

Midterm Talk

Semester 2/2014

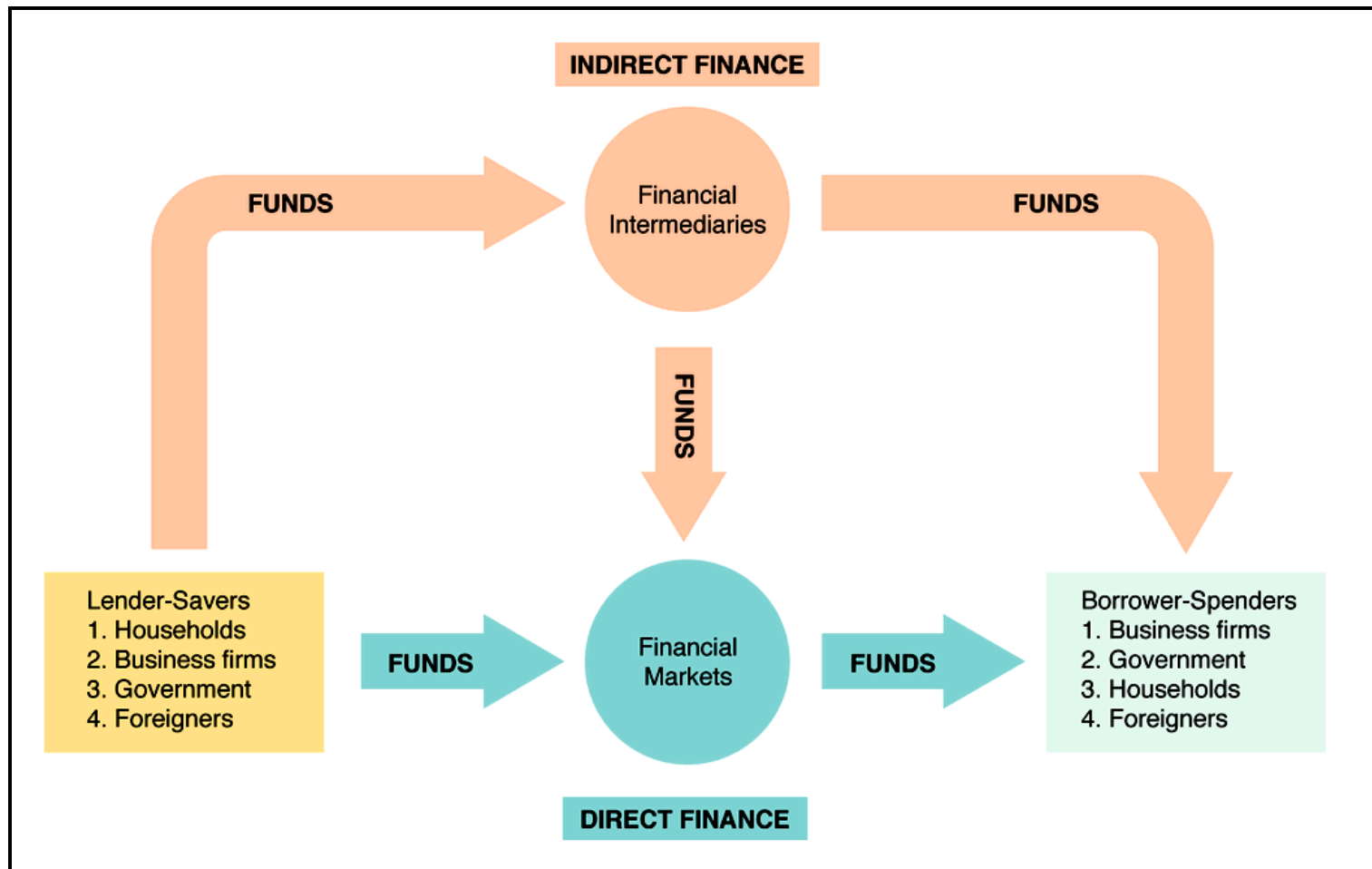
Q1. For economists, what is money?
How can money improve welfare of people in a country?

- **Money** is anything generally accepted in payments for goods or services or in the repayment of debts.
- Money perform 3 functions:
 - Medium of exchange & unit of account → reduces transaction costs and allows specialization
 - Store of value → improves welfare

Q2. Explain the main function of financial system. How can an under-developed financial system affect the economic performance of a country?

- ***Financial system*** transfers fund from savers to investors or other borrowers
- This helps improve the efficiency in using money
- An under-developed financial system increases transaction costs and may transfer fund to the wrong points

Flows of Funds Through the Financial System



Q3. You have just won 10 million baht in the lottery, which promises to pay you 1 million baht (tax free) every year for the next ten years. Have you really won 10 million baht? Explain in details.

- No
- According to the present value concept, 1 million baht today is not equal to 1 million baht next year
- Actually, we get less than 10 million baht in present value

Q4. We observe that the 10-year Bank of Thailand bond pays the same interest rate (about 5%) as the 7-year PTT (AA-rated company) bond. How can you explain this?

- There are two factors: Default risk and liquidity
- In this case, risk premium of PTT bond can be totally offset by liquidity premium of the BOT bond

Q5. If the public expects a corporation to lose 10 baht per share this quarter and it actually loses 8 baht, which is still the largest loss in the history of the company, what does the efficient market hypothesis say will happen to the price of the stock when the 8 baht loss is announced?

- According to the EM hypothesis, stock price should go up with this bad news
- Best expectations are taken into account in market prices, which is equal to the optimal forecasts, already
- If the realization is better than expected, the price will go up to reflect this information

Q6. What is the equity premium puzzle? In behavioral economics, how can we explain the puzzle?

- Equity premium puzzle is the observation that the actual equity premium is too large to be explained by conventional theory
- Behavioral economists believe that there are some mistakes in conventional theory and propose new theory
- Loss aversion, instead of risk aversion, makes people avoid equity

Q7. Assume that the current market interest rate is 3 percent. Calculate the returns and provide all relevant factors to compare between the three alternatives below:

a) A 4-year government bond initially sold to the public on the same date last year (the first coupon paid yesterday). Face value of the bond is 1,000 baht and its coupon rate is 4 percent, while the current price of the bond is at 880 baht.

b) A 3-year zero-coupon government bond initially sold to the public today. Face value is 1,000 baht and the bond is sold at 840 baht.

c) An insurance program with 3 years term-to-maturity. The premium payment is 860 baht for 2 years, the sum insured is 1,000 baht, the cash return is 2 percent of the sum insured at the end of each year for 3 years, and the extra cash return on the maturity date is 110 percent of the sum insured.

- We need to compare i 's (yields-to-maturity) of these options
- Option 1:

$$880 = \frac{40}{1+i_1} + \frac{40}{(1+i_1)^2} + \frac{1,040}{(1+i_1)^3}$$

- Option 2:

$$840 = \frac{1,000}{(1+i_2)^3}$$

- Option 3:

$$860 + \frac{860}{1+i_3} = \frac{20}{1+i_3} + \frac{20}{(1+i_3)^2} + \frac{1,120}{(1+i_3)^3}$$