

Supply and Demand for Assets

Economics 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

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- Read Hubbard and O'Brien, Chapter 4.

Price versus Interest Rate

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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.

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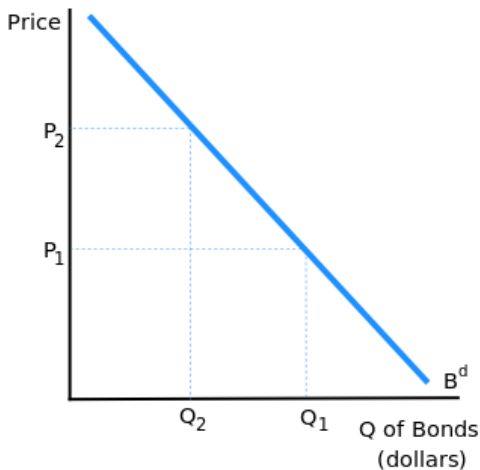
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Demand Curve for Bonds

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- 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.



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Determinants of Asset Demand

- When something *besides the price of the bond* affects the demand for bonds, we say there is a **change in demand** or a **shift in demand**
- 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.
- Expected return: changes in expectations of returns for given asset *and related assets*.
- Risk: degree of uncertainty regarding the return of an asset (includes interest and capital gains).
- Liquidity: ease and speed to which an asset can be converted to a means of payment.
 - An increase in liquidity causes an increase in demand for an asset.

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Expected Return

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- 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

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

- 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
 $\equiv R^e = 0.85(0.25) + 0.15(-1) = 0.055 = 5.5\%$.

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Expected Return

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- An increase in expected return relative to other assets increases demand for the asset today.
- An increase in expected return for alternative assets decreases demand for the asset today.
- Suppose you expect interest rates to rise.
 - What do you expect will happen to the price of the bond?
 - What do you expect will happen to capital gains on the bond?
 - What effect does this expectation have on *today's* demand for the bond?
- Expected Return should consider *real* return, not *nominal* return.
 - What would happen to the demand for a bond with fixed cash flows if there is an increase in expected inflation?

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- **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 neutral 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.
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Determinants of Supply

- When something *besides the price of the bond* affects the supply for bonds, we say there is a **change in supply** or a **shift in supply**.
- An increase in expected profitability of investment opportunities increases the supply of bonds.
 - A recession decreases the profitability of businesses, causes a decrease in supply of bonds.
- Expected inflation: an increase in inflation decreases the real purchasing power of the cash flow.
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- Government budget: when Federal government runs a budget deficit, they sell government bonds, increasing the supply of bonds.

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Equilibrium

- Equilibrium quantity and price (and therefore interest rate) are determined by intersection of supply and demand curves.
- Predict how quantity of bonds, price of bonds, and interest rates will change if...
 - the Federal Reserve sells reserves of Treasury bills on the open market.
 - there is a break down in financial markets that makes it more difficult to buy and sell bonds on the secondary market.
 - businesses expect the an improving economy will result in higher demand for goods and services.
 - people expect the Federal Reserve will soon be raising interest rates.

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Next Topic

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- Chapter 5: More on behavior of interest rates: term structure of interest rates.