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Robert J. Barro , José F. Ursúa

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Stock-Market Crashes and Depressions

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Robert J. Barro
(Harvard University)

José F. Ursúa
(Dodge & Cox)

Abstract

Stock-market crashes are informative about the prospects for macroeconomic depressions. Long-term data for 30 countries reveal that, conditional on a crash, the probability of a minor depression is 31 percent and of a major depression is 10 percent. The largest depressions are particularly likely to be accompanied by crashes. We allow for flexible timing between crashes and depressions to compute the covariance between stock-returns and an asset-pricing factor, which depends on the decline of consumption during a depression. With a coefficient of relative risk aversion around 3.5, this covariance accounts for the observed average (levered) equity premium of 7 percent.

* This paper was originally written in 2009, in the midst of the Global Financial Crisis.

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