Student ID.....

EE431 Economics of Financial Markets and Institutions
Problem Set 2 : Debt Market and Structure of Interest Rate

Please submit at the BE office, 5th floor department of Economics building.

Deadline of submission : February 19, 2015, before 15.00 hrs.

Late submission will not be accepted.

PART 1. Do all questions by using the present value tables.

1. Suppose you expect the interest rate to go down in the future. You are considering to buy one of these bonds, hold it for a year and then sell it out. Which bond you will buy in order to get the highest returns? Explain.

   - Bond A, 10 years bond with 1,000 Baht face value, 10% annual coupon, 10% yield to maturity.
   - Bond B, 3 years bond 100 Baht face value, 10% annual coupon, 10% yield to maturity.

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2. Consider bond XYZ with a modified duration of 6.33. Suppose that the market value of this bond is $3 million. The approximate dollar price change for a 1 percentage change in yield to maturity is .....

3. Consider a 5% coupon bond with the par value of 2,000 Baht, selling for 2,228.46372 Baht. The bond will mature in 4 years. Find the modified duration of the coupon bond and explain its meaning.

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4. When interest rates fall, the prices of outstanding bonds ..... (rise or fall).

5. The market price of longer maturity bonds fluctuates ..... (more or less) compared with shorter maturity bonds as interest rates change.

6. Write the Fisher Equation, relating the nominal interest rate i, the real interest rate r, and expected (or anticipated) inflation π^e :

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7. Suppose your earns 8% nominal interest from your deposit account. If inflation is 5%, what is the real rate of return?

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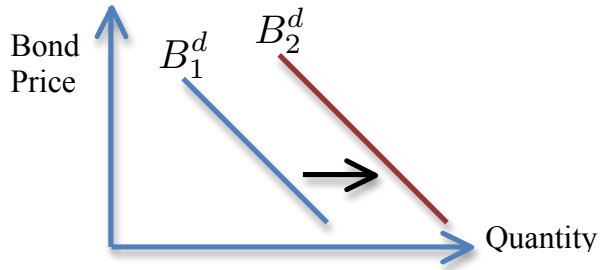
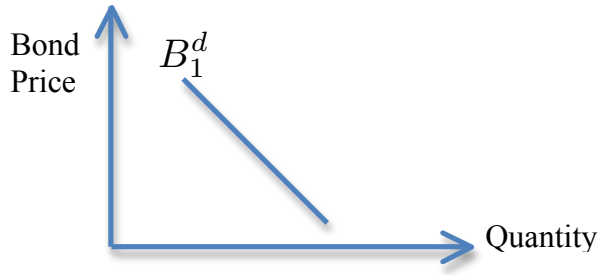
PART 2. Complete the tables.

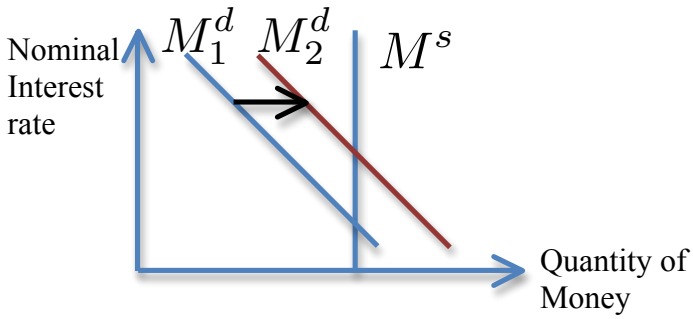
Factors that shift the demand for bonds (B^d)

All else being equal **An increase in**	**Cause**	**Graph the effect on the bond Market**
Wealth ↑ **(example)**	B^d ↑ Shift to the right	
Interest rate ↑	B^d ..... ↑ ..... Bond Price ↓ move along	
Expected Inflation ↑	B^d.....	
Expected Return on other assets ↑	B^d.....	
Riskiness of Bonds relative to other assets ↑	B^d.....	
Liquidity of Bonds relative to other assets ↑	B^d.....	

Factors that shift the supply of bonds (B^S)

All else being equal **An increase in**	**Cause**	**Graph the effect on the bond Market**
Expected Profitability ↑	B^S.....	
Corporate Tax on Profits ↑	B^S.....	
Expected Inflation ↑	B^S.....	
Government Borrowing ↑	B^S.....	

Factors that shift the Demand and Supply of Money

All else being equal **An <u>increase</u> in**	**Cause/ Money Demand or Money Supply/ Increase or decrease**	**Graph the effect on the money market**
Income ↑ (example)	Money Demand ↑	
Price Level ↑		
Money Supply ↑		