Volume 4, Issue 2

Risk-Sharing Externalities and Its Implications for Equity Premium in an Infinite-Horizon Economy

Ohno, Hioraki

Year: 2010 Volume: 4 Issue: 2 Pages: 168-188

Abstract: This paper examines asset prices when risk-sharing externalities are incorporated into an infinite-horizon model where consumers are exposed to the endogenous income risks. It is shown that there exist multiple types of equilibria depending on the degree of market participation. Under incomplete participation, income risks cannot be fully diversified as they induce higher precautionary savings, which are conducive in turn to higher asset prices. However, the exposure to additional dividend risks can lead at the same time to a lower demand for risky assets. The aggregate effect is an increase in the equity risk premium and a decrease in the risk-free rate. Thus, the evidence suggests that the equity premium and risk-free rate puzzles can be partly explained by infinite-horizon models with incomplete market participation.

JEL classification: D11, E21, E44, G12

Keywords: Risk-sharing externalities, endogenous income risks, incomplete market participation, asset prices

RePEc: http://ideas.repec.org/a/fau/aucocz/au2010_168.html

DOWNLOAD [PDF]

Print Recommend to others