

# **Management of Foreign Exchange Risk**

Evidence from Developing Economies

**Yew C. Lum and Sardar M. N. Islam**

# Contents

<i>List of figures</i>	viii
<i>List of tables</i>	xii
<i>Foreword</i>	xiv
<i>Summary and preface</i>	xv
<i>Acknowledgements</i>	xx
<i>List of abbreviations</i>	xxi
<b>1 Strategic overview</b>	<b>1</b>
<i>Background of the study</i>	1
<i>Contribution to knowledge</i>	4
<i>History of the topic</i>	7
<i>Geographical location of the topic</i>	9
<i>Benefits to the community</i>	10
<i>Why is it significant?</i>	11
<i>Who is it significant to?</i>	13
<i>Organisation of book</i>	14
<b>2 Exchange rate risk management and modelling</b>	<b>15</b>
<i>Introduction</i>	15
<i>Exchange rate risk and economic liberalisation</i>	15
<i>Classical time series models and financial series</i>	24
<i>Exchange rate volatility modelling in a univariate framework</i>	25
<i>Exchange rate volatility modelling in a multivariate framework</i>	27
<i>Risk management of exchange rate volatility</i>	29
<i>Conclusion</i>	29
<b>3 Exchange rate risk and economic liberalisation</b>	<b>31</b>
<i>Introduction</i>	31
<i>Developments in the Malaysian exchange rate market</i>	31
<i>Data analysis of Malaysia's exchange rate</i>	39
<i>Implications</i>	46
<i>Conclusion</i>	49

vi	<i>Contents</i>	
<b>4</b>	<b>Volatility modelling of exchange rates in a univariate framework</b>	<b>51</b>
	<i>Introduction</i>	<i>51</i>
	<i>Framework and estimation process</i>	<i>52</i>
	<i>Empirical results</i>	<i>62</i>
	<i>Value at Risk</i>	<i>74</i>
	<i>Implications</i>	<i>78</i>
	<i>Conclusion</i>	<i>83</i>
<b>5</b>	<b>Volatility modelling of exchange rates in a multivariate framework</b>	<b>85</b>
	<i>Introduction</i>	<i>85</i>
	<i>Framework and estimation process</i>	<i>87</i>
	<i>Estimation processes</i>	<i>97</i>
	<i>Diagnostic testing</i>	<i>101</i>
	<i>Implications</i>	<i>106</i>
	<i>Conclusion</i>	<i>111</i>
<b>6</b>	<b>Concluding remarks</b>	<b>113</b>
	<i>Introduction</i>	<i>113</i>
	<i>Volatility issues in the exchange rate market</i>	<i>115</i>
	<i>Implications on risk measurement</i>	<i>118</i>
	<i>Implications on risk management</i>	<i>120</i>
	<i>Limitations and areas of further research</i>	<i>125</i>
	<i>Conclusion</i>	<i>125</i>
	<b>Appendix 1: Foreign exchange changes in Malaysia on 1 April 2005</b>	<b>129</b>
	<b>Appendix 2: Analysis of monthly exchange rate data</b>	<b>131</b>
	<b>Appendix 3: Forecasting diagrams of various GARCH models</b>	<b>135</b>
	<i>MYR/USD</i>	<i>135</i>
	<i>MYR/GBP</i>	<i>136</i>
	<i>MYR/EUR</i>	<i>137</i>
	<i>MYR/JPY</i>	<i>139</i>
	<i>MYR/CHF</i>	<i>140</i>
	<b>Appendix 4: Forecasting diagrams between RiskMetrics and APARCH models</b>	<b>141</b>
	<i>MYR/USD</i>	<i>141</i>
	<i>MYR/GBP</i>	<i>142</i>
	<i>MYR/EUR</i>	<i>143</i>
	<i>MYR/JPY</i>	<i>144</i>
	<i>MYR/CHF</i>	<i>145</i>

<b>Appendix 5: Empirical results for multivariate GARCH models</b>	<b>147</b>
<i>Scalar BEKK(1,1) by Engle and Kroner (1995)</i>	<i>147</i>
<i>Diagonal BEKK</i>	<i>157</i>
<i>RiskMetrics</i>	<i>167</i>
<i>Constant conditional correlations by Bollerslev (1990)</i>	<i>170</i>
<i>Dynamic conditional correlations by Tse and Tsui (2002)</i>	<i>181</i>
<i>Dynamic conditional correlations by Engle (2002)</i>	<i>191</i>
<i>Orthogonal GARCH model</i>	<i>201</i>
<i>GO-GARCH model (by Van der Wedie (2002))</i>	<i>214</i>
<i>NLS GO-GARCH model (by Boswijk and Van der Wedie (2006))</i>	<i>226</i>
<i>References</i>	<b>245</b>
<i>Index</i>	<b>261</b>