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Testing for Rational Bubbles with Time Varying Risk Premium and Non-Linear Cointegration: Evidence from the US and French Stock Markets

This article examines the empirical validity of the present value model with time varying risk premium for the US and French stock markets. We apply a momentum threshold autoregressive (MTAR) procedure (Enders and Granger, 1998; Enders and Siklos, 2001) designed to detect asymmetric short-run adjustments to the long run equilibrium. Our results indicate that without a large conception of fundamental (i.e. earnings instead of dividends) and proxies for the time-varying risk premium, classical tests conclude that the US stock prices exhibit explosive rational bubble (Blanchard and Watson, 1982). However, our findings provide support for the hypothesis that, in the short-run, US stock prices (1871-2002) and French stock prices (1951-2002) exhibit run-ups followed by crashes while, in the long-run, stock prices are attracted by fundamentals.