Abstract

Many currencies exhibit non-zero average returns with respect to US dollar, in an apparent violation of textbook uncovered and covered interest parities. I first show that in the cross-section of countries foreign currency returns are positively related to the sovereign default risk, and then reconcile this finding with the standard theory via the "peso problem". Market players collect premium for bearing the risk of sharp devaluation in case of default. Since defaults are rare in the data, default premium manifests itself in higher currency returns. To formalize the link between default risk and currency returns, I discipline quantitatively a model "with default" based on Arellano (2008) for a set of developing countries. I then use the implications of this model to construct an econometric model for cross-section of currency returns that I estimate using extended Fama and MacBeth (1973) method. I find strong evidence supporting the "peso problem" explanation: credit default swaps' spreads serving as proxy for the risk of default explain around 25% of the cross-country variation of average currency returns.