A New Solution to the Equity Premium Puzzle and the Risk-Free Rate Puzzle: Theory and Evidence

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Abstract

The method for solving the equity premium puzzle in accordance with Mehra and Prescott (1985) needs to be simultaneously consistent with the method for solving the risk-free rate puzzle presented by Weil (1989). That is, the reasonable estimated values for the degree of relative risk aversion in the former solution and for the subjective discount rate in the latter solution need to be plausibly within the experiential bounds. This report indicates that a consistent solution is possible for the equity premium and risk-free rate puzzles even when there is a standard CRRA type utility function. This is possible by formularization of the Euler equation for consumption, taking into account the precautionary saving effect based on Skinner's (1988) expected marginal utility model.

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