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Oil and foreign exchange market tail dependence and risk spillovers for MENA, emerging and developed countries: VMD decomposition based copulas

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Abstract. This paper examines the short- and medium run dependence structures between oil and currency markets for MENA, other developing and developed countries, using a novel multiresolution decomposition method, namely the variational mode decomposition (VMD), along with a battery of time-invariant and time-varying symmetric and asymmetric copula functions. Further, we assess the downside and upside short- and medium-run risk spillovers from oil to U.S. exchange rate returns and vice versa by computing the conditional Value-at-Risk (CoVaR) risk measures. Before the copula estimations, we apply the spillover index of Diebold and Yilmaz (2012) and network diagrams to identify and select the currencies that are the most significant net contributors or net receivers of returns from/to the oil/currency markets. The following copula results show strong evidence of time-varying and high average (tail) dependence between the oil returns and the FX markets, which are net transmitters to oil, for the short and medium time horizons. On the other hand, we find average and relatively low dynamic dependence between oil and the net receiver currencies, regardless of the time horizons. Moreover, there is evidence of up and down risk asymmetric systemic risks from oil to currencies and vice versa for some countries in the short-and medium run horizons. Finally, the risk spillovers are asymmetric over time and investment horizons. These results have several important implications for hedging strategies and diversification benefits for oil and FX traders and institutional investors.

JEL classification: C58, F37, G11, G14
Keywords: Oil prices, Currency markets, Conditional Value at Risk, Copula, Multiresolution approach.
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