

Student ID.....

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

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

Deadline of submission : September 23, 2016, before 15.00 hrs.

1. Based on economists' s forecasts and analysis, one-year Treasury bill rates for the next two years are expected to be as follows:

interest rate on one-year Treasury bill this year (2016)	3.00%
interest rate on one-year Treasury bill this year (2017)	3.00%
interest rate on one-year Treasury bill this year (2018)	3.00%

- (a) Suppose the **pure expectation theory** holds, what are the interest rates on one-year, two-year and three-year government bond rate in 2016? Plot the current yield curve.

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- (b) Let liquidity premium are as follows:

liquidity premium for one year bond	0.00%
liquidity premium for two year bond	0.25%
liquidity premium for three year bond	0.50%

Suppose the **liquidity premium hypothesis** holds, what are the interest rates on one-year, two-year and three-year government bond rate in 2016? Plot the current yield curve.

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(c) Plot yield curve in question (a) and (b) in the same graph.

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| interest rate on one-year Treasury bill this year (2016) | 3.00% |
| interest rate on one-year Treasury bill this year (2017) | 3.25% |
| interest rate on one-year Treasury bill this year (2018) | 3.50% |

- [illegible]

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|---------------------------------------|-------|
| liquidity premium for one year bond | 0.00% |
| liquidity premium for two year bond | 0.25% |
| liquidity premium for three year bond | 0.50% |

[illegible]

(c) Plot yield curve in question (a) and (b) in the same graph.

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- ## Government Bond Yield

(a) Sketch the yield curves in September 2016 and October 2016 in the same graph.

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- (c) Use the government bond yield in **September 2016**. Suppose liquidity premium for 1 year and 2 years are 0% and 0.5% respectively. According to the liquidity premium theory of the yield curve, what is your prediction for the interest rate on one-year bonds in 2017?

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- ## Government Bond Yield

(a) Sketch the yield curves in September 2016

[illegible]

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