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On the Consequences of State Dependent Preferences for the Pricing of Financial Assets

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Abstract:
This paper introduces state dependent utility into the standard Mehra and Prescott (1985) economy by allowing the representative agent's coefficient of relative risk aversion to vary with the underlying economy's growth rate. Existence of equilibrium is proved and its asymptotic properties analyzed. This generalization leads to level dependent marginal rates of substitution, a property that sharply distinguishes this model from the standard construct. For very low coefficients of relative risk aversion, the equilibrium risk free and risky security returns are demonstrated to have volatilities and an associated equity premium that substantially exceed what is found in the data. This provides a contrasting perspective on the classic "equity premium puzzle."

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