

Summary of chapter 1_the end of risk-free rate

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Summary of Chapter 1_The End of Risk-Free Rate While trade risks usually refer to monetary losses, risk-free rate refers to an investment return without financial loss. While this was practical aspect in the past, the sense of the term ' risk-free' has changed in the contemporary world since nothing is truly free. This changed due to the emergence of the financial crisis. This eliminated the idea of free-rate government bonds and brought other negative economic implications such as monetary devaluation, which is the main reason behind inflation. A government bond has an essential role in how the society functions. This is because the bonds provide funds for healthcare, education, law enforcement as well as other public requirements. The most common theories associated to risk free rate and from which other valuations are derived include modern portfolio theory (MPT) and the capital asset pricing model (CAPM). Additionally, the risk free rate functions in rare occasions since the MPT maintains that there is only one risk-free rate, which is the risk-free rate asset that pays a low rate. The risk free rate is used by MPT to determine the optimum portfolio.

At the basic level, risk is said to be the probability of outcomes or events and is divided into three main categories that include absolute, default and relative risk. There have been attempts to use alternatives to the risk-free rate such as the T-bill that remains the best option since it was the closest investment to a short-term riskless security. The main reason why the risk-free rate has changed is the catastrophic events happening in most developed countries' economies that include credit market collapses, stock market collapses, and wars. The valuation level of the risk-free rate can be determined or judged through the Fisher equation. The idea that treasury

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bills have yielded zero or negative in certain periods indicates that there is no real risk-free rate. On the other hand, there have been increased debts in major governments and the development of other aspects such as debt mutualization. This is because of realization of too little growth versus intense debts. In some instances, the total debt has exceeded the total GDP. Without growth, fiscal consolidation proves futile. Fiscal measures should be permanent to help in reduction of debt. If austerity is followed, it could take approximately 10 years to realize results. Debt ratio might increase by attempting to reduce it through austerity, which adds risk premium to government bonds over time.

The market demand for safe assets has increased in the recent past although few are being issued. This increases their prices leading to inflation especially in a post financial crisis era. Prior to the financial crisis, there were regulations such as inflation targeting policies that reduced economic risks. Underpricing of safe assets has been viewed to be connected to the over-reliance on credit ratings as well as the wrong incentives. Safe assets usually fulfill the criteria of low credit and market risks, limited inflation risks, low exchange rate risks, and high market liquidity. Investing in a negatively yielding bond expects the return of zero coupon bond minus a short rate, a forward rate minus expected future spot rate, and a zero coupon yield minus the average expected short rates. The zero bound is a constraint or a limit in using conventional tools. MPT maintains that diversification is achieved through buying the market portfolio.