A common-factors approach to currency classification

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This study proposes a novel approach to classify currencies based on the common driving forces that determine their behavioral features. We employ the multivariate factor stochastic volatility model to estimate the latent factors and apply K-means and hierarchical clustering to the estimated factor loadings. We find that there are three distinct clusters that can be labeled the US dollar, euro, and commodity currency blocks. This approach will prove particularly useful for investors and policy makers to evaluate currency risks, which are shared within currency blocks but differ between them.