

Implications of Keeping up with the Joneses Behavior for the Equilibrium Cross Section of Stock Returns: International Evidence*

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ABSTRACT

This paper tests the cross-section implications of “keeping up with the Joneses” (KUJ) preferences in an international setting. When agents have KUJ preferences, in the presence of un-diversifiable non-financial wealth, both world and domestic risk (the idiosyncratic component of domestic wealth) are priced, and the equilibrium price of risk of the domestic factor is *negative*. We use labor income as a proxy for domestic wealth and find empirical support for these predictions. Our test includes securities from the US, UK, Japan and Germany. In terms of explaining the cross-section of stocks returns and the size of the pricing errors, the model based on relative wealth concerns performs better than alternative international asset pricing models.

JEL Codes: G15, G12, G11.

Keywords: Keeping up with the Joneses, restricted market participation, international asset pricing, local risk, global risk.

*Gómez and Zapatero thank the Spanish MICINN for their generous support through research project number ECO2008-02333-RWC. We thank Limei Che and Dmitri Kantsyrev for excellent research assistance. Many helpful comments and suggestions from an anonymous referee are gratefully acknowledged. We also thank Ilan Cooper, Peter DeMarzo, Valery Polkovnichenko, Rosa Rodríguez, Sergei Sarkissian, Tano Santos, Lucie Tepla, Raman Uppal, Robert Stambaugh (the Editor) and Madhu Veeraraghavan for helpful comments. We would especially like to thank John Griffin who generously provided us with the Datastream codes to collect the stock return data in the UK, Japan and Germany. The usual caveat applies.

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In this paper we test the implications of an international asset pricing model where agents have preferences exogenously defined over their own consumption as well as the contemporaneous average consumption of a reference group, defined in this paper as the agent's countrymen. These preferences are termed "keeping up with the Joneses."

In the absence of frictions, utility based on keeping up with the Joneses preferences yields the symmetric equilibrium described in Galí (1994), in which all agents hold the same global portfolio, and the Joneses behavior translates into a lower price of risk on the single systematic risk factor. We consider two different specifications that incorporate frictions. The first is the case of standard keeping up with the Joneses preferences, in which agents' marginal utility of consumption increases with the aggregate consumption of their neighbors (as in Abel 1990, and Galí 1994), but where some agents do not have access to financial markets. We will call this first specification of the problem *exogenous* keeping up with the Joneses preferences, since the concern for other agents' wealth is directly imposed in the utility function. Our second specification considers a friction in which all agents care about two different goods, a global good and a local good, but the local good is in short supply; in this case, agents optimally take into consideration the wealth of their neighbors because of the effect it might have on the price of the good in limited supply. We call this specification *endogenous* keeping up with the Joneses preferences, since the concern about the neighbors' wealth arises as an equilibrium result. This model is developed in DeMarzo, Kaniel and Kremer (2004).

These two specifications -exogenous and endogenous- of the keeping up with the Joneses preferences have the following implications in an international setting. First, portfolio

holdings of the representative investor of each country differ across countries, as shown in DeMarzo, Kaniel and Kremer (2004); second, in equilibrium, an approximate multi-beta linear factor model arises where, together with the global systematic risk factor, there is an additional systematic risk factor per country which commands a negative price of risk.

The keeping up with the Joneses effect gives rise to negative prices of risk on the country specific factors because investors require a premium for holding stocks with no, or negative, correlation with the non-hedgeable labor or entrepreneurial income (generally foreign stocks). Symmetrically, investors are willing to pay a premium for those stocks which will have a stronger correlation with the un-hedgeable risk of the Joneses (presumably, domestic stocks) since it is these stocks that keep them up with the Joneses. We find empirical support for this prediction, and hence keeping up with the Joneses behavior in the presence of a constraint on some agents. Note that the model's predictions and the empirical results are in contrast to those that are predicted by models of partial integration which suggests a positive price of risk on the local risk factor (see Errunza and Losq (1985)).

Our paper differs from DeMarzo, Kaniel and Kremer (2004) in three main respects. First, we derive the implications of keeping up with the Joneses behavior for the equilibrium cross section of asset returns. Consistent with the results on portfolio choice in their paper, we show that, qualitatively, the asset pricing predictions are the same whether keeping up with the Joneses behavior is exogenous or endogenous. Second, we test empirically the asset pricing implications of keeping up with the Joneses preferences,

whether exogenous or endogenous. Third, although our tests do not allow us to quantify the relative impact of endogenous versus exogenous Joneses, we can assess whether each model in isolation is supported by the data.

To test the asset pricing implications of keeping up with the Joneses preferences we need to proxy for the non-diversifiable income of the reference group (the “Joneses”), whether in the exogenous or endogenous specifications. Due to moral hazard and country specific regulation, human capital (measured by income from labor) is, arguably, the most obvious non-financial, non-tradable asset. Moreover, it represents the largest fraction in the individuals personal income across countries. For instance, Baxter and Jermann (1997) point out that, in the US, labor’s share in national income is about 60%. In a recent paper, Gollin (2002) corrects the estimates for labor income share in total national income by including the income of the self-employed (like our entrepreneurs). After this correction, labor income share is in the range of 65% to 85% for most countries.

We test the asset pricing implications of both exogenous and endogenous keeping up with the Joneses preferences using stock returns from Germany, Japan, the UK and the US. We undertake two types of empirical tests. First, we form portfolios of stocks according to size and, following the suggestions in Daniel and Titman (2005) and Lewellen, Nagel, and Shanken (2006), according to size and the lagged loadings of individual stock returns on the measure of country specific non-diversifiable income. Cross sectional regressions of average stock returns of these portfolios on the models’ factors confirm the predictions that the estimated prices of risk on the country specific factors are negative. The model can explain a reasonable amount of the cross sectional variation in interna-

tional stock returns and on this metric performs better than various other international asset pricing models that use currency risk, macroeconomic risk factors, and the Fama and French (1998) international HML risk factor. Formal analysis of the performance of the model is undertaken by assessing the pricing errors. The pricing errors are smaller than, or similar to, those from other international asset pricing models, lending further support to the role of keeping-up-with-the-Joneses behavior.

The second test is undertaken in order to provide a robustness analysis of the portfolio formation techniques and the two step estimation methodology. Instead of forming portfolios of stock returns, we take randomly chosen individual stock returns from Germany, Japan, the UK and the US and estimate the model parameters using non-linear seemingly unrelated regressions (NLSUR). The simultaneous estimation of betas and prices of risk removes the errors in variables problem inherent in the Fama and MacBeth (1973) two step procedure. Therefore, portfolios do not need to be formed and, consequently, the critique of asset pricing tests raised by Daniel and Titman (2005) and Lewellen, Nagel, and Shanken (2006) that stems from portfolio formation is no longer a concern.¹ Using this methodology we find further support for the model's predictions.

The empirical results support the joint hypothesis of un-diversifiable, non-financial income and relative wealth considerations across agents. As a final piece of analysis, given the estimated prices of risk for the (country-specific) risk factors, we back out the implied Joneses parameter for the exogenous model, the market weighted risk aversion coefficient

¹Burmeister and McElroy (1988) and Elton, Gruber, and Blake (1995) both use joint estimation methods to test asset pricing models. Lewellen, Nagel, and Shanken (2006) suggest that the use of individual securities in tests of asset pricing models would eliminate the problems caused by portfolio formation based on, for example, size and book-to-market.

and the implied risk aversion coefficient, for both the exogenous and endogenous model's representative agent in each country.² We perform this exercise for two different values of the relative (as a percentage of the country's total output) un-diversifiable, non-financial income in each country: including and omitting the income of the self-employed. We take the prices of risk from the model estimated using portfolios as well as individual securities. For all countries, the inferred (exogenous) Joneses parameter is very high and lies within the admissible range according to the model (greater than zero and strictly smaller than one). The market weighted risk aversion coefficient is reasonable both using portfolios and individual securities. Looking at the risk aversion coefficients for the representative agents, in the case of the endogenous Joneses, the implied risk-aversion coefficient is always negative, clearly inadmissible. In contrast, in equilibrium, the implied risk aversion coefficient in the presence of exogenous Joneses behavior takes economically meaningful values for all countries.

The paper is organized as follows. In section 2 we discuss the related literature. We introduce the model and derive its testable implications in section 3. Section 4 presents the data. The main empirical results are reported in section 5. In section 6 we compute the "keeping up with the Joneses" parameter using our estimated prices of risk. Section 7 offers some conclusions.

²For the exogenous Joneses model we need to assume a common risk aversion coefficient across countries.

I. Related literature

To our knowledge this is the first paper to consider and test the asset pricing implications of “keeping up with the Joneses” preferences in an international setting. There are two papers that are related to ours. First, Lauterbach and Reisman (2004) also derive a multi-factor asset pricing model in the presence of keeping up with the Joneses behavior. However, their model does not explain how these factors arise in equilibrium. More importantly, they do not specify how to test the model and neither do they perform any empirical work. Second, Shore and White (2002) study and calibrate an international model with Joneses preferences. They concentrate on portfolio holdings and do not include any empirical test of the asset pricing implications.

Within a purely domestic setting, keeping-up with the Joneses has been discussed in Galí (1994) and Abel (1999). “Catching up with the Joneses” preferences (where past, rather than contemporaneous, consumption of the Joneses is the benchmark) have been used in Abel (1990), Ferson and Constantinides (1991), Campbell and Cochrane (1999), Boldrin, Christiano and Fisher (2001) and Chan and Kogan (2002), as a possible explanation of the equity risk premium puzzle. Chen and Ludvigson (2005) find that a model with habit persistence preference is helpful in explaining the cross-section of US stock returns. Head and Smith (2003) consider Joneses preferences, among others, in their attempt to explain interest rate persistence for a cross-section of countries. Ravina (2005) finds evidence that supports keeping up with the Joneses behavior using micro data in the US. Gómez (2007) shows how, in the presence of non-diversifiable income,

keeping up with the Joneses behavior may yield biased portfolios in equilibrium.

Our paper is also related to the empirical literature on asset pricing under limited market participation in that we assume the existence of non-diversifiable, non-financial income which may include labor income (see, for example, Campbell (2000) and Haliassos and Michaelides (2002)) and entrepreneurial income (see, for example, Heaton and Lucas (2000) and Polkovnichenko (2004)). Since our primary objective is to study implications of keeping up with the Joneses behavior in the cross-section of stock returns, we isolate the Joneses effect by assuming first, all non-tradable income is in the hands of the workers and second, workers cannot invest in any financial asset. In other words, absent any relative wealth effect via endogenous or exogenous keeping up with the Joneses behavior, there is no impact of limited market participation on the equilibrium asset prices.³

Regarding the first assumption, it is arguable that investors with access to financial markets could be endowed with non-tradable assets. This would result in an additional hedging demand on the side of the investors. Viceira (2001) and Cocco, Gomes and Maenhout (2005) study this problem. Notice that the effect we would expect from this *direct* hedging demand for non-financial income would be the opposite to the *indirect* effect resulting from keeping up with the Joneses preferences: assets positively correlated with the investor's non-diversifiable income would be "crowded-out" from the optimal portfolio (whereas, in the case of keeping up with the Joneses preferences, the investor's demand for these assets increases). Hence, investors would demand a higher expected return to hold these assets (contrary to the negative price of risk for the country risk

³The price of non-diversifiable wealth endowments is determined by market clearing in the corresponding spot markets.

factors resulting from keeping up with the Joneses preferences).

With respect to the second assumption, other models like Basak and Cuoco (1998), Polkovnichenko (2004) and Gomes and Michaelides (2007) allow the constrained agents to invest in bonds. This simplification could affect qualitatively our results only if bonds provided country-specific risk-hedging for the workers non-diversifiable income. However, agents endowed with labor or entrepreneurial income are likely to face short-selling constraints. Moreover, as mentioned in DeMarzo, Kaniel and Kremer (2004), moral hazard concerns will prevent workers from borrowing against their future non-diversifiable income.

Our results are also related to the literature on international asset pricing. Empirically it appears that domestic asset pricing models are able to price local assets more accurately than international models, and international asset pricing models can be improved upon if domestic factors are also included. For example, Cho, Eun and Senbet (1986) reject the international APT (see also Gultekin, Gultekin and Penati (1989), and Korajczyk and Viallet (1989)). King, Sentana, and Wadhawani (1994) find that local risk is priced in an international multi factor model. Griffin (2002) claims that the world book-to-market factor is a proxy for a domestic factor. Chan, Karolyi and Stulz (1992) find support for the role of domestic factors in a conditional version of the International CAPM. Harvey (1991) finds that the international CAPM is rejected for developed markets and Dumas, Harvey and Ruiz (2003) reject market integration for 12 developed OECD countries. For developed markets such as those considered in this paper, models of partial integration should be becoming less important because various restrictions that investors faced in

the past no longer apply. In this paper we identify a specific domestic risk factor that results from keeping up with the Joneses preferences within the framework of complete market integration. The empirical tests show that these preferences have a strong effect on asset prices within an international context. Thus, our finding that local factors are important is consistent with the earlier puzzling rejections of asset pricing models of full market integration even for countries where there are no barriers to trade.

Finally, we mention other asset pricing papers based on non-standard preferences. Among the most influential are Campbell and Cochrane (1999), who consider habit formation, but with complete, frictionless markets. Also, Bansal and Yaron (2004) use recursive preferences to develop a model with two factors, aggregate consumption and aggregate wealth, which are priced. Another recent related equilibrium model is DeMarzo, Kaniel and Kramer (2006), who show how market incompleteness can lead to relative wealth concerns and generate financial bubbles when the investors are willing to pay a premium for securities that align their income with that of their cohort.

II. Implications of keeping up with the Joneses preferences

In this section we study the equilibrium consequences of an economy populated by agents with keeping up with the Joneses preferences. We consider the two main specifications discussed in the literature: exogenous and endogenous keeping up with the Joneses preferences.

In both specifications, we assume a one-period economy with two countries, $k \in \{l, f\}$. In each country there is a local firm. At time $t = 0$, each firm issues one share that will

yield a random payoff in time $t = 1$. We normalize the initial value of the firm to 1. Let r_k denote the random excess return on a share of firm k . The vector $r = (r_l, r_f)'$ has a joint distribution function $F(r)$. Firm shares in both countries can be freely traded overseas. There is also a risk-free bond in zero net supply. Let R denote the return on the risk-free bond. Financial markets are assumed to be complete.

In each country there are two types of agents: “investors” and “workers.”

A. Exogenous keeping up with the Joneses preferences

In this subsection we analyze the implications of a version of the keeping up with the Joneses preferences of Abel (1990) and Galí (1994). In particular, in the economy we consider investors are endowed with an utility function⁴

$$u(c, C) = \frac{c^{(1-\alpha)}}{1-\alpha} C^{\gamma\alpha}, \quad (1)$$

where c denotes the investor’s consumption of the single consumption good, the economy’s numeraire; C is the country average or per capita consumption; $\alpha > 0$ is the (constant) relative risk-aversion coefficient and $1 > \gamma \geq 0$ is the “Joneses parameter.” For $\gamma > 0$, the constant average consumption elasticity of marginal utility (around the symmetric equilibrium), $\alpha\gamma$, is positive as well: increasing the average consumption per capita C makes the individual’s marginal consumption more valuable since it helps her to “keep up with the Joneses.” In short, we assume the country average consumption to be a positive consumption externality. By imposing $\gamma < 1$ we ensure a positive risk-aversion

⁴To simplify the notation, we drop the country subindex k for the moment (thus, all variables to be introduced next apply to investors in either country).

coefficient for the representative investor, as it will become clear in the next section.⁵

Here, workers represent agents endowed with non-tradable assets. For instance, their human capital, that will materialize into wage income, or entrepreneurial income. Call w_k^0 the initial aggregate endowment of non-financial wealth for workers in country k ; w_k denotes the final ($t = 1$) random value of their non-tradable income. Workers face incomplete markets because they cannot trade their human capital (due to moral hazard issues) and have no access to financial markets; therefore, they cannot hedge their income risk.

Since each investor takes C as exogenous and common, the typical aggregation property of the CRRA utility functions allows us to replace all the investors in a given country by a representative investor with utility function (1) endowed with the aggregated investors income without affecting the equilibrium prices. At time $t = 0$ each representative investor is endowed with a share of the local firm (unit value by assumption); hence, $c^0 = 1$ in both countries.

The representative investor solves the following optimal portfolio problem:

$$\begin{aligned} x^* &= \operatorname{argmax}_x E u(c, C) \\ \text{s.t.} \quad & c = R + r'x, \\ & C = c + w, \end{aligned} \tag{2}$$

⁵Notice that, by rewriting $\gamma = (\alpha - 1)/\alpha$, $\alpha \geq 1$, the utility function (1) becomes the standard “ratio-habit” representation in Abel (1990):

$$u(c, C) = \frac{(c/C)^{1-\alpha}}{1-\alpha},$$

with average consumption elasticity of marginal utility $(\alpha - 1)$. Our formulation is more convenient for the empirical tests of the model.

where x^* represents the weights invested in firms l and f . The first order condition from problem (2) yields the usual Euler condition, $E(r u_c(c, C)) = 0$. Given the utility function (1) and the definitions in (2) we can write the problem's first order condition as a function of the investor's consumption and the workers relative wealth, w/c :

$$E(r c^{-\alpha(1-\gamma)}(1 + w/c)^{\alpha\gamma}) = 0. \quad (3)$$

Notice that, in the absence of keeping up with the Joneses behavior ($\gamma = 0$), the previous condition reduces to $E(r c^{-\alpha}) = 0$, the standard CRRA Euler equation. However, in the presence of keeping up with the Joneses behavior ($\gamma > 0$) we observe two effects: (i) as in Galí (1994), the risk aversion coefficient for the representative investor is scaled down to $\alpha(1 - \gamma)$; (ii) the marginal utility is “levered” by the relative income of the workers. Due to the keeping up with the Joneses behavior, the more affluent workers become, the higher the marginal utility of consumption for the investor. The impact of this leverage is given by the constant average consumption elasticity of marginal utility (around the symmetric equilibrium), $\alpha\gamma$.

Condition (3) allows us to solve for the representative investor's optimal portfolio. Since financial markets are complete, there exists a mimicking portfolio X^w that maps the workers relative income onto the investment opportunity set such that $w/c = w^0(R + r'X^w)$. Following Galí (1994), given w^0 and X^w , for small values of $E(r)$, the optimal portfolio of the representative investor of country k can be approximated as a function of α , γ and the risk adjusted risk premia $\Omega^{-1}E(r)$, with $E(r)$ and Ω the mean return

vector and covariance matrix of r , respectively:⁶

$$x_k^* = \frac{\theta_k \gamma_k}{1 - \gamma_k} X_k^w + \frac{1}{\alpha_k (1 - \gamma_k)} \Omega^{-1} E(r), \quad (4)$$

with $\theta_k = \frac{w_k^0}{1+w_k^0}$, the workers initial wealth as a proportion of the country's total wealth (investor's plus non-diversifiable wealth).

Equation (4) shows the expected impact of our assumptions on the investor's portfolio holdings. In the first place, if all agents in the country hold a well diversified portfolio (that is, if absent any friction, $\theta_k = 0$), the alleged keeping up with the Joneses behavior of investors would translate into a redefinition of the representative agent's risk aversion parameter $\alpha_k(1 - \gamma_k)$. The optimal portfolio would be accordingly re-scaled and the only asset pricing implication will be a lower expected market price of risk.

Even if there is a friction ($\theta_k > 0$) that prevents full risk-diversification for a set of agents (the workers), investors will hold well diversified portfolios unless they exhibit some degree of keeping up with the Joneses behavior ($\gamma_k > 0$). Thus, it is important to emphasize that investors' portfolios will be locally biased if and only if *both* keeping up with the Joneses behavior and a market friction exist.

⁶Note that $u_c(c, w/c) \approx u_c(c^0, w^0/c^0) + u_{c,c}(c^0, w^0/c^0)(c - c^0) + u_{c,w/c}(c^0, w^0/c^0)(w/c - w^0/c^0) = u_c(1, w^0) \left[1 - \alpha(1 - \gamma)(r'x + R - 1) + \frac{w^0}{1+w^0} \alpha\gamma(r'X^w + R - 1) \right]$. An approximation to the first order condition is obtained by multiplying this expression by r and taking expectations. The linear approximation for the optimal portfolio follows after solving for x^* and taking into account that $E(r'r) \approx \Omega$ and that $E(r)(R - 1) \approx 0$ for small values of $E(r)$ and the (net) risk free rate, $R - 1$.

B. Endogenous keeping up with the Joneses preferences

In this section, we discuss the endogenous keeping up with the Joneses preferences presented in DeMarzo, Kaniel and Kremer (2004). In this specification agents consume two types of goods: c , which has the interpretation of a global good, and w_k , $k \in \{l, f\}$, a local good. Utility over consumption for these two goods is given by:⁷

$$u(c, w) = \frac{1}{1 - \alpha} (c^{1-\alpha} + \delta w^{1-\alpha}).$$

The parameter $\delta > 0$ specifies the relative importance of the local good. All consumption takes place at the end of the period. At time $t = 0$, investors are endowed with shares of the firm that produces the global good. Call c_k^0 the aggregate value of those shares at the beginning of the period for agents in country k . For simplicity, let $c_k^0 = 1$ in both countries. Workers in each country will receive a fixed number \bar{w}_k of units of the local good at time $t = 1$. In equilibrium, the relative price of the local good in terms of the global good at $t = 1$ is given by $p_k = \delta \left(\frac{c_k}{\bar{w}_k} \right)^\alpha$. As it would be expected, the scarcer the (fixed) local good endowment relative to the (stochastic) global good consumption, the higher the relative price of the former. The investor's hedging demand for this risk will trigger the endogenous keeping up with the Joneses behavior in this model. Financial markets are complete, as described at the beginning of the section.

If workers can not diversify their endowment risk (due, for instance, to short-selling

⁷We use the single-parameter, CRRA utility function. It can be shown that the model yields the same predictions for the cross-section of stock returns if this utility function is replaced by the two-parameter, CES utility function in section IV.B of DeMarzo, Kaniel and Kremer (2004), page 1699. It is clear that the exogenous specification parts with an advantage in this comparison, since it has two parameters and, therefore, an additional degree of freedom.

constraints and moral hazard), Proposition 2 in DeMarzo, Kaniel and Kremer (2004) shows that the representative investor's marginal utility is given by:

$$u_c(c, p) = c^{-\alpha} (1 + \delta^{1/\alpha} p^{1-1/\alpha})^\alpha. \quad (5)$$

Let $p^0 = \delta \left(\frac{c^0}{\bar{w}}\right)^\alpha$ denote the relative price at $t = 0$ of one unit of the non-diversifiable, local good endowment of workers at time $t = 1$. Recall that we normalized the initial investor's shares endowment $c^0 = 1$. Hence, $p^0 = \delta \bar{w}^{-\alpha}$. The present value of the workers endowment is therefore $\bar{w}^0 = \delta \bar{w}^{1-\alpha}$.

In this model, the relative wealth at $t = 0$ of the workers in country k as a proportion of the total country wealth is given by $\theta_k = \frac{\bar{w}^0}{1+\bar{w}^0}$. Call $\bar{w}p/\bar{w}^0$ the return on the workers wealth (in units of the global good) over the period. Like in the exogenous preferences specification, under complete (financial) markets, there exists a portfolio X^w such that $\frac{\bar{w}p}{\bar{w}^0} = R + r'X^w$.

After these definitions, and following the same procedure as in section II, we can write the approximate function for the country k investor's optimal portfolio as follows:⁸

$$x_k^* = \frac{\theta_k(\alpha_k - 1)}{\alpha_k} X_k^w + \frac{1}{\alpha_k} \Omega^{-1} E(r). \quad (6)$$

Notice that, in this model, the optimal portfolio for the logarithmic investor ($\alpha = 1$)

⁸Note that, like in the exogenous specification, we can approximate $u_c(c, p)$ around the initial endowment/price (c^0, p^0) such that $u_c(c, p) \approx u_c(1, \delta \bar{w}^{-\alpha}) \left[1 - \alpha(r'x + R - 1) + \frac{\bar{w}^0}{1+\bar{w}^0} (\alpha - 1) \left(\frac{\bar{w}p}{\bar{w}^0} - 1\right) \right]$. We replace $\frac{\bar{w}p}{\bar{w}^0} = R + r'X^w$ in the equation. After multiplying for r and taking expectations we obtain the investors first order condition for the optimal portfolio. The same approximations as in the exogenous specification are assumed to linearize the solution.

coincides with the benchmark, well diversified portfolio $\Omega^{-1}E(r)$. No relative wealth concern arises even in the presence of local, non-diversifiable wealth.

C. Equilibrium asset pricing implications

Comparing (4) and (6) we conclude that, whether endogenous or exogenous, the existence of keeping up with the Joneses behavior and non-diversifiable income implies the following optimal portfolio for the representative investor of country k :

$$x_k^* = \theta_k b_k X_k^w + \tau_k \Omega^{-1} E(r), \quad (7)$$

where the parameters b and τ represent the portfolio bias and the risk-tolerance coefficient, respectively, with values:

JONESES	b	τ
Exogenous	$\frac{\gamma}{1-\gamma}$	$\frac{1}{\alpha(1-\gamma)}$
Endogenous	$\frac{\alpha-1}{\alpha}$	$\frac{1}{\alpha}$

Market clearing in financial markets at time $t = 0$ requires that $\sum_k c_k^0 x_k^* = (c_l^0, c_f^0)'$. Divide both sides by the global financial wealth $c_l^0 + c_f^0$. Call x_M the market portfolio, $x_M = (\omega_l, \omega_f)'$, with $\omega_k = c_k^0 / (c_l^0 + c_f^0)$. Let r_M denote the return on the global market portfolio. The market clearing condition becomes

$$\sum_k \omega_k x_k^* = x_M. \quad (8)$$

Spot market clearing at time $t = 1$ implies that workers consume the proceedings of their (non-tradable) endowment, w , and investors the return on their portfolios, c .⁹

Let $\theta_k > 0$ for $k = \{l, f\}$. We regress the workers non-diversifiable wealth return, $r_k^w = r'X^w$, onto the world market portfolio return plus a constant:¹⁰

$$r_k^w = a_k + \beta_k r_M + \xi_k. \quad (9)$$

Portfolio $\beta_k x_M$ represents the projection of the workers income onto the security market line spanned by the global market portfolio x_M . Define the portfolio $F_k \equiv X_k^w - \beta_k x_M$ as a “residual” factor portfolio with return $r_k^F = r'F_k$. By construction, this portfolio has zero covariance with the global market portfolio. Additionally, it has expected excess return $E(r_k^F) = E(a_k) = E(r_k^w) - \beta_k E(r_M)$. The net investment in this portfolio is $(1 - \beta_k)$. For any $\beta_k \neq 1$, let $\frac{F_k}{(1-\beta_k)}$ be the normalized (that is, unit net investment) zero beta portfolio for country k . After these definitions, the workers’ portfolio can be represented by the orthogonal decomposition:

$$X_k^w = F_k + \beta_k x_M. \quad (10)$$

Equation (10) says that the workers’ portfolio can be expressed as a linear combination of the market portfolio and a zero-beta (orthogonal) portfolio. We replace X_k^w in (7) by

⁹Galí (1994) has shown that if all agents in both countries hold well diversified portfolios, that is, there is no constraint ($\theta_k = 0$, $k = \{l, f\}$), the resulting equilibrium is symmetric, with no keeping up with the Joneses behavior.

¹⁰The Appendix shows the effect of the orthogonalization and compares the prices of risk and the betas of our estimation vis-à-vis the regression without orthogonalizing the return on the local, non-diversifiable income.

(10):

$$x_k^* = \theta_k b_k F_k + \theta_k b_k \beta_k x_M + \tau_k \Omega^{-1} E(r).$$

This portfolio has three components. Portfolio F_k is country-specific and can be interpreted as a *hedge portfolio*: for each country k , portfolio F_k hedges investors from the risk involved in keeping up with the (domestic) non-diversifiable Joneses risk. Given the orthogonality conditions, this portfolio plays the role of a country-specific, zero-beta asset.

The projection component, $\beta_k x_M$, corresponds to that part of the workers wage income perfectly correlated with the global market portfolio. The standard component, $\Omega^{-1} E(r)$, is the highest global Sharpe ratio portfolio, and it is common across countries.

We define the coefficient H , the inverse of the risk-tolerance coefficient as:

$$H^{-1} = \sum_k \omega_k \tau_k.$$

After imposing market clearing (8), we solve for the equilibrium expected returns:¹¹

$$E(r) = H \Omega \left[\left(1 - \sum_k \omega_k \theta_k b_k \beta_k \right) x_M - \omega_l \theta_l b_l F_l - \omega_f \theta_f b_f F_f \right]. \quad (11)$$

¹¹In a simplified setting, De Marzo, Kaniel and Kremer (2004) show that the endogenous Joneses equilibrium can be multiple. If there exists a large enough fraction of the investors who are exogenously biased the equilibrium becomes unique. The case discussed here can be interpreted as a limit case where *all investors* are exogenously biased (i.e., exhibit keeping up with the Joneses preferences). Hence, the exogenous Joneses equilibrium is unique.

Define the matrix \mathbf{F} of dimension $N \times 3$ as the column juxtaposition of the market portfolio and the orthogonal portfolios, $\mathbf{F} \equiv (x_M, F_l, F_f)$. Let $\mathbf{r}^{\mathbf{F}} \equiv (r_M, r_l^F, r_f^F)$ denote the vector of factors' risk premia. Additionally, define the *wealth vector* \mathbf{W} as follows:

$$\mathbf{W} \equiv H \begin{pmatrix} 1 - \sum_k \omega_k \theta_k b_k \beta_k \\ -\omega_l \theta_l b_l \\ -\omega_f \theta_f b_f \end{pmatrix}.$$

Given these definitions, the equilibrium condition (11) can be re-written as follows:

$$E(r) = \Omega \mathbf{F} \mathbf{W}. \quad (12)$$

Pre-multiplying both terms of the previous equation by the transpose of matrix \mathbf{F} we obtain the equilibrium condition for the vector of prices of risk, $\boldsymbol{\lambda}$, with the market risk premium, λ^M , as the first component:

$$\boldsymbol{\lambda} = \mathbf{F}' \Omega \mathbf{F} \mathbf{W}, \quad (13)$$

where $\mathbf{F}' \Omega \mathbf{F}$ is a matrix of dimension 3×3 whose first column (row) includes the market return volatility and a vector of 2 zeros and the remaining elements are the covariances between F_l and F_f .

The risk premia on the market and the two zero-beta portfolios will be:

$$\begin{aligned}
\lambda^M &= H \left(1 - \sum_k \omega_k \theta_k b_k \beta_k \right) \sigma_M^2, \\
\lambda^l &= -H \left(\omega_l \theta_l b_l \text{Var}(r_l^F) + \omega_f \theta_f b_f \text{Cov}(r_l^F, r_f^F) \right), \\
\lambda^f &= -H \left(\omega_l \theta_l b_l \text{Cov}(r_l^F, r_f^F) + \omega_f \theta_f b_f \text{Var}(r_f^F) \right).
\end{aligned} \tag{14}$$

This system of equations will allow us to test the model's predictions. In the first place, the model predicts that all prices of risk should be increasing (in absolute value) in the aggregate risk aversion coefficient H .

The world market portfolio, x_M , is partially correlated with each country's non-diversifiable risk. That correlation is captured by the coefficient β_k . That correlation offers partial hedging against deviations from the local Joneses (in case $\theta b > 0$). Therefore, the equilibrium price of risk for the global risk factor, λ^M , varies relative to the symmetric equilibrium: The parenthesis in the first equation in (14) (which in the case of a symmetric equilibrium would be 1) captures the net price of risk on the global risk factor, after discounting the (capitalization weighted) Joneses hedging effect. If the weighted value of the betas is higher than the world market beta (i.e., 1), the model predicts that the market price of risk could turn negative. Intuitively, if the hedging properties of the market portfolio against Joneses deviations outweigh the compensation for systematic risk the *net* expected market price of risk becomes negative.

Furthermore, if there is a relative wealth concern ($b > 0$) in the economy (either endogenous or exogenous) and workers income is not diversifiable ($\theta > 0$), there should

be two additional risk factors together with the market risk factor. Regarding their sign, the model predicts that if $\text{cov}(r_l^F, r_f^F) > 0$, then λ^l and λ^f will be negative. To understand this result, suppose for the moment that the zero-beta portfolios were orthogonal ($\text{Cov}(r_l^F, r_f^F) = 0$). Then, the price of risk would be easily isolated and strictly negative. The intuition for the negative sign would be as follows: An asset that has positive covariance with portfolio F_k will hedge the investor in country k from the risk of deviating from the non-diversifiable (domestic) income of the Joneses. This investor will be willing to pay a higher price for that asset thus yielding a lower return. In equilibrium, the price of risk for F_k would be, in absolute terms, increasing in b_k and the volatility of the hedge portfolio. If the covariance between both zero-beta portfolios is positive, this just increases the absolute value of the negative prices of risk for every country's hedge portfolio.

Finally, solving for \mathbf{W} in (13) and replacing it in (12), we obtain:

$$E(r) = \boldsymbol{\beta} \boldsymbol{\lambda}, \quad (15)$$

where $\boldsymbol{\beta} = \boldsymbol{\Omega} \mathbf{F} (\mathbf{F}' \boldsymbol{\Omega} \mathbf{F})^{-1}$ denotes the 2×3 (in general $N \times (1 + K)$, with N the number of assets and K the number of countries) matrix of betas, with the first column as the market betas for both assets.

We name this pricing model that captures equilibrium implications of keeping up with the Joneses preferences -both under the exogenous and endogenous specifications- KEEPM, which stands for “KEEping up Pricing Model.”

For a given asset $i \in 1, 2, \dots, N$, the model predicts three betas: the standard (global) market beta and two additional, country-specific betas:

$$\begin{pmatrix} \beta_i^l \\ \beta_i^f \end{pmatrix} = \frac{1}{D} \begin{pmatrix} \text{Var}(r_f^F)\text{Cov}(r_i, r_l^F) - \text{Cov}(r_l^F, r_f^F)\text{Cov}(r_i, r_f^F) \\ \text{Var}(r_l^F)\text{Cov}(r_i, r_f^F) - \text{Cov}(r_l^F, r_f^F)\text{Cov}(r_i, r_l^F) \end{pmatrix},$$

with $D = \text{Var}(r_l^F)\text{Var}(r_f^F) - \text{Cov}^2(r_l^F, r_f^F) > 0$.

To understand the model's prediction in terms of these betas, assume first that both zero-beta portfolios are pairwise orthogonal, $\text{Cov}(r_l^F, r_f^F) = 0$. In this case, an asset positively correlated with country l non-diversifiable Joneses risk ($\text{Cov}(r_i, r_l^F) > 0$) and with no, or negative, correlation with country f non-diversifiable Joneses risk ($\text{Cov}(r_i, r_f^F) \leq 0$) will have $\beta_i^l > 0$ and $\beta_i^f \leq 0$ (the symmetric result follows for an asset i with $\text{Cov}(r_i, r_l^F) \leq 0$ and $\text{Cov}(r_i, r_f^F) > 0$). Notice that if $\text{Cov}(r_l^F, r_f^F) > 0$ (as it is the case in our empirical test) the second term in the computation of the first beta is negative, and the second term in the computation of the second beta is positive, which (along with the minus sign in front of the second terms), goes in the same direction as our previous conclusion about the signs of the betas.

The sign of these betas together with that of the expected price of risk on the orthogonal portfolios in (14) explains the equilibrium expected returns in the KEEPm. Besides the global market risk premium, investors require a premium for holding stocks with no, or negative, correlation with the non-hedgeable local labor or entrepreneurial income (generally foreign stocks). In addition, investors are willing to give up expected returns (that is, pay a premium) for the stocks that are correlated with the idiosyncratic compo-

ment of the domestic Joneses and, therefore, help them keep up with the Joneses. This result depends in a fundamental way on the market friction that prevents some agents from participating in the markets. This effect is absent in the analysis of Campbell and Cochrane (1999), who assume complete markets and frictionless markets. Another popular type of model that also postulates non-standard preferences is the model that uses the recursive preferences of Epstein and Zin (1989) and Weil (1989) (for example, Bansal and Yaron 2004). These are also consumption based models in which the pricing kernel has a second factor, besides aggregate current consumption (equivalent to our market portfolio), which is aggregate wealth. This second factor is used to explain the expected return of securities that can hedge the so-called long run risk (which plays a similar role to our domestic keeping up with the Joneses risk). Finally, DeMarzo, Kaniel and Kramer (2006) base a model on endogenous relative wealth concerns and show that the resulting negative risk premium can explain financial bubbles in equilibrium.

The rest of the paper deals with testing the KEEPM. In section 5 we analyze the general implications of the KEEPM, both under the endogenous and exogenous specifications, and in section 6 we try to distinguish implications of the exogenous and endogenous specifications.

III. Data

We test the asset pricing implications of the KEEPM using data from the US, UK, Japan and Germany. The choice of countries is limited by the availability of a sufficient time series of data that allows for a meaningful test of the model's cross-sectional implications.

In tests of domestic asset pricing models it has become standard to sort stocks into portfolios based on firm characteristics such as size and book-to-market. However, both Daniel and Titman (2005) and Lewellen, Nagel, and Shanken (2006) note that testing asset pricing models using firm characteristics to form portfolios can lead to spurious conclusions about the usefulness of a proposed factor. The reason for this is that the factor structure of the portfolios is so strong that any proposed factor that is only weakly correlated with size or book-to-market will be able to price the test assets. That is, testing a new proposed factor on test assets sorted by size and book-to-market is likely to have very low power.

In order to alleviate this concern we follow the recommendations in Daniel and Titman (2005) and Lewellen, Nagel, and Shanken (2006) and augment characteristic sorted portfolios with portfolios that are sorted by lagged loadings on our proposed factor. The portfolio formation procedure is as follows: Firms are sorted into three size portfolios based on market capitalization (size) as of December year t . For each individual firm we regress its excess return on the measure of orthogonal income based on the twenty four monthly observations leading up to December of year t to obtain the pre-formation factor loading. We then form three sub-portfolios within each size portfolio based on the pre-formation factor loading. These sub-portfolio breakpoints are set such that there is an equal number of firms in each of the nine portfolios.¹² We then calculate monthly returns in year $t + 1$ for each of these nine (value weighted) size and factor loading sorted

¹²We are limited in the number of portfolios that we can form using the double sorting procedure because of the relatively small number of stocks at the beginning of the sample. By forming nine portfolio we ensure that there are a minimum of sixteen stocks in each portfolio in Germany, the country with the least number of listed stocks. This should provide a well diversified portfolio return.

portfolios. The portfolios are re-balanced each year. In addition to these nine portfolios, we also include ten size sorted portfolios, providing a total of nineteen portfolios per country.

The starting period for the analysis is dictated by the availability on Datastream of stock price data for the UK, Japan and Germany. To this end we start in January 1973 and collect data up until December 2006. The data from the US comes for CRSP. All returns are in US dollars and excess returns are calculated by subtracting the US one month T-bill rate from the actual returns.

An additional way of alleviating the problems caused by forming portfolios sorted on firm characteristics highlighted by Daniel and Titman (2005) and Lewellen, Nagel, and Shanken (2006) is to use individual stock returns rather than portfolios. This is impractical in the Fama and MacBeth (1973) methodology due to the errors in variable problem that arises from the two-step methodology of estimating betas in the first step and prices of risk in the second step. However, this problem can be circumvented by estimating the betas and prices of risk simultaneously using Non-Linear Seemingly Unrelated Regressions (NLSUR). The simultaneous estimation of betas and the prices of risk have been used in estimating asset pricing models in, for example, Burmeister and McElroy (1988), Elton, Gruber and Blake (1995) and Priestley (1997). Furthermore, the use of individual securities is helpful in that the formation of portfolios raises a number of other problems in its own right. Brennan, Chorida and Subrahmanyam (1998) show that the data snooping biases lead to a lack of power of tests because portfolios are formed on some empirical characteristic found to be relevant in earlier empirical work (Lo and

MacKinlay (1990) and Berk (2000)). Roll (1977) shows that portfolio formation may eliminate important return characteristics by averaging into portfolios.

When we estimate the model using NLSUR, we require that the stocks survive the sample period. We also face a constraint on the number of securities (N) that can be used relative to the number of time series observations (T). In particular, it is required that $NT > K(N + 1)$, where K represents the number of factors, so that the system of equations has more equations than unknowns. In the case $N > T$ it is problematic to compute the variance-covariance matrix. However, if N is too small, the risk premia will have large standard errors. As a compromise between computational feasibility and a sufficiently large sample such that approximately valid asymptotic inferences can be made, Burmeister and McElroy (1988) suggest seventy stock returns. To this end we include twenty random individual stock returns each from the US, UK, Japan, and Germany, stocks that must have survived the sample period. This gives a total of 80 equations to estimate and is similar to the number used in Burmeister and McElroy (1988) and Priestley (1997).

Rather than simply selecting one random sample of twenty stock returns for each country and estimating the model once, we select one hundred random samples of twenty stocks per country. At the beginning of the sample there are 1507, 303, 658 and 87 stocks that have survived in the entire sample period in, respectively, the US, UK, Japan and Germany. First we selected a random sample of twenty stocks from each country. We then place the stocks back into the entire sample for each country. We then select a new random sample of stocks for each country. We then repeat this procedure one hundred

times. Clearly given the small number of stocks in the sample in Germany the number of truly independent samples is small.

In order to test the model we need to proxy the non-diversifiable income of the workers in each country. As we mentioned in the presentation of the model, human capital is, arguably, one of the main sources of non-diversifiable personal income and labor income seems to be the best available proxy for human capital. Therefore, we use the orthogonal (with respect to the world market portfolio) component of each country's labor income series. The data on labor income are wages and salaries in Germany, wages in Japan, personal income in the US, and wages in the UK. This data is collected from Datastream.

In addition to testing the KEEPM directly, we want to compare its performance relative to that of other international asset pricing models. We consider versions of the international CAPM, the international CAPM with currency risk, the international CAPM with an international book-to-market factor, and an international multifactor model that uses international macroeconomic factors. To proxy currency risk we use a trade weighted index of the US dollar. Other risk factors based on macroeconomic factors are: world unexpected inflation (derived from the IMF world consumer price index), world unexpected industrial production (derived from the OECD aggregate industrial production index), and the return on world government bond markets (derived from Lehman Brothers world government bond market index). The unexpected inflation and industrial production factors are the residuals from autoregressions whilst all other factors are return-based. All the data used in the construction of the risk factors are collected from Datastream except for the HML factor which is kindly provided by Ken French.

IV. Empirical results

Using portfolio data the model can be consistently estimated by the cross-sectional methods due to Fama and MacBeth (1973). We consider the performance of the KEEPM-encompassing both exogenous and endogenous specifications -in terms of a number of metrics. First, and most importantly, we are interested in assessing whether the model's risk factors have the correct sign. A second issue is how well the model does in terms of describing the cross-sectional variation in international stock returns. We report the adjusted R^2 , \bar{R}^2 , of the cross-sectional regression which calculates the amount of cross sectional variation that is captured by the model. Following Jagannathan and Wang (1996) and Lettau and Ludvigson (2001) we calculate the R^2 as $[Var_c(\bar{r}_i) - Var_c(\bar{e}_i)] / Var_c(\bar{r}_i)$ where Var_c is the cross-sectional variance, \bar{r}_i is the average return and \bar{e}_i is the average residual. This metric provides a general indication of the fit of the model but it is not a direct test of the model. For that we examine whether the models pricing errors are zero. Within the above testing framework we also look at how well other international asset pricing models perform.

Using the portfolio returns for the four countries equation (15) implies a five-factor model with the world market price of risk, the US orthogonal labor price of risk, the UK orthogonal labor price of risk, the Japanese orthogonal labor price of risk, and the German orthogonal labor price of risk:

$$E(r_{i,t}) = \lambda^M \beta_i^M + \lambda^{ous} \beta_i^{ous} + \lambda^{ouk} \beta_i^{ouk} + \lambda^{ojp} \beta_i^{ojp} + \lambda^{ogm} \beta_i^{ogm}$$

where $E(r_{i,t})$ is the expected excess return on asset $i \in 1, \dots, N$ at time $t \in 1, \dots, T$, β_i^w is stock i 's β with respect to the world stock market portfolio, λ^M is the world stock market price of risk, β_i^{ous} is stock i 's β with respect to the orthogonalized US labor return, λ^{ous} is the US orthogonalized labor price of risk, β_i^{ouk} is stock i 's β with respect to the orthogonalized UK labor return, λ^{ouk} is the UK orthogonalized labor price of risk, β_i^{ojp} is stock i 's β with respect to the orthogonalized Japanese labor return, λ^{ojp} is the Japanese orthogonalized labor price of risk, β_i^{ogm} is stock i 's β with respect to the orthogonalized German labor return, and λ^{ogm} is the German orthogonalized labor price of risk. The model predicts that $\lambda^{ous} < 0$, $\lambda^{ouk} < 0$, $\lambda^{ojp} < 0$ and $\lambda^{ogm} < 0$.

The Fama and MacBeth (1973) procedure involves a first step in which time series regressions are used to estimate the betas, and a second step in which cross-sectional regressions are used to estimate the lambdas. Because we have a relatively short sample and have already lost twenty four observations in the portfolio formation procedure, we undertake a rolling regression approach of using thirty six observations up to time t in the first step to obtain the first beta. This beta is then used in the second step to estimate a cross-sectional regression of average returns at time $t + 1$ on the beta estimated up until time t . The data is then rolled forward one month and the procedure is repeated. This results in a time-series of cross section estimates of the relevant price of risk. In total we have lost sixty observations given the portfolio formation and rolling beta estimation method. Therefore, the first cross-sectional estimation period is January 1978, providing a total of twenty nine years.

The main empirical results of the paper are presented in the first row of Table I, where

we report estimates of the KEEPM using 76 portfolios, nineteen from each of the US, UK, Japan and Germany. The orthogonal labor prices of risk of UK and Germany are estimated to be negative, as the model predicts, and statistically significant. They are also economically meaningful, with values of -0.218% and -0.537% per month respectively. Overall, the model appears to have empirical support.

[INSERT TABLE I]

Both Daniel and Titman (2005) and Lewellen, Nagel, and Shanken (2006) note that interpreting the success of a factor model based on the cross-section \bar{R}^2 can be dangerous when using size and book-to-market portfolios. This is because obtaining a high \bar{R}^2 is not difficult for any factor that is weakly correlated with size or book-to-market. However, simulations in Lewellen, Nagel, and Shanken (2006) show that it is much harder to get a reasonable \bar{R}^2 when size and book-to-market portfolios are augmented with portfolios not related to these factors, such as the lagged factor loadings that we use. Therefore, in our case, examination and comparisons of \bar{R}^2 should be meaningful. The KEEPM explains 31% of the cross-sectional variation in excess returns which is reasonable when we consider that we use portfolios of stock returns from four different countries. Overall, the empirical results provide evidence consistent with the theoretical model's predictions.

There are not many other data series that could proxy for personal non-diversifiable income. Housing is a potential candidate (for example, it might capture a part of the entrepreneurial income we also discussed in the model section) and we use it as a second measure of orthogonal local personal income, for robustness purposes. For the UK we

use the Halifax Building Society's house price index. The US housing data is the median price of sales of existing one-family homes. Monthly data on house price indices are not available for Japan and Germany. The results using housing data, which are only available from 1983 due to lack of housing data back further in time in the UK, indicate that the orthogonal prices of risk in both the UK and US are negative and statistically significant. The actual estimates (t -statistics) are -0.808 (2.88) and -0.585 (2.64) for the US and UK respectively. Thus, we find further support for the model's predictions when using an alternative measure of local orthogonal wealth.

Whilst our central concern is with testing our theoretical model, we also consider its performance and robustness relative to a class of other international asset pricing models. The first model is the international CAPM (ICAPM), see Black (1974). This model assumes standard preferences, complete integration of capital markets, and that purchasing power parity (PPP) holds:

$$E(r_{i,t}) = \lambda^{ICAPM} \beta_i^{ICAPM},$$

where λ^{ICAPM} is the ICAPM market price of risk and β_i^{ICAPM} is stock i 's β with respect to the excess return on the world stock market portfolio. We also consider the model of Fama and French (1998) who suggest a two factor model for international asset pricing that includes the excess return on the world stock market portfolio and the international high minus low book-to-market factor (HML):

$$E(r_{i,t}) = \lambda^M \beta_i^M + \lambda^{HML} \beta_i^{HML},$$

where λ^{HML} is the price of risk associated with the HML risk factor and β_i^{HML} is the β with respect to the HML risk factor.

Since it is well known that PPP does not hold, at least in the short and medium term (see, for example, Grilli and Kaminsky (1991), Wu (1996) and Papell (1997)), investors may be exposed to real exchange rate risk. Theoretical models that incorporate currency risk include Solnik (1974), Stulz (1981), Adler and Dumas (1983). The empirical specification that we examine is:

$$E(r_{i,t}) = \lambda^M \beta_i^M + \lambda^{cb} \beta_i^{cb},$$

where λ^{cb} is the currency index price of risk and β_i^{cb} is the β with respect to the currency index.

In addition to exchange rates, other macroeconomic factors have been used in international asset pricing models (see, for example, Ferson and Harvey (1994)). Therefore, we also examine a model that includes the currency basket and three macroeconomic based factors: world unexpected inflation, world unexpected industrial production, and the return on world money markets:

$$E(r_{i,t}) = \lambda^{ui} \beta_i^{ui} + \lambda^{uip} \beta_i^{uip} + \lambda^{gb} \beta_i^{gb} + \lambda^{cb} \beta_i^{cb},$$

where λ^{ui} is the inflation price of risk, β_i^{ui} is the β with respect to unexpected inflation,

λ^{uip} is the industrial production price of risk, β_i^{uip} is the β with respect to unexpected industrial production, λ^{gb} is the world government bond market price of risk, and β_i^{gb} is the β with respect to the return on the world government bond market.

The rest of Table I reports the estimates of the various models discussed above. In the second row an estimate of the International CAPM is presented. According to the \bar{R}^2 , which is 4%, the ICAPM, like its domestic counterpart, is unable to explain much of the cross-sectional variation in average returns and as we will see later, the pricing errors from this model are large. This is interesting since it suggests that most of the explanatory power in the KEEPM model is coming from the local factors and not the market factor.

The next model in row number 3 includes the world HML factor and the world stock market factor. The estimate of the HML price of risk is not statistically significant. Including the HML factor has little impact on the estimate of the world stock market factor. This model can explain 20% of the cross sectional variation in the asset returns.

The fourth row of Table I reports the model which includes a measure of currency risk along with the world stock market portfolio. The estimated price of currency risk is -0.421% per month and is marginally statistically significant. This model explains 21% of the cross sectional variation in the excess stock returns. The final row of the table provides results from a version of an international multifactor model that uses only macroeconomic based risk factors. In this case only the currency risk factor is statistically significant and the \bar{R}^2 shows that 21% of the variation in average returns is captured by the model. In summary, Table I shows that the KEEPM model has empirical support

and that it performs reasonable well when compared to alternative international asset pricing models that have been used in the extant literature.

A. Individual security returns

In this part of the paper we examine the robustness of the results presented so far by analyzing individual security returns instead of portfolios. Due to the use of individual securities we employ a NLSUR methodology which, recall, has the advantage over the traditional Fama and MacBeth (1973) two step methodology in that it avoids the errors in variables problem of estimating betas in one step and then the prices of the risk in a second step. Moreover, using NLSUR allows for correlations in the residual variance-covariance matrix which will lead to more efficient estimates (both asymptotically and in most small samples, see Shaken and Zhou (2006)).¹³

The drawback of using individual securities is that the firms have to survive the sample period. This induces some survivorship bias on the sample. However, in a relatively short sample such as the one used here the extent of survivorship bias is likely to be limited and is unlikely to effect the signs of the estimated risk premia.

Given a k factor model and a set of N test assets over T observations, the asset pricing model can be expressed as:

$$\mathbf{r}_t = E(\mathbf{r}) + \beta_k \mathbf{f}_{kt} + \mathbf{u}_t \tag{16}$$

¹³Connor and Korajczyk (1993) argue that residuals may be cross correlated due to industry specific factors that are not pervasive across the whole cross section.

$$E(\mathbf{r}) = \beta_k \lambda_k, \quad (17)$$

where \mathbf{r}_t is a N vector of excess security returns, \mathbf{f}_{kt} is a k vector of observations on the k risk factors, β_k is a $N \times k$ matrix of betas (sensitivities of returns to the factors), \mathbf{u}_t is a N vector of residual error terms, $E(\mathbf{r})$ is a N vector of expected excess returns and λ_k is a k vector of prices of risk. Substituting equation (17) into (16) and stacking the equations for the N securities gives:

$$\mathbf{r} = \{\mathbf{I}_N \otimes [(\lambda' \otimes \iota_T) + \mathbf{f}]\} \beta + \mathbf{u}, \quad (18)$$

where \mathbf{r} is a $NT \times 1$ vector of excess returns, λ is a $k \times 1$ vector of prices of risk, \mathbf{f} is a $T \times k$ matrix of observations of the k factors, β is a $Nk \times 1$ vector of sensitivities, \mathbf{I}_N is a $N \times N$ identity matrix and \otimes is the Kronecker product operator. The NLSUR estimators are those that solve the following minimization problem:

$$\min_{\lambda, \beta} \mathbf{u}' \left(\hat{\Sigma}_{\mathbf{u}}^{-1} \otimes \mathbf{I}_T \right) \mathbf{u}, \quad (19)$$

where $\hat{\Sigma}_{\mathbf{u}}^{-1}$ is the residual covariance matrix obtained from estimating (18).

[INSERT TABLE II]

Recall from the data section that we have chosen 100 random samples of twenty stocks from each of the four countries. We estimate the model 100 times and report the means, standard deviations, the 75th percentile and the 25th percentile for both the estimates and t -statistics (in parenthesis). Table II reports the findings and shows that the mean

estimate of all four prices of risk on the orthogonal local labor income measures are negative and statistically significant with the exception of Japan. Except for Germany, the mean estimates are larger for the individual securities than for the portfolios. Even at the 75th percentile the estimates for the US and UK are negative and highly statistically significant. Interestingly, when using individual securities we find that the world stock market price of risk is estimated to be positive and is reasonable at 0.574% per month which translates into an annual return similar to the actual market premium. The mean \overline{R}^2 is 51% which indicates that the model does quite well in describing the cross-sectional variation in individual asset returns in the four countries. At the 25th percentile the \overline{R}^2 is 30% and at the 75th percentile it is 71%. The findings in panel A of Table II provide corroborating evidence to that in Table I which suggests that keeping up with the Joneses behaviour affects asset prices.

The remaining panels of Table II report estimates from the alternative international asset pricing models considered in Table I. Panel B provides the distribution of the estimates and t -statistics for the ICAPM. Although the estimated market price of risk is positive and statistically significant, and the standard deviation of the estimate is small, the model can not explain any of the cross sectional variation in returns. Even at the 75th percentile the \overline{R}^2 is only 6%. Panels C reports the results using the FF HML factor which is estimated to be statistically significant, but has a negative sign. Although the estimate is significant the explanatory power of the model is poor with a mean \overline{R}^2 of only 3%. The results from estimating the ICAPM with currency risk are reported in panel D and indicate that whilst the estimated sign and size of the coefficient on currency risk

are similar to those obtained in Table I when using portfolio data, the mean t -statistic indicates that the coefficient is not statistically significant on average. Whilst the estimate is statistically significant for the 25th percentile, at the 75th percentile the estimate is insignificant. The \overline{R}^2 is 12% for the individual securities, less than that obtained using portfolios.

Panel E reports the results from the model that uses macroeconomic factors. According to the mean t -statistics none of the estimates are statistically significant. However the model explains on average 69% of the cross sectional variation in returns. The reason for this is that the standard deviation of the estimates are large and the actual estimates switch from significant and positive to significant and negative. Unlike the KEEPM model where the estimates are consistently negative across the use of portfolios or individual securities, the signs on the currency factor and the inflation factor have different signs when using portfolios as compared to individual securities.

Overall, the findings in Panel A of Table II provide further support for the KEEPM model. Based on the level of statistical significance and the \overline{R}^2 the results are stronger here than in Table I when using portfolios, although they are qualitatively the same. The reason that the prices of risk are more statistically significant in the case of individual securities is likely to stem from the fact that the NLSUR method provides more efficient estimates and the omission of small stocks when using individual securities.

B. Analysis of pricing errors

Table III reports the estimates of the pricing errors across aggregated portfolios. Panel A reports the square root of the average squared pricing errors for nine aggregated portfolios. For each of the models in Table I, we report pricing errors by portfolio formation method (only Size, S, and Size and Factor Loadings, SFL) for each country and across all 76 portfolios. Standard errors are reported in parentheses. The column headed KEEPM shows that the pricing errors across all the portfolios are 0.29%. The next column reports the pricing errors from the ICAPM. For most portfolios and countries the pricing errors are smaller in the KEEPM than the ICAPM. Similar results are found for the models that include the HML and currency basket factors (columns 4 and 5). The model that includes the macroeconomic factors has slightly higher pricing errors across all portfolios than the KEEPM. The patterns in the pricing errors across countries for each model are similar to those of the pricing errors for the aggregated portfolios.

[INSERT TABLE III]

In Panel B we test whether the average pricing errors are significantly different from zero using an asymptotic χ^2 (Wald) test of the null hypothesis that all the pricing errors are jointly zero. In the majority of cases we reject the null hypothesis that the pricing errors are jointly zero and in every case when we test across all pricing errors (rather than a group of them) we reject the null hypothesis. Only in the case of Germany is the null hypothesis of zero pricing errors not rejected at the 5% level for some of the models.

So far, we have established that the pricing errors for the KEEPM are smaller than other models, but that in most cases it is possible to reject the null hypothesis that the pricing errors are zero. The final row of the table tests whether the pricing errors from the KEEPM are smaller than those from the other models. Under the column ICAPM we show that we can reject the null hypothesis that the pricing errors from the KEEPM are the same as those of the ICAPM. Whilst the pricing errors from the KEEPM are smaller than the remaining models, it is not possible to reject the null hypothesis that the pricing errors are the same.

Panel A of Table IV reports the square root of the average squared pricing errors for the five estimated versions of the model using individual securities. The pricing errors for the individual securities are the average pricing errors across all individual assets in all four countries. We then take the average of these across the one hundred versions of the model that we estimate. We report the pricing errors, along with standard errors in parentheses, aggregated across all stocks. The pricing errors for the individual securities are similar in size to those of the portfolios. The pricing errors from the KEEPM are 0.236% which is considerably lower than the pricing errors from the alternative models except the model that uses macroeconomic factors which has a pricing error of 0.21%, slightly lower than the KEEPM model.

[INSERT TABLE IV]

Tests of the null hypothesis that the pricing errors are jointly zero are reported in Panel B. The null hypothesis that the pricing errors are jointly zero is rejected in every

model, similar to the case of the portfolios. We do reject the null hypothesis that the pricing errors from the KEEPM model are the same as the other models. In particular, we find that the pricing errors from the KEEPM are statistically lower than those of the other models with the exception of the model with macroeconomic factors, which has statistically lower pricing errors than the KEEPM.

In summary, the analysis of the model's pricing errors has established further empirical support for the KEEPM, both under the exogenous and endogenous specifications, by showing that the pricing errors are smaller than most other models. In general, we reject the null hypothesis that the pricing errors are jointly zero across most portfolios, across pricing errors within a given country and type of portfolio formation methodology, and across individual securities. However, the pricing errors from the KEEPM model are lower than other models when testing using portfolio returns and lower than all models except the IMACRO model when using individual stock returns.

V. Inference on the model parameters

In this section of the paper we attempt to assess whether the inferred parameters of the model are consistent with an exogenous specification, motivated by *status comparison*, or a model where the endogenous *community effect* arises by the relative price of non-tradable assets in limited-supply. It is important to stress here that both explanations are not mutually exclusive and, as stated by DeMarzo, Kaniel and Kremer (2004), "it is possible that both status and community effects are important. In this case the two effects will reinforce each other, increasing the tendency for investor herding."

Ideally, we would like to estimate the parameters of the model directly via, for example, maximum likelihood or GMM. However, it is not possible to identify them individually.¹⁴ Therefore, we propose to back-out the deeper parameters of the model using the estimated prices of risk. Whilst this approach is limited in that we cannot obtain standard errors, it should provide a reasonable estimate of the direction of the effect and therefore sheds light on the underlying economic mechanism at work.

Given that there are k estimated prices of risk, it is possible from (14) to solve for H and b_k as a function of $\{\lambda^k, \omega_k, \theta_k, \beta_k\}$, the global market portfolio volatility, σ_M^2 , and the covariance matrix of the orthogonal portfolios. We perform these exercises using the prices of risk estimated from the portfolios. As a robustness test, we repeat the same exercise using the prices of risk estimated with individual securities as reported in Panel A of Table III.

As a starting point we focus on the prices of risk presented in the first row of Table I. However, notice that the market price of risk is non-significant. In order to obtain a meaningful estimate for the aggregate risk aversion coefficient H , we impose an exogenous (monthly) value of $\lambda_M = 0.43$ which is simply the mean monthly average excess return on the world stock market portfolio. We then take the residuals from this model and re-estimate the Joneses price of risk on the orthogonal risk factors.¹⁵ The new estimates

¹⁴Given $\omega_k \theta_k b_k$ in (14), the coefficient of interest, b_k , cannot be independently estimated without additional moment conditions on the distribution of financial wealth across countries ω_k , and, more importantly, the ratio of non-diversifiable to total country wealth, θ_k .

¹⁵We thank the referee for this suggestion. As explained in footnote 5, assuming $\gamma = \frac{\alpha-1}{\alpha}$ results into the “ratio-habit” representation in Able (1990). This would reduce the Joneses inferences to a single parameter, α , just like in the endogenous model. Notice however, that under this specification, $b = \alpha - 1$ and $\tau = 1$. This implies $H^{-1} = \sum_k \omega_k \tau_k = 1$.

H is estimated endogenously -see equation (14). Assuming the ratio-habit representation is equivalent to introducing an ad hoc restriction on H inconsistent with the estimation procedure. When we use

are -0.034% for the US, -0.185% for the UK, -0.224% for Japan and -0.627% for Germany, which are very close to those presented in the unconstrained model in row 1 of Table I. These are the estimates that we will use, along with the positive market price of risk of 0.43%, to provide values for the model's deeper parameters in Panel B. For robustness, we re-estimate the parameters for a lower value of $\lambda_M = 0.215\%$ (Panel A) which is fifty percent lower than the mean market premium and a higher value of $\lambda_M = 0.645\%$ (Panel C) which is fifty percent higher than the mean. The estimates of the prices of risk remain virtually constant across the three panels.¹⁶

The values for the betas are $(\beta_{US}, \beta_{UK}, \beta_{JP}, \beta_{GM}) = (0.0102, -0.0156, -0.0107, -0.0095)$, estimated over the period January 1975 through to December 2006. The global stock market return variance is 0.1684% per month. The weights of each country in total market value are normalized to sum up to one: $(\omega_{US}, \omega_{UK}, \omega_{JP}, \omega_{GM}) = (64.50\%, 13.22\%, 16.88\%, 5.40\%)$, as reported by Morgan Stanley International in 2004.

For the values of θ , the proportion of local non-diversifiable income over the total country income, we take the shares reported in Gollin (2002), Table II. For every country we take two possible values: the “naive calculation,” defined as employed compensation relative to national output, and the “adjusted calculation,” which includes the income of the self-employed as labor income. Given the interpretation of θ as non-diversifiable income, the adjusted calculation is probably more appropriate. Gollin's paper does not report any values for Germany so we assume the the same values for Germany as for the

individual securities, where we obtain a reasonable estimate of the market price of risk, the inferred value of $H = 2.1672$ is clearly different from 1. This implicitly rejects the ratio-habit formulation.

¹⁶This was to be expected since, by construction, the country specific risk factors are orthogonal to the market portfolio return.

UK.

[INSERT TABLE V]

For each country and for the two values of θ under consideration, Table V, reports the inferred estimates of the portfolio bias b , the Joneses parameter γ , and the relative risk aversion coefficient for the representative agent in the endogenous model, α_{EN} . The estimated aggregate risk aversion coefficient is equal to, respectively, $H = 0.6683$ (Panel A), $H = 1.9640$ (Panel B) and $H = 3.2299$ (Panel C), all of them reasonable values. Of course, as expected, the higher the assumed market's risk premium, the higher the implied aggregate risk aversion coefficient.

Given the definition of b in section C, we can interpret this parameter as a function of the exogenous keeping up with the Joneses preferences parameter γ , or, in the case of the endogenous model, the investor's risk aversion coefficient, α_{EN} . In the exogenous case, keeping up with the Joneses behavior arises for values of $0 < \gamma < 1$. The endogenous keeping up with the Joneses effect arises for $\alpha_{EN} > 1$.

The estimates for the parameter γ are, for all countries and across the three panels, within the admissible range and very high. This is consistent with strong exogenous keeping up with the Joneses behavior. As for the estimates of the parameter α_{EN} , they are negative for all countries and θ values, which is inconsistent with the predictions of the endogenous model.

We calculate the implied risk aversion coefficient in the absence of keeping up with the Joneses behavior, α_{EX} , and the scaled risk aversion coefficient under keeping up with

the Joneses behavior, $\tau^{-1} = \alpha_{EX}(1 - \gamma)$. They are reported in Table V, columns 5 and 6, respectively. For this purpose we take the definition of the equilibrium $H^{-1} = \sum_k \omega_k \tau_k$ and assume that α_{EX} is common across countries. Given the definition of b and τ in the exogenous relative wealth concerns model we obtain that $\alpha_{EX} = H \sum_k \omega_k (1 + b_k)$. The implied value of risk aversion coefficient for the naive (lower) estimates of θ is, respectively, $\alpha_{EX} = 100.67$ (Panel A), $\alpha_{EX} = 100.80$ (Panel B) and $\alpha_{EX} = 100.92$ (Panel C). For the adjusted (higher) values of θ , $\alpha_{EX} = 72.15$ (Panel A), $\alpha_{EX} = 72.72$ (Panel B) and $\alpha_{EX} = 73.28$ (Panel C). In either case, α_{EX} has implausible high values. This result is probably due to the low standard deviation of labor income during the period under consideration, especially in the US (7.42% annual) and the UK (12% annual) compared to Japan and Germany where the standard deviations are 23% and 20% per annum respectively.

In the presence of keeping up with the Joneses behavior, however, our exogenous parameter specification model predicts that the representative agent's risk aversion coefficient τ^{-1} , will be scaled down by $(1 - \gamma)$ relative to α_{EX} . The final column of Table V reports the estimates of τ^{-1} and shows that for both the lower and higher values of θ and across panels, the estimates are economically meaningful. In contrast, the estimated risk aversion coefficients in the endogenous relative wealth concern case are negative for all countries and values of θ .

[INSERT TABLE VI]

Table VI backs out the model's deeper parameters using individual securities. Panel A reports the inferred parameters when using the mean lambdas from Panel A of Table

II. The market weighted risk aversion coefficient becomes $H = 2.1672$. The exogenously specified keeping up with the Joneses parameter and the endogenous risk aversion coefficient are similar to the values reported for portfolios in Table V. The estimates of the implied risk aversion coefficient for the exogenous model are $\alpha_{EX} = 510,929$ for the lower values of θ and $\alpha_{EX} = 379$ for the higher values of θ . Both are higher than in the case of portfolios. After taking into account the keeping up with the Joneses parameter γ , the implied risk-aversion coefficients for the representative investor are reported in the last column of Table VI. All the estimates are reasonable with the exception of Japan, arguably too high (25.42 and 24.21 for the naive and adjusted θ s, respectively).

For the sake of comparison, Panel B reports the inferred parameters after imposing the ad hoc market price of risk $\lambda_M = 0.43\%$ as in Table V, Panel B. We then take the residuals from this model and re-estimate the prices of risk on the orthogonal risk factors (which are very similar to the original prices of risk reported in Panel A). The aggregate risk aversion coefficient turns out to be $H = 1.3135$. The estimates of the implied risk aversion coefficient for the exogenous model are $\alpha_{EX} = 510.30$ for the lower values of θ and $\alpha_{EX} = 378.33$ for the higher values of θ . Both are higher than in the case of portfolios (Table V) and virtually identical to the values in Table VI, Panel A. Comparing Panel B in tables V and VI we observe that the estimate of b becomes much larger in the case of individual securities for the United States and the United Kingdom. The Joneses parameter γ is large and below one in both cases; the endogenous risk aversion coefficient α_{EN} is negative in both tables. Relative to the estimates in Table V, the implied Joneses adjusted risk aversion coefficient, τ^{-1} , in Table VI is higher for Japan and Germany,

lower for the United States and very similar for the United Kingdom.

Overall, the empirical evidence suggests that the price-driven (endogenous) explanation of the keeping up with the Joneses preferences cannot generate the expected prices of risk predicted by the model and confirmed by the data. Although the estimated parameters are consistent with an explanation fully based on the exogenous preferences used in this paper, two caveats should be mentioned here: First, by definition, H is an average across *all* countries in the world. The US, UK, Japan and Germany represent jointly about 65% of the world market capitalization. Assuming that the orthogonal prices of risk for the remaining countries are also negative, our estimate of H should be considered as a lower bound. Second, our tests cannot rule out the (most plausible) scenario in which the endogenous and exogenous effects reinforce each other.

VI. Conclusion

In this paper, we derive and test in an international setting equilibrium pricing implications of “keeping up with the Joneses” preferences with frictions. We consider two different specifications present in the literature, that we call exogenous and endogenous keeping up with the Joneses preferences, depending on whether the concern about the wealth of a reference group is directly imposed in the utility function (as in Abel 1990 and Galí 1994) or the result of competition over a good in short supply (as in the model of DeMarzo, Kaniel and Kremer 2004). Equilibrium prices for both the exogenous and endogenous versions are explained by a multi-factor model where both world and domestic risk (the non-diversifiable component of domestic wealth) are priced. The equilibrium

price of risk associated with domestic risk is negative, since investors are willing to pay more for assets that help them to keep up with the local un-diversifiable wealth component. This is in contrast to the positive price of risk that arises in models of partial integration.

We test the model using securities from the US, UK, Japan and Germany, and the time series of domestic labor income as a proxy for un-diversifiable domestic wealth. Using both portfolios and individual securities and alternative estimation methodologies we find that the domestic risk factor has a negative risk premium, as predicted by the equilibrium implications of keeping up with the Joneses preferences. When we study the pricing errors, we show that keeping up with the Joneses preferences do a better job at explaining security prices than a number of well established international asset pricing models. We also use data on housing (instead of labor income) as a robustness test, and we obtain similar conclusions.

Using our risk premium estimates, we back-out the parameters of each of the two specifications, exogenous and endogenous, considered in the paper. The derived values are consistent with the exogenous keeping up with the Joneses parametrization, but are out of the acceptable range for the endogenous wealth concerns specification. The derived risk aversion coefficient for the representative agent is only acceptable after accounting for the risk-adjustment implied by keeping up with the Joneses. However, we cannot rule out, what is probably the most plausible scenario, that both effects are simultaneously in play and they reinforce each other.

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Appendix

Let X_1, X_2 be a set of regressors (independent variables) and y the dependent variable. Here, we make $X_1 = r_M$, the return on the world market portfolio; $X_2 = (r_l^w, r_f^w)$, the return on, respectively, the local (l) and foreign (f) non-diversifiable wealth; $y = r_i$ is the return on a given asset/portfolio i . Consider now the following three **time-series regressions**:

Regression 1: $y = X_1\beta + \epsilon$; call $\hat{\beta} = (X_1'X_1)^{-1}X_1'y$ the OLS estimator of the slope in this regression. This would be the regression of the ICAPM with “no frictions:” the world market portfolio as the only risk factor.

Regression 2: $y = X_1\beta_1 + X_2\beta_2 + \epsilon$; call

$$\begin{aligned}\hat{\beta}_1 &= (X_1'X_1)^{-1}X_1'(y - X_2\hat{\beta}_2) \\ \hat{\beta}_2 &= (X_2'M_1X_2)^{-1}X_2'M_1y,\end{aligned}$$

the corresponding slope estimates, with $M_1 = (I - X_1(X_1'X_1)^{-1}X_1')$. This regression would correspond with the equilibrium test of keeping up with the Joneses preferences (after imposing market clearing) *but without orthogonalizing* the local, non-diversifiable wealth returns.

Call $\hat{\gamma}_2 = (X_1'X_1)^{-1}X_1'X_2$ and $e_2 = M_1X_2$ the slope estimate and the residuals, respectively, of the regression of X_2 on X_1 . Then, the orthogonal decomposition (9) can be written as

$$X_2 = X_1\hat{\gamma}_2 + e_2.$$

Regression 3: $y = X_1b_1 + e_2b_2 + \epsilon$, with $X_1 \perp e_2$ by construction. This is the time-series regression in (12). Then, it is easy to show (based on the Frisch-Waugh Theorem in Green's textbook, page 232) that $\hat{b}_1 = \hat{\beta}$ and $\hat{b}_2 = \hat{\beta}_2$.

From the previous definitions, it follows that

$$\hat{\beta}_1 = \hat{b}_1 - \hat{\gamma}_2\hat{b}_2. \tag{A1}$$

Let's look now at the **cross-sectional regressions**:

Cross-section regression 1:

$$y = \lambda_1\hat{\beta}_1 + \lambda_2\hat{\beta}_2 + \epsilon, \tag{A2}$$

the cross-section regression *without orthogonalizing* local non-diversifiable wealth returns.

Cross-section regression 2:

$$y = \lambda'_1\hat{b}_1 + \lambda'_2\hat{b}_2 + \epsilon', \tag{A3}$$

which corresponds to our cross-sectional test (15). Replacing (A1) for $\hat{\beta}_1$ in (A2), the later can be written as follows:

$$y = \lambda_1 \hat{b}_1 + (\lambda_2 - \hat{\gamma}_2 \lambda_1) \hat{b}_2 + \epsilon. \quad (\text{A4})$$

Comparing now equations (A3) and (A4) we obtain that the prices of risk from equation (14) satisfy:

$$\begin{aligned} \hat{\lambda}'_1 &= \hat{\lambda}_1, \\ \hat{\lambda}'_2 &= \hat{\lambda}_2 - \hat{\gamma}_2 \hat{\lambda}_1. \end{aligned}$$

This equation shows us that (i) as for the global market price of risk, the orthogonalization makes no difference ($\hat{\lambda}'_1$ and $\hat{\lambda}_1$ coincide); (ii) the price of risk on the country specific orthogonal residuals, $\hat{\lambda}'_2$, yields the return on the local wealth *net* of diversifiable local risk reward, $\hat{\gamma}_2 \hat{\lambda}_1$, perfectly correlated with the global market return. The KEEPm, either exogenous or endogenous, predicts that this net price of risk should be negative: it hedges investors against the local *non-diversifiable* risk.

Table I
Fama and MacBeth Cross-Sectional Tests

The table reports Fama and MacBeth second stage cross-sectional estimates of prices of risk (%) using ten size portfolios from each of the US, UK, Japan (JP) and Germany (GM) and nine size and lagged factor loading portfolios for each country. λ^M is the world stock market price of risk, λ^{US} is the orthogonal US local labor income price of risk, λ^{UK} is the orthogonal UK local labor income price of risk, λ^{JP} is the orthogonal Japanese local labor income price of risk, λ^{GM} is the orthogonal German local labor income price of risk, λ^{hml} is the international version of Fama and French's high minus low book-to-market factor price of risk, λ^i is the currency basket price of risk, λ^i is the international inflation price of risk, λ^{ip} is the international industrial production price of risk, and λ^m is the international interest rate price of risk. R^2 is $[Var_c(\bar{r}_i) - Var_c(\bar{e}_i)] / Var_c(\bar{r}_i)$ and \bar{R}^2 is the adjusted R^2 . t-statistics are reported in parentheses.

Model	λ^M	λ^{US}	λ^{UK}	λ^{JP}	λ^{GM}	λ^{hml}	λ^{cb}	λ^i	λ^{ip}	λ^m	\bar{R}^2
1	-0.397 (1.13)	-0.052 (0.80)	-0.218 (2.02)	-0.148 (0.73)	-0.537 (2.74)						31
2	-0.326 (0.79)										4
3	-0.369 (0.91)					0.352 (1.33)					20
4	-0.531 (1.30)						-0.421 (1.86)				21
5							-0.450 (2.09)	0.008 (0.32)	-0.030 (0.18)	-0.071 (0.28)	21

Table II
NLSUR Estimates
Using Individual Stock Returns

The table reports NLSUR estimates of prices of risk (%) using individual stock returns.: λ^M is the world stock market price of risk, λ^{US} is the orthogonal US local labor income price of risk, λ^{UK} is the orthogonal UK local labor income price of risk, λ^{JP} is the orthogonal Japanese local labor income price of risk, λ^{GM} is the orthogonal German local labor income price of risk. λ^{hml} is the international version of Fama and French's high minus low book-to-market factor price of risk, λ^{cb} is the currency basket price of risk, λ^i is the international inflation price of risk, λ^{ip} is the international industrial production price of risk, and λ^m is the international interest rate price of risk. R^2 is $[Var_c(\bar{r}_i) - Var_c(\bar{e}_i)] / Var_c(\bar{r}_i)$ and \bar{R}^2 is the adjusted R^2 . t-statistics are reported in parentheses. The table reports the mean, standard deviation (Std Dev), 25th percentile and 75th percentile from one hundred estimates of the parameters of interest. KEEPM is the Keeping-up-with-the-Joneses model, ICAPM is the international CAPM, IFF is the international Fama and French model, ICAPM-CR is the ICAPM that includes a currency risk factor, IMACRO is an international multi-factor model.

Panel A: KEEPM

	λ^M	λ^{US}	λ^{UK}	λ^{JP}	λ^{GM}	λ^{hml}	λ^{cb}	λ^i	λ^{ip}	λ^m	\bar{R}^2
Mean	0.574 (4.65)	-0.598 (6.03)	-1.007 (6.63)	-0.519 (0.81)	-0.531 (1.94)						51
Std Dev	0.266 (1.74)	0.552 (3.13)	1.035 (2.16)	2.098 (2.34)	1.033 (1.98)						24
25th %	0.528 (3.82)	-0.753 (8.22)	-1.067 (8.17)	-0.717 (3.12)	-0.727 (3.35)						30
75th %	0.696 (5.86)	-0.362 (3.81)	-0.677 (5.23)	0.265 (1.19)	-0.091 (0.51)						71

Panel B: ICAPM

	λ^M	λ^{US}	λ^{UK}	λ^{JP}	λ^{GM}	λ^{hml}	λ^{cb}	λ^i	λ^{ip}	λ^m	\bar{R}^2
Mean	0.585 (6.63)										< 0
Std Dev	0.069 (0.84)										15
25th %	0.542 (5.76)										< 0
75th %	0.634 (6.95)										6

Panel C: IFF

	λ^M	λ^{US}	λ^{UK}	λ^{JP}	λ^{GM}	λ^{hml}	λ^{cb}	λ^i	λ^{ip}	λ^m	\overline{R}^2
Mean	0.665 (6.18)					-0.863 (4.24)					3
Std Dev	0.119 (1.03)					0.258 (1.12)					17
25th %	0.576 (5.45)					-1.010 (5.16)					< 0
75th %	0.731 (6.94)					-0.680 (3.46)					12

Panel D: ICAPM_CR

	λ^M	λ^{US}	λ^{UK}	λ^{JP}	λ^{GM}	λ^{hml}	λ^{cb}	λ^i	λ^{ip}	λ^m	\overline{R}^2
Mean	0.589 (5.98)						-0.417 (0.98)				12
Median	0.585 (6.07)						-0.185 (0.95)				12
Std Dev	0.107 (1.08)						1.327 (2.48)				24
25th %	0.545 (5.31)						-0.721 (2.91)				< 0
75th %	0.644 (6.66)						0.558 (1.27)				28

Panel E: IMACRO

	λ^M	λ^{US}	λ^{UK}	λ^{JP}	λ^{GM}	λ^{hml}	λ^{cb}	λ^i	λ^{ip}	λ^m	\overline{R}^2
Mean							0.536 (1.18)	-0.209 (1.74)	-0.690 (1.43)	-0.661 (1.18)	69
Std Dev							2.995 (24.67)	0.630 (17.91)	2.568 (21.49)	3.083 (21.33)	20
25th %							-0.783 (1.40)	-0.185 (3.21)	-1.342 (3.19)	-2.245 (2.89)	60
75th %							2.147 (3.02)	-0.003 (0.67)	0.007 (0.37)	0.384 (0.65)	80

Table III
Pricing Errors
Using Portfolio Returns

This table reports the analysis of pricing errors (%) using portfolio returns. KEEPM is the Keeping-up-with-the-Joneses model, ICAPM is the international CAPM, IFF is the international Fama and French model, ICAPM_CR is the ICAPM that includes a currency risk factor, IMACRO is an international multi-factor model. S denotes 10 size sorted portfolios and SFL denotes nine size and factor loadings sorted portfolios. All includes all 76 portfolios. Panel A reports the square root of the average squared pricing error for the aggregated portfolios. Standard errors are reported in parenthesis. Panel B reports a Wald test that the pricing errors of the portfolios that make up the aggregate portfolios are jointly zero. The final row of Panel B reports a test that the pricing errors from the KEEPM model are smaller than those from the other models. * denotes the null hypothesis is rejected at the 5% level and ** denotes the null hypothesis is rejected at the 10% level.

Panel A: Square Root of Average Squared Pricing Errors					
Portfolios	KEEPM	ICAPM	IFF	ICAPM_CR	IMACRO
US S	0.188 (0.19)	0.203 (0.21)	0.160 (0.16)	0.151 (0.25)	0.197 (0.28)
US SFL	0.440 (0.39)	0.627 (0.42)	0.561 (0.39)	0.490 (0.39)	0.420 (0.34)
UK S	0.460 (0.33)	0.631 (0.38)	0.554 (0.43)	0.480 (0.33)	0.353 (0.45)
UK SFL	0.148 (0.11)	0.140 (0.07)	0.150 (0.11)	0.151 (0.09)	0.230 (0.16)
JP S	0.298 (0.33)	0.376 (0.30)	0.323 (0.29)	0.433 (0.29)	0.430 (0.32)
JP SFL	0.291 (0.25)	0.231 (0.17)	0.241 (0.161)	0.220 (0.19)	0.263 (0.21)
GM S	0.177 (0.15)	0.132 (0.16)	0.155 (0.16)	0.149 (0.11)	0.116 (0.08)
GM SFL	0.349 (0.16)	0.410 (0.16)	0.332 (0.16)	0.457 (0.22)	0.421 (0.18)
All	0.290 (0.27)	0.343 (0.32)	0.310 (0.25)	0.320 (0.25)	0.302 (0.23)

Panel B: Tests of Pricing Errors					
Portfolios	KEEPM	ICAPM	IFF	ICAPM_CR	IMACRO
US S	68.115*	63.367*	53.614*	72.796*	83.434*
US SFL	207.14*	195.06*	169.96*	177.97*	183.67*
UK S	93.405*	75.206*	90.874*	74.133*	91.775*
UK SFL	17.975*	18.422*	23.023*	16.743**	28.237*
JP S	50.875*	44.502*	42.938*	46.386*	75.053*
JP SFL	69.156*	29.600*	28.388*	36.468*	45.376*
GM S	16.961**	12.820	15.802**	17.008**	10.455
GM SFL	45.081*	19.614*	18.465*	36.491*	33.947*
All	2898.01*	2553.15*	2406.45*	2624.43*	2606.81*
All Keep - other		-3.161*	-1.015	-1.457	-0.533

Table IV
Pricing Errors
Using Individual Securities

This table reports analysis of pricing errors (%) using individual securities. KEEPM is the Keeping-up-with-the-Joneses model, ICAPM is the international CAPM, IFF is the international Fama and French model, ICAPM_CR is the ICAPM that includes a currency risk factor, IMACRO is an international multi-factor model. All includes the average pricing errors across 80 individual stocks and across one hundred estimates of the model. Panel A reports the square root of the average squared pricing error for aggregated portfolios. Standard errors are reported in parenthesis. Panel B reports a t test that the average pricing error over the one hundred versions of the model are jointly zero. The final row of Panel B tests that the pricing errors from the KEEPM model are smaller than those from the other models. * denotes the null hypothesis is rejected at the 5% level and ** denotes the null hypothesis is rejected at the 10% level.

Panel A: Square Root of Average Squared Pricing Errors

Models	KEEPM	ICAPM	IFF	ICAPM_CR	IMACRO
ALL	0.236 (0.06)	0.363 (0.03)	0.353 (0.03)	0.332 (0.04)	0.210 (0.33)

Panel B: Tests of Pricing Errors

Models	KEEPM	ICAPM	IFF	ICAPM_CR	IMACRO
ALL	36.111*	119.99*	111.73*	75.290*	14.715*
All KEEP - Other		-19.406*	-17.877*	-14.666*	3.993*

Table V
Inference on the Model Parameters
Using Portfolios

The table reports the inferred deeper parameters in the model using the prices of risk estimated with portfolios. We consider in each panel a different price of risk for the global market portfolio, λ_M (%). We then estimate the prices of risk for the orthogonal risk factors. The implied aggregate risk aversion coefficient, H , is also reported. θ is the proportion of labor income over the total country income. The two values per country are taken from Table 2 in Gollin (2002). The higher value includes the compensation of the self-employed. The parameter b represents a measure of portfolio bias. It is a function of the Joneses parameter, γ , in the exogenous model; in the endogenous model, it is a function of the relative risk aversion coefficient for the representative agent, α_{EN} . α_{EX} is the implied risk aversion coefficient in the exogenous model without Joneses behavior. $\tau^{-1} = \alpha_{EX}(1 - \gamma)$ is the scaled risk aversion coefficient for the representative agent in the presence of Joneses behavior.

θ	b	γ	α_{EN}	α_{EX}	τ^{-1}
Panel A: $\lambda_M = 0.215$; $H = 0.6683$					
United States					
60%	20.71	0.9539	-0.0507	100.67	4.63
77%	16.14	0.9416	-0.0660	72.15	4.20
United Kingdom					
57%	391.61	0.9974	-0.0025	100.67	0.25
81%	275.57	0.9963	-0.0036	72.15	0.26
Japan					
56%	61.83	0.9840	-0.0164	100.67	1.60
73%	47.43	0.9793	-0.0215	72.15	1.48
Germany					
57%	1370.12	0.9992	-0.0007	100.67	0.073
81%	964.16	0.9989	-0.0010	72.15	0.074
Panel B: $\lambda_M = 0.43$; $H = 1.9640$					
United States					
60%	7.20	0.8781	-0.1610	100.80	12.28
77%	5.61	0.8488	-0.2166	72.72	10.99
United Kingdom					
57%	128.62	0.9922	-0.0078	100.80	0.77
81%	90.51	0.9890	-0.0111	72.72	0.79
Japan					
56%	24.86	0.9613	-0.0419	100.80	3.89
73%	19.07	0.9501	-0.0553	72.72	3.62
Germany					
57%	452.75	0.9977	-0.0022	100.80	0.222
81%	318.60	0.9968	-0.0031	72.72	0.227
Panel C: $\lambda_M = 0.645$; $H = 3.2299$					
United States					
60%	4.47	0.8174	-0.2875	100.92	18.42
77%	3.48	0.7772	-0.4017	73.28	16.32
United Kingdom					
57%	75.46	0.9869	-0.0134	100.92	1.31
81%	53.10	0.9815	-0.0191	73.28	1.35
Japan					
56%	17.39	0.9456	-0.0610	100.92	5.48
73%	13.34	0.9302	-0.0810	73.28	5.11
Germany					
57%	267.32	0.9962	-0.0037	100.92	0.37
81%	188.11	0.9947	-0.0053	73.28	0.38

Table VI
Inference on the Model Parameters
Using Individual Securities

The table reports the inferred deeper parameters in the model using the mean prices of risk estimated with random samples of individual securities. Panel A uses the mean prices of risk as reported in Table II, Panel A. The implied aggregate risk aversion coefficient is $H = 2.1672$. For comparison purposes, Panel B reports the parameter estimates after imposing $\lambda_M = 0.43\%$ as in Table V, Panel B. The implied aggregate risk aversion coefficient is $H = 1.3135$. θ is the proportion of labor income over the total country income. The two values per country are taken from Table 2 in Gollin (2002). The higher value includes the compensation of the self-employed. The parameter b represents a measure of portfolio bias. It is a function of the Joneses parameter, γ , in the exogenous model; in the endogenous model, it is a function of the relative risk aversion coefficient for the representative agent, α_{EN} . α_{EX} is the implied risk aversion coefficient in the exogenous model without Joneses behavior. $\tau^{-1} = \alpha_{EX}(1 - \gamma)$ is the scaled risk aversion coefficient for the representative agent in the presence of Joneses behavior.

θ	b	γ	α_{EN}	α_{EX}	τ^{-1}
Panel A: $\lambda_M = 0.574; H = 2.1672$					
United States					
60%	174.13	0.9942	-0.0057	510.92	2.91
77%	135.69	0.9926	-0.0074	379.00	2.77
United Kingdom					
57%	812.89	0.9987	-0.0012	510.92	0.62
81%	572.03	0.9982	-0.0017	379.00	0.66
Japan					
56%	19.09	0.9502	-0.0552	510.92	25.42
73%	14.64	0.9360	-0.0732	379.00	24.21
Germany					
57%	217.20	0.9954	-0.0046	510.92	2.34
81%	152.84	0.9935	-0.0065	379.00	2.46
Panel B: $\lambda_M = 0.43; H = 1.3135$					
United States					
60%	287.74	0.9965	-0.0034	510.30	1.76
77%	224.21	0.9955	-0.0044	378.33	1.67
United Kingdom					
57%	1340.78	0.9992	-0.0007	510.30	0.38
81%	943.51	0.9989	-0.0010	378.33	0.40
Japan					
56%	30.93	0.9686	-0.0334	510.30	15.98
73%	23.72	0.9595	-0.0439	378.33	15.29
Germany					
57%	359.25	0.9972	-0.0027	510.30	1.41
81%	252.81	0.9960	-0.0039	378.33	1.49