

- We model the exchange rate risk premium and portfolio holdings in small open economy (SOE) New Keynesian model.
- Demonstrate that under floating exchange rate, nominal bond holdings becomes a state contingent asset in real terms.
- Being able to trade in such asset improves the utility of the SOE household.
- Exchange rate risk premium is not invariant to policy changes.
- Results have implication for DSGE estimation, decision to join a monetary union and the uncovered interest rate parity puzzle.