

ASSET RETURNS WITH TRANSACTIONS COSTS
AND UNINSURED INDIVIDUAL RISK: A STAGE III EXERCISE

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ABSTRACT

We attempt to construct models that are consistent with the following features of asset returns and turnover in the post-war U.S. economy: (i) The risk free real interest rate is very low. (ii) There is a large spread between returns on liquid assets (government debt and liquid accounts at depository institutions and money market funds) and stocks. (iii) Transaction velocities are much higher for liquid assets than for stocks. Specifically, we explore the extent to which incorporating an explicit motive for holding liquid assets can explain the above observations. We introduce a demand for liquid assets by adding uninsured individual risk together with differential costs of trading securities. We then parameterize a class of such models and compute the stationary equilibria. The simulations indicate that attempting to match the return data generates a ratio of liquid assets to income considerably below observed levels. We then explore some possible reasons for this discrepancy.

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