# Financial markets assignment

Economics, Financial Markets

FINANCIAL MARKETS & INSTITUTIONS ASSIGNMENT 1. Explain how interest rates decline following major Fed purchases of mortgage-backed securities. The FED implements quantitative easing by buying financial assets of longer maturity, e. g. , mortgage-backed securities, from commercial banks and other private institutions in order to inject a pre-determined quantity ofmoneyinto the economy. This is a means of stimulating the economy and lowering longer-term interest rates further out on the yield curve; quantitative easing increases the excess reserves of the banks, and raises the prices of the financial assets bought, which lowers their yield.

Graphically, this can be explained with the aid of Figure below. The supply of money is shifted from point 1 to the right (MS1 to MS2) and, all else equal, the new equilibrium point (with aggregate money demand curve) is at point 2, where the interest rate is lower. i i1 i2 AD1 MS1 MS2 Quantity of Money 2. What could be the implications of lower interest rates for households and businesses? By implanting the policy of purchasing mortgage-backed securities, the FED has set its sight on increasing consumption and investment, which will ultimately increase employment.

As described in question one Bernanke’s policy decreased interest rates to new record lows, encouraging borrowing for both businesses and households. The ability to borrow money at more attractive rates stimulates investment in durable consumer goods, such as automobiles, and in operational necessities such as buildings and capital equipment for businesses. Indeed, after the implementation of the policy mortgage applications increased significantly.

Because of low interest rates households and businesses as investors could shift their preference away from bonds and into stocks. According to frbsf. org, the increase in stock trading volume has the effect of raising the value of existing stock portfolios, which in turn stimulates consumer and spending across the country due to the psychological effects of rapid capital appreciation. Lower interest rates can have negative effects on the value of the local currency compared to other currencies.

As foreign investors dump their local-denominated investments in favor of more profitable currencies, exchange rates can shift to the detriment of the local currency. The weakening of the local currency serves to increase the attractiveness of local goods to foreign purchasers, which has the effect of boosting exports and international sales. All of the factors mentioned above have the combined effect of increasing productive output, or GDP, and increasing employment across a wide range of industries.

As individuals, businesses and foreign investors are encouraged to spend more due to increased access to capital, higher portfolio valuations and weaker currency values, businesses in nearly every sector experience an increase in sales, often requiring them to grow their operations and employ additional labor. However, there are some negative implications from this policy. Without a strong commitment to control inflation over the long run, the risk of higher inflation is one potential implication of experiencing real interest rates below the economy’s natural interest rate.

Low interest rates provide a powerful incentive to spend rather than save. In the short term, this may not matter much, but over a longer period, low interest rates penalize savers and those who rely heavily on interest income.

If short-term interest rates are low relatively to long-term rates, households and firms may overinvest in long-term assets, such as Treasury securities. If interest rates rise unexpectedly, the value of those assets will fall (bond prices and yields move in opposite directions), exposing investors to substantial losses.

Finally, low short-term interest rates reduce the profitability of money market funds, which are key providers of short-term credit for many (large) firms, e. g. the commercial paper market. 3. Explain the Fed's policy dilemma and try to rationalize why unemployment in the US is stubbornly high while inflation is low. Based on the theory of the Philip's curve diagram we notice that there is an inverse relationship between inflation and unemployment. Stated simply the lower the unemployment in an economy the higher the rate of inflation.

Philip's Curve Inflation Unemployment The explanation of the inverse relationship between inflation and unemployment is based on two assumptions. The first has to do with the fact that as unemployment rises there is no room for workers and labor unions to demand an increase so a wage inflation that would increase the prices of the final products cannot occur. Secondly high unemployment is a reflection of the decline in economic output and indicates an economy's slowdown. Therefore competition among firms in recession will lead the prices at lower levels.

But this is not the case currently in the US since we observe high unemployment and low inflation. The FED is concerned about the unemployment rate and in an effort to stimulate the economy and improve the labor market conditions it started implementing the quantitative easing policy. So the FED purchased MBS, helped banks to rebuilt their balance sheets, contributed into maintaining price stability, preserved interest rates near zero for more than three years, and prevented the economy from slipping into greater recession. Despite all these efforts the situation in the labor market did not improve.

Apparently the fact that unemployment is still very high depicts the limitations of the monetary policy. The low business confidence, policy uncertainty, and the government’s reluctance to act are beyond the FED’s capacity. What is more the infinite use of the quantitative easing may produce undesirable effects in the long run such as stagflation. The only optimal solution under these circumstances is the co ordination of the FED’s monetary policy with the government’s fiscal policy plan that could boost the society’s confidence. . Do you think that another round of quantitative easing (QE) by the Fed would help stimulate the US economy? Please explain. The FED declared that the use of QE will be aggressively continued until the economy is improved. The cash injections into the economy helped interest rates to remain at low levels. Consequently everyone wins from this decision in the short run; homeowners can borrow at historical low levels of interest rate, corporations can also take advantage of this act and invest, consumption increased and also the banks increased their profits and the stocks record a growth. So as long as the QE is active in the short run everyone is a winner. But in the long run things become vague. First of all historical evidence shows that despite the fact that interest rates may be at levels near zero it remains uncertain whether this will be the incentive to boost the actual economy. Secondly the fact that consumers will have more money to spend but fewer goods to buy might lead to a hyper inflation.

Furthermore by repeating the use of QE is very possible to lead to a liquidity trap, unless the economy finds ways to stimulate production. Last but not least the FED's decision to inject cash into the economy by purchasing MBS is questionable; Mortgage backed securities entail the risk of defaulting once again as they did in the real estate crisis and that would cost the Americans a lot more money repeating the history that started back in the September of 2001. To sum up the use of QE is indeed very effective but only in the short run.

Short periods of economic recession can be avoided by stimulating the economy temporarily through cash injections but to maintain growth on the real economy we need to improve labor market conditions, productivity, innovation and bolster the economy's confidence. So a combination of fiscal and monetary policy is the only way to prevent an economy from collapsing, and also is this is the only way to avoid a possible systemic risk that will negatively affect all the institutions and individuals. . How is a loose Fed monetary policy in the US affecting fundamentals (such as inflation, asset and commodity prices) in other countries? What does that imply about global monetary policy? Since the dollar is the vehicle currency in the global economy almost every country is tied to its value and everyone is affected by the monetary decisions of the FED. By the QE, the supply of dollars is increased and consequently the dollar depreciates against foreign currencies.

This means that America’s exports will increase and on the contrary the imports will decrease. So countries trading with the US fear about the capital inflows and the possible inflation on commodities. On the other hand the FED support that there can be no further inflation since the global economy is in recession. Moreover countries experiencing huge capital inflows resulting in inflation can implement fiscal policy, such as imposing taxes, in order to contain the effects of foreign capital inflows which push up local stock prices and the currency itself.

Every country should focus on its own monetary policy adjusting it to the problems that may experience. For example the US chose to inject more money in the economy. The results of such a decision are low interest rates, more exports but always with the risk of inflation. On the other hand a country experiencing high inflation might limit the money supply, increasing the interest rates with the risk of experiencing a decline in exports.