

## **Abstract**

This paper applies stochastic discount factor methodology to modeling the foreign exchange risk premium in Armenia. We use weekly data on foreign and domestic currency deposits, which coexist in the Armenian banking system. This coexistence implies elimination of the cross-country risks and transaction costs, leaving the pure foreign exchange risk. It is shown that there exists a systematic time-varying risk premium that increases with maturity. Using two-currency affine term structure and generalized autoregressive conditional heteroskedasticity (GARCH)-in-mean models, we find that the central bank's foreign exchange market interventions and ratio-of-deposit volumes significantly affect public expectations about foreign exchange fluctuations. We also find that the foreign exchange risk premium accounts for the largest part of the interest differential. When accounting for economic and institutional differences, our results can be extended to other countries.

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