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**„When is Market Incompleteness Irrelevant for the Price  
of Aggregate Risk?“**

# When is Market Incompleteness Irrelevant for the Price of Aggregate Risk? \*

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## Abstract

We construct a model with a large number of agents who have constant relative risk aversion (CRRA) preferences and face potentially tight solvency constraints. We show that the absence of insurance markets for idiosyncratic labor income risk has no effect on the premium for aggregate risk if the distribution of idiosyncratic risk is independent of aggregate shocks. In the equilibrium, which features trade and binding solvency constraints, as opposed to Constantinides and Duffie (1996), households only use the stock market to smooth consumption; the bond market is inoperative. Furthermore we show that the cross-sectional wealth and consumption distributions are not affected by aggregate shocks. Equilibrium consumption allocations can be obtained by solving for an equilibrium in a version of the model without aggregate shocks, as in Bewley (1986), and then re-scaling the allocation by aggregate income. These results hold regardless of the persistence of idiosyncratic shocks, as long as they are not permanent, and arise even when households face very tight solvency constraints.

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# 1 Introduction

This paper provides general conditions under which closing down insurance markets for idiosyncratic risk (our definition of market incompleteness) does not increase the risk premium that stocks command over bonds.

We study a standard incomplete markets endowment economy populated by a continuum of agents who have CRRA preferences and who can trade a risk-free bond and a stock, subject to potentially binding solvency constraints. In the benchmark version of our model the growth rate of the aggregate endowment is uncorrelated over time, that is, the logarithm of aggregate income is a random walk.

Under these assumptions, the presence of *uninsurable idiosyncratic risk* is shown to lower the equilibrium risk-free rate, but it has no effect on the price of aggregate risk in equilibrium if the distribution of idiosyncratic shocks is statistically independent of aggregate shocks. Consequently, in this class of models, the representative agent Consumption-CAPM (CCAPM) developed by Rubinstein (1974), Breeden (1979) and Lucas (1978) prices the excess returns on the stock correctly. Therefore, as long as idiosyncratic shocks are distributed independently of aggregate shocks, the extent to which households manage to insure against idiosyncratic income risk is irrelevant for risk premia. These results deepen the equity premium puzzle, because we show that Mehra and Prescott's (1985) statement of the puzzle applies to a much larger class of incomplete market models.<sup>1</sup> We also show that uninsurable income risk does not contribute any variation in the *conditional* market price of risk.

The asset pricing implications of our model follow from a crucial result about equilibrium consumption and portfolio allocations. We show that in this class of incomplete market models with idiosyncratic and aggregate risk, the equilibrium allocations and prices can be obtained from the allocations and interest rates of an equilibrium in a stationary model with only idiosyncratic risk (as in Bewley (1986), Huggett (1993) or Aiyagari (1994)). Specifically, we demonstrate that scaling up the consumption allocation of the Bewley equilibrium by the aggregate endowment delivers an equilibrium for the model with aggregate risk. In this equilibrium, there is *no* trade in bond markets, only in stock markets. This result is the key to why the history of aggregate shocks has no bearing on equilibrium allocations and prices. Households in equilibrium only trade the stock, regardless of their history of idiosyncratic shocks, and this irrelevance of the history of idiosyncratic shocks for the household portfolio composition directly implies the irrelevance of the history of aggregate shocks for equilibrium prices and allocations. Financial wealth is irrelevant for the portfolio allocation decision even in the presence of binding solvency constraints.

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<sup>1</sup>Weil's (1989) statement of the risk-free rate puzzle, on the contrary, does not.

This finding has several important consequences beyond the asset pricing irrelevance result. First, it implies that the wealth and consumption distribution in the model with aggregate risk (normalized by the aggregate endowment) coincides with the stationary wealth distribution of the Bewley equilibrium. Aggregate shocks therefore have no impact on these equilibrium distributions.<sup>2</sup>

In the Bewley model, due to the absence of aggregate risk, a bond and a stock have exactly the same return characteristics in equilibrium and thus one asset is redundant. Households need not use the bond to smooth consumption. This portfolio implication carries over to the model with aggregate risk: at equilibrium prices households do not want to trade the uncontingent bond and only use the stock to transfer resources over time. In equilibrium, all households bear the same share of aggregate risk and they all hold the same portfolio, regardless of their history of idiosyncratic shocks and hence financial wealth holdings. Hence, this class of models does not generate any demand for bonds at the equilibrium interest rate, if bonds are in zero net supply.<sup>3</sup>

We also show that making markets more complete does not always lead to more consumption smoothing in equilibrium. In particular, allowing agents to trade claims on payoffs that are contingent on *aggregate shocks*, in addition to the risk-free bond and the stock, leaves their equilibrium consumption allocations unaltered. Agents still only trade the stock, and there are no effects of introducing these additional state contingent claims on interest rates and asset prices.

In our benchmark model, aggregate consumption growth is not predictable (that is, the growth rate of the aggregate endowment is i.i.d.). This is a standard assumption in the asset pricing literature (e.g. Campbell and Cochrane (1999)), because the empirical evidence for such predictability is rather weak (see e.g. Heaton and Lucas (1996)). It is also a natural benchmark, because all of the dynamics in the conditional market price of risk, if any, come from the model itself rather than the exogenously specified consumption growth process. However, if there is predictability in aggregate income growth in our model, we show that agents want to hedge their portfolio against interest rate shocks, creating a role for trade in

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<sup>2</sup>Since stationary equilibria in Bewley models are relatively straightforward to compute, our result implies an algorithm for computing equilibria in this class of models which appears to be simpler than the auctioneer algorithm devised by Lucas (1994) and its extension to economies with a continuum of agents. There is also no need for computing a law of motion for the aggregate wealth distribution, or approximating it by a finite number of moments, as in Krusell and Smith (1997, 1998),

This result also implies the existence of a recursive competitive equilibrium with only asset holdings in the state space. Kubler and Schmedders (2002) establish the existence of such an equilibrium in more general models, but only under very strong conditions. Miao (2005) relaxes these conditions, but he includes continuation utilities in the state space.

<sup>3</sup>Of course, excluding some households from the stock market would force them to trade bonds for consumption smoothing purposes, destroying the irrelevance result.

a richer menu of assets. The risk premium irrelevance result, however, still applies as long as households can trade a full set of aggregate state-contingent claims, provided that the solvency constraints do not bind.

The key ingredients underlying our irrelevance result are (i) a continuum of agents, (ii) CRRA utility, (iii) idiosyncratic labor income risk that is independent of aggregate risk, (iv) a constant capital share of income and (v) solvency constraints or borrowing constraints on total financial wealth that are proportional to aggregate income. We now discuss each of these assumptions in detail to highlight and explain the differences with existing papers in the literature.

First, we need to have a large number of agents in the economy. As forcefully pointed out by Denhaan (2001), in an economy with a finite number of agents, each idiosyncratic shock is by construction an aggregate shock because it changes the wealth distribution and, through these wealth effects, asset prices.

Second, our results rely on the homotheticity of CRRA utility, but not crucially on the time separability of the lifetime utility function. At least for the benchmark case of i.i.d. aggregate income growth rates the results extend to Epstein-Zin utility.

Third, in our model labor income grows with the aggregate endowment, as is standard in this literature.<sup>4</sup> In addition, for our results to go through, idiosyncratic income shocks must be distributed independently of aggregate shocks. This explicitly rules out that the variance of idiosyncratic shocks is higher in recessions (henceforth we refer to this type of correlation as countercyclical cross-sectional variance of labor income shocks, or CCV).

Fourth, we require the assumption that the capital share of income is independent of the aggregate state of the economy. This assumption is standard in macroeconomics, and it is not obviously at odds with the data (Cooley and Prescott (1995)). Asset pricing studies that relax this assumption, tend to have only modest fluctuations in the capital share, as e.g. Heaton and Lucas (1996).

Finally, we can allow households to face either constraints on total net wealth today or state-by-state solvency constraints on the value of their portfolio in each state tomorrow, but these constraints have to be proportional to aggregate income. This is also a common assumption in the literature. If it were not satisfied, the tightness of the constraints would depend on the aggregate history of shocks, ruling out the computation of a standard recursive equilibrium. In addition, if one were to endogenize the constraints along the lines suggested by Zhang (1996), Alvarez and Jermann (2000) or Lustig (2005), these “endoge-

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<sup>4</sup>By contrast, Weil (1992) derives a positive effect of background risk on the risk premium in a two-period model in which labor income is not proportional to the aggregate endowment. This non-homotheticity invalidates our mapping from the growing to the stationary economy.

nous” constraints satisfy the proportionality condition.<sup>5</sup> We show that these solvency and borrowing constraints do not create a link between equilibrium portfolio choice and financial wealth, contrary to what one might expect. Our irrelevance result only survives short-sale constraints on *individual* securities if aggregate consumption growth is uncorrelated over time, as assumed in the benchmark case. In that case households only trade the stock to smooth their consumption. Therefore, in the benchmark case, our result is also robust to transaction costs in the bond market (but not to such costs in the stock market).

## 1.1 Related Literature

Most related to our paper is Constantinides and Duffie (henceforth CD) (1996), who consider an environment in which agents face only permanent idiosyncratic income shocks and in which they can trade stocks and bonds. Their equilibrium is characterized by the absence of trade in financial markets. By choosing the right stochastic household income process, CD deliver autarchic equilibrium asset prices with all desired properties. CD’s results also imply that if the cross-sectional variance of consumption growth is orthogonal to returns, then the equilibrium risk premium is equal to the one in the representative agent model. We show that this characterization of the household consumption process is indeed the correct one in equilibrium in a large class of incomplete market models.<sup>6</sup> Relative to CD, our paper adds potentially binding solvency or borrowing constraints. Moreover, our equilibrium does feature trade in financial markets, but we do not make any assumptions about the distribution of the underlying shocks other than mean reversion. The consumption growth distribution across households in our model is the endogenous, equilibrium outcome of these trades, but we can still fully characterize equilibrium asset prices.<sup>7</sup>

Our analysis is also complementary to Mankiw (1986) who argued that *if* the cross-sectional variance of consumption is independent of the aggregate state of the economy and all agents satisfy their Euler equation for stocks and bonds, then the risk premium in models with idiosyncratic shocks is identical to that of the representative agent model. We identify conditions under which the consumption distribution, a fully endogenous object in

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<sup>5</sup>It is more common in the literature to impose short-sale constraints on stocks and bonds separately instead of total financial wealth, but this is done mostly for computational reasons, to bound the state space. In fact, if the solvency constraints are meant to prevent default, they should impose restrictions directly on total financial wealth (see e.g. Zhang (1996) and Alvarez and Jermann (2000)).

<sup>6</sup>Krebs (2005) derives the same result in a production economy with human capital accumulation.

<sup>7</sup>In a separate class of continuous-time diffusion models, Grossman and Shiller (1982) have demonstrated that heterogeneity has no effect on risk premia, simply because the cross-sectional variance of consumption growth is locally deterministic. Our irrelevance result is obtained in a different class of discrete-time incomplete market models in which unisurable idiosyncratic background risk does potentially matter, as shown by Mankiw (1986), CD (1996) and others.

our model, satisfies this independence assumption, even with binding solvency constraints.

In the quest towards the resolution of the equity premium puzzle identified by Hansen and Singleton (1983) and Mehra and Prescott (1985), uninsurable idiosyncratic income risk has been introduced into standard dynamic general equilibrium models.<sup>8</sup> Incomplete insurance of household consumption against idiosyncratic income risk was introduced into quantitative asset pricing models by Telmer (1993), Lucas (1994), Heaton and Lucas (1996), Marcet and Singleton (1999) and others. Their main result, derived numerically for various parameterizations, can be summarized as suggesting that the impact of uninsurable labor income risk per se has only small effects on the equity premium. The main contribution of our paper is to establish *theoretically* that, under a set of fairly general conditions spelled out above and further discussed below<sup>9</sup>, adding uninsurable idiosyncratic income risk to the standard consumption based asset pricing model does not alter the asset pricing implications of the model with respect to excess returns at all. Our theoretical result holds regardless of how tight the solvency constraints are, how persistent the income process is and how much agents discount the future. It is therefore, in particular, independent of the degree of consumption smoothing that can be achieved by households that face idiosyncratic income shocks. In equilibrium, all households bear the same amount of aggregate risk, and accordingly, they are only compensated in equilibrium for the aggregate consumption growth risk they take on by investing in stocks.

Most of the work on incomplete markets and risk premia focuses on the moments of model-generated data for particular calibrations of the model, but there are few general results. Levine and Zame (2002) show that in economies populated by agents with infinite horizons, the equilibrium allocations converge in the limit, as their discount factors go to one, to the complete markets allocations. Consequently the pricing implications of the incomplete markets model converge to that of the representative agent model as households become perfectly patient. We provide a qualitatively similar equivalence result that applies only to the risk premium. Our result, however, does not depend on the time discount factor of households. For households with CARA utility, closed form solutions of the individual decision problem in incomplete markets models with idiosyncratic risk are sometimes available, as Willen (1999) shows.<sup>10</sup> In contrast to Willen, we employ CRRA preferences, and we obtain an unambiguous (and negative) result for the impact of uninsurable income risk for the equity premium in case the distribution of individual income shocks is independent

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<sup>8</sup>For examples, see the work of Ayiagari and Gertler (1991), Telmer (1993), Lucas (1994), Heaton and Lucas (1996), Krusell and Smith (1998), and Marcet and Singleton (1999). see Kocherlakota (1996) for an overview

<sup>9</sup>Evidently in all quantitative papers cited above at least one of the assumptions we make is relaxed.

<sup>10</sup>CARA utility eliminates wealth effects which crucially simplifies the analysis.

of aggregate shocks.

There is large literature that documents strong correlation in the data between financial wealth and equity holdings (see e.g. Campbell (2006)). We show analytically that the history of a household's idiosyncratic shocks and hence their financial wealth has no bearing on their portfolio choice in our class of incomplete markets models.

The result of our paper that equilibria in the model with aggregate risk can be obtained from equilibria of the stationary Bewley model makes contact with the literature on aggregation. Constantinides (1982), building on work by Negishi (1960) and Wilson (1968), derives an aggregation result for heterogeneous agents in complete market models, implying that assets can be priced off the intertemporal marginal rate of substitution of an agent who consumes the aggregate endowment. Rubinstein (1974) derives an aggregation result without assuming complete markets, but he does not allow for non-traded assets. Our findings extend these aggregation results to a large class of incomplete market models with idiosyncratic income shocks, but the result only applies to excess returns. Alvarez and Jermann (2000, 2001) derive a similar result, but they consider a different trading arrangement; in the AJ-model, agents trade a *complete* menu of assets subject to binding solvency constraints. Instead, the focus of our paper is on what happens exactly when the markets for idiosyncratic risk are shut down.

The paper is structured as follows. In section 2, we lay out the physical environment of our model. This section also demonstrates how to transform a model where aggregate income grows stochastically into a stationary model with a constant aggregate endowment. In section 3 we study this stationary model, called the Bewley model henceforth. The next section, section 4, introduces the Arrow model, a model with aggregate uncertainty and a full set of Arrow securities whose payoffs are contingent on the realization of the aggregate shock. We show that a stationary equilibrium of the Bewley model can be mapped into an equilibrium of the Arrow model just by scaling up allocations by the aggregate endowment. In section 5 we derive the same result for a model where only a one-period risk-free bond can be traded. We call this the *Bond* model. After briefly discussing the classic Lucas-Breeden representative agent model (henceforth *LB* model), section 6 shows that risk premia in the representative agent model and the Arrow model (and by implication, in the Bond model) coincide. Section 7 investigates the robustness of our results with respect to the assumptions about the underlying stochastic income process, and shows in particular that most of our results can be extended to the case where the aggregate shocks are correlated over time. Finally, section 8 concludes; all proofs are contained in the appendix.

## 2 Environment

Our exchange economy is populated by a continuum of individuals of measure 1. There is a single nonstorable consumption good. The aggregate endowment of this good is stochastic. Each individual's endowment depends, in addition to the aggregate shock, also on the realization of an idiosyncratic shock. Thus, the model we study is identical to the one described by Lucas (1994), except that ours is populated by a continuum of agents (as in Bewley (1986), Aiyagari and Gertler (1991), Huggett (1993) and Aiyagari (1994)), instead of just two agents.

### 2.1 Representation of Uncertainty

We denote the current aggregate shock by  $z_t \in Z$  and the current idiosyncratic shock by  $y_t \in Y$ . For simplicity, both  $Z$  and  $Y$  are assumed to be finite. Furthermore, let  $z^t = (z_0, \dots, z_t)$  and  $y^t = (y_0, \dots, y_t)$  denote the history of aggregate and idiosyncratic shocks. As shorthand notation, we use  $s_t = (y_t, z_t)$  and  $s^t = (y^t, z^t)$ . We let the economy start at an initial aggregate node  $z_0$ . Conditional on an idiosyncratic shock  $y_0$  and thus  $s_0 = (y_0, z_0)$ , the probability of a history  $s^t$  is given by  $\pi_t(s^t|s_0)$ . We assume that shocks follow a first order Markov process with transition probabilities given by  $\pi(s'|s)$ .

### 2.2 Preferences and Endowments

Consumers rank stochastic consumption streams  $\{c_t(s^t)\}$  according to the following homothetic utility function:

$$U(c)(s_0) = \sum_{t=0}^{\infty} \sum_{s^t \geq s_0} \beta^t \pi(s^t|s_0) \frac{c_t(s^t)^{1-\gamma}}{1-\gamma}, \quad (1)$$

where  $\gamma > 0$  is the coefficient of relative risk aversion and  $\beta \in (0, 1)$  is the constant time discount factor. We define  $U(c)(s^t)$  to be the continuation expected lifetime utility from a consumption allocation  $c = \{c_t(s^t)\}$  in node  $s^t$ . This utility can be constructed recursively as follows:

$$U(c)(s^t) = u(c_t(s^t)) + \beta \sum_{s_{t+1}} \pi(s_{t+1}|s_t) U(c)(s^t, s_{t+1}),$$

where we made use of the Markov property the underlying stochastic processes. The economy's aggregate endowment process  $\{e_t\}$  depends only on the aggregate event history; we let  $e_t(z^t)$  denote the aggregate endowment at node  $z^t$ . Each agent draws a 'labor income' share  $\eta(y_t, z_t)$ , as a fraction of the aggregate endowment in each period. Her labor income

share only depends on the current individual and aggregate event. We denote the resulting individual labor income process by  $\{\eta_t\}$ , with

$$\eta_t(s^t) = \eta(y_t, z_t)e_t(z^t), \quad (2)$$

where  $s^t = (s^{t-1}, y_t, z_t)$ . We assume that  $\eta(y_t, z_t) > 0$  in all states of the world. The stochastic growth rate of the endowment of the economy is denoted by  $\lambda(z^{t+1}) = e_{t+1}(z^{t+1})/e_t(z^t)$ . We assume that aggregate endowment growth only depends on the current aggregate state.

**Condition 2.1.** *Aggregate endowment growth is a function of the current aggregate shock only:*

$$\lambda(z^{t+1}) = \lambda(z_{t+1}).$$

Furthermore, we assume that a Law of Large Numbers holds<sup>11</sup>, so that  $\pi(s^t|s_0)$  is not only a household's individual probability of receiving income  $\eta_t(s^t)$ , but also the fraction of the population receiving that income.

In addition to labor income, there is a Lucas tree that yields a constant share  $\alpha$  of the total aggregate endowment as capital income, so that the total dividends of the tree are given by  $\alpha e_t(z^t)$  in each period. The remaining fraction of the total endowment accrues to individuals as labor income, so that  $1 - \alpha$  denotes the labor income share. Therefore, by construction, the labor share of the aggregate endowment equals the sum over all individual labor income shares:

$$\sum_{y_t \in Y} \Pi_{z_t}(y_t)\eta(y_t, z_t) = (1 - \alpha), \quad (3)$$

for all  $z_t$ , where  $\Pi_{z_t}(y_t)$  represents the cross-sectional distribution of idiosyncratic shocks  $y_t$ , conditional on the aggregate shock  $z_t$ . By the law of large numbers, the fraction of agents who draw  $y$  in state  $z$  only depends on  $z$ . An increase in the capital income share  $\alpha$  translates into proportionally lower individual labor income shares  $\eta(y, z)$  for all  $(y, z)$ .<sup>12</sup>

At time 0, the agents are endowed with initial wealth  $\theta_0$ . This wealth represents the value of an agent's share of the Lucas tree producing the dividend flow in units of time 0 consumption, as well as the value of her labor endowment at date 0. We use  $\Theta_0$  to denote the initial joint distribution of wealth and idiosyncratic shocks  $(\theta_0, y_0)$ .

Most of our results are derived in a de-trended version of our model. This de-trended model features a constant aggregate endowment and a growth-adjusted transition probability

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<sup>11</sup>See e.g. Hammond and Sun (2003) for conditions under which a LLN holds with a continuum of random variables.

<sup>12</sup>Our setup nests the baseline model of Heaton and Lucas (1996), except for the fact that they allow for the capital share  $\alpha$  to depend on  $z$ .

matrix. The agents in this de-trended model, discussed now, have stochastic time discount factors.

### 2.3 Transformation of the Growth Model into a Stationary Model

We transform our growing model into a stationary model with a stochastic time discount rate and a growth-adjusted probability matrix, following Alvarez and Jermann (2001). First, we define growth deflated consumption allocations (or consumption shares) as

$$\hat{c}_t(s^t) = \frac{c_t(s^t)}{e_t(z^t)} \text{ for all } s^t. \quad (4)$$

Next, we define *growth-adjusted* probabilities and the growth-adjusted discount factor as:

$$\hat{\pi}(s_{t+1}|s_t) = \frac{\pi(s_{t+1}|s_t)\lambda(z_{t+1})^{1-\gamma}}{\sum_{s_{t+1}} \pi(s_{t+1}|s_t)\lambda(z_{t+1})^{1-\gamma}} \text{ and } \hat{\beta}(s_t) = \beta \sum_{s_{t+1}} \pi(s_{t+1}|s_t)\lambda(z_{t+1})^{1-\gamma}.$$

Note that  $\hat{\pi}$  is a well-defined Markov matrix in that  $\sum_{s_{t+1}} \hat{\pi}(s_{t+1}|s_t) = 1$  for all  $s_t$  and that  $\hat{\beta}(s_t)$  is stochastic as long as the original Markov process is not *iid* over time. For future reference, we also define the time zero discount factor applied to utils at time  $t$ :

$$\hat{\beta}(s^t) = \hat{\beta}(s_0) \cdot \dots \cdot \hat{\beta}(s_t)$$

and we note that  $\frac{\hat{\beta}(s^t)}{\hat{\beta}(s^{t-1})} = \hat{\beta}(s_t)$ . Finally, we let  $\hat{U}(\hat{c})(s^t)$  denote the lifetime expected continuation utility in node  $s^t$ , under the new transition probabilities and discount factor, defined over consumption shares  $\{\hat{c}_t(s^t)\}$

$$\hat{U}(\hat{c})(s^t) = u(\hat{c}_t(s^t)) + \hat{\beta}(s_t) \sum_{s_{t+1}} \hat{\pi}(s_{t+1}|s_t) \hat{U}(\hat{c})(s^t, s_{t+1}). \quad (5)$$

In the appendix we prove that this transformation does not alter the agents' ranking of different consumption streams.

**Proposition 2.1.** *Households rank consumption share allocations in the de-trended model in exactly the same way as they rank the corresponding consumption allocations in the original model with growth: for any  $s^t$  and any two consumption allocations  $c, c'$*

$$U(c)(s^t) \geq U(c')(s^t) \iff \hat{U}(\hat{c})(s^t) \geq \hat{U}(\hat{c}')(s^t)$$

where the transformation of consumption into consumption shares is given by (4).

This result is crucial for demonstrating that equilibrium allocations  $c$  for the stochastically growing model can be found by solving for equilibrium allocations  $\hat{c}$  in the transformed model.

## 2.4 Independence of Idiosyncratic Shocks from Aggregate Conditions

Next, we assume that idiosyncratic shocks are independent of the aggregate shocks. This assumption is crucial for most of the results in this paper.

**Condition 2.2.** *Individual endowment shares  $\eta(y_t, z_t)$  are functions of the current idiosyncratic state  $y_t$  only, that is  $\eta(y_t, z_t) = \eta(y_t)$ . Also, transition probabilities of the shocks can be decomposed as*

$$\pi(z_{t+1}, y_{t+1} | z_t, y_t) = \varphi(y_{t+1} | y_t) \phi(z_{t+1} | z_t).$$

That is, individual endowment *shares* and the transition probabilities of the idiosyncratic shocks are independent of the aggregate state of the economy  $z$ . In this case, the growth-adjusted probability matrix  $\hat{\pi}$  and the re-scaled discount factor is obtained by adjusting only the transition probabilities for the *aggregate* shock,  $\phi$ , but not the transition probabilities for the idiosyncratic shocks:

$$\hat{\pi}(s_{t+1} | s_t) = \varphi(y_{t+1} | y_t) \hat{\phi}(z_{t+1} | z_t), \text{ and } \hat{\phi}(z_{t+1} | z_t) = \frac{\phi(z_{t+1} | z_t) \lambda(z_{t+1})^{1-\gamma}}{\sum_{z_{t+1}} \phi(z_{t+1} | z_t) \lambda(z_{t+1})^{1-\gamma}}.$$

Furthermore, the growth-adjusted discount factor only depends on the aggregate state  $z_t$ :

$$\hat{\beta}(z_t) = \beta \sum_{z_{t+1}} \phi(z_{t+1} | z_t) \lambda(z_{t+1})^{1-\gamma} \quad (6)$$

We assume that  $\max_{z_t} \hat{\beta}(z_t) < 1$  in order to insure that lifetime utility remains finite. Evidently this jointly restricts the time discount factor  $\beta$ , the endowment growth process and the coefficient of relative risk aversion  $\gamma$ .

The first part of our analysis, section 6 included, assumes that the aggregate shocks are independent over time:

**Condition 2.3.** *Aggregate endowment growth is i.i.d.:*

$$\phi(z_{t+1} | z_t) = \phi(z_{t+1}).$$

In this case the growth rate of aggregate endowment is uncorrelated over time, so that the logarithm of the aggregate endowment follows a random walk with drift.<sup>13</sup> As a result, the growth-adjusted discount factor is a constant:  $\hat{\beta}(z_t) = \hat{\beta}$ , since  $\hat{\phi}(z_{t+1}|z_t) = \hat{\phi}(z_{t+1})$ . There are two competing effects on the growth-adjusted discount rate: consumption growth itself makes agents more impatient, while the consumption risk makes them more patient.<sup>14</sup>

## 2.5 A Quartet of Models

In order to derive our results, we study four models, whose main characteristics are summarized in table 1. The first three models are endowment models with aggregate shocks. The models differ along two dimensions, namely whether agents can trade a full set of Arrow securities against aggregate shocks, and whether agents face idiosyncratic risk, in addition to aggregate risk. Idiosyncratic risk, if there is any, is never directly insurable.

<b>Table 1: Summary of Four Models</b>			
<i>Model</i>	<i>Idiosyncr. Shocks</i>	<i>Aggregate Shocks</i>	<i>Arrow Securities</i>
Bond	Yes	Yes	No
Arrow	Yes	Yes	Yes
<i>BL</i>	No	Yes	Yes
Bewley	Yes	No	N/A

Our primary goal is to understand asset prices in the first model in the table, the Bond model. This model has idiosyncratic and aggregate risk, as well as incomplete markets. Agents can only insure against idiosyncratic and aggregate shocks by trading a single bond and a stock.

The standard representative agent complete markets Breeden (1979)-Lucas (1978) (*BL*) model lies on the other end of the spectrum; there is no idiosyncratic risk and there is a full menu of Arrow securities for the representative agent to hedge against aggregate risk. Through our analysis we will demonstrate that in the Bond model the standard representative agent Euler equation for excess returns is satisfied:

$$E_t [\beta (\lambda_{t+1})^{-\gamma} (R_{t+1}^s - R_t)] = 0, \quad (7)$$

<sup>13</sup>In section 7 we show that most of our results survive the introduction of persistence in the growth rates if a complete set of contingent claims on aggregate shocks is traded.

<sup>14</sup>The growth-adjusted measure  $\hat{\phi}$  is obviously connected to the risk-neutral measure commonly used in asset pricing (Harrison and Kreps, 1979). Under our hatted measure, agents can evaluate utils from consumption streams while abstracting from aggregate risk; under a risk-neutral measure, agents can price payoffs by simply discounting at the risk-free rate.

where  $R_{t+1}^s$  is the return on the stock,  $R_t$  is the return on the bond and  $\lambda_{t+1}$  is the growth rate of the aggregate endowment. Hence, the aggregate risk premium is identical in the Bond and the *BL* model. Constantinides (1982) had already shown that, in the case of complete markets, even if agents are heterogeneous in wealth, there exists a representative agent who satisfies the Euler equation for excess returns (7) and also the Euler equation for bonds:

$$E_t [\beta (\lambda_{t+1})^{-\gamma} R_t] = 1. \quad (8)$$

The key to Constantinides' result is that markets are *complete*. We show that the first Euler equation in (7) survives market incompleteness and potentially binding solvency constraints. The second one does not. To demonstrate this, we employ a third model, the Arrow model (second row in the table). Here, households trade a full set of Arrow securities against aggregate risk, but not against idiosyncratic risk. The fundamental result underlying our asset pricing findings is that equilibria in both the Bond and the Arrow model can be found by first determining equilibria in a model with *only* idiosyncratic risk (the Bewley model, fourth row in the table) and then by simply scaling consumption allocations in that model by the stochastic aggregate endowment.

We therefore start in section 3 by characterizing equilibria for the Bewley model, a stationary model with a constant aggregate endowment in which agents trade a single discount bond and a stock.<sup>15</sup> This model merely serves as a computational device. Then we turn to the stochastically growing economy (with different market structures), the one whose asset pricing implications we are interested in, and we show that equilibrium consumption allocations from the Bewley model can be implemented as equilibrium allocations in the stochastically growing Bond and Arrow model.

### 3 The Bewley Model

In this model the aggregate endowment is constant and equal to 1. Households face idiosyncratic shocks  $y$  that follow a Markov process with transition probabilities  $\varphi(y'|y)$ . The household's preferences over consumption shares  $\{\hat{c}(y^t)\}$  are defined in equation (5), with the constant time discount factor  $\hat{\beta}$  as defined in equation (6).

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<sup>15</sup>One of the two assets will be redundant for the households, so that this model is a standard Bewley model, as studied by Bewley (1986), Huggett (1993) or Aiyagari (1994). The presence of both assets will make it easier to demonstrate our equivalence results with respect to the *THL* and Arrow model later on.

### 3.1 Market Structure

Agents trade only a riskless one-period discount bond and shares in a Lucas tree that yields safe dividends of  $\alpha$  in every period. The price of the Lucas tree at time  $t$  is denoted by  $v_t$ .<sup>16</sup> The riskless bond is in zero net supply. Each household is indexed by an initial condition  $(\theta_0, y_0)$ , where  $\theta_0$  denotes its wealth (including period 0 labor income) at time 0.

The household chooses consumption  $\{\hat{c}_t(\theta_0, y^t)\}$ , bond positions  $\{\hat{a}_t(\theta_0, y^t)\}$  and share holdings  $\{\hat{\sigma}_t(\theta_0, y^t)\}$  to maximize its normalized expected lifetime utility  $\hat{U}(\hat{c})(s^0)$ , subject to a standard budget constraint:<sup>17</sup>

$$\hat{c}_t(y^t) + \frac{\hat{a}_t(y^t)}{\hat{R}_t} + \hat{\sigma}_t(y^t)\hat{v}_t = \eta(y_t) + \hat{a}_{t-1}(y^{t-1}) + \hat{\sigma}_{t-1}(y^{t-1})(\hat{v}_t + \alpha).$$

Finally, each household faces one of two types of borrowing constraints. The first one restricts household wealth at the end of the current period. The second one restricts household wealth at the beginning of the next period:<sup>18</sup>

$$\frac{\hat{a}_t(y^t)}{\hat{R}_t} + \hat{\sigma}_t(y^t)\hat{v}_t \geq \hat{K}_t(y^t) \text{ for all } y^t. \quad (9)$$

$$\hat{a}_t(y^t) + \hat{\sigma}_t(y^t)(\hat{v}_{t+1} + \alpha) \geq \hat{M}_t(y^t) \text{ for all } y^t. \quad (10)$$

### 3.2 Equilibrium in the Bewley Model

The definition of equilibrium in this model is standard.

**Definition 3.1.** *For an initial distribution  $\Theta_0$  over  $(\theta_0, y_0)$ , a competitive equilibrium for the Bewley model consists of trading strategies  $\{\hat{c}_t(\theta_0, y^t), \hat{a}_t(\theta_0, y^t), \hat{\sigma}_t(\theta_0, y^t)\}$ , and prices  $\{\hat{R}_t, \hat{v}_t\}$  such that*

1. *Given prices, trading strategies solve the household maximization problem*

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<sup>16</sup>The price of the tree is nonstochastic due to the absence of aggregate risk.

<sup>17</sup>We suppress dependence on  $\theta_0$  for simplicity whenever there is no room for confusion.

<sup>18</sup>This distinction is redundant in the Bewley model, but it will become meaningful in our models with aggregate risk.

2. *The goods markets and asset markets clear in all periods  $t$*

$$\begin{aligned}\int \sum_{y^t} \varphi(y^t|y_0) \hat{c}_t(\theta_0, y^t) d\Theta_0 &= 1. \\ \int \sum_{y^t} \varphi(y^t|y_0) \hat{a}_t(\theta_0, y^t) d\Theta_0 &= 0. \\ \int \sum_{y^t} \varphi(y^t|y_0) \hat{\sigma}_t(\theta_0, y^t) d\Theta_0 &= 1.\end{aligned}$$

In the absence of aggregate risk, the bond and the stock are perfect substitutes for households, and no-arbitrage implies that the stock return equals the risk-free rate:

$$\hat{R}_t = \frac{\hat{v}_{t+1} + \alpha}{\hat{v}_t}.$$

In addition, at these equilibrium prices, household portfolios are indeterminate. Without loss of generality one can therefore focus on trading strategies in which households only trade the stock, but not the bond:  $\hat{a}_t(\theta_0, y^t) \equiv 0$ .<sup>19</sup>

A *stationary equilibrium* in the Bewley model consists of a constant interest rate  $\hat{R}$ , a share price  $\hat{v}$ , optimal household allocations and a time-invariant measure  $\Phi$  over income shocks and financial wealth.<sup>20</sup> In the stationary equilibrium, households move within the invariant wealth distribution, but the wealth distribution itself is constant over time.

## 4 The Arrow Model

We now turn to our main object of interest, the model with aggregate risk. We first consider the Arrow market structure in which households can trade shares of the stock and a complete menu of contingent claims on aggregate shocks. Idiosyncratic shocks are still uninsurable. We demonstrate in this section that the allocations and prices of a stationary Bewley equilibrium can be transformed into equilibrium allocations and prices in the Arrow model with aggregate risk.

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<sup>19</sup>Alternatively, we could have agents simply trade in the bond and adjust the net supply of bonds to account for the positive capital income  $\alpha$  in the aggregate. We only introduce both assets into the Bewley economy to make the mapping to allocations in the Arrow and *THL* models simpler.

<sup>20</sup>See Chapter 17 of Ljungqvist and Sargent (2004) for the standard formal definition and the straightforward algorithm to compute such a stationary equilibrium.

## 4.1 Trading

Let  $a_t(s^t, z_{t+1})$  denote the quantity purchased of a security that pays off one unit of the consumption good if aggregate shock in the next period is  $z_{t+1}$ , irrespective of the idiosyncratic shock  $y_{t+1}$ . Its price today is given by  $q_t(z^t, z_{t+1})$ . In addition, households trade shares in the Lucas tree. We use  $\sigma_t(s^t)$  to denote the number of shares a household with history  $s^t = (y^t, z^t)$  purchases today and we let  $v_t(z^t)$  denote the price of one share.

An agent starting period  $t$  with initial wealth  $\theta_t(s^t)$  buys consumption commodities in the spot market and trades securities subject to the usual budget constraint:

$$c_t(s^t) + \sum_{z_{t+1}} a_t(s^t, z_{t+1}) q_t(z^t, z_{t+1}) + \sigma_t(s^t) v_t(z^t) \leq \theta_t(s^t). \quad (11)$$

If next period's state is  $s^{t+1} = (s^t, y_{t+1}, z_{t+1})$ , her wealth is given by her labor income, the payoff from the contingent claim purchased in the previous period as well as the value of her position on the stock, including dividends:

$$\theta_{t+1}(s^{t+1}) = \eta(y_{t+1}, z_{t+1}) e_{t+1}(z_{t+1}) + a_t(s^t, z_{t+1}) + \sigma_t(s^t) [v_{t+1}(z^{t+1}) + \alpha e_{t+1}(z_{t+1})]. \quad (12)$$

In addition to the budget constraints, the households' trading strategies are subject to solvency constraints of one of two types. The first type of constraint imposes a lower bound on the value of the asset portfolio at the end of the period today,

$$\sum_{z_{t+1}} a_t(s^t, z_{t+1}) q_t(z^t, z_{t+1}) + \sigma_t(s^t) v_t(z^t) \geq K_t(s^t), \quad (13)$$

while the second type imposes state-by-state lower bounds on net wealth tomorrow,

$$a_t(s^t, z_{t+1}) + \sigma_t(s^t) [v_{t+1}(z^{t+1}) + \alpha e_{t+1}(z_{t+1})] \geq M_t(s^t, z_{t+1}) \text{ for all } z_{t+1}. \quad (14)$$

We assume these solvency constraints are at least tight enough to prevent Ponzi schemes. In addition, we impose restrictions on the solvency constraints that make them proportional to the aggregate endowment in the economy:

**Condition 4.1.** *We assume that the borrowing constraints only depend on the aggregate history through the level of the aggregate endowment. That is, we assume that:*

$$K_t(y^t, z^t) = \hat{K}_t(y^t) e_t(z^t),$$

and

$$M_t(y^t, z^t, z_{t+1}) = \hat{M}_t(y^t) e_{t+1}(z^{t+1}).$$

If the constraints did not have this feature in a stochastically growing economy, the constraints would become more or less binding as the economy grows, clearly not a desirable feature<sup>21</sup>. The definition of an equilibrium is completely standard (see section A.1 of the Appendix).

Instead of working with the model with aggregate risk, we transform the Arrow model into a stationary model. As we are about to show, the equilibrium allocations and prices in the de-trended model are the same as the allocations and prices in a stationary Bewley equilibrium.

## 4.2 Equilibrium in the De-trended Arrow Model

We use hatted variables to denote the variables in the stationary model. Households rank consumption shares  $\{\hat{c}_t\}$  in exactly the same way as original consumption streams  $\{c_t\}$ . Dividing the budget constraint (11) by  $e_t(z^t)$  and using equation (12) yields the deflated budget constraint:

$$\begin{aligned} & \hat{c}_t(s^t) + \sum_{z_{t+1}} \hat{a}_t(s^t, z_{t+1}) \hat{q}_t(z^t, z_{t+1}) + \sigma_t(s^t) \hat{v}_t(z^t) \\ & \leq \eta(y_t) + \hat{a}_{t-1}(s^{t-1}, z_t) + \sigma_{t-1}(s^{t-1}) [\hat{v}_t(z^t) + \alpha], \end{aligned} \quad (15)$$

where we have defined the deflated Arrow positions as  $\hat{a}_t(s^t, z_{t+1}) = \frac{a_t(s^t, z_{t+1})}{e_{t+1}(z^{t+1})}$  and prices as  $\hat{q}_t(z^t, z_{t+1}) = q_t(z^t, z_{t+1}) \lambda(z_{t+1})$ . The deflated stock price is given by  $\hat{v}_t(z^t) = \frac{v_t(z^t)}{e_t(z^t)}$ . Similarly, by deflating the solvency constraints (13) and (14), using condition (4.1), yields:

$$\sum_{z_{t+1}} \hat{a}_t(s^t, z_{t+1}) \hat{q}_t(z^t, z_{t+1}) + \sigma_t(s^t) \hat{v}_t(z^t) \geq \hat{K}_t(y^t). \quad (16)$$

$$\hat{a}_t(s^t, z_{t+1}) + \sigma_t(s^t) [\hat{v}_{t+1}(z^{t+1}) + \alpha] \geq \hat{M}_t(y^t) \text{ for all } z_{t+1}. \quad (17)$$

Finally, the goods market clearing condition is given by:

$$\int \sum_{y^t} \phi(y^t | y_0) \hat{c}_t(\theta_0, s^t) d\Theta_0 = 1. \quad (18)$$

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<sup>21</sup>In the incomplete markets literature the borrowing constraints usually satisfy this condition (see e.g. Heaton and Lucas (1996)). It is easy to show that solvency constraints that are not too tight in the sense of Alvarez and Jermann (2000) also satisfy this condition.

The conditional probabilities simplify due to condition (2.2). The asset market clearing conditions are exactly the same as before. In the stationary model, the household maximizes  $\hat{U}(\hat{c})(s_0)$  by choosing consumption, Arrow securities and shares of the Lucas tree, subject to the budget constraint (15) and the solvency constraint (16) or (17) in each node  $s^t$ . The definition of a competitive equilibrium in the de-trended Arrow model is straightforward.

**Definition 4.1.** *For initial aggregate state  $z_0$  and distribution  $\Theta_0$  over  $(\theta_0, y_0)$ , a competitive equilibrium for the de-trended Arrow model consists of trading strategies  $\{\hat{a}_t(\theta_0, s^t, z_{t+1})\}$ ,  $\{\hat{\sigma}_t(\theta_0, s^t)\}$ ,  $\{\hat{c}_t(\theta_0, s^t)\}$  and prices  $\{\hat{q}_t(z^t, z_{t+1})\}$ ,  $\{\hat{v}_t(z^t)\}$  such that*

1. *Given prices, trading strategies solve the household maximization problem*
2. *The goods market clears, that is, equation (18) holds for all  $z^t$ .*
3. *The asset markets clear*

$$\int \sum_{y^t} \varphi(y^t|y_0) \hat{\sigma}_t(\theta_0, s^t) d\Theta_0 = 1$$

$$\int \sum_{y^t} \varphi(y^t|y_0) \hat{a}_t(\theta_0, s^t, z_{t+1}) d\Theta_0 = 0 \text{ for all } z_{t+1} \in Z$$

The first order conditions and complementary slackness conditions, together with the appropriate transversality condition, are listed in the appendix in section (A.1.1). These are necessary and sufficient conditions for optimality on the household side. Now we are ready to establish the equivalence between equilibria in the Bewley model and in the Arrow model.

### 4.3 Equivalence Results

The equilibria in the Bewley model can be mapped into equilibria of the stochastically growing Arrow model.

**Theorem 4.1.** *An equilibrium of the Bewley model  $\{\hat{c}_t(\theta_0, y^t), \hat{a}_t(\theta_0, y^t), \hat{\sigma}_t(\theta_0, y^t)\}$  and  $\{\hat{R}_t, \hat{v}_t\}$  can be made into an equilibrium for the Arrow model with growth,  $\{a_t(\theta_0, s^t, z_{t+1})\}$ ,*

$\{\sigma_t(\theta_0, s^t)\}$ ,  $\{c_t(\theta_0, s^t)\}$  and  $\{q_t(z^t, z_{t+1})\}$ ,  $\{v_t(z^t)\}$ , with

$$\begin{aligned}
c_t(\theta_0, s^t) &= \hat{c}_t(\theta_0, y^t)e_t(z^t) \\
\sigma_t(\theta_0, s^t) &= \hat{\sigma}_t(\theta_0, y^t) \\
a_t(\theta_0, s^t, z_{t+1}) &= \hat{a}_t(\theta_0, y^t)e_{t+1}(z^{t+1}) \\
v_t(z^t) &= \hat{v}_t e_t(z^t) \\
q_t(z^t, z_{t+1}) &= \frac{1}{\hat{R}_t} * \frac{\hat{\phi}(z_{t+1})}{\lambda(z_{t+1})} = \frac{1}{\hat{R}_t} * \frac{\phi(z_{t+1})\lambda(z_{t+1})^{-\gamma}}{\sum_{z_{t+1}} \phi(z_{t+1})\lambda(z_{t+1})^{1-\gamma}}
\end{aligned} \tag{19}$$

The proof is given in the appendix, but here we provide its main intuition. Conjecture that the equilibrium prices of Arrow securities in the de-trended Arrow model are given by:

$$\hat{q}_t(z^t, z_{t+1}) = \frac{\hat{\phi}(z_{t+1})}{\hat{R}_t}. \tag{20}$$

An unconstrained household's Euler equation for the Arrow securities is given by (see section (A.1.1) in the appendix)

$$1 = \frac{\hat{\beta}(s_t)}{\hat{q}_t(z^t, z_{t+1})} \sum_{s^{t+1}|s^t, z_{t+1}} \hat{\pi}(s_{t+1}|s_t) \frac{u'(\hat{c}_{t+1}(s^t, s_{t+1}))}{u'(\hat{c}_t(s^t))}.$$

But, in light of conditions (2.2) and (2.3) and given our conjecture that consumption allocations in the de-trended Arrow model only depend on idiosyncratic shock histories  $y^t$  and not on  $s^t = (y^t, z^t)$ , this Euler equation reduces to

$$1 = \frac{\hat{\beta}\hat{\phi}(z_{t+1})}{\hat{q}_t(z^t, z_{t+1})} \sum_{y_{t+1}} \varphi(y_{t+1}|y_t) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} \tag{21}$$

$$= \hat{\beta}\hat{R}_t \sum_{y_{t+1}} \varphi(y_{t+1}|y_t) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))}, \tag{22}$$

where we used the conjectured form of prices in (20). But this is exactly the Euler equation for bonds in the Bewley model. Since Bewley equilibrium consumption allocations satisfy this condition, they therefore satisfy the Euler equation in the de-trended Arrow model, if prices are of the form (20). The proof in the appendix shows that a similar argument applies for the Euler equation with respect to the stock (under the conjectured stock prices), and also shows that for agents whose solvency constraints binds the Lagrange multipliers on the constraints in the Bewley equilibrium are also valid Lagrange multipliers for the constraints in the de-trended Arrow model. This implies, in particular, that our results go

through regardless of how tight the solvency constraints are. Once one has established that allocations and prices of a Bewley equilibrium are an equilibrium in the de-trended Arrow model, one simply needs to scale up allocation and prices by the appropriate growth factors to obtain the equilibrium prices and allocations in the stochastically growing Arrow model, as stated in the theorem.

It is straightforward to compute risk-free interest rates for the Arrow model. By summing over aggregate states tomorrow on both sides of equation (20), we find that the risk-free rate in the de-trended Arrow model coincides with that of the Bewley model:

$$\hat{R}_t^A = \frac{1}{\sum_{z_{t+1}} \hat{q}_t(z^t, z_{t+1})} = \hat{R}_t. \quad (23)$$

Once we have determined risk free interest rates for the de-trended model,  $\hat{R}_t^A = \hat{R}_t$ , we can back out the implied interest rate for the original growing Arrow model, using (19) in the previous theorem.<sup>22</sup>

**Corollary 4.1.** *If equilibrium risk-free interest rates in the de-trended Arrow model are given by (23), equilibrium risk-free interest rates in the Arrow model with aggregate risk are given by*

$$R_t^A = \frac{1}{\sum_{z_{t+1}} q_t(z^t, z_{t+1})} = \hat{R}_t \frac{\sum_{z_{t+1}} \phi(z_{t+1}) \lambda(z_{t+1})^{1-\gamma}}{\sum_{z_{t+1}} \phi(z_{t+1}) \lambda(z_{t+1})^{-\gamma}}. \quad (24)$$

The theorem implies that we can solve for an equilibrium in the Bewley model of section 3 (and in, in particular, a stationary equilibrium), including risk free interest rates  $\hat{R}_t$ , and we can deduce the equilibrium allocations and prices for the Arrow model from those in the Bewley model, using the mapping described in theorem 4.1. The key to this result is that households in the Bewley model face exactly the same Euler equations as the households in the de-trended version of the Arrow model.

This theorem has several important implications. First, we will use this equivalence result to show below that asset prices in the Arrow model are identical to those in the representative agent model, except for a lower risk-free interest rate (and a higher price/dividend ratio for stocks).<sup>23</sup> Second, the existence proofs in the literature for stationary equilibria in the Bewley model directly carry over to the stochastically growing model.<sup>24</sup> Third, the moments of the

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<sup>22</sup>The dependence of  $\hat{R}_t^A$  on time  $t$  is not surprising since, for an arbitrary initial distribution of assets  $\Theta_0$ , we cannot expect the equilibrium to be stationary. In the same way we expect that  $\hat{v}_t(z^t)$  is only a function of  $t$  as well, but not of  $z^t$ .

<sup>23</sup>The fact that the risk-free interest rate is lower comes directly from the fact that interest rates in the Bewley model are lower than in the corresponding representative agent model without aggregate risk.

<sup>24</sup>See e.g. Huggett (1993), Aiyagari (1994) or Miao (2002) for (elements of) existence proofs. Uniqueness of a stationary equilibrium is much harder to establish. Our equivalence result shows that for any station-

wealth distribution vary over time but proportionally to the aggregate endowment. If the initial wealth distribution in the de-trended model corresponds to an invariant distribution in the Bewley model, then for example the ratio of the mean to the standard deviation of the wealth distribution is constant in the Arrow model with aggregate risk as well. Finally, an important result of the previous theorem is that, in the Arrow equilibrium, the trade of Arrow securities is simply proportional to the aggregate endowment:  $a_t(\theta_0, s^t, z_{t+1}) = \hat{a}_t(\theta_0, y^t) e_{t+1}(z^{t+1})$ , or, equivalently, in the de-trended Arrow model households choose not to make their contingent claims purchases contingent on next period's aggregate shock:  $\hat{a}_t(\theta_0, s^t, z_{t+1}) = \hat{a}_t(\theta_0, y^t)$ . Furthermore, since in the Bewley model without loss of generality  $\hat{a}_t(\theta_0, y^t) = 0$ , we can focus on the situation where Arrow securities are not traded at all:  $a_t(\theta_0, s^t, z_{t+1}) = 0$ . This no-trade result for contingent claims suggests that our equivalence result will carry over to environments with more limited asset structures. That is what we show in the next section.

## 5 The Bond Model

We now turn our attention to the main model of interest, namely the model with a stock and a single one-period discount bond. This section establishes the equivalence of equilibria in the Bond model and the Bewley model by showing that the optimality conditions in the de-trended Arrow and the de-trended Bond model are identical. In addition, we show that in the benchmark case with i.i.d. aggregate endowment growth shocks, agents do not even trade bonds in equilibrium.

### 5.1 Market Structure

In the Bond model, agents only trade a one-period discount bond and a stock. An agent who starts period  $t$  with initial wealth composed of his stock holdings, bond and stock payouts, and labor income, buys consumption commodities in the spot market and trades a one-period bond and the stock, subject to the budget constraint:

$$c_t(s^t) + \frac{b_t(s^t)}{R_t(z^t)} + \sigma_t(s^t)v_t(z^t) \leq \eta(y_t)e_t(z_t) + b_{t-1}(s^{t-1}) + \sigma_{t-1}(s^{t-1}) [v_t(z^t) + \alpha e_t(z_t)]. \quad (25)$$

Here,  $b_t(s^t)$  denotes the amount of bonds purchased and  $R_t(z^t)$  is the gross interest rate from period  $t$  to  $t + 1$ . As was the case in the Arrow model, short-sales of the bond and the stock

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any Bewley equilibrium there exists a corresponding Arrow equilibrium in the model with aggregate risk. Furthermore note that our result does not rule out other Arrow equilibria either.

are constrained by a lower bound on the value of the portfolio today,

$$\frac{b_t(s^t)}{R_t(z^t)} + \sigma_t(s^t)v_t(z^t) \geq K_t(s^t), \quad (26)$$

or a state-by-state constraint on the value of the portfolio tomorrow,

$$b_t(s^t) + \sigma_t(s^t) [v_{t+1}(z^{t+1}) + \alpha e_{t+1}(z_{t+1})] \geq M_t(s^t, z_{t+1}) \text{ for all } z_{t+1}. \quad (27)$$

Since  $b_t(s^t)$  and  $\sigma_t(s^t)$  are chosen before  $z_{t+1}$  is realized, at most one of the constraints (27) will be binding at a given time. The definition of an equilibrium for the Bond model follows directly. (see section (A.2) in the appendix). We now show that the equilibria in the Arrow and the Bond model coincide. As a corollary, it follows that the asset pricing implications of both models are identical. In order to do so, we first transform the model with growth into a stationary, de-trended model.

## 5.2 Equilibrium in the De-trended Bond Model

Dividing the budget constraint (25) by  $e_t(z^t)$  we obtain

$$\hat{c}_t(s^t) + \frac{\hat{b}_t(s^t)}{R_t(z^t)} + \sigma_t(s^t)\hat{v}_t(z^t) \leq \eta(y_t) + \frac{\hat{b}_{t-1}(s^{t-1})}{\lambda(z_t)} + \sigma_{t-1}(s^{t-1}) [\hat{v}_t(z^t) + \alpha], \quad (28)$$

where we define the deflated bond position as  $\hat{b}_t(s^t) = \frac{b_t(s^t)}{e_t(z^t)}$ . Using condition (4.1), the solvency constraints in the de-trended model are simply:

$$\frac{\hat{b}_t(s^t)}{R_t(z^t)} + \sigma_t(s^t)\hat{v}_t(z^t) \geq \hat{K}_t(y^t), \text{ or} \quad (29)$$

$$\frac{\hat{b}_t(s^t)}{\lambda(z_{t+1})} + \sigma_t(s^t) [\hat{v}_{t+1}(z^{t+1}) + \alpha] \geq \hat{M}_t(y^t) \text{ for all } z_{t+1}. \quad (30)$$

The definition of equilibrium in the de-trended Bond model is straightforward and hence omitted.<sup>25</sup> We now show that equilibrium consumption allocations in the de-trended Bond model coincide with those of the Arrow model.

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<sup>25</sup>We list the first order conditions for household optimality and the transversality conditions in section (A.2) of the appendix.

### 5.3 Equivalence Results

As for the Arrow model, we can show that the Bewley equilibrium allocations and prices constitute, after appropriate scaling by endowment (growth) factors, an equilibrium of the Bond model with growth.

**Theorem 5.1.** *An equilibrium of a stationary Bewley model, given by trading strategies  $\{\hat{c}_t(\theta_0, y^t), \hat{a}_t(\theta_0, y^t), \hat{\sigma}_t(\theta_0, y^t)\}$  and prices  $\{\hat{R}_t, \hat{v}_t\}$ , can be made into an equilibrium for the Bond model with growth,  $\{b_t(\theta_0, s^t)\}$ ,  $\{c_t(\theta_0, s^t)\}$ ,  $\{\sigma_t^B(\theta_0, s^t)\}$  and  $\{R_t(z^t)\}$  and  $\{v_t(z^t)\}$  where*

$$\begin{aligned} c_t(\theta_0, s^t) &= \hat{c}_t(\theta_0, y^t) e_t(z^t) \\ \sigma_t^B(\theta_0, s^t) &= \frac{\hat{a}_t(\theta_0, y^t)}{[\hat{v}_{t+1} + \alpha]} + \hat{\sigma}_t(\theta_0, y^t) \\ v_t(z^t) &= \hat{v}_t e_t(z^t) \\ R_t(z^t) &= \hat{R}_t * \frac{\sum_{z_{t+1}} \phi(z_{t+1}) \lambda(z_{t+1})^{1-\gamma}}{\sum_{z_{t+1}} \phi(z_{t+1}) \lambda(z_{t+1})^{-\gamma}} \end{aligned}$$

and bond holdings given by  $b_t(\theta_0, s^t) = 0$ .

The crucial step of the proof, given in the appendix, shows that Bewley allocations, given the prices proposed in the theorem, satisfy the necessary and sufficient conditions for household optimality and all market clearing conditions in the de-trended Bond model.

This theorem again has several important consequences. First, equilibrium risk-free rates in the Arrow and in the Bond model coincide, despite the fact that the set of assets agents can trade to insure consumption risk differs in the two models. Second, in equilibrium of the Bond model, the bond market is inoperative:  $b_{t-1}(s^{t-1}) = \hat{b}_{t-1}(s^{t-1}) = 0$  for all  $s^{t-1}$ . Therefore all consumption smoothing is done by trading stocks, and agents keep their net wealth proportional to the level of the aggregate endowment.<sup>26</sup> From the deflated budget constraint in (28):

$$\hat{c}_t(y^t) + \frac{\hat{b}_t(y^t)}{R_t} + \sigma_t(y^t) \hat{v}_t \leq \eta(y_t) + \frac{\hat{b}_{t-1}(y^{t-1})}{\lambda(z_t)} + \sigma_{t-1}(y^{t-1}) [\hat{v}_t + \alpha],$$

it is clear that bond holdings  $b_t(y^{t-1}) = 0$  need to be zero for all  $y^{t-1}$ , if all the consumption,

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<sup>26</sup>There is a subtle difference between this result and the corresponding result for the Arrow model. In the Arrow model we demonstrated that contingent claims positions were in fact uncontingent:  $\hat{a}_t(\theta_0, s^t, z_{t+1}) = \hat{a}_t(\theta_0, y^t)$  and equal to the Bond position in the Bewley equilibrium, but not necessarily equal to zero. In the Bond model bond positions *have to be* zero. But since bonds in the Bewley equilibrium are a redundant asset, one can restrict attention to the situation where  $\hat{a}_t(\theta_0, y^t) = 0$ , although this is not necessary for our results.

portfolio choices and prices, are independent of the aggregate history  $z^t$ , simply because the bond return in the deflated economy depends on the aggregate shock  $z_t$  through  $\lambda(z_t)$ . This demonstrates the irrelevance of the history of idiosyncratic shocks  $y^t$  for portfolio choice. There is no link between financial wealth and the share of this wealth being held in equity.

In summary, our results show that one can solve for equilibria in a standard Bewley model and then map this equilibrium into an equilibrium for both the Arrow model and the Bond model *with* aggregate risk. The risk-free interest rate and the price of the Lucas tree are the same in the stochastic Arrow and Bond models. Finally, without loss of generality, we can restrict attention to equilibria in which bonds are not traded; consequently transaction costs in the bond market would not change our results. Transaction costs in the stock market of course would (see section (7)). In addition, this implies that our result is robust to the introduction of short-sale constraints imposed on stocks and bonds separately, because agents choose not to trade bonds in equilibrium, as long as these short-sale constraints are not tighter than the solvency constraints.

In both the Arrow and the Bond model, households do not have a motive for trading bonds, unless there are tighter short-sale constraints on stocks. We do not deal with this case. In addition, the no-trade result depends critically on the i.i.d assumption for aggregate shocks, as we will show in section (7). If the aggregate shocks are not i.i.d, agents want to hedge against the implied shocks to interest rates. We will show in section (7) that these interest rate shocks look like taste shocks in the de-trended model. But, first, we compare the asset pricing implications of the equilibria just described in the Arrow and the Bond models to those emerging from the *BL* (standard representative agent) model.

## 6 Asset Pricing Implications

This section shows that the multiplicative risk premium on a claim to aggregate consumption in the Bond model -and the Arrow model- equals the risk premium in the representative agent model. Uninsurable idiosyncratic income risk only lowers the risk-free rate.

### 6.1 Consumption-CAPM

The benchmark model of consumption-based asset pricing is the representative agent *BL* model. The representative agent owns a claim to the aggregate ‘labor’ income stream  $\{(1 - \alpha)e_t(z^t)\}$  and she can trade a stock (a claim to the dividends  $\alpha e_t(z^t)$  of the Lucas tree), a bond and a complete set of Arrow securities.<sup>27</sup>

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<sup>27</sup>See separate appendix available on-line for a complete description.

First, we show that the *Breeden-Lucas Consumption-CAPM* also prices excess returns on the stock in the Bond model and the Arrow model. Let  $R^s$  denote the return on a claim to aggregate consumption. We have

**Lemma 6.1.** *The BL Consumption-CAPM prices excess returns in the Arrow model and the Bond model. In equilibrium in both models*

$$E_t [(R_{t+1}^s - R_t) \beta (\lambda_{t+1})^{-\gamma}] = 0$$

The appendix shows that this result follows directly from subtracting the Euler equations for the bond from that for the stock in both models. This result has important implications for empirical work in asset pricing. First, and conditional on either the Arrow model or the Bond model being the correct model of the economy, despite the existence of market incompleteness and binding solvency constraints, an econometrician can estimate the coefficient of risk aversion (or the intertemporal elasticity of substitution) directly from aggregate consumption data and the excess return on stocks, as in Hansen and Singleton (1983). Second, the result provides a strong justification for explaining the cross-section of excess returns, when using the CCAPM, without trying to match the risk-free rate. The implications of the *BL*, the Arrow and the Bond model are the same with respect to excess returns, while not with respect to the risk-free rate.

## 6.2 Risk Premia

We now show that, perhaps not surprisingly in light of the previous result, the equilibrium risk premium in the Arrow and the Bond model is identical to the one in the representative agent model.<sup>28</sup> While the risk-free rate is higher in the representative agent model than in the Arrow and Bond model, and consequently the price of the stock is correspondingly lower, the multiplicative risk premium is the same in all three models and it is constant across states of the world.

In order to demonstrate our main result we first show that the stochastic discount factors that price stochastic payoffs in the representative agent model and the Arrow (and thus the Bond) model only differ by a non-random multiplicative term, equal to the ratio of (growth-deflated) risk-free interest rates in the two models. In what follows we use the superscript *RE* to denote equilibrium variables in the representative agent model.

**Proposition 6.1.** *The equilibrium stochastic discount factor in the Arrow and the Bond*

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<sup>28</sup>Note that this does *not* immediately follow from the result in Lemma 6.1.

model given by

$$m_{t+1}^A = m_{t+1}^{RE} \kappa_t$$

where the non-random multiplicative term is given

$$\kappa_t = \frac{\hat{R}_t^{RE}}{\hat{R}_t} \geq 1$$

and  $m_{t+1}^{RE}$  is the stochastic discount factor in the representative agent model.

$\kappa_t$  is straightforward to compute, because it only involves the equilibrium risk-free interest rates from the stationary version of the representative agent model,  $\hat{R}_t^{RE}$ , and the equilibrium interest rates from the Bewley model,  $\hat{R}_t$ . Luttmer (1991) and Cochrane and Hansen (1992) had already established a similar aggregation result for the case in which households face market wealth constraints, but in a complete markets environment. We show that their result survives even if households trade only a stock and a bond.

The proof that risk premia are identical in the representative agent model and the Arrow as well as the Bond model follows directly from the previous decomposition of the stochastic discount factor.<sup>29</sup> Let  $R_{t,j}[\{d_{t+k}\}]$  denote the  $j$ -period holding return on a claim to the endowment stream  $\{d_{t+k}\}_{k=0}^{\infty}$  at time  $t$ . Consequently  $R_{t,1}[1]$  is the gross risk-free rate and  $R_{t,1}[\alpha e_{t+k}]$  is the one-period holding return on a  $k$ -period strip of the aggregate endowment (a claim to  $\alpha$  times the aggregate endowment  $k$  periods from now). Thus  $R_{t,1}[\{\alpha e_{t+k}\}]$  is the one period holding return on an asset (such as a stock) that pays  $\alpha$  times the aggregate endowment in all future periods. Finally, we define the multiplicative risk premium as the ratio of the expected return on stocks and the risk-free rate:

$$1 + \nu_t = \frac{E_t R_{t,1}[\{\alpha e_{t+k}\}]}{R_{t,1}[1]}.$$

With this notation in place, we can state now our main result.

**Theorem 6.1.** *The multiplicative risk premium in the Arrow model and Bond model equals that in the representative agent model*

$$1 + \nu_t^A = 1 + \nu_t^B = 1 + \nu_t^{RE},$$

and is constant across states of the world.

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<sup>29</sup>The proof strategy follows Alvarez and Jermann (2001) who derive a similar result in the context of a complete markets model populated by two agents that face endogenous solvency constraints.

Thus, the extent to which households smooth idiosyncratic income shocks in the Arrow model or in the Bond model has absolutely no effect on the size of risk premia; it merely lowers the risk-free rate. Market incompleteness does not generate any dynamics in the conditional risk premia either: the conditional risk premium is constant.

## 7 Robustness and Extensions of the Main Results

In this section, we investigate how robust our results are to the assumption that aggregate shocks are *i.i.d* over time, which implies that the growth rate of the aggregate endowment is *i.i.d* over time. We show that our results go through even aggregate shocks are serially correlated, but only for the Arrow model, and only if the solvency constraints (i) do not bind or (ii) are reverse-engineered.

### 7.1 Non-iid Aggregate Shocks

Assume that the aggregate shock  $z$  follows a first order Markov chain characterized by the transition matrix  $\phi(z'|z) > 0$ . So far we studied the special case in which  $\phi(z'|z) = \phi(z')$ . Recall that the growth-adjusted Markov transition matrix and time discount factor are given by

$$\hat{\phi}(z'|z) = \frac{\phi(z'|z)\lambda(z')^{1-\gamma}}{\sum_{z'} \phi(z'|z)\lambda(z')^{1-\gamma}} \text{ and } \hat{\beta}(z) = \beta \sum_{z'} \phi(z'|z)\lambda(z')^{1-\gamma}.$$

Thus if  $\phi$  is serially correlated, so is  $\hat{\phi}$ , and the discount factor  $\hat{\beta}$  does depend on the current aggregate state of the world. This indicates (and will show this below) that the aggregate endowment shock acts as an aggregate taste shock in the de-trended model which renders all households more or less impatient. Since this shock affects all households in the same way, they will not be able to insure against it. As a result, this shock affects the price/dividend ratio and the interest rate, but it leaves the risk premium unaltered. In contrast to our previous results, however, now there is trade in Arrow securities in equilibrium, so the equivalence between equilibria in the Arrow and the Bond model breaks down.

#### 7.1.1 Stationary Bewley Model

We adhere to the same strategy, and we will argue that the equilibrium allocations and prices from a stationary version of the model, which we call the Bewley model, as before, can be implemented, after appropriate scaling by the aggregate endowment, as equilibria in the stochastically growing model. Since the time discount factors are subject to aggregate shock, we first have to choose an appropriate nonstochastic time discount factor for this

Bewley model. We will choose a sequence of non-random time discount factors that assures that Bewley equilibrium allocations satisfy the time zero budget constraint in the model with aggregate shocks when the initial wealth distribution  $\Theta_0$  in the two models coincide.

Let

$$\hat{\beta}_{0,\tau}(z^\tau|z_0) = \hat{\beta}(z_0)\hat{\beta}(z_1)\dots\hat{\beta}(z_\tau)$$

denote the time discount factor between period 0 and period  $\tau + 1$ , given by the product of one-period time discount factors. We define the average (across aggregate shocks) time discount factor between period 0 and  $t$  as:

$$\tilde{\beta}_t = \sum_{z^{t-1}|z_0} \hat{\phi}(z^{t-1}|z_0)\hat{\beta}_{0,t-1}(z^{t-1}|z_0), t \geq 1, \quad (31)$$

where  $\hat{\phi}(z^{t-1}|z_0)$  is the probability distribution over  $z^{t-1}$  induced by  $\phi(z'|z)$ . If aggregate shocks are *i.i.d.*, then we have that  $\tilde{\beta}_t = \hat{\beta}^t$ , as before. Since  $z_0$  is a fixed initial condition, we chose not to index  $\tilde{\beta}_t$  by  $z_0$  to make sure it is understood that  $\tilde{\beta}_t$  is nonstochastic.

In order to construct equilibrium allocations in the stochastically growing model, we will show that equilibrium allocations and interest rates in the Bewley model with a sequence of non-random time discount factors  $\{\tilde{\beta}_t\}_{t=1}^\infty$  can be implemented as equilibrium allocations and interest rates for the *actual* Arrow model with stochastic discount factors. The crucial adjustment in this mapping is to rescale the risk-free interest rate in proportion to the taste shock  $\hat{\beta}(z)$ .

To understand the effect of these aggregate taste shocks on the time discount rate to be used in the Bewley model, we use a simple example

**Example 7.1.** *Suppose that  $\hat{\beta}(z) = e^{-\hat{\rho}(z)}$  is lognormal and *i.i.d.*, where  $\hat{\rho}(z)$  has mean  $\hat{\rho}$  variance  $\sigma^2$ . Define the average  $t$ -period time discount rate  $\tilde{\rho}_t$  by  $\tilde{\beta}_t = e^{-\tilde{\rho}_t}$ . Then the average one-period discount rate used in the Bewley model is given by:*

$$\frac{\tilde{\rho}_t}{t} = \hat{\rho} - \frac{1}{2}\sigma^2 \text{ for any } t \geq 1$$

*Thus the presence of taste shocks ( $\sigma^2 > 0$ ) in the de-trended Arrow model induces a discount rate  $\tilde{\rho}$  to be used in the Bewley model that is lower than the mean discount rate  $\hat{\rho}$  because of the risk associated with the taste shocks.*

This example suggests that these taste shocks lower the risk-free interest rates compared to those in model without taste shocks (which originate from aggregate endowment shocks in the stochastically growing model).

As before, we denote the Bewley equilibrium by  $\{\hat{c}_t(\theta_0, y^t), \hat{a}_t(\theta_0, y^t), \hat{\sigma}_t(\theta_0, y^t)\}$  and  $\{\hat{R}_t, \hat{v}_t\}$  Bewley equilibrium allocations and prices, for a given sequence of time discount factors  $\{\tilde{\beta}_t\}$ . The risk-free rate has to equal the stock return in each period, to rule out arbitrage:

$$\hat{R}_t = \frac{\hat{v}_{t+1} + \alpha}{\hat{v}_t}.$$

Only the total wealth positions in the Bewley model are uniquely pinned down. Without loss of generality, we focus on the case where  $\hat{a}_t(\theta_0, y^t) = 0$  for all  $y^t$ . We now argue that the allocation  $\{\hat{c}_t(\theta_0, y^t), \hat{\sigma}_t(\theta_0, y^t)\}$  can be made into an Arrow equilibrium, and in the process show why we need to choose the specific discount factor sequence in (31) for the Bewley model. We introduce some additional notation for state prices.

$$\tilde{Q}_{t,\tau} = \prod_{j=0}^{\tau-t-1} \hat{R}_{t+j}^{-1} = \frac{1}{\hat{R}_{t,\tau}} \quad (32)$$

denotes the Bewley equilibrium price of one unit of consumption to be delivered at time  $\tau$ , in terms of consumption at time  $t$ . By convention  $\tilde{Q}_\tau = \tilde{Q}_{0,\tau}$  and  $\tilde{Q}_{\tau,\tau} = 1$  for all  $\tau$ .  $\hat{R}_{t,\tau}$  is the gross risk-free interest rate between period  $t$  and  $\tau$  in the Bewley equilibrium.

### 7.1.2 Arrow Model

In contrast to the Bewley model, the de-trended Arrow model features aggregate shocks to the time discount factor  $\hat{\beta}$ . These need to be reflected in prices. We therefore propose state-dependent equilibrium prices for the de-trended Arrow model, then we show that the Bewley equilibrium allocations, in turn, satisfy the Euler equations when evaluated at these prices, and they also satisfy the intertemporal budget constraint in the de-trended Arrow model. This implies that, absent binding solvency constraints, the Bewley equilibrium can be made into an equilibrium of the de-trended Arrow model, and thus, after the appropriate scaling, into an equilibrium of the original Arrow model. Finally, we discuss potentially binding solvency constraints and the Bond model.

We conjecture that the Arrow-Debreu prices in the deflated Arrow model are given by

$$\hat{Q}_t(z^t|z_0) = \hat{\phi}(z^t|z_0) \tilde{Q}_t \frac{\hat{\beta}_{0,t-1}(z^{t-1}|z_0)}{\tilde{\beta}_t} = \hat{\phi}(z^t|z_0) \frac{\hat{\beta}_{0,t-1}(z^{t-1}|z_0)}{\tilde{\beta}_t \hat{R}_{0,t}}, \quad (33)$$

where  $\tilde{Q}_t$  was defined above as the time 0 price of consumption in period  $t$  in the Bewley

model. The prices of the (one-period ahead) Arrow securities are then given by:

$$\hat{q}_t(z^t, z_{t+1}) = \frac{\hat{Q}_{t+1}(z^{t+1}|z_0)}{\hat{Q}_t(z^t|z_0)} = \hat{\beta}(z_t)\hat{\phi}(z_{t+1}|z_t)\frac{1}{\hat{R}_t}\frac{\tilde{\beta}_t}{\tilde{\beta}_{t+1}} = \hat{q}_t(z_{t+1}|z_t), \quad (34)$$

where we used the fact that  $\frac{1}{\hat{R}_t} = \frac{\hat{R}_{0,t}}{\hat{R}_{0,t+1}}$ . Arrow prices are Markovian in  $z_t$ , since  $\hat{R}_t$  and  $(\tilde{\beta}_t, \tilde{\beta}_{t+1})$  are all deterministic. Equation (34) implies that interest rates in the de-trended Arrow model are given by

$$\hat{R}_t^A(z_t) \equiv \sum_{z_{t+1}} \hat{q}_t(z_{t+1}|z_t) = \hat{R}_t \frac{\tilde{\beta}_{t+1}}{\hat{\beta}(z_t)\tilde{\beta}_t}. \quad (35)$$

Interest rates now depend on the current aggregate state of the world  $z_t$ . Finally, we also conjecture that the stock price in the de-trended Arrow model satisfies:

$$\hat{v}_t(z^t) = \hat{v}_t(z_t) = \sum_{z_{t+1}} \hat{\phi}(z_{t+1}|z_t) \left( \frac{\hat{v}_{t+1}(z_{t+1}) + \alpha}{\hat{R}_t^A(z_t)} \right) \quad (36)$$

Armed with these conjectured prices we can now prove the following result.

**Lemma 7.1.** *Absent solvency constraints, the household Euler equations are satisfied in the Arrow model at the Bewley allocations  $\{\hat{c}_{t+1}(y^t, y_{t+1})\}$  and Arrow prices  $\{\hat{q}_t(z_{t+1}|z_t)\}$  given by (34).*

**Trading** Next, we spell out which asset trades support the Bewley equilibrium consumption allocations in the de-trended Arrow model, and we show that the implied contingent claims positions clear the market for Arrow securities.

At any point in time and any node of the event tree, the position of Arrow securities at the beginning of the period, plus the value of the stock position cum dividends, has to finance the value of excess demand from today into the infinite future. Thus, the Arrow securities position implied by the Bewley equilibrium allocation  $\{\hat{c}_t(\theta_0, y^t), \hat{\sigma}_t(\theta_0, y^t)\}$  is given by:<sup>30</sup>

$$\begin{aligned} \hat{a}_{t-1}(\theta_0, y^{t-1}, z^t) &= \hat{c}_t(\theta_0, y^t) - \eta(y_t) + \sum_{\tau=t+1}^{\infty} \sum_{z^\tau, y^\tau} \hat{Q}_\tau(z^\tau|z_t)\varphi(y^\tau|y^t) (\hat{c}_\tau(\theta_0, y^\tau) - \eta(y_\tau)) \\ &\quad - \hat{\sigma}_{t-1}(\theta_0, y^{t-1}) [\hat{v}_t(z_t) + \alpha] \\ &= \hat{a}_{t-1}(\theta_0, y^{t-1}, z_t). \end{aligned} \quad (37)$$

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<sup>30</sup>We will verify below that the price of the stock in the de-trended Arrow model satisfies  $\hat{v}_t(z^t) = \hat{v}_t(z_t)$ .

**Proposition 7.1.** *The contingent claims positions implied by the Bewley allocations in (37) clear the Arrow securities markets, that is*

$$\int \sum_{y^{t-1}} \varphi(y^{t-1}|y_0) \hat{a}_{t-1}(\theta_0, y^{t-1}, z^t) d\Theta_0 = 0 \text{ for all } z^t.$$

Since the wealth from stock holdings at the beginning of the period

$$\hat{\sigma}_{t-1}(\theta_0, y^{t-1}) [\hat{v}_t + \alpha] = \alpha \hat{\sigma}_{t-1}(\theta_0, y^{t-1}) \sum_{\tau=t}^{\infty} \tilde{Q}_{t,\tau}$$

has to finance future excess consumption demand in the Bewley equilibrium, we can state the contingent claims positions as:

$$\begin{aligned} \hat{a}_{t-1}(\theta_0, y^{t-1}, z_t) &= \sum_{\tau=t+1}^{\infty} \sum_{z^\tau} \left( \hat{Q}_\tau(z^\tau|z_t) - \tilde{Q}_{t,\tau} \right) \sum_{y^\tau} \varphi(y^\tau|y^t) (\hat{c}_\tau(\theta_0, y^\tau) - \eta(y_\tau)) \\ &\quad - \hat{\sigma}_{t-1}(\theta_0, y^{t-1}) \alpha \sum_{\tau=t+1}^{\infty} \sum_{z^\tau} \left( \hat{Q}_\tau(z^\tau|z_t) - \tilde{Q}_{t,\tau} \right) \end{aligned}$$

The Arrow securities positions held by households are used to hedge against the interest rate shocks that govern the difference between the stochastic  $\hat{Q}_\tau(z^\tau|z_t)$  and the deterministic  $\tilde{Q}_{t,\tau}$ . If aggregate endowment growth is i.i.d, there are no taste shocks in the detrended Arrow model, and from (35) we see that the interest rates are deterministic. The gap between  $\hat{Q}_\tau(z^\tau|z_t)$  and  $\tilde{Q}_{t,\tau}$  is zero and no Arrow securities are traded in equilibrium, confirming the results in section 4.

In order to close our argument, we need to show that no initial wealth transfers between individuals are required for this implementation. In other words, the initial Arrow securities position  $\hat{a}_{-1}(\theta_0, y^{-1}, z_0)$  implied by (37) at time 0, is zero for all households.<sup>31</sup>

To do so we proceed in two steps. First, we show that the average time zero state prices in the Arrow model coincide with the state prices in the Bewley model. For this result to hold our particular choice of time discount factors  $\{\tilde{\beta}_t\}$  for the Bewley model is crucial.

**Lemma 7.2.** *The conjectured prices for the Arrow model in (33) and the prices in the Bewley model defined in (32) satisfy*

$$\sum_{z^\tau} \hat{Q}_\tau(z^\tau|z_0) = \tilde{Q}_\tau$$

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<sup>31</sup>Without this argument we merely would have shown that a Bewley equilibrium for initial condition  $\Theta_0$  can be implemented as equilibrium of the de-trended Arrow model with initial conditions  $z_0$  and some initial distribution of wealth, but not necessarily  $\Theta_0$ .

Finally, using this result we can establish that no wealth transfers are necessary to implement the Bewley equilibrium as equilibrium in the de-trended Arrow model.

**Lemma 7.3.** *The Arrow securities position at time 0 given in (37) is zero:*

$$\hat{a}_{-1}(\theta_0, y^{-1}, z_0) = 0.$$

Having established that the Bewley equilibrium is an equilibrium for the de-trended Arrow model with the same initial wealth distribution  $\Theta_0$ , the following theorem obviously results.

**Theorem 7.2.** *An equilibrium of the Bewley model  $\{\hat{c}_t(\theta_0, y^t), \hat{\sigma}_t(\theta_0, y^t)\}$  and  $\{\hat{R}_t, \hat{v}_t\}$  where households have a sequence of time discount factors  $\{\tilde{\beta}_t\}$  can be made into an equilibrium for the Arrow model with growth,  $\{a_t(\theta_0, s^t, z_{t+1})\}$ ,  $\{\sigma_t(\theta_0, s^t)\}$ ,  $\{c_t(\theta_0, s^t)\}$  and  $\{q_t(z^t, z_{t+1})\}$ ,  $\{v_t(z^t)\}$ , with*

$$\begin{aligned} c_t(\theta_0, s^t) &= \hat{c}_t(\theta_0, y^t) e_t(z^t) \\ \sigma_t(\theta_0, s^t) &= \hat{\sigma}_t(\theta_0, y^t) \\ a_t(\theta_0, s^t, z_{t+1}) &= \hat{a}_t(\theta_0, y^t, z_{t+1}) e_{t+1}(z^{t+1}) \text{ with } \hat{a}_t \text{ defined in (37)} \\ v_t(z_t) &= \sum_{z_{t+1}} \frac{\hat{\phi}(z_{t+1}|z_t)}{\lambda(z_{t+1})} \left[ \frac{v_{t+1}(z_{t+1}) + \alpha e_{t+1}(z_{t+1})}{\hat{R}_t^A(z_t)} \right] \\ \hat{R}_t^A(z_t) &= \frac{\hat{R}_t \tilde{\beta}_{t+1}}{\hat{\beta}(z_t) \tilde{\beta}_t} \\ q_t(z^t, z_{t+1}) &= \frac{\hat{q}_t(z^t, z_{t+1})}{\lambda(z_{t+1})} = \frac{1}{\hat{R}_t^A(z_t)} * \frac{\phi(z_{t+1}|z_t) \lambda(z_{t+1})^{-\gamma}}{\sum_{z_{t+1}} \phi(z_{t+1}|z_t) \lambda(z_{t+1})^{1-\gamma}} \end{aligned}$$

**Risk Premia** Of course, this implies that our baseline irrelevance result for risk premia survives the introduction of non-i.i.d. aggregate shocks, provided that a complete menu of aggregate-state-contingent securities is traded.<sup>32</sup> These aggregate taste shocks only affect interest rates and price/dividend ratios, not risk premia. When agents in the transformed model become more impatient, the interest rises and the price/dividend ratio decreases, but the conditional expected excess return is unchanged.

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<sup>32</sup>Note that

$$\kappa_t(z_t) = \frac{\hat{R}_t^{RE}(z_t)}{\hat{R}_t^A(z_t)} = \frac{\tilde{\beta}_t}{\hat{R}_t \tilde{\beta}_{t+1}} = \kappa_t$$

is still deterministic, and thus the proofs of section 6 go through unchanged.

**Solvency Constraints** So far, we have abstracted from binding solvency constraints. Previously, we assumed that the solvency constraints satisfy  $K_t(s^t) = \hat{K}_t(y^t)e_t(z^t)$  and  $M_{t+1}(s^{t+1}) = \hat{M}_t(y^t)e_t(z^{t+1})$ . The allocations computed in the stationary model using  $\hat{K}_t(y^t)$  and  $\hat{M}_t(y^t)$  as solvency constraints, satisfy a modified version of the solvency constraints  $K_t(s^t)$  and  $M_{t+1}(s^{t+1})$ .

**Proposition 7.2.** *The allocations from theorem 7.2 satisfy the modified solvency constraints:*

$$K_t^*(s^t) = K_t(s^t) + \sum_{z_{t+1}} q_t(z^t, z_{t+1})a_t(\theta_0, s^t, z_{t+1}) + \sigma_t(\theta_0, s^t) [v_t(z_t) - \hat{v}_t e_t(z^t)] \quad (38)$$

$$M_{t+1}^*(s^{t+1}) = M_{t+1}(s^{t+1}) + a_t(\theta_0, s^t, z_{t+1}) + \sigma_t(\theta_0, s^t) [v_{t+1}(z_{t+1}) - \hat{v}_{t+1} e_{t+1}(z^{t+1})] \quad (39)$$

where  $\hat{v}_t$  is the (deterministic) Bewley equilibrium stock price.

If the allocations satisfy the constraints in the stationary Bewley model, they satisfy the modified solvency constraints in the actual Arrow model, but not the ones we originally specified, because of the nonzero state-contingent claims positions.<sup>33</sup> Nevertheless, in principle, one could reverse-engineer a sequence of auxiliary solvency constraints such that in the actual equilibrium the modified version of the auxiliary constraints coincides with the actual constraints we want to impose,  $K_t(s^t)$ .

### 7.1.3 Bond Model

Finally, in the Bond model, our previous equivalence result no longer holds, since with predictability in aggregate consumption growth households trade state-contingent claims in the equilibrium of the Arrow model. Unless there are only two aggregate shocks, the market structure of the Bond model prevents them from doing so, and thus our implementation and irrelevance results in this model are not robust to the introduction of non-i.i.d aggregate endowment growth.

## 7.2 Preferences

What role do preferences play in our results? While it is key to have homogeneous preferences, time separability is not critical, at least not in the benchmark case of i.i.d. aggregate shocks. In a separate appendix<sup>34</sup> we show that (only) in this case the irrelevance result survives for the case of Epstein-Zin (1989) preferences.

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<sup>33</sup>Note that these violations of the original constraints are completely due to the impact of interest rate shocks on the value of the asset portfolio.

<sup>34</sup>Available on both authors' homepages, or upon request.

## 8 Conclusion

We have shown analytically that the history of a household's idiosyncratic shocks has no effect on his portfolio choice, even in the presence of binding solvency constraints. This portfolio irrelevance result directly implies the risk premium irrelevance result. Since all households bear the same amount of aggregate risk in equilibrium, the history of aggregate shocks does not affect equilibrium prices and allocations. The equilibrium risk-free rate, the risk premium and the price/dividend ratio are all deterministic, at least in the benchmark model without predictability in aggregate consumption growth.

There are two ways around this. One approach is to concentrate aggregate risk by forcing some households out of the stock market altogether. This is the approach adopted in the literature on limited participation (see e.g. Guvenen (2003) and Vissing-Jorgensen (2002)). The second approach consists of concentrating labor income risk in recessions. Recently Krusell and Smith (1997) and Storesletten, Telmer and Yaron (2006) have argued that models with idiosyncratic income shocks and incomplete markets can generate an equity premium that is substantially larger than the CCAPM if there is counter-cyclical cross-sectional variance (CCV) in labor income shocks. Storesletten, Telmer and Yaron (2004) argue that this condition is satisfied in the data, although it is not clear the CCV in the data is strong enough to explain equity risk premia at reasonable levels of risk aversion. Our paper demonstrates analytically that CCV in labor income is not only sufficient, but *necessary* to make uninsurable idiosyncratic income shocks potentially useful for explaining the equity premium, even in the presence of binding solvency constraints.

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# A Additional Definitions

## A.1 Arrow Model

The definition of an equilibrium in the Arrow model is standard. Each household is assigned a label that consists of its initial financial wealth  $\theta_0$  and its initial state  $s_0 = (y_0, z_0)$ . A household of type  $(\theta_0, s_0)$  then chooses consumption allocations  $\{c_t(\theta_0, s^t)\}$ , trading strategies for Arrow securities  $\{a_t(\theta_0, s^t, z_{t+1})\}$  and shares  $\{\sigma_t(\theta_0, s^t)\}$  to maximize her expected utility (1), subject to the budget constraints (11) and subject to solvency constraints (13) or (14).

**Definition A.1.** For initial aggregate state  $z_0$  and distribution  $\Theta_0$  over  $(\theta_0, y_0)$ , a competitive equilibrium for the Arrow model consists of household allocations  $\{a_t(\theta_0, s^t, z_{t+1})\}$ ,  $\{c_t(\theta_0, s^t)\}$ ,  $\{\sigma_t(\theta_0, s^t)\}$  and prices  $\{q_t(z^t, z_{t+1})\}$ ,  $\{v_t(z^t)\}$  such that

1. Given prices, household allocations solve the household maximization problem
2. The goods market clears for all  $z^t$ ,

$$\int \sum_{y^t} \frac{\pi(y^t, z^t | y_0, z_0)}{\pi(z^t | z_0)} c_t(\theta_0, s^t) d\Theta_0 = e_t(z^t)$$

3. The asset markets clear for all  $z^t$

$$\int \sum_{y^t} \frac{\pi(y^t, z^t | y_0, z_0)}{\pi(z^t | z_0)} \sigma_t(\theta_0, s^t) d\Theta_0 = 1$$

$$\int \sum_{y^t} \frac{\pi(y^t, z^t | y_0, z_0)}{\pi(z^t | z_0)} a_t(\theta_0, s^t, z_{t+1}) d\Theta_0 = 0 \text{ for all } z_{t+1} \in Z$$

### A.1.1 Optimality Conditions for De-trended Arrow Model

Define the Lagrange multiplier

$$\hat{\beta}(s^t) \hat{\pi}(s^t | s_0) u'(\hat{c}_t(s^t)) \hat{\mu}(s^t) \geq 0$$

for the constraint in (16) and

$$\hat{\beta}(s^t) \hat{\pi}(s^t | s_0) u'(\hat{c}_t(s^t)) \hat{\kappa}_t(s^t, z_{t+1}) \geq 0$$

for the constraint in (17). The Euler equations of the de-trended Arrow model are given by:

$$1 = \frac{\hat{\beta}(s_t)}{\hat{q}_t(z^t, z_{t+1})} \sum_{s^{t+1}|s^t, z_{t+1}} \hat{\pi}(s_{t+1}|s_t) \frac{u'(\hat{c}_{t+1}(s^t, s_{t+1}))}{u'(\hat{c}_t(s^t))} + \hat{\mu}_t(s^t) + \frac{\hat{\kappa}_t(s^t, z_{t+1})}{\hat{q}_t(z^t, z_{t+1})} \forall z_{t+1}. \quad (40)$$

$$1 = \hat{\beta}(s_t) \sum_{s^{t+1}|s^t} \hat{\pi}(s_{t+1}|s_t) \left[ \frac{\hat{v}_{t+1}(z^{t+1}) + \alpha}{\hat{v}_t(z^t)} \right] \frac{u'(\hat{c}_{t+1}(s^t, s_{t+1}))}{u'(\hat{c}_t(s^t))} + \hat{\mu}_t(s^t) + \sum_{z_{t+1}} \hat{\kappa}_t(s^t, z_{t+1}) \left[ \frac{\hat{v}_{t+1}(z^{t+1}) + \alpha}{\hat{v}_t(z^t)} \right]. \quad (41)$$

Only one of the two Lagrange multipliers enters the equations, depending on which version of the solvency constraint we consider. The complementary slackness conditions for the Lagrange multipliers are given by

$$\hat{\mu}_t(s^t) \left[ \sum_{z_{t+1}} \hat{a}_t(s^t, z_{t+1}) \hat{q}_t(z^t, z_{t+1}) + \hat{\sigma}_t(s^t) \hat{v}_t(z^t) - \hat{K}_t(y^t) \right] = 0$$

$$\hat{\kappa}_t(s^t, z_{t+1}) \left[ \hat{a}_t(s^t, z_{t+1}) + \hat{\sigma}_t(s^t) [\hat{v}_{t+1}(z^{t+1}) + \alpha] - \hat{M}_t(y^t) \right] = 0.$$

The appropriate transversality conditions read as

$$\lim_{t \rightarrow \infty} \sum_{s^t} \hat{\beta}(s^{t-1}) \hat{\pi}(s^t|s_0) u'(\hat{c}_t(s^t)) [\hat{a}_{t-1}(s^{t-1}, z_t) - \hat{M}_{t-1}(y^{t-1})] = 0,$$

$$\lim_{t \rightarrow \infty} \sum_{s^t} \hat{\beta}(s^{t-1}) \hat{\pi}(s^t|s_0) u'(\hat{c}_t(s^t)) [\hat{\sigma}_{t-1}(s^{t-1}) (\hat{v}_t(z^t) + \alpha) - \hat{M}_{t-1}(y^{t-1})] = 0,$$

and

$$\lim_{t \rightarrow \infty} \sum_{s^t} \hat{\beta}(s^{t-1}) \hat{\pi}(s^t|s_0) u'(\hat{c}_t(s^t)) \left[ \sum_{z_{t+1}} \hat{a}_t(s^t, z_{t+1}) \hat{q}_t(z^t, z_{t+1}) - \hat{K}_t(y^t) \right] = 0,$$

$$\lim_{t \rightarrow \infty} \sum_{s^t} \hat{\beta}(s^{t-1}) \hat{\pi}(s^t|s_0) u'(\hat{c}_t(s^t)) \left[ \hat{\sigma}_t(s^t) \hat{v}_t(z^t) - \hat{K}_t(y^t) \right] = 0.$$

Since the household optimization has a concave objective function and a convex constraint set the first order conditions and complementary slackness conditions, together with the transversality condition, are necessary and sufficient conditions for optimality of household allocation choices.

## A.2 Bond Model

Agents only trade a single bond a single stock. Wealth tomorrow in state  $s^{t+1} = (s^t, y_{t+1}, z_{t+1})$  is given by

$$\theta_{t+1}(s^{t+1}) = \eta(y_{t+1}) e_{t+1}(z_{t+1}) + b_t(s^t) + \sigma_t(s^t) [v_{t+1}(z^{t+1}) + \alpha e_{t+1}(z_{t+1})].$$

**Definition A.2.** For an initial aggregate state  $z_0$  and distribution  $\Theta_0$  over  $(\theta_0, y_0)$ , a competitive equilibrium for the Bond model consists of household allocations  $\{b_t(\theta_0, s^t)\}$ ,  $\{c_t(\theta_0, s^t)\}$ ,  $\{\sigma_t(\theta_0, s^t)\}$ , and interest rates  $\{R_t(z^t)\}$  and share prices  $\{v_t(z^t)\}$  such that

1. Given prices, allocations solve the household maximization problem.

2. The goods market clears for all  $z^t$ :

$$\int \sum_{y^t} \frac{\pi(y^t, z^t | y_0, z_0)}{\pi(z^t | z_0)} c_t(\theta_0, s^t) d\Theta_0 = e_t(z^t).$$

3. The asset markets clear for all  $z^t$ :

$$\begin{aligned} \int \sum_{y^t} \frac{\pi(y^t, z^t | y_0, z_0)}{\pi(z^t | z_0)} \sigma_t(\theta_0, s^t) d\Theta_0 &= 1. \\ \int \sum_{y^t} \frac{\pi(y^t, z^t | y_0, z_0)}{\pi(z^t | z_0)} b_t(\theta_0, s^t) d\Theta_0 &= 0. \end{aligned}$$

### A.2.1 Optimality Conditions for Bond Model

Define the Lagrange multiplier

$$\hat{\beta}(s^t) \hat{\pi}(s^t | s_0) u'(\hat{c}_t(s^t)) \hat{\mu}(s^t) \geq 0$$

for the constraint in (29) and

$$\hat{\beta}(s^t) \hat{\pi}(s^t | s_0) u'(\hat{c}_t(s^t)) \hat{\kappa}_t(s^t, z_{t+1}) \geq 0$$

for the constraint in (30). In the detrended Bond model the Euler equations read as

$$\begin{aligned} 1 &= \hat{\beta}(s_t) \sum_{s^{t+1} | s^t} \hat{\pi}(s_{t+1} | s_t) \left[ \frac{R_t(z^t)}{\lambda(z_{t+1})} \right] \frac{u'(\hat{c}_{t+1}(s^t, s_{t+1}))}{u'(\hat{c}_t(s^t))} \\ &\quad + \hat{\mu}_t(s^t) + \sum_{z_{t+1}} \hat{\kappa}_t(s^t, z_{t+1}) \left[ \frac{R_t(z^t)}{\lambda(z_{t+1})} \right]. \end{aligned} \tag{42}$$

$$\begin{aligned} 1 &= \hat{\beta}(s_t) \sum_{s^{t+1} | s^t} \hat{\pi}(s_{t+1} | s_t) \left[ \frac{\hat{v}_{t+1}(z^{t+1}) + \alpha}{\hat{v}_t(z^t)} \right] \frac{u'(\hat{c}_{t+1}(s^t, s_{t+1}))}{u'(\hat{c}_t(s^t))} \\ &\quad + \hat{\mu}_t(s^t) + \sum_{z_{t+1}} \hat{\kappa}_t(s^t, z_{t+1}) \left[ \frac{\hat{v}_{t+1}(z^{t+1}) + \alpha}{\hat{v}_t(z^t)} \right], \end{aligned} \tag{43}$$

with complementary slackness conditions given by:

$$\begin{aligned}\hat{\mu}_t(s^t) \left[ \frac{\hat{b}_t(s^t)}{R_t(z^t)} + \hat{\sigma}_t(s^t)\hat{v}_t(z^t) - \hat{K}_t(y^t) \right] &= 0 \\ \hat{\kappa}_t(s^t, z_{t+1}) \left[ \frac{\hat{b}_t(s^t)}{\lambda(z_{t+1})} + \hat{\sigma}_t(s^t) [\hat{v}_{t+1}(z^{t+1}) + \alpha] - \hat{M}_t(y^t) \right] &= 0.\end{aligned}$$

The transversality conditions are given by

$$\begin{aligned}\lim_{t \rightarrow \infty} \sum_{s^t} \hat{\beta}(s^{t-1}) \hat{\pi}(s^t | s_0) u'(\hat{c}_t(s^t)) \left[ \frac{\hat{b}_{t-1}(s^{t-1})}{\lambda(z_t)} - \hat{M}_{t-1}(y^{t-1}) \right] &= 0. \\ \lim_{t \rightarrow \infty} \sum_{s^t} \hat{\beta}(s^{t-1}) \hat{\pi}(s^t | s_0) u'(\hat{c}_t(s^t)) [\hat{\sigma}_{t-1}(s^{t-1})(\hat{v}_t(z^t) + \alpha) - \hat{M}_{t-1}(y^{t-1})] &= 0\end{aligned}$$

and

$$\begin{aligned}\lim_{t \rightarrow \infty} \sum_{s^t} \hat{\beta}(s^{t-1}) \hat{\pi}(s^t | s_0) u'(\hat{c}_t(s^t)) \left[ \frac{\hat{b}_t(s^t)}{R_t(z^t)} - \hat{K}_t(y^t) \right] &= 0. \\ \lim_{t \rightarrow \infty} \sum_{s^t} \hat{\beta}(s^{t-1}) \hat{\pi}(s^t | s_0) u'(\hat{c}_t(s^t)) \left[ \hat{\sigma}_t(s^t)\hat{v}_t(z^t) - \hat{K}_t(y^t) \right] &= 0.\end{aligned}$$

## B Proofs

- Proof of Proposition 2.1:

We use  $U(c)(s^t)$  to denote the continuation utility of an agent from consumption stream  $c$ , starting at history  $s^t$ . This continuation utility follows the simple recursion

$$U(c)(s^t) = u(c_t(s^t)) + \beta \sum_{s_{t+1}} \pi(s_{t+1} | s_t) U(c)(s^t, s_{t+1}),$$

where it is understood that  $(s^t, s_{t+1}) = (z^t, z_{t+1}, y^t, y_{t+1})$ . Divide both sides by  $e_t(s^t)^{1-\gamma}$  to obtain

$$\frac{U(c)(s^t)}{e_t(z^t)^{1-\gamma}} = u(\hat{c}_t(s^t)) + \beta \sum_{s_{t+1}} \pi(s_{t+1} | s_t) \frac{e_{t+1}(z^{t+1})^{1-\gamma}}{e_t(z^t)^{1-\gamma}} \frac{U(c)(s^t, s_{t+1})}{e_{t+1}(z^{t+1})^{1-\gamma}}.$$

Define a new continuation utility index  $\hat{U}(\cdot)$  as follows:

$$\hat{U}(\hat{c})(s^t) = \frac{U(c)(s^t)}{e_t(z^t)^{1-\gamma}}.$$

It follows that

$$\begin{aligned}\hat{U}(\hat{c})(s^t) &= u(\hat{c}_t(s^t)) + \beta \sum_{s_{t+1}} \pi(s_{t+1} | s_t) \lambda(z_{t+1})^{1-\gamma} \hat{U}(\hat{c})(s^t, s_{t+1}). \\ &= u(\hat{c}_t(s^t)) + \hat{\beta}(s_t) \sum_{s_{t+1}} \hat{\pi}(s_{t+1} | s_t) \hat{U}(\hat{c})(s^t, s_{t+1}).\end{aligned}$$

Thus it follows, for two consumption streams  $c$  and  $c'$ , that

$$U(c)(s^t) \geq U(c')(s^t) \text{ if and only if } \hat{U}(\hat{c})(s^t) \geq \hat{U}(\hat{c}')(s^t),$$

i.e., the household orders original and growth-deflated consumption streams in exactly the same way.

- Proof of Theorem 4.1:

The proof consists of two parts. In a first step, we argue that the Bewley equilibrium allocations and prices can be transformed into an equilibrium for the de-trended Arrow model, and in a second step, we argue that by scaling the allocations and prices by the appropriate endowment (growth) factors, we obtain an equilibrium of the stochastically growing Arrow model.

Step 1: Take allocations and prices from a Bewley equilibrium,  $\{\hat{c}_t(y^t), \hat{a}_t(y^t), \hat{\sigma}_t(y^t)\}$ ,  $\{\hat{R}_t, \hat{v}_t\}$  and let the associated Lagrange multipliers on the solvency constraints be given by

$$\hat{\beta}^t \varphi(y^t|y_0) u'(\hat{c}_t(y^t)) \hat{\mu}(y^t) \geq 0,$$

for the constraint in (9) and

$$\hat{\beta}^t \varphi(y^t|y_0) u'(\hat{c}_t(y^t)) \hat{\kappa}_t(y^t) \geq 0,$$

for the constraint in (10). The first order conditions (which are necessary and sufficient for household optimal choices together with the complementary slackness and transversality conditions) in the Bewley model, once combined to the Euler equations, are given by:

$$1 = \hat{R}_t \hat{\beta} \sum_{y^{t+1}|y^t} \varphi(y_{t+1}|y_t) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} + \hat{\mu}_t(y^t) + \hat{R}_t \hat{\kappa}_t(y^t). \quad (44)$$

$$= \hat{\beta} \left[ \frac{\hat{v}_{t+1} + \alpha}{\hat{v}_t} \right] \sum_{y^{t+1}|y^t} \varphi(y_{t+1}|y_t) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} + \hat{\mu}_t(y^t) + \left[ \frac{\hat{v}_{t+1} + \alpha}{\hat{v}_t} \right] \hat{\kappa}_t(y^t). \quad (45)$$

The corresponding Euler equations for the de-trended Arrow model, evaluated at the Bewley equilibrium allocations and Lagrange multipliers  $\hat{\mu}(y^t)$  and  $\hat{\kappa}_t(y^t) \hat{\phi}(z_{t+1})$ , read as (see (40) and (41)):

$$\begin{aligned} 1 &= \frac{\hat{\beta}(s_t)}{\hat{q}_t(z^t, z_{t+1})} \sum_{s^{t+1}|s^t, z_{t+1}} \hat{\pi}(s_{t+1}|s_t) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} \\ &\quad + \hat{\mu}_t(y^t) + \frac{\hat{\kappa}_t(y^t) \hat{\phi}(z_{t+1})}{\hat{q}_t(z^t, z_{t+1})} \quad \forall z_{t+1}. \\ 1 &= \hat{\beta}(s_t) \sum_{s^{t+1}|s^t} \hat{\pi}(s_{t+1}|s_t) \left[ \frac{\hat{v}_{t+1}(z^{t+1}) + \alpha}{\hat{v}_t(z^t)} \right] \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} \\ &\quad + \hat{\mu}_t(y^t) + \hat{\kappa}_t(y^t) \sum_{z_{t+1}} \hat{\phi}(z_{t+1}) \left[ \frac{\hat{v}_{t+1}(z^{t+1}) + \alpha}{\hat{v}_t(z^t)} \right]. \end{aligned}$$

Evaluated at the conjectured prices,

$$\hat{v}_t(z^t) = \hat{v}_t \quad (46)$$

$$\hat{q}_t(z^t, z_{t+1}) = \frac{\hat{\phi}(z_{t+1})}{\hat{R}_t}, \quad (47)$$

and using the independence and i.i.d. assumptions, which imply

$$\begin{aligned} \hat{\pi}(s_{t+1}|s_t) &= \varphi(y_{t+1}|y_t)\hat{\phi}(z_{t+1}) \\ \hat{\beta}(s_t) &= \hat{\beta} \end{aligned}$$

these Euler equations can be restated as follows:

$$1 = \frac{\hat{\beta}\hat{R}_t}{\hat{\phi}(z_{t+1})} \sum_{y^{t+1}|y^t} \varphi(y_{t+1}|y_t)\hat{\phi}(z_{t+1}) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} + \hat{\mu}_t(y^t) + \hat{R}_t\hat{\kappa}_t(y^t). \quad (48)$$

$$\begin{aligned} 1 &= \hat{\beta} \sum_{y^{t+1}|y^t} \varphi(y_{t+1}|y_t) \sum_{z_{t+1}} \hat{\phi}(z_{t+1}) \left[ \frac{\hat{v}_{t+1} + \alpha}{\hat{v}_t} \right] \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} \\ &\quad + \hat{\mu}_t(y^t) + \hat{\kappa}_t(y^t) \left[ \frac{\hat{v}_{t+1} + \alpha}{\hat{v}_t} \right] \sum_{z_{t+1}} \hat{\phi}(z_{t+1}), \end{aligned} \quad (49)$$

which are, given that  $\sum_{z_{t+1}} \hat{\phi}(z_{t+1}) = 1$ , exactly the Euler conditions (44) and (45) of the Bewley model and hence satisfied by the Bewley equilibrium allocations. A similar argument applies to the complementary slackness conditions, which for the Bewley model read as

$$\hat{\mu}_t(y^t) \left[ \frac{\hat{a}_t(y^t)}{\hat{R}_t} + \hat{\sigma}_t(y^t)\hat{v}_t - \hat{K}_t(y^t) \right] = 0. \quad (50)$$

$$\hat{\kappa}_t(y^t) \left[ \hat{a}_t(y^t) + \hat{\sigma}_t(y^t)(\hat{v}_{t+1} + \alpha) - \hat{M}_t(y^t) \right] = 0, \quad (51)$$

and for the de-trended Arrow model, evaluated at Bewley equilibrium allocations and conjectured prices, read as

$$\begin{aligned} \hat{\mu}_t(y^t) \left[ \frac{\hat{a}_t(y^t)}{\hat{R}_t} \sum_{z_{t+1}} \hat{\phi}(z_{t+1}) + \hat{\sigma}_t(y^t) - \hat{K}_t(y^t) \right] &= 0. \\ \hat{\kappa}_t(y^t) \left[ \hat{a}_t(y^t) + \hat{\sigma}_t(y^t)[\hat{v}_{t+1} + \alpha] - \hat{M}_t(y^t) \right] &= 0/\hat{\phi}(z_{t+1}). \end{aligned}$$

Again, the Bewley equilibrium allocations satisfy the complementary slackness conditions in the de-trended Arrow model. The argument is exactly identical for the transversality conditions. Finally, we have to check whether the Bewley equilibrium allocation satisfies the de-trended Arrow budget constraints. Plugging in the allocations yields:

$$\hat{c}_t(s^t) + \frac{\hat{a}_t(y^t)}{\hat{R}_t} \sum_{z_{t+1}} \hat{\phi}(z_{t+1}) + \hat{\sigma}_t(y^t)\hat{v}_t \leq \eta(y_t) + \hat{a}_{t-1}(y^{t-1}) + \sigma_{t-1}(y^{t-1})[\hat{v}_t + \alpha], \quad (52)$$

which is exactly the budget constraint in the Bewley model. Thus, given the conjectured

prices, the Bewley equilibrium allocations are optimal in the de-trended Arrow model.

Since the market clearing conditions for assets and consumption goods coincide in the two models, Bewley allocations satisfy the market clearing conditions in the de-trended Arrow model. Thus we conclude that the Bewley equilibrium allocations, together with prices (46) and (47) are an equilibrium in the de-trended Arrow model.

Step 2: Now, we need to show that an equilibrium of the de-trended Arrow model is, after appropriate scaling, an equilibrium in the stochastically growing model, but this was established in section 4.2, in which we showed that by with the transformations  $\hat{c}_t(s^t) = \frac{c_t(s^t)}{e_t(z^t)}$ ,  $\hat{a}_t(s^t, z_{t+1}) = \frac{a_t(s^t, z_{t+1})}{e_{t+1}(z_{t+1})}$ ,  $\hat{\sigma}_t(s^t) = \sigma_t(s^t)$ ,  $\hat{q}_t(z^t, z_{t+1}) = q_t(z^t, z_{t+1})\lambda(z_{t+1})$ ,  $\hat{v}_t(z^t) = \frac{v_t(z^t)}{e_t(z^t)}$  household problems and market clearing conditions in the de-trended and the stochastically growing Arrow model coincide.

- Proof of Theorem 5.1:

As in the Arrow model, the crucial part of the proof is to argue that Bewley equilibrium allocations and prices can be made into an equilibrium for the de-trended Bond model. The Euler equations of the Bewley model where given in (44) and (45).

The corresponding Euler equations for the de-trended Bond model, evaluated at the Bewley equilibrium allocations and Lagrange multipliers  $\hat{\mu}(y^t)$  and  $\hat{\kappa}_t(y^t)\hat{\phi}(z_{t+1})$ , read as (see (42) and (43))

$$\begin{aligned} 1 &= \hat{\beta}(s_t) \sum_{s^{t+1}|s^t} \hat{\pi}(s_{t+1}|s_t) \left[ \frac{R_t(z^t)}{\lambda(z_{t+1})} \right] \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} \\ &\quad + \hat{\mu}(y^t) + \hat{\kappa}_t(y^t) \sum_{z_{t+1}} \hat{\phi}(z_{t+1}) \left[ \frac{R_t(z^t)}{\lambda(z_{t+1})} \right]. \\ 1 &= \hat{\beta}(s_t) \sum_{s^{t+1}|s^t} \hat{\pi}(s_{t+1}|s_t) \left[ \frac{\hat{v}_{t+1}(z^{t+1}) + \alpha}{\hat{v}_t(z^t)} \right] \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} \\ &\quad + \hat{\mu}(y^t) + \hat{\kappa}_t(y^t) \sum_{z_{t+1}} \hat{\phi}(z_{t+1}) \left[ \frac{\hat{v}_{t+1}(z^{t+1}) + \alpha}{\hat{v}_t(z^t)} \right]. \end{aligned}$$

Using the conjectured prices, we note that

$$\begin{aligned} \hat{v}_t(z^t) &= \hat{v}_t. \\ R_t(z^t) &= \hat{R}_t * \frac{\sum_{z_{t+1}} \phi(z_{t+1})\lambda(z_{t+1})^{1-\gamma}}{\sum_{z_{t+1}} \phi(z_{t+1})\lambda(z_{t+1})^{-\gamma}}. \end{aligned}$$

Now we use the independence and i.i.d. assumptions, which imply

$$\begin{aligned} \hat{\pi}(s_{t+1}|s_t) &= \varphi(y_{t+1}|y_t)\hat{\phi}(z_{t+1}) \\ \hat{\beta}(s_t) &= \hat{\beta}. \end{aligned}$$

Furthermore by definition of  $\hat{\phi}(z_{t+1})$ ,

$$R_t(z^t) \sum_{z_{t+1}} \frac{\hat{\phi}(z_{t+1})}{\lambda(z_{t+1})} = R_t(z^t) \frac{\sum_{z_{t+1}} \phi(z_{t+1}) \lambda(z_{t+1})^{-\gamma}}{\sum_{z_{t+1}} \phi(z_{t+1}) \lambda(z_{t+1})^{1-\gamma}} = \hat{R}_t$$

and thus the Euler equations can be restated as:

$$1 = \hat{\beta} \hat{R}_t \sum_{y^{t+1}|y^t} \varphi(y_{t+1}|y_t) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} + \hat{\mu}(y^t) + \hat{\kappa}_t(y^t) \hat{R}_t. \quad (53)$$

$$1 = \hat{\beta} \sum_{y^{t+1}|y^t} \varphi(y_{t+1}|y_t) \left[ \frac{\hat{v}_{t+1} + \alpha}{\hat{v}_t} \right] \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} \sum_{z_{t+1}} \hat{\phi}(z_{t+1}) \quad (54)$$

$$+ \hat{\mu}(y^t) + \hat{\kappa}_t(y^t) \left[ \frac{\hat{v}_{t+1} + \alpha}{\hat{v}_t} \right] \sum_{z_{t+1}} \hat{\phi}(z_{t+1}),$$

which again are, given that  $\sum_{z_{t+1}} \hat{\phi}(z_{t+1}) = 1$ , exactly the Euler conditions (44) and (45) of the Bewley model and hence satisfied by the Bewley equilibrium allocations. For the Bewley model, the complementary slackness conditions were given in (50) and (51), and for the de-trended Bond model, evaluated at the proposed allocations in the theorem (which had bond holdings equal to zero) these equations are given by:

$$\begin{aligned} \hat{\mu}_t(y^t) \left[ \hat{\sigma}_t^B(y^t) \hat{v}_t - \hat{K}_t(y^t) \right] &= \hat{\mu}_t(y^t) \left[ \left( \frac{\hat{a}_t(y^t)}{[\hat{v}_{t+1} + \alpha]} + \hat{\sigma}_t(y^t) \right) \hat{v}_t - \hat{K}_t(y^t) \right] \\ &= \hat{\mu}_t(y^t) \left[ \frac{\hat{a}_t(y^t)}{\hat{R}_t} + \hat{\sigma}_t(y^t) \hat{v}_t - \hat{K}_t(y^t) \right] = 0, \end{aligned}$$

and

$$\begin{aligned} \hat{\kappa}_t(y^t) \left[ \hat{\sigma}_t^B(y^t) [\hat{v}_{t+1} + \alpha] - \hat{M}_t(y^t) \right] &= \hat{\kappa}_t(y^t) \left[ \left( \frac{\hat{a}_t(y^t)}{[\hat{v}_{t+1} + \alpha]} + \hat{\sigma}_t(y^t) \right) [\hat{v}_{t+1} + \alpha] - \hat{M}_t(y^t) \right] \\ &= \hat{\kappa}_t(y^t) \left[ \hat{a}_t(y^t) + \hat{\sigma}_t(y^t) [\hat{v}_{t+1} + \alpha] - \hat{M}_t(y^t) \right] = 0/\hat{\phi}(z_{t+1}), \end{aligned}$$

where we use the fact that the Bewley equilibrium prices and interest rates satisfy

$$\hat{R}_t = \frac{\hat{v}_{t+1} + \alpha}{\hat{v}_t}.$$

These complementary slackness conditions are satisfied since the Bewley equilibrium allocations satisfy the complementary slackness conditions in the Bewley model. The argument is exactly identical for the transversality conditions. Finally, we have to check whether the allocations proposed in the theorem satisfy the de-trended Bond model budget constraints.

Plugging these into the de-trended Bond model budget constraint yields

$$\begin{aligned}
\hat{c}_t(y^t) + \frac{\hat{b}_t(y^t)}{R_t} + \hat{\sigma}_t^B(y^t)\hat{v}_t &\leq \eta(y_t) + \frac{\hat{b}_{t-1}(y^{t-1})}{\lambda(z_t)} + \hat{\sigma}_{t-1}^B(y^{t-1})[\hat{v}_t + \alpha] \quad (55) \\
\hat{c}_t(y^t) + \left[ \frac{\hat{a}_t(y^t)}{[\hat{v}_{t+1} + \alpha]} + \hat{\sigma}_t(y^t) \right] \hat{v}_t &\leq \eta(y_t) + \left[ \frac{\hat{a}_{t-1}(y^{t-1})}{[\hat{v}_t + \alpha]} + \hat{\sigma}_{t-1}(y^{t-1}) \right] [\hat{v}_t + \alpha] \\
\hat{c}_t(y^t) + \frac{\hat{a}_t(y^t)}{\hat{R}_t} + \hat{\sigma}_t(y^t)\hat{v}_t &\leq \eta(y_t) + \hat{a}_{t-1}(y^{t-1}) + \hat{\sigma}_{t-1}(y^{t-1})[\hat{v}_t + \alpha],
\end{aligned}$$

which is exactly the budget constraint in the Bewley model. Thus, given the conjectured prices the allocations proposed in the theorem are optimal household choices in the de-trended Bond model. Equation (55) shows why, in contrast to the Arrow model, in the Bond model bond positions have to be zero. Nothing in this equation depends on the aggregate shock  $z_t$  except for the term  $\frac{\hat{b}_{t-1}(y^{t-1})}{\lambda(z_t)}$ . Therefore the budget constraint can only be satisfied if  $\hat{b}_{t-1}(y^{t-1}) = 0$ . In the model with growth, households want to keep wealth at the beginning of the period proportional to the aggregate endowment in the economy, but, since bond positions are chosen in the previous period, and thus cannot depend on the realization of the aggregate shock today, bond positions have to be zero to achieve proportionally of wealth and the aggregate endowment. The market clearing conditions for bonds in the de-trended Bond model is trivially satisfied because bond positions are identically equal to zero. The goods market clearing condition is identical to that of the Bewley model and thus satisfied by the Bewley equilibrium consumption allocations. It remains to be shown that the stock market clears. We know that:

$$\begin{aligned}
&\int \sum_{y^t} \varphi(y^t|y_0) \hat{\sigma}_t^B(\theta_0, y^t) d\Theta_0 \\
&= \int \sum_{y^t} \varphi(y^t|y_0) \left[ \frac{\hat{a}_t(\theta_0, y^t)}{[\hat{v}_{t+1} + \alpha]} + \hat{\sigma}_t(\theta_0, y^t) \right] d\Theta_0 \\
&= \frac{1}{[\hat{v}_{t+1} + \alpha]} \int \sum_{y^t} \varphi(y^t|y_0) \hat{a}_t(\theta_0, y^t) d\Theta_0 + \int \sum_{y^t} \varphi(y^t|y_0) \hat{\sigma}_t(\theta_0, y^t) d\Theta_0 \\
&= 0 + 1,
\end{aligned}$$

where the last line follows from the fact that the bond and stock market clears in the Bewley equilibrium. Thus, we conclude that the allocations and prices proposed in the theorem indeed are an equilibrium in the de-trended Bond model, and, after appropriate scaling, in the original Bond model.

- Proof of Lemma 6.1:

The stock return is defined as:

$$R_{t+1}^s(z^{t+1}) = \frac{v_{t+1}(z^{t+1}) + \alpha e_{t+1}(z_{t+1})}{v_t(z^t)}.$$

Subtracting the two Euler equations (48)-(49) in the Arrow model and (53)-(54) in the Bond

model yields, in both cases

$$\hat{\beta} \sum_{z^{t+1}|z^t} \hat{\phi}(z_{t+1}) \left[ \frac{\hat{v}_{t+1}(z^{t+1}) + \alpha}{\hat{v}_t(z^t)} - \hat{R}_t(z^t) \right] = 0.$$

Using the fact that  $\hat{v}_{t+1}(z^{t+1}) = v_{t+1}(z^{t+1})/e_{t+1}(z_{t+1})$  and the definition of  $\hat{\phi}(z_{t+1})$  and  $\hat{\beta}$ , as well as (23) yields

$$\beta \sum_{z^{t+1}|z^t} \phi(z_{t+1}) \lambda(z_{t+1})^{-\gamma} [R_{t+1}^s(z^{t+1}) - R_t(z^t)] = 0$$

or in short

$$E_t \{ \beta \lambda(z_{t+1})^{-\gamma} [R_{t+1}^s - R_t] \} = 0$$

Thus the representative agent stochastic discount factor  $\beta \lambda(z_{t+1})^{-\gamma}$  prices the excess return of stocks over bonds in both the Arrow and the Bond model. Note that in the Arrow model (but not in the Bond model) this stochastic discount factor any excess return  $R_{t+1}^i - R_t$  as long as the returns only depend on the aggregate state  $z_{t+1}$ .

- Proof of Proposition 6.1:

From theorem 4.1 we know that in the Arrow model equilibrium prices for Arrow securities are given by:

$$q_t^A(z^t, z_{t+1}) = \frac{\hat{q}_t^A(z^t, z_{t+1})}{\lambda(z_{t+1})} = \frac{\hat{\phi}(z_{t+1})}{\lambda(z_{t+1}) \hat{R}_t^A}$$

whereas in the representative agent model equilibrium prices for Arrow securities are given by:

$$q_t(z^t, z_{t+1}) = \frac{\hat{q}_t(z^t, z_{t+1})}{\lambda(z_{t+1})} = \hat{\beta} \frac{\hat{\phi}(z_{t+1})}{\lambda(z_{t+1})}$$

so that

$$\frac{q_t^A(z^t, z_{t+1})}{q_t(z^t, z_{t+1})} = \frac{1}{\hat{\beta} \hat{R}_t^A} = \frac{\hat{R}^{RE}}{\hat{R}_t^A} = \kappa_t \geq 1 \quad (56)$$

where

$$\hat{R}_t^{RE} = \hat{R}^{RE} = \frac{1}{\sum_{z_{t+1}} \hat{q}_t(z^t, z_{t+1})} = \frac{1}{\sum_{z_{t+1}} \hat{\beta} \hat{\phi}(z_{t+1})} = \frac{1}{\hat{\beta}}$$

is the risk-free interest rate in the de-trended representative agent model. Note that the multiplicative factor  $\kappa_t$  may depend on time since  $\hat{R}_t^A$  may, but is nonstochastic, since  $\hat{R}_t^A = \hat{R}_t$  (the risk-free interest rate in the de-trended Arrow model equals that in the Bewley model, which is evidently nonstochastic). Since interest rates in the Bewley model are (weakly) smaller than in the representative agent model,  $\kappa_t \geq 1$ . Equation (56) implies that the stochastic discount factor in the Arrow model equals the SDF in the representative agent model, multiplied by  $\kappa_t$ :

$$m_{t+1}^A(z^{t+1}) = m_{t+1}^{RE}(z^{t+1}) \kappa_t$$

Finally, since the stochastic discount factor for the Arrow model is also a valid stochastic discount factor in the Bond model (although not necessarily the unique valid stochastic

discount factor), the previous result also applies to the Bond model.

- Proof of Theorem 6.1:

Remember that we defined the multiplicative risk premium in the main text as

$$1 + \nu_t = \frac{E_t R_{t,1} [\{e_{t+k}\}]}{R_{t,1} [1]}$$

We use  $m_{t,t+k} = m_{t+1} \cdot m_{t+2} \dots \cdot m_{t+k}$  to denote the  $k$ -period ahead pricing kernel (with convention that  $m_{t,t} = 1$ ), such that  $E_t(d_{t+k}m_{t,t+k})$  denotes the price at time  $t$  of a random payoff  $d_{t+k}$ . Note that whenever there is no room for confusion we suppress the dependence of variables on  $z^t$ .

First, note that the multiplicative risk premium on a claim to aggregate consumption can be stated as a weighted sum of risk premia on strips (as shown by Alvarez and Jermann (2001)). By definition of  $R_{t,1} [\{e_{t+k}\}]$  we have

$$R_{t,1} [\{e_{t+k}\}] = \frac{\sum_{k=1}^{\infty} E_{t+1} m_{t+1,t+k} \alpha e_{t+k}}{\sum_{k=1}^{\infty} E_t m_{t,t+k} \alpha e_{t+k}} \quad (57)$$

$$= \frac{1}{\sum_{j=1}^{\infty} E_t m_{t,t+j} e_{t+j}} * \sum_{k=1}^{\infty} \frac{E_{t+1} m_{t+1,t+k} e_{t+k}}{E_t m_{t,t+k} e_{t+k}} * E_t m_{t,t+k} e_{t+k} \quad (58)$$

$$= \sum_{k=1}^{\infty} \frac{E_{t+1} m_{t+1,t+k} e_{t+k}}{E_t m_{t,t+k} e_{t+k}} \frac{E_t m_{t,t+k} e_{t+k}}{\sum_{j=1}^{\infty} E_t m_{t,t+j} e_{t+j}} \\ = \sum_{k=1}^{\infty} \omega_k R_{t,1} [e_{t+k}] \quad (59)$$

where the nonrandom weights  $\omega_k$  are given by

$$\omega_k = \frac{E_t m_{t,t+k} e_{t+k}}{\sum_{j=1}^{\infty} E_t m_{t,t+j} e_{t+j}}$$

Thus

$$1 + \nu_t = \frac{E_t R_{t,1} [\{e_{t+k}\}]}{R_{t,1} [1]} = \sum_{k=1}^{\infty} \omega_k \frac{E_t R_{t,1} [e_{t+k}]}{R_{t,1} [1]} \quad (60)$$

and it is sufficient to show that the multiplicative risk premium  $E_t R_{t,1} [e_{t+k}] / R_{t,1} [1]$  on all  $k$ -period strips of aggregate consumption (a claim to the Lucas tree's dividend in period  $k$  only, not the entire stream) is the same in the Arrow model as in the representative agent model. First, we show that the one-period ahead conditional strip risk premia are identical:

$$\frac{E_t \frac{E_{t+1} e_{t+1}}{E_t [m_{t+1}^A e_{t+1}]}}{\frac{1}{E_t [m_{t+1}^A]}} = \frac{E_t \frac{E_{t+1} \lambda_{t+1}}{E_t [m_{t+1}^A \lambda_{t+1}]}}{\frac{1}{E_t [m_{t+1}^A]}} = \frac{E_t \frac{E_{t+1} \lambda_{t+1}}{E_t [m_{t+1}^{RE} \lambda_{t+1}]}}{\frac{1}{E_t [m_{t+1}^{RE}]}}$$

The first equality follows from dividing through by  $e_t$ . The second equality follows from the expression for  $m^A$  in Proposition 6.1:  $m_{t+1}^A = m_{t+1}^{RE} \kappa_t$ .

Next we repeat the argument for the risk premium of a  $k$ -period strip:

$$\frac{E_t R_{t,1}^A [e_{t+k}]}{E_t R_{t,1}^A [1]} = \frac{E_t \frac{E_{t+1}[m_{t+1,t+k}^A e_{t+k}]}{E_t[m_{t,t+k}^A e_{t+k}]}}{\frac{1}{E_t[m_{t+1}^A]}} = \frac{E_t \frac{\kappa_{t+1} \dots \kappa_{t+k-1} E_{t+1}[m_{t+1,t+k}^{RE} e_{t+k}]}{\kappa_t \kappa_{t+1} \dots \kappa_{t+k-1} E_t[m_{t,t+k}^{RE} e_{t+k}]}}{\frac{1}{\kappa_t E_t[m_{t+1}^{RE}]}} = \frac{E_t R_{t,1}^{RE} [e_{t+k}]}{R_{t,1}^{RE} [1]}$$

and thus risk premia on all  $k$ -period consumption strips in the Arrow model coincide with those in the representative agent model. But then (60) implies that the multiplicative risk premium in the two models coincide as well.

- Proof of Lemma 7.1: Absent binding solvency constraints the Euler equation in the Bewley model read as

$$\begin{aligned} 1 &= \frac{\tilde{\beta}_{t+1}}{\tilde{\beta}_t} \hat{R}_t \sum_{y^{t+1}|y^t} \varphi(y_{t+1}|y_t) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} \\ &= \frac{\tilde{\beta}_{t+1}}{\tilde{\beta}_t} \frac{\hat{v}_{t+1} + \alpha}{\hat{v}_t} \sum_{y^{t+1}|y^t} \varphi(y_{t+1}|y_t) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} \end{aligned}$$

while in the Arrow model the Euler equations for Arrow securities are given by

$$1 = \frac{\hat{\beta}(z_t) \hat{\phi}(z_{t+1}|z_t)}{\hat{q}_t(z^t, z_{t+1})} \sum_{y^{t+1}|y^t} \varphi(y_{t+1}|y_t) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))}.$$

With conjectured Arrow securities prices  $\hat{q}_t(z^t, z_{t+1}) = \hat{\beta}(z_t) \hat{\phi}(z_{t+1}|z_t) \frac{1}{\hat{R}_t} \frac{\tilde{\beta}_t}{\tilde{\beta}_{t+1}}$  these equations obviously coincide with the bond Euler equation in the Bewley model, and thus the Bewley equilibrium allocation satisfies the Euler equations for Arrow securities. A similar argument applies to the Euler equation for stocks:

$$\begin{aligned} 1 &= \hat{\beta}(z_t) \sum_{z^{t+1}|z^t} \hat{\phi}(z_{t+1}|z_t) \left[ \frac{\hat{v}_{t+1}(z^{t+1}) + \alpha}{\hat{v}_t(z^t)} \right] \sum_{y^{t+1}|y^t} \varphi(y_{t+1}|y_t) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} \\ &= \frac{\tilde{\beta}_{t+1}}{\tilde{\beta}_t} \hat{R}_t \sum_{y^{t+1}|y^t} \varphi(y_{t+1}|y_t) \frac{u'(\hat{c}_{t+1}(y^t, y_{t+1}))}{u'(\hat{c}_t(y^t))} \end{aligned}$$

The state-contingent interest rate in this model is given by:

$$\frac{1}{\hat{R}_t^A(z_t)} = \hat{\beta}(z_t) \frac{\tilde{\beta}_t}{\hat{R}_t \tilde{\beta}_{t+1}}$$

which can easily be verified from equation (34).

- Proof of Proposition 7.1:

We need to check that Arrow securities positions defined in (37) satisfy the market clearing condition

$$\int \sum_{y^{t-1}} \varphi(y^{t-1}|y_0) \hat{a}_{t-1}(\theta_0, y^{t-1}, z^t) d\Theta_0 = 0 \text{ for all } z^t.$$

for each  $z^t$ . By the goods market clearing condition in the Bewley model we have, since total

labor income makes up a fraction  $1 - \alpha$  of total income

$$\begin{aligned}
& \int \sum_{y^{t-1}} \varphi(y^{t-1}|y_0) (\hat{c}_t(y^t, \theta_0) - \eta(y_t)) d\Theta_0 \\
&= \int \sum_{y^{t-1}} \varphi(y^{t-1}|y_0) \sum_{y^t|y^{t-1}} \varphi(y^t|y^{t-1}) (\hat{c}_t(y^t, \theta_0) - \eta(y_t)) d\Theta_0 \\
&= \sum_{y^t} \varphi(y^t|y_0) (\hat{c}_t(y^t, \theta_0) - \eta(y_t)) d\Theta_0 = \alpha
\end{aligned}$$

Similarly

$$\int \sum_{y^{t-1}} \varphi(y^{t-1}|y_0) \sum_{y^\tau} \varphi(y^\tau|y^t) [\hat{c}_\tau(\theta_0, y^\tau) - \eta(y_\tau)] d\Theta_0 = \alpha \text{ for all } \tau > t$$

Since the stock market clears in the Bewley model we have

$$\int \sum_{y^{t-1}} \varphi(y^{t-1}|y_0) \hat{\sigma}_{t-1}(\theta_0, y^{t-1}) d\Theta_0 = 1.$$

Since the stock is a claim to  $\alpha$  times the aggregate endowment in all future periods its (ex-dividend) price has to satisfy

$$\hat{v}_t(z_t) = \alpha \sum_{\tau=t+1}^{\infty} \sum_{z^\tau} \hat{Q}_\tau(z^\tau|z_t)$$

Combining these results implies that

$$\begin{aligned}
& \int \sum_{y^t} \varphi(y^t|y_0) \hat{a}_{t-1}(\theta_0, y^{t-1}, z^t) d\Theta_0 \\
&= \alpha + \alpha \sum_{\tau=t+1}^{\infty} \sum_{z^\tau} \hat{Q}_\tau(z^\tau|z_t) - 1 \left( \alpha + \alpha \sum_{\tau=t+1}^{\infty} \sum_{z^\tau} \hat{Q}_\tau(z^\tau|z_t) \right) = 0
\end{aligned}$$

for each  $z_t$ . Thus, each of the Arrow securities markets clears if households hold portfolios given by (37).

- Proof of Lemma 7.2:

By (33)

$$\hat{Q}_t(z^t|z_0) = \hat{\phi}(z^t|z_0) \tilde{Q}_t \frac{\hat{\beta}_{0,t-1}(z^{t-1}|z_0)}{\tilde{\beta}_t}$$

and thus

$$\begin{aligned}
\sum_{z^t} \hat{Q}_t(z^t|z_0) &= \frac{\tilde{Q}_t}{\tilde{\beta}_t} \sum_{z^t|z_0} \hat{\phi}(z^t|z_0) \hat{\beta}_{0,t-1}(z^{t-1}|z_0) \\
&= \frac{\tilde{Q}_t}{\tilde{\beta}_t} \sum_{z^t|z^{t-1}} \hat{\phi}(z^t|z^{t-1}) \sum_{z^{t-1}|z_0} \hat{\phi}(z^{t-1}|z_0) \hat{\beta}_{0,t-1}(z^{t-1}|z_0) = \tilde{Q}_t.
\end{aligned}$$

by definition of  $\tilde{\beta}_t$  in equation (31) and the fact that  $\sum_{z^t|z^{t-1}} \hat{\phi}(z^t|z^{t-1}) = 1$ .

- Proof of Lemma 7.3:

The Arrow securities position at time zero needed to finance all future excess consumption mandated by the Bewley equilibrium is given by

$$\begin{aligned} \hat{a}_{-1}(\theta_0, y_0, z_0) &= \hat{c}_0(\theta_0, y_0) - \eta(y_0) + \sum_{\tau=1}^{\infty} \sum_{z^\tau, y^\tau} \hat{Q}_\tau(z^\tau|z_0) (\hat{c}_\tau(\theta_0, y^\tau) - \eta(y_\tau)) \\ &\quad - \hat{\sigma}_0(\theta_0, y_0) [\hat{v}_0(z_0) + \alpha], \end{aligned}$$

where we substituted indexes  $_{-1}$  by 0 to denote initial conditions. In particular,  $\hat{\sigma}_0(\theta_0, y_0)$  is the initial share position of an individual with wealth  $\theta_0$ . But

$$\begin{aligned} &\hat{a}_{-1}(\theta_0, y_0, z_0). \\ &= \hat{c}_0(\theta_0, y_0) - \eta(y_0) + \sum_{\tau=1}^{\infty} \sum_{z^\tau, y^\tau|z_0, y_0} \hat{Q}_\tau(z^\tau|z_0) \varphi(y^\tau|y_0) (\hat{c}_\tau(\theta_0, y^\tau) - \eta(y_\tau)) - \hat{\sigma}_0(\theta_0, y_0) [\hat{v}_0(z_0) + \alpha]. \\ &= \hat{c}_0(\theta_0, y_0) - \eta(y_0) + \sum_{\tau=1}^{\infty} \sum_{y^\tau|y_0} \varphi(y^\tau|y_0) (\hat{c}_\tau(\theta_0, y^\tau) - \eta(y_\tau)) \sum_{z^\tau|z_0} \hat{Q}_\tau(z^\tau|z_0) \\ &\quad - \hat{\sigma}_0(\theta_0, y_0) \alpha \left[ 1 + \sum_{\tau=1}^{\infty} \sum_{z^\tau|z_0} \hat{Q}_\tau(z^\tau|z_0) \right]. \\ &= \hat{c}_0(\theta_0, y_0) - \eta(y_0) + \sum_{\tau=1}^{\infty} \tilde{Q}_\tau \sum_{y^\tau|y_0} \varphi(y^\tau|y_0) (\hat{c}_\tau(\theta_0, y^\tau) - \eta(y_\tau)) - \hat{\sigma}_0(\theta_0, y_0) \alpha \left[ \sum_{\tau=0}^{\infty} \tilde{Q}_\tau \right] \\ &= 0, \end{aligned}$$

where the last equality comes from the intertemporal budget constraint in the standard incomplete markets Bewley model and the fact that the initial share position in that model is given by  $\hat{\sigma}_0(\theta_0, y_0)$ .

- Proof of Proposition 7.2:

The stationary Bewley allocation  $\{\hat{a}_t^B(y^t) = 0, \hat{\sigma}_t(y^t)\}$  satisfies the constraint

$$\frac{\hat{a}_t^B(y^t)}{\hat{R}_t} + \hat{\sigma}_t(y^t) \hat{v}_t \geq \hat{K}_t(y^t). \quad (61)$$

Using the fact that  $\hat{a}_t^B(y^t) = 0$  and adding

$$\sum_{z_{t+1}} \hat{q}_t(z_{t+1}|z_t) \hat{a}_t(y^t, z_{t+1}) + \hat{\sigma}_t(y^t) \hat{v}_t(z_t)$$

to both sides of (61) yields

$$\begin{aligned}
& \sum_{z_{t+1}} \hat{q}_t(z_{t+1}|z_t) \hat{a}_t(y^t, z_{t+1}) + \hat{\sigma}_t(y^t) \hat{v}_t(z_t) \\
& \geq \hat{K}_t(y^t) + \sum_{z_{t+1}} \hat{q}_t(z_{t+1}|z_t) \hat{a}_t(y^t, z_{t+1}) + \hat{\sigma}_t(y^t) [\hat{v}_t(z_t) - \hat{v}_t] \\
& \equiv \hat{K}_t^*(y^t, z_t)
\end{aligned}$$

where  $\hat{K}_t^*(y^t)$  is the modified constraint for the de-trended Arrow model. Multiplying both sides by  $e_t(z^t)$  gives the modified constraint for the Arrow model with growth stated in the main text. For the alternative constraint, we know that the Bewley equilibrium allocation satisfies

$$\hat{a}_t^B(y^t) + \hat{\sigma}_t(y^t) [\hat{v}_{t+1} + \alpha] \geq \hat{M}_t(y^t). \quad (62)$$

Again using  $\hat{a}_t^B(y^t) = 0$  and adding

$$\hat{a}_t(y^t, z_{t+1}) + \hat{\sigma}_t(y^t) [\hat{v}_{t+1}(z_{t+1}) + \alpha]$$

to both sides of (61) yields

$$\begin{aligned}
& \hat{a}_t(y^t, z_{t+1}) + \hat{\sigma}_t(y^t) [\hat{v}_{t+1}(z_{t+1}) + \alpha] \\
& \geq \hat{M}_t(y^t) + \hat{a}_t(y^t, z_{t+1}) + \hat{\sigma}_t(y^t) [\hat{v}_{t+1}(z_{t+1}) - \hat{v}_{t+1}] \\
& \equiv \hat{M}_t^*(y^t, z_{t+1})
\end{aligned}$$

Multiplying both sides by  $e_{t+1}(z^{t+1})$  again gives rise to the constraint stated in the main text.

## C Separate Appendix

### C.1 Representative Agent Model

The budget constraint of the representative agent who consumes aggregate consumption  $c_t(z^t)$  reads as

$$\begin{aligned} & c_t(z^t) + \sum_{z_{t+1}} a_t(z^t, z_{t+1}) q_t(z^t, z_{t+1}) + \sigma_t(z^t) v_t(z^t) \\ & \leq e_t(z^t) + a_{t-1}(z^{t-1}, z_t) + \sigma_{t-1}(z^{t-1}) [v_t(z^t) + \alpha e_t(z_t)] \end{aligned}$$

After deflating by the aggregate endowment  $e_t(z^t)$ , the budget constraint reads as

$$\begin{aligned} & \hat{c}_t(z^t) + \sum_{z_{t+1}} \hat{a}_t(z^t, z_{t+1}) \hat{q}_t(z^t, z_{t+1}) + \sigma_t(z^t) \hat{v}_t(z^t) \\ & \leq 1 + \hat{a}_{t-1}(z^{t-1}, z_t) + \sigma_{t-1}(z^{t-1}) [\hat{v}_t(z^t) + \alpha], \end{aligned}$$

where  $\hat{a}_t(z^t, z_{t+1}) = \frac{a_t(z^t, z_{t+1})}{e_{t+1}(z^{t+1})}$  and  $\hat{q}_t(z^t, z_{t+1}) = q_t(z^t, z_{t+1}) \lambda(z_{t+1})$  as well as  $\hat{v}_t(z^t) = \frac{v_t(z^t)}{e_t(z^t)}$ , precisely as in the Arrow model. Obviously, in an equilibrium of this model the representative agent consumes the aggregate endowment. The next (well-known) lemma follows directly from the household Euler equations and the definitions of  $\hat{\beta}$ ,  $\hat{\phi}$ ,  $\hat{q}$  and  $\hat{v}$ .

**Lemma C.1.** *Equilibrium asset prices are given by*

$$\begin{aligned} \hat{q}_t(z^t, z_{t+1}) &= \hat{\beta} \hat{\phi}(z_{t+1}) = \hat{q}(z_{t+1}) \text{ for all } z_{t+1}. \\ \hat{v}_t(z^t) &= \hat{\beta} \sum_{z_{t+1}} \hat{\phi}(z_{t+1}) [\hat{v}_{t+1}(z^{t+1}) + \alpha]. \end{aligned}$$

### C.2 Recursive Utility

We consider the class of preferences due to Epstein and Zin (1989). Let  $V(c^i)$  denote the utility derived from consuming  $c^i$ :

$$V(c^i) = \left[ (1 - \beta) c_t^{1-\rho} + \beta (\mathcal{R}_t V_1)^{1-\rho} \right]^{\frac{1}{1-\rho}},$$

where the risk-adjusted expectation operator is defined as:

$$\mathcal{R}_t V_{t+1} = (E_t V_{t+1}^{1-\alpha})^{1/1-\alpha}.$$

$\alpha$  governs risk aversion and  $\rho$  governs the willingness to substitute consumption intertemporally. These preferences impute a concern for the timing of the resolution of uncertainty to agents. In the special case where  $\rho = \frac{1}{\alpha}$ , these preferences collapse to standard power utility preferences with CRRA coefficient  $\alpha$ . As before, we can define *growth-adjusted* probabilities and the growth-adjusted

discount factor as:

$$\hat{\pi}(s_{t+1}|s_t) = \frac{\pi(s_{t+1}|s_t)\lambda(z_{t+1})^{1-\alpha}}{\sum_{s_{t+1}} \pi(s_{t+1}|s_t)\lambda(z_{t+1})^{1-\alpha}} .$$

$$\text{and } \hat{\beta}(s_t) = \beta \left( \sum_{s_{t+1}} \pi(s_{t+1}|s_t)\lambda(z_{t+1})^{1-\alpha} \right)^{\frac{1-\rho}{1-\alpha}} .$$

As before,  $\hat{\beta}(s_t)$  is stochastic as long as the original Markov process is not *iid* over time. Note that the adjustment of the discount rate is affected by both  $\rho$  and  $\alpha$ . If  $\rho = \frac{1}{\alpha}$ , this transformation reduces to the case we discussed in section (2).

Finally, let  $\hat{V}_t(\hat{c})(s^t)$  denote the lifetime expected continuation utility in node  $s^t$ , under the new transition probabilities and discount factor, defined over consumption shares  $\{\hat{c}_t(s^t)\}$  :

$$\hat{V}_t(\hat{c})(s^t) = \left[ (1 - \beta)\hat{c}_t^{1-\rho} + \hat{\beta}(s_t)(\hat{\mathcal{R}}_t \hat{V}_{t+1}(s^{t+1}))^{1-\rho} \right]^{\frac{1}{1-\rho}} ,$$

where  $\hat{\mathcal{R}}$  denotes the following operator:

$$\hat{\mathcal{R}}_t V_{t+1} = \left( \hat{E}_t \hat{V}_{t+1}^{1-\alpha} \right)^{1/1-\alpha} .$$

and  $\hat{E}$  denotes the expectation operator under the hatted measure  $\hat{\pi}$ .

**Proposition C.1.** *Households rank consumption share allocations in the de-trended model in exactly the same way as they rank the corresponding consumption allocations in the original growing model: for any  $s^t$  and any two consumption allocations  $c, c'$*

$$V(c)(s^t) \geq V(c')(s^t) \iff \hat{V}(\hat{c})(s^t) \geq \hat{V}(\hat{c}')(s^t),$$

where the transformation of consumption into consumption shares is given by (4).

**Detrended Arrow Model** We proceed as before, by conjecturing that the equilibrium consumption shares only depend on  $y^t$ . Our first result states that if the consumption shares in the de-trended model do not depend on the aggregate history  $z^t$ , then it follows that the interest rates in this model are deterministic.

**Proposition C.2.** *In the de-trended Arrow model, if there exists a competitive equilibrium with equilibrium consumption allocations  $\{\hat{c}_t(\theta_0, y^t)\}$ , then there is a deterministic interest rate process  $\{\hat{R}_t^A\}$  and equilibrium prices  $\{\hat{q}_t(z^t, z_{t+1})\}$ , that satisfy:*

$$\hat{q}_t(z^t, z_{t+1}) = \frac{\hat{\phi}(z_{t+1})}{\hat{R}_t^A} . \tag{63}$$

All the results basically go through. We can map an equilibrium of the Bewley model into an equilibrium of the detrended Arrow model. The proof of the next result follows directly from this proposition and uses exactly the same steps as the proofs of Theorems 4.1 and 5.1.

**Theorem C.1.** *An equilibrium of the Bewley model  $\{\hat{c}_t(\theta_0, y^t), \hat{a}_t(\theta_0, y^t), \hat{\sigma}_t(\theta_0, y^t)\}$  and  $\{\hat{R}_t, \hat{v}_t\}$  can be made into an equilibrium for the Arrow model with growth,  $\{a_t(\theta_0, s^t, z_{t+1})\}$ ,  $\{\sigma_t(\theta_0, s^t)\}$ ,  $\{c_t(\theta_0, s^t)\}$  and  $\{q_t(z^t, z_{t+1})\}$ ,  $\{v_t(z^t)\}$ , with*

$$\begin{aligned} c_t(\theta_0, s^t) &= \hat{c}_t(\theta_0, y^t) e_t(z^t) \\ \sigma_t(\theta_0, s^t) &= \hat{\sigma}_t(\theta_0, y^t) \\ a_t(\theta_0, s^t, z_{t+1}) &= \hat{a}_t(\theta_0, y^t) e_{t+1}(z^{t+1}) \\ v_t(z^t) &= \hat{v}_t e_t(z^t) \\ q_t(z^t, z_{t+1}) &= \frac{1}{\hat{R}_t} * \frac{\phi(z_{t+1}) \lambda(z_{t+1})^{-\alpha}}{\sum_{z_{t+1}} \phi(z_{t+1}) \lambda(z_{t+1})^{1-\alpha}} \end{aligned}$$

As a result, even for a model with agents who have these Epstein-Zin preferences, the risk premium is not affected.

- **Proof of Proposition C.1:** First, we divided through by  $e_t(z^t)$  on both sides in equation (C.2):

$$\begin{aligned} \frac{V_t(s^t)}{e_t(z^t)} &= \left[ (1 - \beta) \frac{c_t^{1-\rho}}{e_t^{1-\rho}} + \beta \frac{(\mathcal{R}_t V_{t+1})^{1-\rho}}{e_t^{1-\rho}} \right]^{\frac{1}{1-\rho}} \\ \hat{V}_t(s^t) &= \left[ (1 - \beta) \hat{c}_t^{1-\rho} + \beta \left( \frac{\mathcal{R}_t V_{t+1}}{e_t} \right)^{1-\rho} \right]^{\frac{1}{1-\rho}}. \end{aligned} \quad (64)$$

Note that the risk-adjusted continuation utility can be stated as:

$$\begin{aligned} \frac{\mathcal{R}_t V_{t+1}}{e_t(z^t)} &= \left( E_t \left( \frac{e_{t+1}}{e_t} \right)^{1-\alpha} \frac{V_{t+1}^{1-\alpha}}{e_{t+1}^{1-\alpha}} \right)^{1/1-\alpha} \\ &= \left( \sum_{s_{t+1}} \pi(s_{t+1}|s_t) \lambda(z_{t+1})^{1-\alpha} \hat{V}_{t+1}^{1-\alpha}(s_{t+1}) \right)^{1/1-\alpha} \end{aligned}$$

Next, we define growth-adjusted probabilities and the growth-adjusted discount factor as:

$$\hat{\pi}(s_{t+1}|s_t) = \frac{\pi(s_{t+1}|s_t) \lambda(z_{t+1})^{1-\alpha}}{\sum_{s_{t+1}} \pi(s_{t+1}|s_t) \lambda(z_{t+1})^{1-\alpha}} \text{ and } \hat{\beta}(s_t) = \beta \sum_{s_{t+1}} \pi(s_{t+1}|s_t) \lambda(z_{t+1})^{1-\alpha}.$$

and note that:

$$\begin{aligned} \frac{\mathcal{R}_t V_{t+1}}{e_t(z^t)} &= \left( \sum_{s_{t+1}} \pi(s_{t+1}|s_t) \lambda(z_{t+1})^{1-\alpha} \hat{V}_{t+1}^{1-\alpha}(s_{t+1}) \right)^{1/1-\alpha} \\ &= \left( \sum_{s_{t+1}} \pi(s_{t+1}|s_t) \lambda(z_{t+1})^{1-\alpha} \right)^{1/1-\alpha} \hat{\mathcal{R}}_t \hat{V}_{t+1}(s_{t+1}) \end{aligned}$$

Using the definition of  $\hat{\beta}(s_t)$  :

$$\hat{\beta}(s_t) = \beta \left( \sum_{s_{t+1}} \pi(s_{t+1}|s_t) \lambda(z_{t+1})^{1-\alpha} \right)^{\frac{1-\rho}{1-\alpha}},$$

we finally obtain the desired result:

$$\hat{V}_t(s^t) = \left[ (1 - \beta) \hat{c}_t^{1-\rho} + \hat{\beta}(s_t) (\hat{\mathcal{R}}_t \hat{V}_{t+1}(s^{t+1}))^{1-\rho} \right]^{\frac{1}{1-\rho}}$$

As before, if the  $z$  shocks are ii.d, then  $\hat{\beta}$  is constant.

• Proof of Proposition C.2:

First, we suppose the borrowing constraints are not binding, which is the easiest case. Assume the equilibrium allocations only depend on  $y^t$ , not on  $z^t$ . Then conditions 2.2 and 2.3 imply that the Euler equations of the Arrow economy, for the contingent claim and the stock respectively, read as follows:

$$\begin{aligned} 1 &= \frac{\hat{\beta} \hat{\phi}(z_{t+1})}{\hat{q}_t(z^t, z_{t+1})} \sum_{y_{t+1}} \varphi(y_{t+1}|y_t) \left( \frac{\hat{c}_{t+1}(y^t, y_{t+1})}{\hat{c}_t(y^t)} \right)^{-\rho} \left( \frac{\hat{V}_{t+1}(y^{t+1})}{\hat{V}_t(y^t)} \right)^{\rho-\alpha} \quad \forall z_{t+1} \\ 1 &= \hat{\beta} \sum_{z_{t+1}} \hat{\phi}(z_{t+1}) \left[ \frac{\hat{v}_{t+1}(z^{t+1}) + \alpha}{\hat{v}_t(z^t)} \right] \end{aligned} \quad (65)$$

$$* \sum_{y_{t+1}} \varphi(y_{t+1}|y_t) \left( \frac{\hat{c}_{t+1}(y^t, y_{t+1})}{\hat{c}_t(y^t)} \right)^{-\rho} \left( \frac{\hat{V}_{t+1}(y^{t+1})}{\hat{V}_t(y^t)} \right)^{\rho-\alpha} \quad \text{for all } z_{t+1}. \quad (66)$$

In the first Euler equation, the only part that depends on  $z_{t+1}$  is  $\frac{\hat{\phi}(z_{t+1})}{\hat{q}_t(z^t, z_{t+1})}$  which therefore implies that  $\frac{\hat{\phi}(z_{t+1})}{\hat{q}_t(z^t, z_{t+1})}$  cannot depend on  $z_{t+1}$  :  $\hat{q}_t(z^t, z_{t+1})$  is proportional to  $\hat{\phi}(z_{t+1})$ . Thus define  $\hat{R}_t^A(z^t)$  by

$$\hat{q}_t(z^t, z_{t+1}) = \frac{\hat{\phi}(z_{t+1})}{\hat{R}_t^A(z^t)} \quad (67)$$

as the risk-free interest rate in the stationary Arrow economy. Using this condition, the Euler equation simplifies to the following expression:

$$1 = \hat{\beta} \hat{R}_t^A(z^t) \sum_{y_{t+1}} \varphi(y_{t+1}|y_t) \left( \frac{\hat{c}_{t+1}(y^t, y_{t+1})}{\hat{c}_t(y^t)} \right)^{-\rho} \quad (68)$$

$$\left( \frac{\hat{V}_{t+1}(y^{t+1})}{\hat{V}_t(y^t)} \right)^{\rho-\alpha} \quad (69)$$

Apart from  $\hat{R}_t^A(z^t)$  noting in this condition depends on  $z^t$ , so we can choose  $\hat{R}_t^A(z^t) = \hat{R}_t^A$ .