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# Emerging market local currency sovereign bond yields: the role of exchange rate risk

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This paper explores the role of exchange rate risk in determining local currency sovereign bond yields in emerging market economies (EMEs). We find that EME local currency sovereign bond yields are indeed influenced by exchange rate risk (volatility and expected depreciation of the exchange rate). This finding holds when controlling for endogeneity and a number of key domestic and international factors. We also show that the effect of exchange rate volatility has strengthened over time, particularly since the US Federal reserve announced in May 2013 that it would reduce the pace and size of its large-scale asset purchases. The influence of exchange rate volatility is less pronounced in EMEs with higher shares of foreign ownership of local currency sovereign bonds, larger capital account openness and greater exchange rate flexibility. Our findings have a number of implications for policymakers, in particular as to how emerging market economies can be vulnerable to perception of greater exchange rate risk as global monetary conditions tighten.

Keywords: Emerging markets, exchange rate risk, local currency sovereign bond yields

JEL classification: E43, E44

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