Conditional Currency Risk Premia

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Proposal Summary for Coleman Fung Risk Management Research Center

Themes: Macroeconomic Risk, Liquidity Risk, Bank Regulation and Leverage

We are investigating the sources of macroeconomic risk in the currency market and how they are related both to other asset markets, such as equity and bonds, and to the risk management and international transactions of financial institutions.

Our approach exploits the variation in risk through the business cycle and focuses on disentangling risk in bad states of the world.

While these states might be underrepresented in the sample data, they are the states that contain the most interesting information about risk in asset markets. Finally we provide a rationale for our empirical exercise by linking the observed variation in risk premia to the state of the financial system. Intuitively states of the world where the financial system is well capitalized correspond to low risk premia, while states of the world with a distressed financial system correspond to high risk premia due to the extra compensation financial institutions require to hold risk. To tie currency returns to the risk management practices of financial institutions, we plan to collect data on international banking flows.

The completed project will shed light on the interrelation between sources of macroeconomic risk and financial risk management in the currency and other asset markets.

The grant funds are essential to allow us to purchase data on currency returns, international bank positions, and for summer support for a graduate student researcher.