Discussion of

Rare Disasters and Exchange Rates

by

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UPenn and NBER

Really three papers...

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UIP

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- Or is it beta? Picking up nickels...

Rietz (1988, *JME*)-Barro (2006, *QJE*) tradition

Ancestors and Relatives: I

e.g., Mark (1995, *AER*)

$$\Delta \ln S_{t,t+h} = f(S_t - F_t)$$

$$F_t = g(\Delta \ln Y_t - \Delta \ln Y_{t*},\ \Delta \ln M_t - \Delta \ln M_{t*},\ i_t - i_{t*},\ \ldots)$$

Ancestors and Relatives: II

ARCH vol (Engle, 1982, *Econometrica*):

$$\hat{\sigma}_t^2 = \hat{\omega} + \hat{\alpha}\Delta\ln S_{t-1}^2 + \hat{\beta}\sigma_{t-1}^2$$

Realized vol (Andersen et al., 2006, *Econometrica*)

$$\sigma_t^2 = f(\hat{\sigma}_{t-1}^2,\ \hat{\sigma}_{t-2}^2,\ \ldots)$$

Long memory

Unconditional fat tails

Reduction under temporal aggregation

Descendants?

$$\Delta \ln S_t \sim \begin{cases} D_1 \ w.p. \ p_t \\ D_2 \ w.p. \ (1-p_t) \end{cases}$$

$$p_t = f(p_{t-1}, p_{t-2}, \ldots)$$

Hamilton (1989)
Diebold, Lee and Weinbach (1994)

Disaster *Probability* or Disaster *Fear*?

Campbell-Diebold (2008), Goetzman et al. (2008)

Two key excess return predictors:

I. Livingston expected business conditions

II. Lettau-Ludvigson CAY_t

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(RISK AVERSION)