

# Financial Crises and Risk Premia

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## Abstract

I analyze the behavior of risk premia in financial crises, wars, and recessions in an international panel spanning over 140 years and 14 countries. I document that expected returns, or risk premia, increase substantially in financial crises, but not in the other episodes. Asset prices decline in all episodes, but the decline in financial crises is substantially larger than the decline in fundamentals so that expected returns going forward are large. However, drops in consumption and consumption volatility are fairly similar across financial crises and recessions and are largest during wars, so asset pricing models based on aggregate consumption have trouble matching these facts. Comparing crises to “deep” recessions strengthens these findings further. By disentangling financial crises from other bad macroeconomic times, the results suggest that financial crises are particularly important to understanding why risk premia vary. I discuss implications for theory more broadly and discuss both rational and behavioral models that are consistent with the facts. Theories where asset prices are related to the health of the financial sector appear particularly promising.

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