Abstract

We address the issue of foreign exchange risk and its macroeconomic determinants in several new EU members. We derive the observable macroeconomic factors—consumption and inflation—using the stochastic discount factor (SDF) approach. The joint distribution of excess returns in the foreign exchange market and the factors are modeled using a multivariate GARCH-in-mean specification. Our findings show that both real and nominal factors play important roles in explaining the variability of the foreign exchange risk premium. Both types of factors should be included in monetary general equilibrium models employed to study excess returns. To contribute to the further stability of domestic currencies, the new EU members should strive to implement stabilization policies aimed at achieving nominal as well as real convergence with the core EU members.

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