The Equity Premium in a DSGE Model with Rule of Thumb Consumers

Lorenzo Menna (Catholic University of Milan, Italy)

Asset pricing models based on the representative agent assumption cannot rationalize observed equity premia, i.e. the observed correlation between asset returns and consumption growth is "too weak". In response to this, exchange economy models have introduced agents heterogeneity, typically in the form of bond and equity holders. In this case the correlation between aggregate consumption and equity returns no longer matters for the equity premium. We reconsider the issue in the context of a DSGE model characterized by limited asset market participation (LAMP), i.e. a fraction of households does not hold any asset. The correlation between asset holders' consumption and asset returns strongly increases in the share of agents excluded from financial markets participation. LAMP therefore allows to strongly increase the predicted unconditional equity premium. We also identify the role of shocks and friction that characterize standard DSGE models in determining the premium. Further, our model is also able to replicate the responses of the main macro variables to productivity, monetary and government spending shocks and to deliver macro moments consistent with the data.