be considered, using Gaussian and Student distributed errors. This study contributes in two ways. First, it will make a significant contribution to the knowledge base on the selected topic in the context of developing countries, since there is little work done on modeling exchange rate volatility in The Gambian market and thus helping to fill the knowledge gap. Second, this study applied the DCC on GARCH model and different GARCH extensions which is quite different from what has been done in the previous studies.

The outline of this study is as follows: Section 2 describes the exchange rate data from the Central Bank of The Gambia. In Section 3, we present the two models namely the Univariate GARCH model and the multivariate GARCH model (DCC-GARCH) while Section 4 deals with applications of the data, and Chapter 5 gives the conclusion of our findings.

2. Data description

The data used for performing the empirical analysis is weekly data of the exchange rates of The Gambia from 2000 to 2017. The data is obtained from the Central Bank of The Gambia (CBG). The currencies used in this study are US Dollar (USD), EURO and the Great British Pound (GBP) exchange rates against The Gambian Dalasi (GMD). As in most empirical finance literature, the variable to be modeled is percentage daily exchange rate returns which is the first difference of the natural logarithm ($\ln$) of the exchange rate and is given by the following equation:

$$r_t = \ln(e_t/e_{t-1}) \times 100,$$

where $r_t$ is the daily percentage return to the exchange rate and $e_t$ and $e_{t-1}$ denote the exchange rate at the spot day and previous day respectively.

The sample consists of 936 observations for each exchange rate return against the Dalasi. R-Software is used in this empirical study as the statistical software for the data analysis.

From Table 1, all the returns shows evidence of non normality with negative skewness, means that all the three exchange rate returns are skewed to the left. The mean return for the three currencies are close to zero. The kurtosis are large for all the three currencies, excess kurtosis is found in the summary above which supports an appropriateness of the usage of Student-t distribution. The weekly standard deviation (SD) shows that the GBP return is the most volatile with a value of (2.02), followed by the EURO return and USD return respectively. All the currencies show evident of fat tails since their kurtosis exceed 3 while negative skewness for the currencies indicate that left tail are particularly extreme.

To test for normality of the skewness and kurtosis, Jarque-Bera test was used and the main focus is the p-values for the chi square which all are (0.0000). Since the p-values are all less than 5%, it indicates that there is enough evidence to reject normality of the return series ($H_0$). In addition, the empirical distribution present in figure 1, confirm the fact that the difference currencies are not normally distributed.

Prior modeling the exchange rate return series, Augmented Dickey fuller test was employed to determine the stationarity of the returns of the exchange rate series. Testing the null hypothesis of a unit root against the alternative hypothesis of
Table 1. Summary Statistics

<table>
<thead>
<tr>
<th></th>
<th>USD</th>
<th>EURO</th>
<th>GBP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Summary of the exchange rate returns</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum</td>
<td>-25.99</td>
<td>-26.60</td>
<td>-33.38</td>
</tr>
<tr>
<td>Median</td>
<td>0.07</td>
<td>0.12</td>
<td>0.13</td>
</tr>
<tr>
<td>Mean</td>
<td>0.15</td>
<td>0.17</td>
<td>0.13</td>
</tr>
<tr>
<td>Maximum</td>
<td>14.91</td>
<td>8.48</td>
<td>12.30</td>
</tr>
<tr>
<td>SD</td>
<td>1.90</td>
<td>1.94</td>
<td>2.02</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>68.91</td>
<td>49.85</td>
<td>92.13</td>
</tr>
<tr>
<td>Skewness</td>
<td>-4.16</td>
<td>-3.59</td>
<td>-5.60</td>
</tr>
<tr>
<td><strong>B. Jarque Bera Test</strong></td>
<td>172110</td>
<td>87625</td>
<td>314610</td>
</tr>
<tr>
<td></td>
<td>(0.000)</td>
<td>(0.000)</td>
<td>(0.000)</td>
</tr>
<tr>
<td><strong>C. Augmented Dickey Fuller (ADF) Test</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>p-value</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
</tr>
<tr>
<td>lag order</td>
<td>9</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td><strong>D. Ljung Box Test</strong></td>
<td>15.515</td>
<td>8.6711</td>
<td>14.766</td>
</tr>
<tr>
<td>Q-Statistic</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>p-value</td>
<td>0.1144</td>
<td>0.5636</td>
<td>0.1408</td>
</tr>
<tr>
<td>df</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td><strong>E. ARCH-LM Diagnostic Test</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LM Statistic</td>
<td>4706</td>
<td>10293</td>
<td>20569</td>
</tr>
<tr>
<td>p-value</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>lag order</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

no unit root for the three return series. Since the p-values for the variables are all less than 5%, we reject the null hypothesis and accept the alternative. This means that the exchange rate return series are all stationary thus, there is no differencing of the return series.

Ljung Box Test was also employed to check whether the residuals are random, it shows that the three exchange rate return p-values are all greater than 5%. Therefore we fail to reject the null hypothesis for the three series. It means we accept the null hypothesis that the residuals are random for all the return series, and they are independent and identically-distributed.

Finally, ARCH-LM Diagnostic Test was also used to check whether their is ARCH effect. Testing the null hypothesis of no ARCH effect against the alternative of ARCH effect. The Lagrange-Multiplier test in the table 2.1 offer significant evidence of ARCH effect, an indication that the series are candidates of GARCH type modeling.

Histogram density plot is also used to check for normality. According to the histogram density graphs above, all the three exchange rate returns looked not normally distributed. It shows the absence of normality for the three situations. The evolution plots show that all the three return series have volatility clustering, i.e.
Fig. 1. Evolution and Density plot of the three return series

periods with high volatility and periods with low volatility, which indicates that a GARCH model can be used to fit the data.

The ACF plots for the three exchange rate returns seem to be white noise, all the lags fall inside the confidence interval. It also indicates no correlation and quickly decaying to zero. The PACF plots for the EURO shows that, all the lags are inside
Fig. 2. ACF and PACF plot of the three return series

USD Returns

ACF

Partial ACF

Lag

USD Returns

ACF

Partial ACF

Lag

EURO Returns

ACF

Partial ACF

Lag

GBP Returns

ACF

Partial ACF

Lag

the confidence bound and at most two lags are outside the confidence bound for the USD and GBP, thus there is evidence that the squared returns is predictable.
3. Methodology

3.1. The GARCH Models and its extensions

In this paper, we use both univariate and multivariate models. The univariate GARCH models are more interested in the sensitivity and persistence of a variable volatility shock on itself. Conversely, multivariate GARCH models (MV-GARCH) analyze the impact of the volatility of a variable on another variable. The most obvious application of MV-GARCH models is the study of relationships between co-volatilities and volatility in several markets.

3.1.1. Univariate Model

Understanding and analyzing how the univariate GARCH model works is the base for a study of the DCC multivariate GARCH model of Engle and Sheppard (2001). The GARCH(p,q) model introduced by Bollerslev (1986) is defined as:

\[ r_t = \mu_t + \epsilon_t \]  
\[ \epsilon_t = h_t z_t \]  
\[ h_t^2 = \alpha_0 + \alpha_1 \epsilon_{t-1}^2 + \ldots + \alpha_q \epsilon_{t-q}^2 + \beta_1 h_{t-1}^2 + \cdots + \beta_p h_{t-p}^2 \]

Where \( r_t \) is the log return of an asset at time \( t \), \( \epsilon_t \) is the mean-corrected return of an asset at time \( t \), \( \mu_t \) is the expected value of the conditional \( r_t \), \( h_t \) is the conditional variance at time \( t \) conditioned on the past, \( z_t \) is the sequence of independent and identically distributed (iid) standardized random variables thus \( E[z_t] = 0 \) and \( Var[z_t] = 1 \). \( \alpha_i \)'s and the \( \beta_j \)'s are the parameters of the model and \((p, q)\) is the order of the GARCH model. The coefficients \( \alpha_i \) \((i = 1, 2, \ldots, q)\) and \( \beta_j \) \((j = 1, 2, \ldots, p)\) are all assumed to be positive to ensure that the conditional variance \( h_t^2 \) is always positive and \( \sum_{i=1}^q \alpha_i + \sum_{j=1}^p \beta_j < 1 \) ensures that the process is stationary.

In the literature, the most considered GARCH model is the case where \( p = q = 1 \). Notice that, the GARCH\((p, q)\) does not include the asymmetry of the errors, which is a drawback. Some of the extended GARCH models accommodate the asymmetry of the returns such as the EGARCH model by Nelson (1991) and the GJR-GARCH model of Glosten et al. (1993).

3.1.2. EGARCH model

\[ \ln h_t^2 = \alpha_0 + \sum_{i=1}^q \alpha_i \epsilon_{t-i}^2 + \sum_{j=1}^p \beta_j \ln h_{t-j}^2 \]

\( \epsilon_{t-i}^2, h_{t-j}^2 \) are not i.i.d. and the conditional variance is invariant to changes in sign of the \( \epsilon_t \)'s.
When $p=q=1$, we have

$$\ln h_t^2 = \alpha_0 + \alpha \epsilon_{t-1}^2 + \beta \ln h_{t-1}^2.$$ \hfill (4)

### 3.1.3. GJR-GARCH model

The GJR-GARCH model was named after the authors who introduced it, Glosten et al. (1993). It extends the standard GARCH $(p,q)$ to include asymmetric terms that capture an important phenomenon in the conditional variance.

$$h_t^2 = \alpha_0 + \sum_{i=1}^{q} \alpha_i \epsilon_{t-i}^2 + \sum_{i=1}^{q} \epsilon_{t-i}^2 \gamma_i I_{t-i} + \sum_{j=1}^{p} \beta_j h_{t-j}^2$$

where

$$I_{t-i} = \begin{cases} 1 & \text{if } \epsilon_{t-i} < 0 \\ 0 & \text{if } \epsilon_{t-i} \geq 0 \end{cases}$$

The conditional variance for a $gjrGARCH(1,1)$ is

$$h_t^2 = \alpha_0 + \alpha \epsilon_{t-1}^2 + \epsilon_{t-1}^2 \gamma I_{t-1} + \beta h_{t-1}^2$$

In sample, to select the best GARCH model, the AIC and BIC model selection information criteria are considered.

### 3.1.4. Multivariate DCC GARCH model

The multivariate GARCH model proposed in this paper is the Dynamic Conditional Correlation (DCC) model introduced by Engle and Sheppard (2001) which offers a simple and more parsimonious means of modeling multivariate volatility. The DCC-GARCH belongs to the class models of conditional variances and correlations. The idea of the models in this class is that the covariance matrix $H_t$ can be decomposed into conditional standard deviations $D_t$ and a correlation matrix $R_t$. In the DCC-GARCH model both $D_t$ and $R_t$ are designed to be time varying. A DCC model can be defined as:

Let $r_t$ be a vector of $(n \times 1)$ of a stationary process, $r_t \sim DDC-GARCH$ is:

$$r_t = \mu + \epsilon_t$$ \hfill (5)

$$\epsilon_t = H_t^2 z_t$$ \hfill (6)

$$H_t = D_t R_t D_t$$ \hfill (7)
Where $D_t$ is the diagonal of an $n \times n$ matrix of time varying standard deviation from univariate GARCH models and $R_t$ is the time varying conditional correlation matrix of the disturbance term $\epsilon_t$.

$D_t$ and $R_t$ are in the forms:

$$
D_t = \begin{bmatrix}
\sqrt{h_{11,t}} & 0 & 0 & \cdots & 0 \\
0 & \sqrt{h_{22,t}} & 0 & \cdots & 0 \\
0 & 0 & \sqrt{h_{33,t}} & \cdots & 0 \\
\vdots & \vdots & \ddots & \ddots & \vdots \\
0 & 0 & \cdots & 0 & \sqrt{h_{nn,t}}
\end{bmatrix}
$$

$$
R_t = \begin{bmatrix}
1 & q_{12,t} & q_{13,t} & \cdots & q_{1n,t} \\
q_{21,t} & 1 & q_{23,t} & \cdots & q_{2n,t} \\
q_{31,t} & q_{32,t} & 1 & \cdots & \vdots \\
\vdots & \vdots & \ddots & \ddots & \ddots \\
q_{n1,t} & q_{n2,t} & q_{n3,t} & \cdots & 1
\end{bmatrix}
$$

where $n$ is the sample size.

### 3.2. Estimation of DCC-GARCH

Here we describe how the parameters of a DCC-GARCH model may be determined. We consider two different distributions for the standardized error $z_t$: the multivariate Gaussian distribution and the multivariate Student’s t-distribution.

#### 3.2.1. Multivariate Gaussian distributed errors

When the standardized errors, $z_t$, are multivariate Gaussian distributed, the joint distribution of $z_1, ..., z_T$ is:

$$
f(z_t) = \prod_{t=1}^{T} \frac{1}{(2\pi)^{n/2}} \exp \left(-\frac{1}{2} z_t^T z_t \right)
$$

The model estimation is done in two steps: The first step is to estimate the conditional variance of the series with a univariate GARCH $\log_v(\theta)$ and the second is to use the standardized residuals obtained to estimate the parameters of the dynamic correlation matrix $\log_c(\theta, \phi)$.

The log Likelihood function in the first step is:

$$
\log(L(\phi)) = -\frac{1}{2} \sum_{t=1}^{T} \left( \log h_t + \frac{\epsilon_t^2}{h_t} \right) + \text{constant}
$$

The log likelihood in the second step is:

$$
\log(L(\psi)) = -\frac{1}{2} \sum_{t=1}^{T} \left( n \log(2\pi) + 2 \log(|D_t|) + \log(|R_t|) + \epsilon_t^T R_t^{-1} \epsilon_t \right)
$$

$\psi = (a, b)$ are the parameters of the correlation. Since $D_t$ is constant when conditioning on the parameters from step one, we can exclude the constant terms and maximize:

---

\[
\log(L(\psi)) = -\frac{1}{2} \sum_{t=1}^{T} (n \log(2\pi) + \log(|R_t|) + \epsilon_t^T R_t^{-1} \epsilon_t)
\]

3.2.2. Multivariate Student’s t-distributed errors

When the standardized errors, \(z_t\), are multivariate Student’s distributed, the joint distribution of \(z_1, \ldots, z_T\) is:

\[
f(z_t|\nu) = \prod_{t=1}^{T} \frac{\Gamma(\frac{\nu+n}{2})}{\Gamma(\frac{\nu}{2})} \left[1 + \frac{z_t^T z_t}{\nu - 2}\right]^{-\frac{n+\nu}{2}}
\]

where \(\Gamma(.)\) is the gamma function.

\[
\Gamma(\alpha) = \int_{0}^{\infty} x^{\alpha-1} e^{-x} dx \quad \text{for } \alpha > 0.
\]

Engle and Sheppard (2001) have shown that the change of the error distribution does not virtually affect the parameters. Therefore the parameters of the univariate GARCH models are fitted using the pseudo-maximum-likelihood. Assuming the errors to be Gaussian distributed, the log Likelihood function in the first step is the same as the one in the multivariate Gaussian.

The log likelihood in the second step is:

\[
\log(L(\psi)) = \sum_{t=1}^{T} \left[ \log[\Gamma(\frac{\nu+n}{2})] - \log[\Gamma(\frac{1}{2})] - \frac{n}{2} \log[\pi(\nu-2)] - \frac{1}{2} \log[|R_t|] - \log[|D_t|] - \frac{\nu + 2}{2} \log[1 + \frac{\epsilon_t^T R_t^{-1} \epsilon_t}{\nu - 2}] \right]
\]

Since \(D_t\) is constant when conditioning on the parameters from step one, we can exclude the constant term and maximize:

\[
\log(L(\psi)) = \sum_{t=1}^{T} \left[ \log[\Gamma(\frac{\nu+n}{2})] - \log[\Gamma(\frac{1}{2})] - \frac{n}{2} \log[\pi(\nu-2)] - \frac{1}{2} \log[|R_t|] - \frac{\nu + 2}{2} \log[1 + \frac{\epsilon_t^T R_t^{-1} \epsilon_t}{\nu - 2}] \right]
\]

The proposed dynamic correlation structure For a DCC(p, q)
Modelling exchange rate volatility in The Gambia using dynamic conditional correlation model.

\[ Q_t = (1 - \sum_{i=1}^{P} \alpha_i - \sum_{j=1}^{Q} \beta_j)Q + \sum_{i=1}^{P} \alpha_i(\epsilon_{t-i} \epsilon'_{t-i}) + \sum_{j=1}^{Q} (\beta_j)Q_{t-1} \]

\[ R_t = Q_{t-1}^* Q_t^{-1} \]

\( Q \) is the unconditional covariance of the standardized residuals where \( Q_t \) is a positive definite matrix defining the structure of the dynamics and \( Q_{t-1}^* \) is a diagonal matrix with the square root of the diagonal elements of \( Q_t \) at the diagonal.

For a DCC(1,1)

\[ Q_t = (1 - \alpha - \beta)Q + \alpha e_{t-1} e'_{t-1} + \beta Q_{t-1} \]

\[ Q = \text{cov}(\epsilon_t, \epsilon'_t) = E[\epsilon_t \epsilon'_t] \]

where \( \alpha \) and \( \beta \) are scalars.

**Remark:** The matrix \( R_t \) is positive if and only if the matrix \( Q_t \) is positive. So that \( H_t \) is positive, it is necessary that the following conditions are satisfied:

\[ \alpha > 0; \beta > 0; \text{ with } \alpha + \beta < 1. \]

Consider a DCC-GARCH(1,1) multivariate model used in this study:

\[ H_{11,t} = \alpha_{0,1} + \alpha_{11} e_{1,t-1}^2 + \beta_{11} H_{11,t-1} \]

\[ H_{22,t} = \alpha_{0,2} + \alpha_{22} e_{2,t-1}^2 + \beta_{22} H_{22,t-1} \]

\[ H_{33,t} = \alpha_{0,3} + \alpha_{33} e_{3,t-1}^2 + \beta_{33} H_{33,t-1} \]

The parameters to be estimated are \( \alpha_{0,1}, \alpha_{0,2} \) and \( \alpha_{0,3} \) representing the average conditional volatility of series 1, 2 and 3; \( \alpha_{11}, \alpha_{22} \) and \( \alpha_{33} \) are ARCH parameters measuring sensitivity and \( \beta_{11}, \beta_{22} \) and \( \beta_{33} \) are GARCH parameters that measure the persistence. Thus \( \alpha_{ij} \forall i,j = 1,2,3 \) measures the sensitivity of the shock of the asset \( i \) on the asset \( j \) and \( \beta_{ij} \forall i,j = 1,2,3 \) measures the persistence of the shock of asset \( i \) on the asset \( j \).

**3.3. Forecasting of DCC-GARCH**

After the parameters of the model are estimated, the next step is to determine the forecast of the conditional covariance matrix, \( H_{t+k} = D_{t+k} R_{t+k} D_{t+k} \), at time \( t+k \) when the history up to time \( t \) is known. When forecasting the covariance matrix, the forecasts of \( D_{t+k} \) and \( R_{t+k} \) can be separately done.
3.3.1. Forecasting the conditional variances in $D_{t+k}$

The forecasts of the univariate variances in $D_{t+k} = \text{diag}(\sqrt{h_{1,t+k}}, \ldots, \sqrt{h_{n,t+k}})$ can be done separately for each of the $n$ assets. The $k$-step ahead forecast for the general GARCH($q,p$) is:

$$E[h_{i,t+k}|F_t] = \alpha_0 + \sum_{j=1}^{\max(p,q)} (\alpha_j + \beta_j) E[h_{i,t+k-j}|F_t]$$

where

$$F_t = h_{i,1}, h_{i,2}, \ldots, h_{i,n}$$

and

$$E[h_{i,t+k}|F_t] = z^2_{i,t+k}, \text{ for } k < 0, i = 1, 2, \cdots, n.$$

The forecast of the conditional variance is

$$E[D_{t+k}|F_t] = \text{diag}(\sqrt{E[h_{1,t+k}|F_t]}, \ldots, \sqrt{E[h_{n,t+k}|F_t]}).$$

3.3.2. Forecasting the conditional correlation matrix $R_{t+k}$

The elements of $R_{t+k}$ are not themselves forecast but they are the ratio of the forecast of the conditional covariance to the square root of the product of the forecasts of the conditional variances.

The expectation of the positive defined matrix $Q_{t+k}$ is:

$$\begin{cases} 
E[Q_{t+1}|F_t] = (1 - a - b)\bar{Q} + a\epsilon_t^2 + bQ_t \quad \text{if } k = 1 \\
E[Q_{t+k}|F_t] = (1 - a - b)\bar{Q} + aE[\epsilon_{t+k-1}\epsilon^T_{t+k-1}|F_t]bQ_{t+k-1}|F_t] \quad \text{if } k > 1
\end{cases}$$

where $E[\epsilon_{t+k-1}\epsilon^T_{t+k-1}|F_t] = E[R_{t+k-1}|F_t] = E[Q_{t+k-1}^{-1}Q_{t+k-1}|F_t]$. We cannot directly compute the $k$-step ahead forecast because $E[Q_{t+k-1}^{-1}Q_{t+k-1}|F_t]$ is unknown. To approximate the forecast, we assumed $\hat{R} \approx \bar{Q}$ and $E[\hat{R}_{t+i}|F_t] \approx E[Q_{t+i}|F_t]$ for $i = 1, \ldots, k$.
\[E[R_{t+1}|F_t] \approx E[Q_{t+1}|F_t] \]
\[\approx (1 - a - b)Q + aE[R_{t+k-1}|F_t] + bE[Q_{t+k-1}|F_t] \]
\[\approx (1 - a - b)\bar{R} + (a + b)E[R_{t+k-1}|F_t] \]
\[\approx (1 - a - b)\bar{R} + (a + b)(1 - a - b)\bar{R} + (a + b)E[R_{t+k-2}|F_t] \]
\[\approx (1 - a - b)\bar{R} + (1 - a - b)\bar{R} + (a + b)E[R_{t+k-2}|F_t] \]
\[\approx \cdots \]
\[\approx \sum_{i=0}^{k-2} (1 - a - b)\bar{R}(a + b)^i + (a + b)^{k-1}E[R_{t+1}|F_t] \]
\[\approx (1 - (a + b)^{k-1})\bar{R} + (a + b)^{k-1}E[R_{t+1}|F_t], \quad (8)\]

where \(E[R_{t+1}|F_t] \approx \hat{Q}_t^{-1}\hat{Q}_{t+1}\hat{Q}_t^{-1} \hat{Q}_t^{-1}, \hat{Q}_t = (1 - a - b)Q + a\epsilon_t^T + bQ_t\) and \(\bar{R} = \hat{Q}^*\hat{Q}\hat{Q}^*\), where \(\hat{Q}^*\) is a diagonal matrix with the square root of the diagonal elements of \(Q\) on the diagonal.

There exist another method to approximate the forecast. See Engle and Sheppard (2001) for that method.

### 4. Applications

In this chapter, we use the Gambia exchange rate data for empirical Analysis. As it was shown in the data description part when the log returns were examined for heteroskedasticity, ARCH-LM test provides strong evidence of ARCH effects in the return series, which indicates that we can now proceed with the modeling of the index return volatility by using GARCH methodology (see Figure 1). The graph of the three series shows that, the USD has the highest volatility except around 2015/2016 were the GBP was the highest.

In the following, we check the GARCH model and some of the extension GARCH models. The different results are presented in Table 2.

**Table 2.** Comparison of Models using AIC and BIC for Gaussian and student distributed errors. Akaike’s information criterion (AIC) and Bayes information criterion (BIC) compare the quality of a set of statistical models to each other.

<table>
<thead>
<tr>
<th></th>
<th>Gaussian</th>
<th>Student</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GARCH</td>
<td>eGARCH</td>
</tr>
</tbody>
</table>

The results in Table 3 considering the minimum Akaike Information Criteria (AIC) and Bayes information criterion (BIC) which estimate the quality of each model, relative to each of the other models, we can conclude that the eGARCH better fit the data for both the Gaussian and Student distributed error. Thus we consider eGARCH for the two distributed errors.

4.1. Parameter Estimation

First we fit $\epsilon_t$ assuming Gaussian distributed errors, $z_t$. When $z_t \sim N(0, I)$, and $\epsilon_t \sim N(0, H_t)$. The estimated parameters from step one are given in Table 4.1.

Table 3 shows the results from estimating a trivariate eGARCH model using the weekly exchange rate returns, USD, EURO and GBP over the sample period 7th January, 2000 to 29th December, 2017, a total of 936 observation for each series. The parameters of the variance equation ($\alpha_1$ and $\beta_1$) are all significant for the three series. The significance of $\alpha$ and $\beta$ indicates that lagged conditional variance and squared disturbance has an impact on the conditional variance. In other words this means that news about volatility from the previous periods has an explanatory power on current volatility ($H_t$ rely on $H_{t-1}$).
Table 3. Parameters from step 1 when assuming Gaussian distributed errors for EGARCH. Notes: ** is 5% significant. $\mu$ is the intercept of the conditional mean model, $\omega$ is the intercept of the GARCH(1,1) model, $\alpha_1$ is the ARCH term, $\beta_1$ is the GARCH term and $\gamma_1$ is the asymmetric effect term.

<table>
<thead>
<tr>
<th>Currency</th>
<th>Estimate</th>
<th>Std. Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD</td>
<td>0.007953</td>
<td>0.025957</td>
</tr>
<tr>
<td></td>
<td>0.120973**</td>
<td>0.046317</td>
</tr>
<tr>
<td></td>
<td>0.115062**</td>
<td>0.067615</td>
</tr>
<tr>
<td></td>
<td>0.870029**</td>
<td>0.013344</td>
</tr>
<tr>
<td></td>
<td>0.539885**</td>
<td>0.085296</td>
</tr>
<tr>
<td>EURO</td>
<td>0.048751</td>
<td>0.054049</td>
</tr>
<tr>
<td></td>
<td>0.270102**</td>
<td>0.084591</td>
</tr>
<tr>
<td></td>
<td>0.255397**</td>
<td>0.108687</td>
</tr>
<tr>
<td></td>
<td>0.834349**</td>
<td>0.052409</td>
</tr>
<tr>
<td></td>
<td>0.731454**</td>
<td>0.139884</td>
</tr>
<tr>
<td>GBP</td>
<td>0.021257</td>
<td>0.050759</td>
</tr>
<tr>
<td></td>
<td>0.367869**</td>
<td>0.138880</td>
</tr>
<tr>
<td></td>
<td>0.261654**</td>
<td>0.158252</td>
</tr>
<tr>
<td></td>
<td>0.720866**</td>
<td>0.051458</td>
</tr>
<tr>
<td></td>
<td>0.979685**</td>
<td>0.231517</td>
</tr>
</tbody>
</table>

Since we, as described above, assumed Gaussian distributed errors in step one i.e univariate model, the estimated parameters in this step are exactly the same as the parameters given in Table 3.

Table 4. Parameters from step 2 when assuming Gaussian and student distributed errors. NB. $dcca1$ and $dccb1$ are the ARCH and GARCH parameters of the estimated DCC model and mshape is the estimated parameter of the DCC for Student distribution

<table>
<thead>
<tr>
<th>Group</th>
<th>Estimate</th>
<th>Std. Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gaussian</td>
<td></td>
<td></td>
</tr>
<tr>
<td>dcca1</td>
<td>0.057540**</td>
<td>0.023076</td>
</tr>
<tr>
<td>dccb1</td>
<td>0.641737**</td>
<td>0.156908</td>
</tr>
<tr>
<td>Student</td>
<td>Estimate</td>
<td>Std. Error</td>
</tr>
<tr>
<td>dcca1</td>
<td>0.086182**</td>
<td>0.025312</td>
</tr>
<tr>
<td>dccb1</td>
<td>0.759199 **</td>
<td>0.057061</td>
</tr>
<tr>
<td>mshape</td>
<td>4.000001**</td>
<td>0.622391</td>
</tr>
</tbody>
</table>

The estimated parameters in step two, summarized in Table 4.1, are also significant i.e conditional correlation parameters dcca1 and dccb1 are statistically significant for both distributed errors. The parameter mshape is also significant which corresponds to the degree of freedom for the student distributed error.
Table 5. Residuals Test Results

<table>
<thead>
<tr>
<th>Test</th>
<th>Gaussian T-statistic</th>
<th>p-value</th>
<th>Student T-statistic</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$Q(m)$ of $\epsilon_t$:</td>
<td>2.861338</td>
<td>0.984</td>
<td>5.660861</td>
<td>0.842</td>
</tr>
<tr>
<td>Rank-based test:</td>
<td>64.36503</td>
<td>5e-10</td>
<td>60.1749</td>
<td>3e-09</td>
</tr>
<tr>
<td>$Q_k(m)$ of $\epsilon_t$:</td>
<td>86.81395</td>
<td>0.575</td>
<td>136.1427</td>
<td>0.001</td>
</tr>
<tr>
<td>Robust $Q_k(m)$:</td>
<td>142.5182</td>
<td>.0003</td>
<td>130.7848</td>
<td>0.003</td>
</tr>
</tbody>
</table>

As shown in Tsay (2014), Robust $Q_k(m)$ works well in detecting conditional heteroscedasticity of multivariate return series. According to the joint Robust statistic test, as interpreted in Tsay (2014), of the three return series, presented in Table 4.1, shown that the p-values for both the Gaussian and Student distributed errors are statistically significant at the 5% confidence level with 90 degrees of freedom of a chi-squared distribution. This confirms the existence of serial dependence in the three return series. Meaning that the three return series are correlated. Thus the two models are adequate for further analysis.

Figure 4 and 5 show the fitted volatilities and correlations resulting from the Gaussian and Student eGARCH models respectively. According to the graphs, we see that the correlation between USD and GBP is more volatile in both cases. The student distributed error shows negative correlation around 2002. The graphs also
show relatively stable and persistent conditional correlation. They also show that the moving pattern are centralized around an upward rising trend.

4.2. Forecasts

To complete the study, we forecast the distributed errors using the conditional correlation matrix. Figure 6 shows the forecast off diagonals for the correlation matrix of the Gaussian and student distributed errors. The red line is the unconditional correlation matrix, the purple line is the one year forecast for the Gaussian distributed error and the green line is the one year forecast of the student distributed error. In all the correlation forecast, we see that the green line i.e student distributed error is closer to the unconditional correlation. This shows that the student distributed error is better. The graph also indicates constant correlation except around the first week to the eight week of the USD and EURO correlation for Student distributed error which was a bit above the unconditional correlation. The Student and Gaussian distributed errors show the same correlation between GBP and EURO around the first week to the fifth week. The student distributed error for EURO and GBP is closer to the unconditional correlation than the correlation between the USD and EURO and the correlation between GBP and USD. This shows that the EURO and GBP has the highest correlation.

5. Conclusion

In this study we investigated the statistical properties of The Gambia exchange rates (USD, EURO and GBP) from 2000 to 2017 and specify two distributed errors namely the Gaussian and the Student distributed errors. The data was divided into two (in-sample and out-sample) and fit the DCC eGARCH(1,1) model for both distributed errors. The models for the two distributed errors were selected using some of the in-sample characteristic AIC and BIC and estimated the parameter which were significant. The sum of the GARCH parameters $\alpha_1$ and $\beta_1$ were found to be very close to one, indicating that volatility in the exchange rate is highly persistent. The remaining part of the data set was used for out-of-sample forecasting of the conditional correlation. Our results indicate that the exchange rates of The Gambia Dalasi are correlated and the student distributed errors better forecast the conditional correlation.

The variation of weekly exchange rates of USD, EURO and GBP currencies against the Gambian Dalasi shows instability behavior during the selected period which is associated with exchange rate risk. This fluctuation is considered non-stationary and has been frequently observed in a number of time-series data applied in previous studies. The movement shows an upward trend, indicating that the currency Dalasi against the three international currencies has been depreciating over the past decades. One of the main factors of this nature is the decline of the country’s re-export trade due to the timing of external tariffs in the developments of the state to compete and effective port facilities, mainly in Senegal.
This study will help policy directives for those working in the central Bank of The Gambia, Government Ministries and Financial institutions to fulfill some of the pronouncements in The Gambian constitution and Act (2005) where one of the main objectives is to maintain and stabilize the prices of goods and currencies. Being one of the import led nations and depending a lot on remittances coming from abroad, there is the need to conduct research and studies of trends and volatility of the exchange rates of The Gambia over a period of time, to achieve some of these goals. It may be of interest to future researchers to use Value-at-Risk to measure the exchange rate risk and to get a better analysis of how volatility affects the exchange rate of The Gambian Economy and not
just the market, it might be better to use other distribution errors such as a skewed Student and Normal Inverse Gaussian (NIG). In our analysis, for both the Student and Gaussian distribution, we assumed the same distribution for the three series. This might be very restrictive Criteria. One then might use another multivariate GARCH model (Copula-GARCH) to link the marginals together for different distribution assumption of the three series which might better fit the data.

Acknowledgment The authors would like to greatly thank the editor and the presentation. Special thanks are extended to the referees for the careful reading and valuable comments which greatly helped in improving the paper.
The Gambia using dynamic conditional correlation model.

References


Modelling exchange rate volatility in The Gambia using dynamic conditional correlation model.
