Financial market and institutions ( )

Finance

Financial Market and The questions below related to Chapter 4: why do interest rates change? From the book “ financial market and institution, 7eMishkin”.

Q1.

Wealth: as wealth increase, demand for assets is more likely to increase. When an economy expands with the growing wealth, demand for bonds raises, conversely, the demand for bonds falls when the economy and income falls. Expected returns: changes in expected return impact on the demand of the asset. Higher or increased expected interest rates in the future economy decreases the demand for long-term bonds; on the other hand, lower or reduced expected interest rates in the future increases demand for long-term bonds. Risk: an increase in risk causes the demand for bonds to fall; alternatively, reduced risk of assets causes the demand for bonds to rise. Liquidity: Fast and flexible liquidity of the asset market enhances demand for the assets. Conversely, increased liquidity of the alternative asset markets (like the stock market) lowers the demand for bonds. Wealth is the factor that impact on the total asset demand and that influence investors to demand one asset over another.

Q2.

Equilibrium interest rate is determined when the money supply and the interest are balanced. The interest rate moves towards equilibrium when the temporarily above or below the below or above the rate of equilibrium because of excess or extreme supply, which in turn rises the interest rate.

Q3.

The transparent analysis of the Fisher effects is that if the expected inflation rises by 5% and above, the expected return on interest rate falls as a result of fall in the demand for the bond. Fisher effects occur because when expected inflation increases or rises, the nominal interest rates rise in return (Mishkin and Eakins 140). The rise in expected inflation is a transparent proves that the real cost of borrowing or lending has declined, causing increase in the quantity of bonds supplied. Equilibrium bonds with fall in demand and increase in supply.

Q4.

If bonds turn out to be riskier than other assets, investors tend to switch and invest in less risky assets. Increase in relative risk of bonds decreases bond demand.

Q5.

The decreased riskiness of bonds increases the demand for bonds. The demand curve shifts to the right and the equilibrium bond price rises and the interest rate falls. Higher federal government deficits increase the supply of bonds

Q6.

Re= P1R1+p2R2+……….+ PnRn

Re= 0. 66*9%+0. 33*3%= 7%

Standard deviation is asset's risk and is equivalent to 2. 282%.

Bonds with lower standard deviation of return are preferred while all other are equal. The others are have a standard deviation of 4. 5% which is has the same expected returns.

Q7.

Expected Profitability of Investment Opportunities; in a business cycle expansion, the supply bond falls when there are fewer expected profitable investment opportunities. Expected Inflation; supply of bond increase when there is an increase in expected inflation. Government Activities; higher federal government deficits increase the supply of bonds, conversely, government surpluses reduces the supply of bonds.

These questions related to Chapter 5: How do risk and term structure affect on interest rate. From the book " financial market and institution, 7eMishkin".

Q1.

Liquidity premium theory elaborates all the facts of the term structure that entails states interest rates for various maturities move together, yield curves have downward slope in conditions that short rates are high and steep upwards slope when short rates are low and yield curve is typically upward sloping. Market segmentation theory elaborates one factor of the term structure. It elaborates that a yield curve is typically upward sloping.

Q2.

Borrowing cost for local government and municipalities culminates increased I income tax because of the huge tax differentials. Increased demand for borrowing funds causes the government to postpone buying decisions, raise tax, or highly rely on bond issues.

Q3.

The yield curve is an essential tool equipped with information about future interest rates that assists in real output production and forecast inflation.

Q4.

This is because expectation theory is transparently explains that bonds of various maturities are perfect substitutes. It is proved in the statement that Re on bonds of various maturities are equal.

Q5.

Risk structure of interest rate is the relationship focused on bond interest rate of same dept instruments such as maturity, payment structure, and issuer.

Q6.

Severe recession will always raise the premium risk. This in turn shifts the demand curve towards the left.

Q7.

This is because, if a corporate begins to suffer huge losses, the default risk on the corporate bond increases. The bonds return will turn out to be uncertain, meaning, which will in turn cause the expected return on the corporate bond to fall.

Q8.

Credit-rating are obligated to assign credit ratings. The ratings rate a debtors ability to make timely debt payment and the likelihood that default will culminate. The agencies are essential in assessing the risk of investing in the government and other firms.

Q9.

Liquidity is quick and cheaper. It can be converted into cash in case any need culminates. This makes it to be widely accepted.

Works Cited

Mishkin, Fredric, and Eakins Starnley. Financial Markets and Institutions. New Jersey: Pearson Education. 2014, Print.