How Can Asset Prices Value Exchange Rate Wedges

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When available financial securities allow investors to optimally diversify risk across countries, standard theory implies that exchange rates should reflect this behavior. However, exchange rates observed in the data deviate from these predictions. In this paper, we develop a framework to value the welfare costs of these exchange rate wedges, as disciplined by asset returns. This framework applies to a general class of asset pricing and exchange rate models. We further decompose the value of these wedges into components, showing that the ability of goods markets to respond to financial markets through exchange rate adjustment has significant implications for welfare.

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