

Incomplete Market Participation, Labor Income Risks and Asset Prices *

HIROAKI OHNO[†]

Graduate School of Economics, Osaka University

JSPS Research Fellow

Abstract

Incorporating the externality to share risks into the infinite-horizon economy where endogenous labor income risks are generated by the existence of non stockholders, this paper examines asset prices. These risks induce precautionary savings, which enhance security prices, and at the same time make consumers more risk averse, decreasing the demand for risky assets. Hence, the existence of rational non-market participants may explain both the risk-free rate puzzle and the equity premium puzzle.

JEL classification: D11; E21; E44; G12.

Keywords: endogenous labor income risks; incomplete market participation; externality sharing risks; asset prices.

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[†]Graduate School of Economics, Osaka University. Address: 1-7 Machikaneyamamachi, Toyonaka, Osaka, 560-0043, JAPAN. E-mail:dg032oh@mail2.econ.osaka-u.ac.jp Telephone and fax numbers:+81-6-6850-6111