ESSAYS ON RISK PREMIA IN EMERGING MARKET CURRENCIES

VU THANH TRUNG

National Graduate Institute for Policy Studies

Tokyo, December 2018

SUMMARY

Emerging Market (EM) currencies have positive risk premia against the U.S. dollar. Although this fact has been well documented, current international economics literature does not provide adequate explanations of why these risk premia exist. The aim of this dissertation is to close the gap in the literature by offering a theoretical model of currency risk premia and reporting some new empirical evidences. Throughout this dissertation, foreign exchange rate is viewed as an asset price, and currency risk premium is derived from a multi-country consumption-based asset-pricing framework. There are two main conclusions. Firstly, long-run consumption growth risk is one component in EM currency risk premia; and asymmetric consumption growth risk between the US and EM countries determines the sign and magnitude of currency risk premia. Compared with the US, EM countries that have higher long-run consumption growth risk and lower long-run risk persistence often have substantial positive currency risk premia.

Secondly, macroeconomic models should treat EM and G10 currencies differently because the two groups of currencies face different risk profiles. Compared to G10 currencies, EM currencies are exposed more to Global Risk Factor. Additionally, short-term interest rate differential relative to the US is a significant common risk factor for EM currencies, but not for G10 currencies.

This dissertation is the first study in the literature showing that a multi-country theoretical model of long-run risk can be used to explain for risk premia in EM currencies.

There are three main chapters. The first chapter provides empirical backgrounds and a literature survey on currency risk premia. The second chapter shows that a model of long-run consumption growth risk can account for the risk premia in EM currencies. The third chapter reports new empirical evidences that G10 and EM currencies do not have common risk factors.