

# Do Peso Problems Explain the Returns to the Carry Trade?

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Craig Burnside , Martin Eichenbaum , Isaac Kleshchelski , Sergio Rebelo

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## Abstract

We study the properties of the carry trade, a currency speculation strategy in which an investor borrows low-interest-rate currencies and lends high-interest-rate currencies. This strategy generates payoffs that are on average large and uncorrelated with traditional risk factors. We argue that these payoffs reflect a peso problem. The underlying peso event features high values of the stochastic discount factor rather than very large negative payoffs.

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