

CURRENCY RISK IN EMERGING EQUITY MARKETS

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Abstract

The paper develops an international capital asset pricing model, which includes foreign currency risk, and examines the impact of capital market liberalisation on the pricing of risks. It applies the model to data from Pacific Basin financial markets and finds substantial evidence that not only currency risk is priced in both pre and post liberalisation periods, but the model is superior to one which does not include currency risk. This evidence suggests that an international capital asset pricing model, which omits currency risk, will be misspecified. Furthermore, the results imply that since currency risk is priced and investors are compensated for bearing such risk they should not be discouraged by more flexible exchange rate regimes from investing in emerging markets.

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