Supply and Demand for Assets

ECO 301: Money and Banking

Learning Outcomes

- LO3: Predict changes in interest rates using fundamental economic theories including present value calculations, behavior towards risk, and supply and demand models of money and bond markets.
- LO4: Describe how interest rates, interest rate risk, and expectations of future interest rates affect decisions made by consumers and financial institutions.

Reading and Exercises

- Supply and demand for bonds: Chapter 4, pp. 102-115
- Loanable funds market: Chapter 4, pp. 129-137
- **Canvas quiz due Wednesday 11:59 PM**.
- **Homework/Exercise due Friday 11:59 PM**. We will work together in class on Thursday

Bond Price versus Interest Rate

Yield to maturity, i, on a discount bond, face value, F, maturity date, T, and price, P:

$$P = \frac{F}{(1+i)^T}$$

$$(1+i)^T = \frac{F}{P}$$

$$1 + i = \left(\frac{F}{P}\right)^{1/T}$$

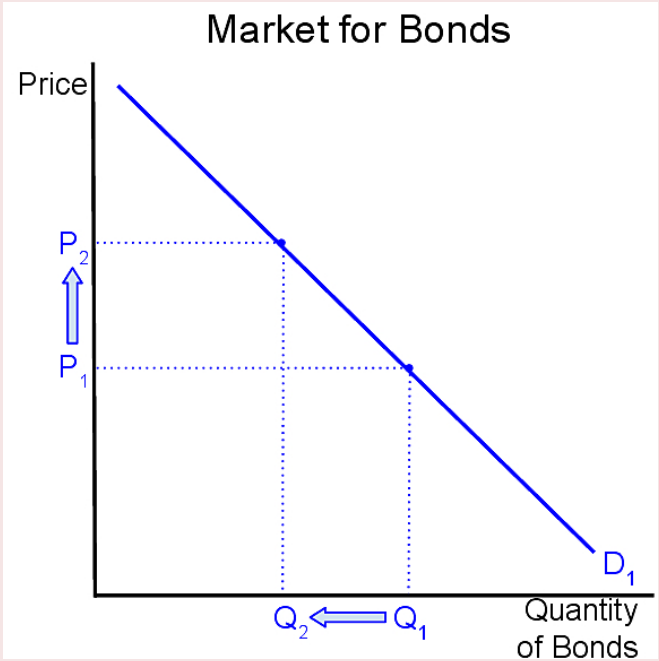
Interest rate is inversely proportional to the price of the bond.

Demand Curve for Bonds

Demand Curve and Interest Rate

- Interest rate decrease ≡ Bond price increase
- → **lower return on lending (buying bonds)**
- → **decrease in quantity bonds demanded**
- Law of demand for bonds implies the demand curve will be downward sloping.

Demand Curve for Bonds

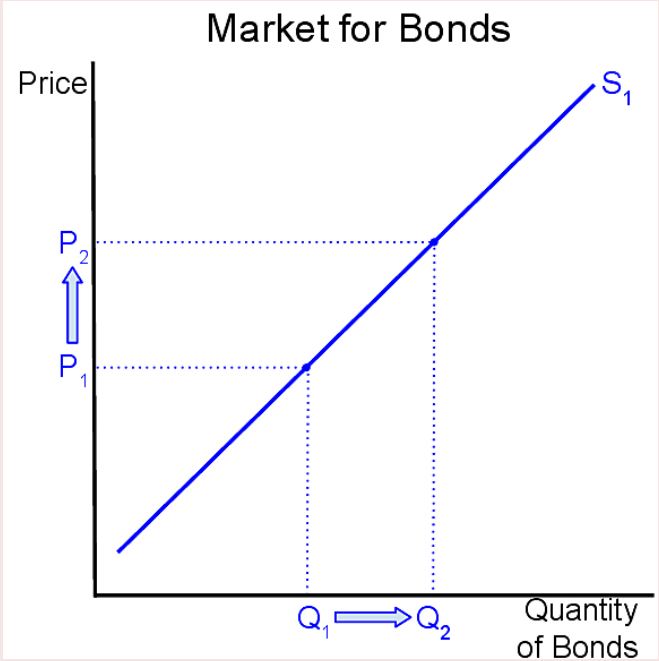


Supply Curve for Bonds

Supply Curve and Interest Rate

- Interest rate decrease ≡ Bond price increase
- → **lower cost of borrowing (selling bonds)**
- → **increase in quantity bonds supplied**
- Law of demand for supply implies the supply curve will be upward sloping.

Supply Curve for Bonds

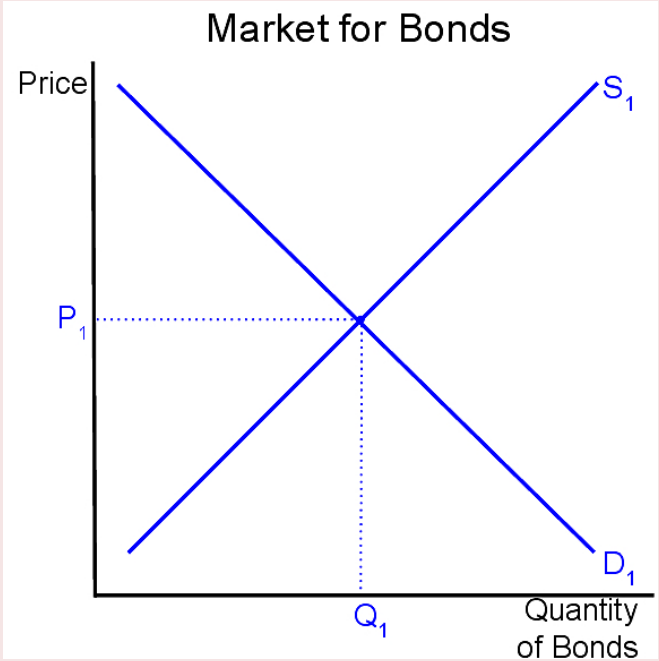


Equilibrium

Equilibrium in the Bond Market

- Equilibrium price of bonds is the price such that the quantity supplied is equal to the quantity demanded
- The equilibrium quantity is that corresponding quantity

Graphical Equilibrium

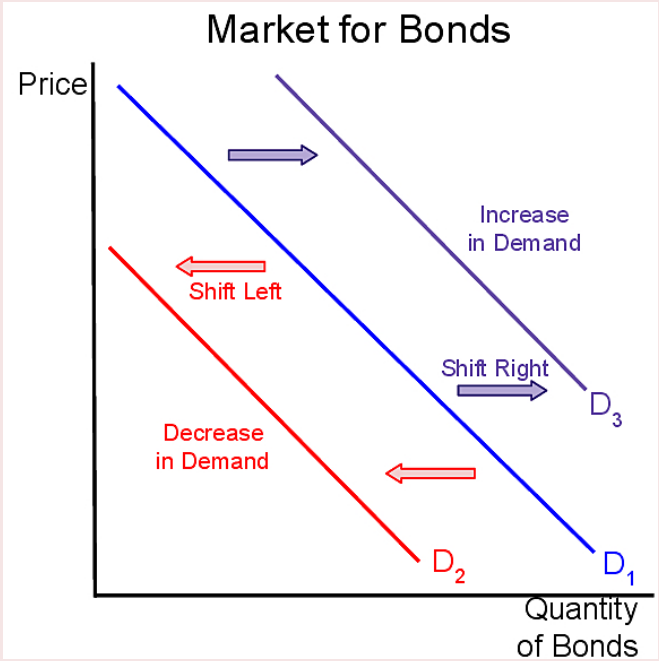


Demand Curve Shifts

Shifts in Bond Demand Curve

- When something *besides the price of the bond (or equivalently, besides the interest rate)* affects the demand for bonds, there is a *shift in demand*.
- Something that **increases** bond demand shifts the demand curve to the **right**
- Something that **decreases** bond demand shifts the demand curve to the **left**

Shifts in Demand

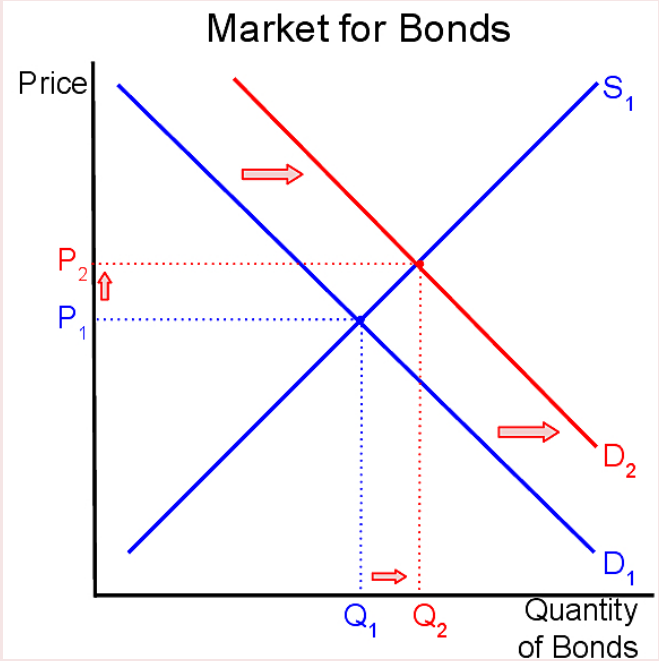


Increase in Wealth

Increase in Wealth

- Wealth: total value of all resources owned by an individual, including all assets.
- An increase in wealth shifts the demand for bonds to the right.
- Price of bonds increases
- Interest rate decreases
- Quantity of bonds (quantity of borrowing) increases

Equilibrium



Risk

- **Risk averse:** a lender/saver is risk averse if he/she is willing to accept a lower expected return for an asset that has greater *certainty* for the rate of return.
- **Risk neutral:** a lender/saver is risk averse if uncertainty regarding a return *does not affect* the demand for an asset. Only expected return is considered important.
- **Risk loving:** a lender/saver is risk loving if he/she is willing to accept a lower expected return for an asset that has greater *uncertainty* for the rate of return.
- Assuming risk-averse lenders/savers, an increase in the risk of an asset causes a decrease in the demand for the asset.

Expected Return

- Expected return: weighted average of all possible cash flows for an asset.
- Example: Suppose a one-year discount bond with face value equal to \$150 is purchased for \$120
- ... and there is a 15% chance of full default

$$\text{YTM:} \quad P = \frac{CF}{1+i}, \qquad 1+i = \frac{CF}{P} \qquad i = \frac{CF}{P} - 1$$

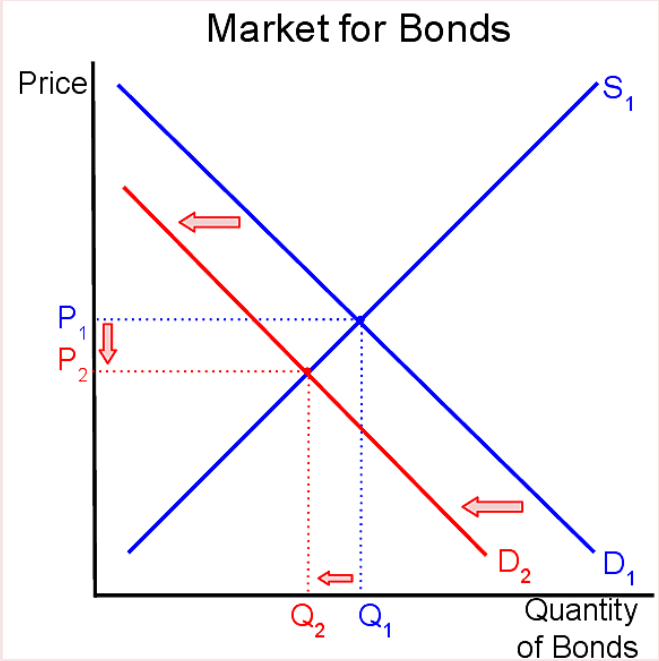
  - Return if no default $CF = 150$, $P = 120 \rightarrow YTM = i = 150/120 - 1 = 0.25 = 25\%$
  - Return if default: $CF = 0$, $P = 120 \rightarrow YTM = i = 0/120 - 1 = -1 = -100\%$
  - Expected return $\equiv R^e = 0.85(0.25) + 0.15(-1) = 0.055 = 5.5\%$.
- Higher probability of default → decreases expected return → decreases demand for bonds

Risk of Default

Increase in Default Risk

- Higher default risk leads to a decrease in demand for bonds
- Price of bonds decreases
- Interest rate increases
- Quantity of bonds (quantity of borrowing) decreases

Equilibrium

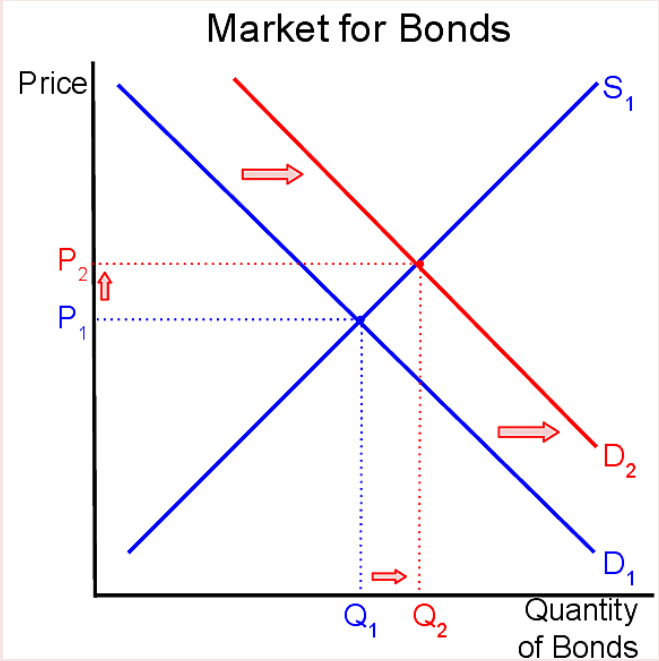


Interest Rate Risk

Interest Rate Risk

- Less uncertainty regarding future path of interest rates leads to less capital gains risk
- Bond demand shifts to the right
- Price of bonds increases
- Interest rate decreases
- Quantity of bonds (quantity of borrowing) increases

Equilibrium

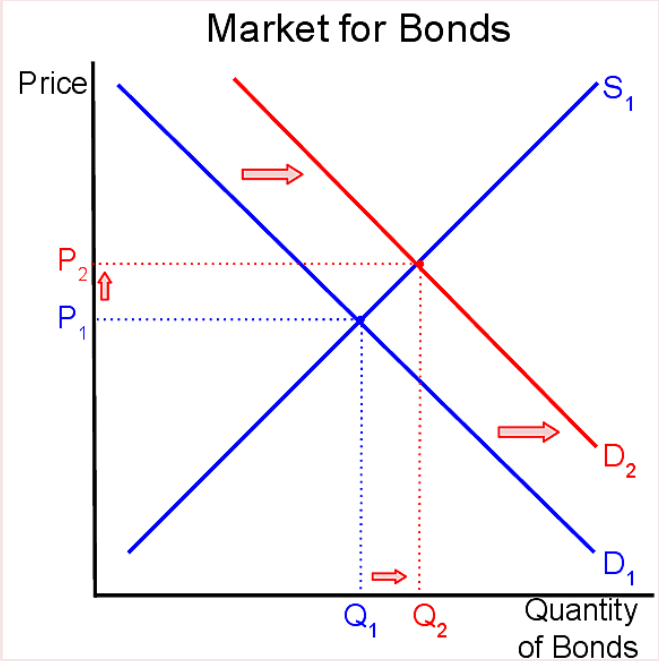


Liquidity

Increase in Liquidity

- More liquidity causes bond demand to shift to the right
- Price of bonds increases
- Interest rate decreases
- Quantity of bonds (quantity of borrowing) increases

Equilibrium

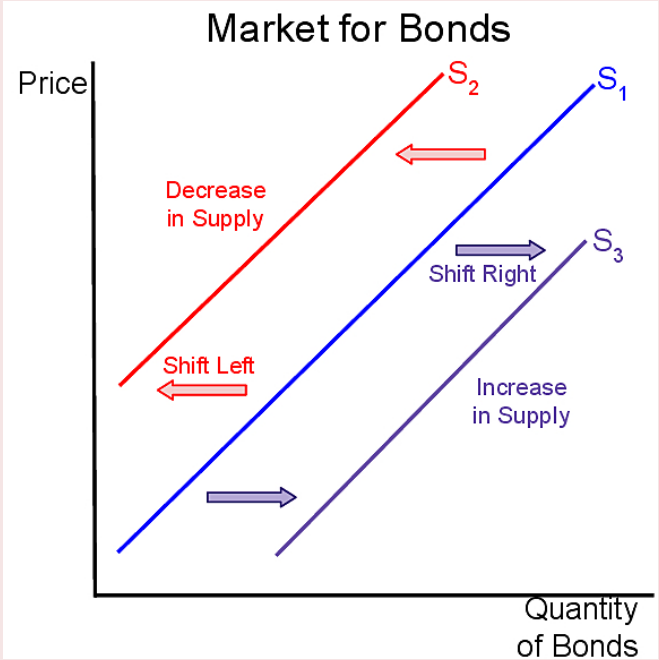


Supply Curve Shifts

Shifts in Bond Supply Curve

- Corporations, governments, financial institutions supply bonds to borrow funds
- When something *besides the price of the bond (or equivalently, besides the interest rate)* affects the supply for bonds, there is a *shift in supply*.
- Something that **increases** bond supply shifts the supply curve to the **right**
- Something that **decreases** bond supply shifts the supply curve to the **left**

Shifts in Supply

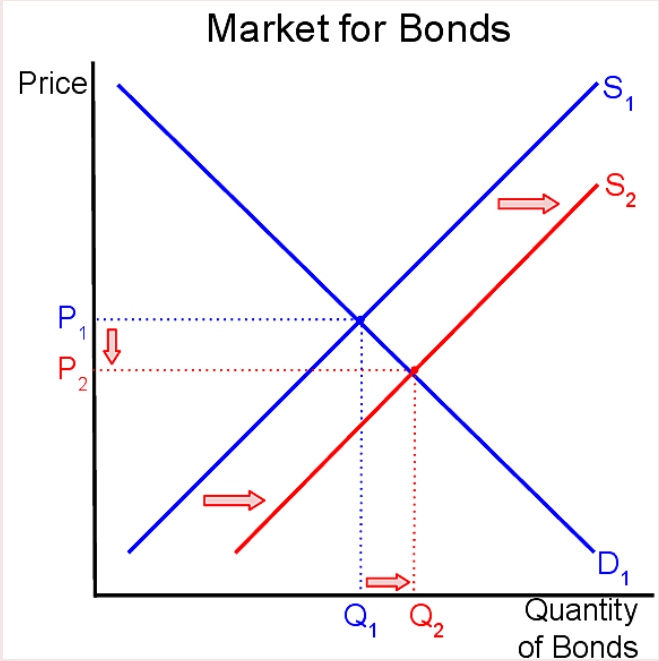


Expectations for Profitability

Increase in Expected Profitability

- If corporations are optimistic about future profitability, they are more likely to invest in capital, more willing to borrow to finance investment
- Bond supply shifts to the right
- Price of bonds decreases
- Interest rate increases
- Quantity of bonds (quantity of borrowing) increases

Equilibrium

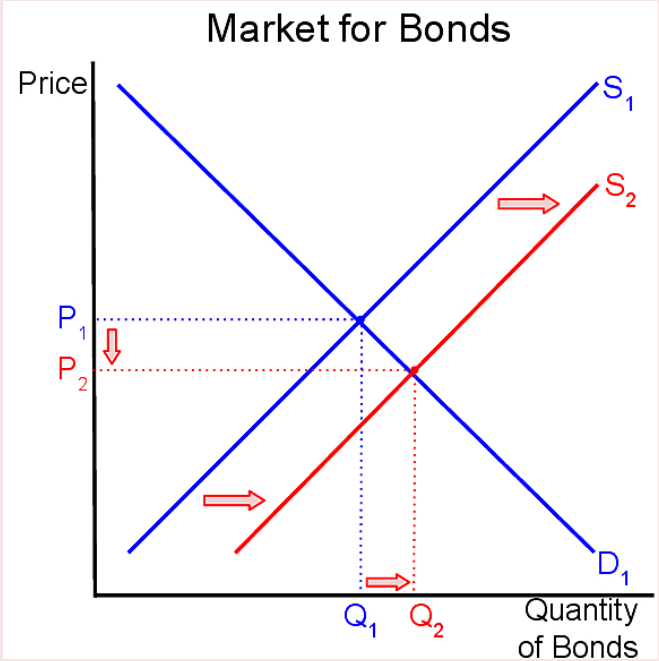


Government Borrowing

Increase in Government Borrowing

- When governments borrow more, bond supply shifts to the right
- Price of bonds decreases
- Interest rate increases
- Quantity of bonds (quantity of borrowing) increases

Equilibrium

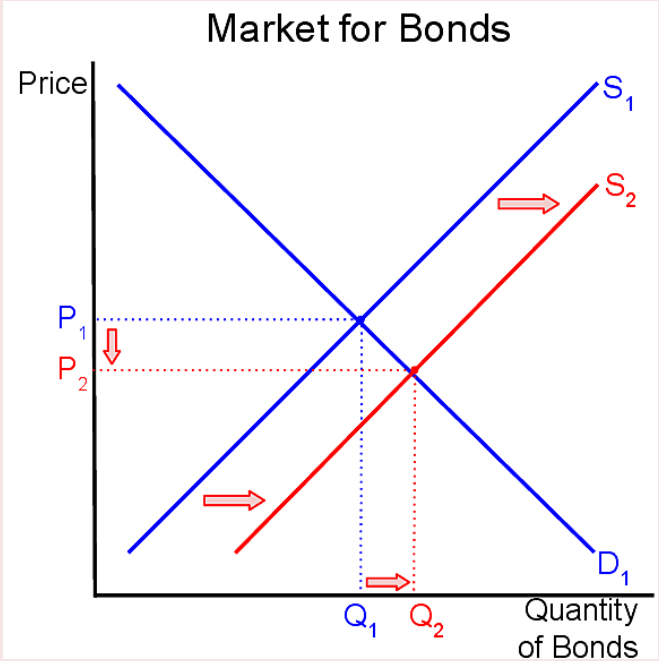


Open Market Operations

Open Market Sale of Bonds

- When the central bank conducts an open market sale of bonds, bond supply shifts to the right
- Price of bonds decreases
- Interest rate increases
- Quantity of bonds increases

Equilibrium

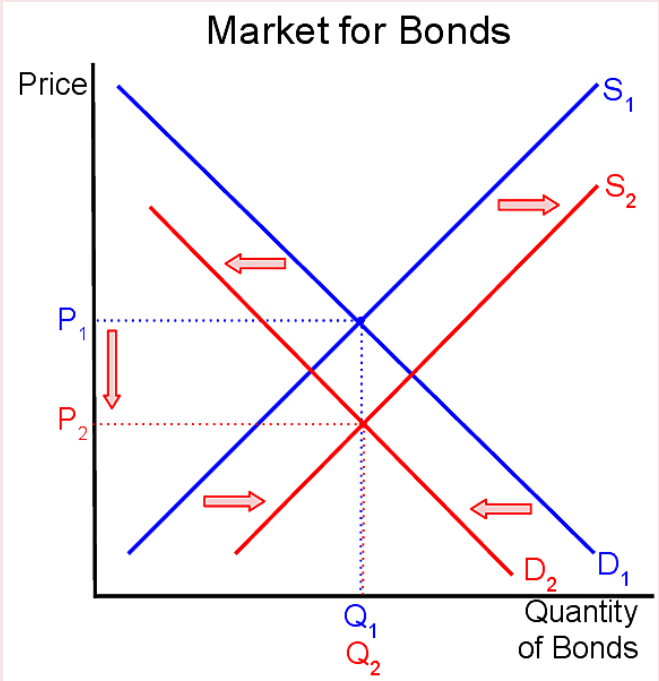


Expectations for Inflation

Increase in Expected Inflation

- If corporations expect higher inflation → they expect the real value of the future bond payments to decrease → more willing to borrow to finance investment
- If lenders expect higher inflation → they expect the real value of the future cash flows to decrease → less willing to borrow to finance investment
- Bond supply shifts to the right, bond demand shifts to the left
- Price of bonds decreases, interest rate increases

Equilibrium



Loanable Funds Market

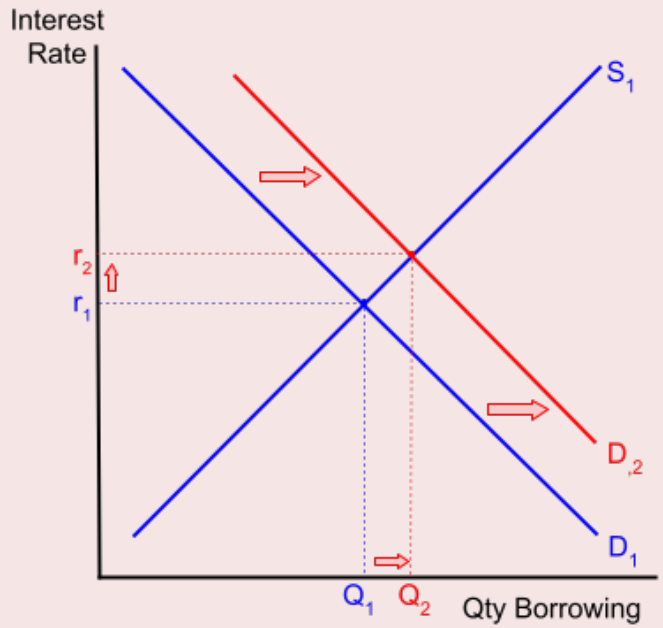
- Alternative to the supply and demand model for bonds
- Can represent borrowing and lending more generally, than just sales of bonds
- **Demand for loanable funds:** Borrowers who *pay interest* to obtain borrowed funds
- **Supply of loanable funds:** Lenders and savers who *receive interest* on their loans or savings
- Price in the market: interest rate
- Quantity in the market: quantity of loanable funds
- The demand side for the bonds market is the supply side of the loanable funds market
- The supply side for the bonds market is the demand side of the loanable funds market

Expectations for Profitability

Increase in Expected Profitability

- If corporations are optimistic about future profitability, they are more likely to invest in capital, more willing to borrow to finance investment
- Demand for loanable funds shifts to the right
- Interest rate increases
- Quantity of borrowing increases

Equilibrium

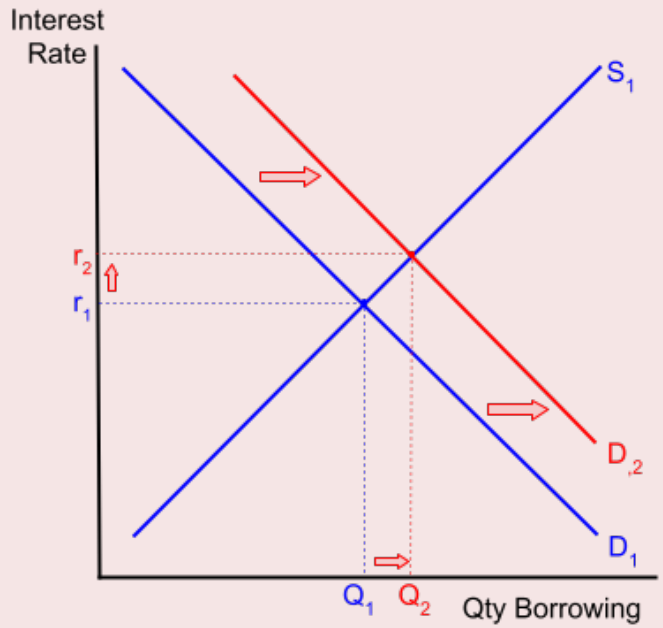


Government Borrowing

Increase in Government Borrowing

- When governments borrow more, demand for loanable funds shifts to the right
- Interest rate increases
- Quantity of borrowing increases
- Crowding out: increase in government borrowing leads to a decrease in private borrowing

Equilibrium

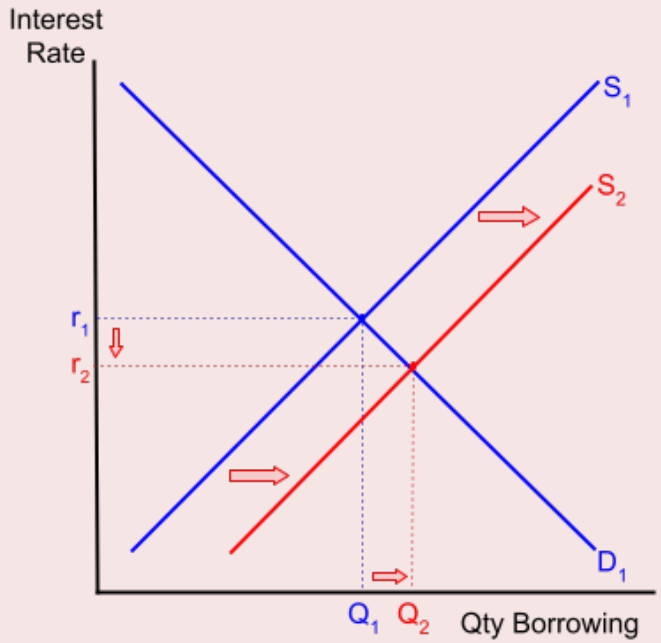


Increase in Wealth

Increase in Wealth

- Wealth: total value of all resources owned by an individual, including all assets.
- An increase in wealth shifts the supply of loanable funds to the right.
- Interest rate decreases
- Quantity borrowing increases

Equilibrium

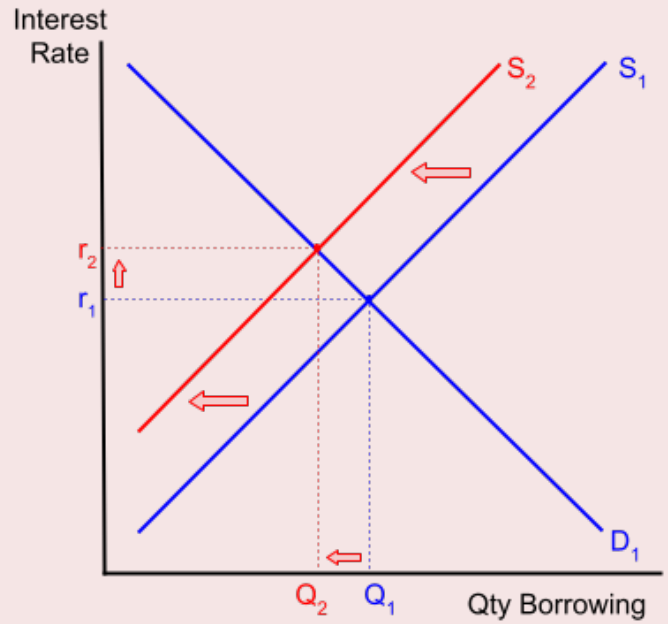


Risk of Default

Increase in Default Risk

- Higher default risk leads to a decrease in willingness to lond
- Supply of loanable funds shifts left
- Interest rate increases
- Quantity of borrowing decreases

Equilibrium

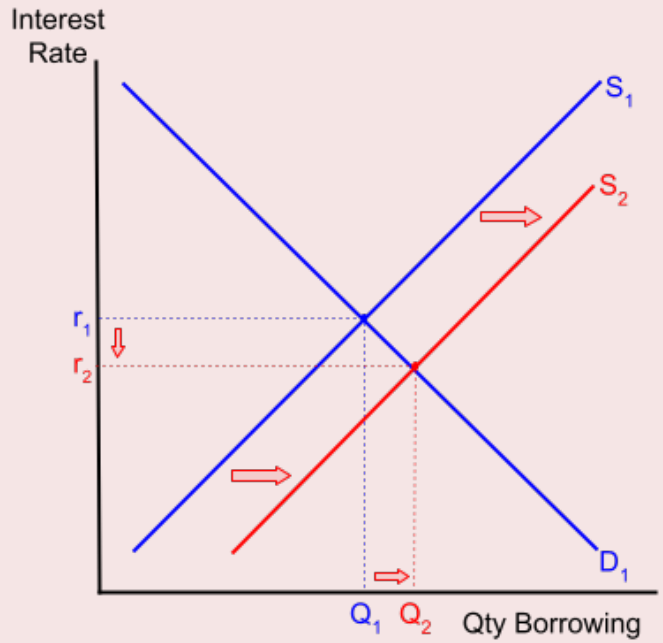


Interest Rate Risk

Interest Rate Risk

- Less uncertainty regarding future path of interest rates leads to less capital gains risk
- Increased willingness to lend
- Supply of loanable funds increases
- Interest rate decreases
- Quantity of borrowing increases

Equilibrium

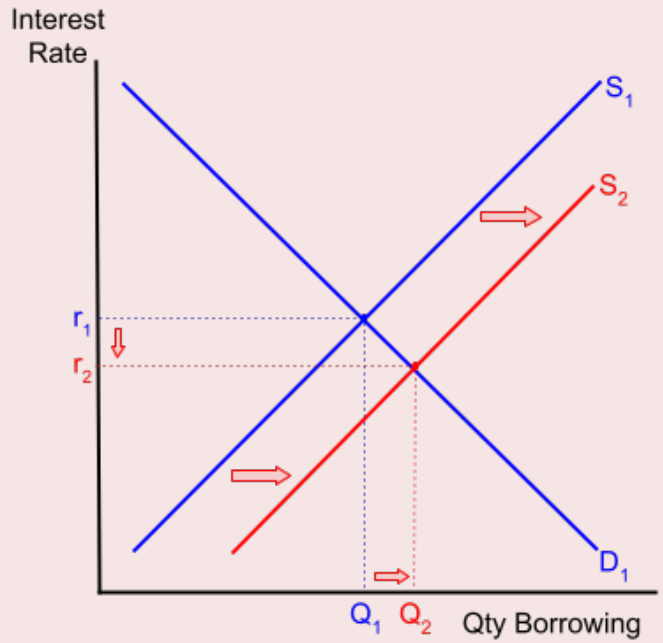


Liquidity

Increase in Liquidity

- More liquidity for debt-based securities leads to more willingness to lend
- Supply of loanable funds increases
- Interest rate decreases
- Quantity of borrowing increases

Equilibrium



Reading and Exercises

- Supply and demand for bonds: Chapter 4, pp. 102-115
- Loanable funds market: Chapter 4, pp. 129-137
- **Canvas quiz due Wednesday 11:59 PM**.
- **Homework/Exercise due Friday 11:59 PM**. We will work together in class on Thursday