Analyzing Exchange Rate Dynamics within the Global Financial Cycle: A DCC-Copula approach

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ABSTRACT

Exchange rate comovements intensify during episodes of global financial stress, with consequences for portfolio diversification, contagion risk and macroprudential policy. This paper studies how the Global Financial Cycle (GFC)—the joint movements in global risk appetite, capital flows and asset prices—shapes the time-varying dependence structure among 24 currencies from developed and emerging economies. We estimate pairwise dynamic conditional correlations using a DCC-Copula framework and then assess their determinants using quantile panel regressions, which characterize the effects of the GFC drivers across the entire correlation distribution. We document three main findings. First,

exchange rate correlations are time-varying, rising sharply during periods of global financial stress. Second, we provide systematic evidence that the VIX, as a proxy for the GFC, is a significant determinant of time-varying exchange rate correlations. Third, the VIX has a strong effect on correlations at higher quantiles, indicating that comovement intensifies precisely when the risk of contagion is most pronounced.