ECO 301: Money and Banking **Name:** ______________________

In-class Exercise: Supply and Demand for Bonds

Learning Objective: 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.

Directions: Work in groups of up to four people and answer the following questions. All papers will be collected, but only one member's paper will be randomly selected and graded and all members of the group will receive the same grade.

By signing below, you agree that the following work represents the efforts of everyone in the group, and you are willing to accept as your own grade for the group project the grade earned from this representation of your group's work. Every member must agree to these terms to earn a non-zero grade for this assignment.

______________________	______________________	____________
Signature Group Member 1	Print Name	Date
______________________	______________________	____________
Signature Group Member 2	Print Name	Date
______________________	______________________	____________
Signature Group Member 3	Print Name	Date
______________________	______________________	____________
Signature Group Member 4	Print Name	Date

1. (10 points) The Federal Reserve can print money and also owns reserves of Treasury bonds and other securities. Recently the Fed has kept interest rates extremely low (the Federal Funds rate is between 0% and 0.25%). Use a supply and demand market for bonds to illustrate how the Fed can keep interest rates so low. Explain what action the Fed must be taking.

2. (10 points) Suppose the actions of the Federal Reserve cause people to expect inflation to rise. What will be the impact in the bond market? What will be the impact on interest rates? What does this imply about the sustainability of current monetary policy?

3. (10 points) What impact does increased uncertainty about future interest rates and inflation rates have on the bond market? What is the impact on interest rates on long-term bonds versus short-term bonds?

4. Suppose people expect government deficits to continue to grow, and expect the government to little to reduce national debt.

    (a) (10 points) What will be the impact of this expectation on expected future interest rates? Answer using a bond market supply and demand analysis.

    (b) (10 points) What impact does your answer to part (a) have on the bond market today? What will be the change in interest rates? Answer using a bond market supply and demand analysis.

    (c) (10 points) How will this effect investment in new capital equipment, such as construction of new buildings, factories, and machines? What impact will this have on GDP today? What impact will this have on GDP in the long run?

5. Moody's Investor Services rates corporate and government bonds on their degree of risk. On Wednesday, February 3, 2009, they warned that the triple-A rating of U.S. treasury bonds may soon decrease.

   (a) (10 points) Suppose Moody does downgrade the rating for U.S. government bonds. What will be the impact on bond prices, interest rates, and on the quantity of treasury bills sold on the market.

   (b) (10 points) What will be the impact on the Federal government's ability to spend money and stimulate the economy?

   (c) (10 points) What will be the impact on the capital gains for individuals currently holding long term Treasury bonds.

   (d) (10 points) What do you predict will be the impact on consumer spending, GDP, and unemployment. Explain.