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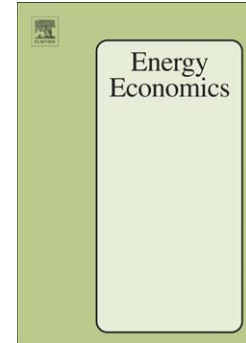
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Habit Formation and Exhaustible Resource Risk-Pricing^{*}

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Abstract

This paper studies the risk-pricing implications of introducing habit formation in consumption in a model that encompasses growth with nonrenewable resources and capital markets. It is shown that the expected return on nonrenewable resource stocks incorporates both short-run and long-run risk factors. The short-run risk factor is associated with shocks to current surplus consumption growth. The long-run risk factor reflects the investor's desire to hedge against long-run shocks to future surplus consumption prospects (long-run habit risk premium). The model is tested using energy commodities index and US aggregate real per capita consumption data, and the results confirm that habit enters significantly in the pricing equation by entertaining a long-run time-varying risk coefficient. Compared to results obtained with a no-habit formation model (time-separable preferences), we found that long-run future prospects of surplus consumption constitute a forward-looking risk factor to be taken into account in explaining the dynamics of energy prices under uncertainty.

Keywords: Habit Formation, Exhaustible Resource, Risk Pricing, Short-run Risk, Long-run Risk, Energy Prices.

JEL Classification: Q30, G12, Q4, C52

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