Overview of Financial System

Economics 301: Money and Banking

Goals and Learning Outcomes

- Goals:
  - Learn to compute present values, rates of return, rates of return.
- 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.

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Reading

- Read Mishkin, Chapter 4.

Cash Flows

- **Cash flows:** size and timing of payments made for various debt instruments.
- **Present value:** aka **present discounted value**, discounts payments made in the future to a current date equivalent.
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Simple Loan Example

- Simple loan: lender provides funds to borrower, borrower pays back principal and interest at maturity date.
- Suppose interest rate is 5% (denote with i), simple loan of \$100 (denote with P).
- Balance (denote with A) with a one year maturity:
  - $A_1 = P(1+i) = \$100(1+0.05) = \$105.$
- Let it ride for another year...
  - $A_2 = A_1(1+i) = \$105(1+0.05) = \$110.25$
  - $A_2 = P(1+i)(1+i) = P(1+i)^2 = \$100(1+0.05)^2 = \$110.25$
- At the end of n years, we have
  - $A_n = P(1+i)^n.$

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Present Value

- Present value: indifferent between \$100 today, \$105 next year, or \$110.25 in two years.
- Given future cash flow of \$105 or \$110.25, respectively, the present value is,

$$PV = 100 = \frac{105}{(1+0.05)}$$

$$PV = 100 = \frac{110.25}{(1+0.05)^2}$$

- General formula,

$$PV = \frac{CF_n}{(1+i)^n}$$

- Example: what is the present value of \$100,000 to be paid in 30 years if the interest rate is 4%?

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Types of Credit Market Instruments

- Simple loan.
- Fixed-payment loan: borrower makes a fixed payment (that includes interest and principal) each period until maturity date.
- Coupon bond: borrower pays fixed interest payments (coupon payments) until maturity date, pays face value at maturity.
  - **Coupon rate:** dollar amount of coupon payments as a percentage of face value. Related to, but not exactly an interest rate.
- Discount bond: bought at a price below its face value, makes no payments until maturity date, at which time pays face value.

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Compounded Interest

- **Compounded interest:** when interest payments are made multiple times in a given period.
- Compounded annually: full interest payment paid out once per year.
- Compounded quarterly: payment for 1/4 of interest rate made 4 times per year.
- Compounded monthly: payment for 1/12 of interest rate made 12 times per year.
- Compounded daily: payment for 1/365 of interest rate made 365 times per year.
- Compounded continuously: interest payments constantly made. Occurs in nature.

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Present Value Computations

- The geometric series is a useful mathematical tool in PV computations: If $\beta \in (0, 1)$, then,

$$\frac{1}{1-\beta} = 1 + \beta + \beta^2 + \beta^3 + \beta^4 + \ldots$$

- Extensions:

$$\frac{\beta^{(T+1)}}{1-\beta} = \beta^{(T+1)} + \beta^{(T+2)} + \beta^{(T+3)} + \beta^{(T+4)} + \ldots$$

Subtract the second equation from the first,

$$\frac{1-\beta^{T+1}}{1-\beta} = 1 + \beta + \beta^2 + \beta^3 + \ldots + \beta^T$$

- Used in present values: $\beta = \frac{1}{1+i}$ which is between 0 and 1 for positive interest rates.

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- Present value of a stream of cash flows (CF_t) from time $t = 0$ (today) to $t = T$:

$$PV = \sum_{t=0}^{T} \frac{CF_t}{(1+i)^t} = CF_0 + \frac{CF_1}{1+i} + \frac{CF_2}{(1+i)^2} + ... + \frac{CF_T}{(1+i)^T}$$

- Suppose you have an auto loan,
  - Annual interest rate is 6% interest.
  - Compounded monthly.
  - Five year loan.
  - Your monthly payment is \$200.
  - How much was your car?

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More Computations

- Compute the present value of coupon bond with
  - Face value $3000.
  - 10 year maturity.
  - Coupon rate 5%.
  - Prevailing interest rate in economy 5%.
- Compute the present value of a discount bond with,
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Yield to Maturity

- **Yield to maturity:** the annual interest rate that equates the present value of cash flow of payments received from a debt instrument with its current day value.
- Example: yield to maturity for a simple loan.
  - PV = Cash borrowed = $200.
  - CF = Cash flow = payment received after $n = 5$ years $280.51.

$$PV = \frac{CF}{(1+i)^n} \quad \rightarrow \quad 200 = \frac{280.51}{(1+i)^5}$$

$$(1+i)^5 = \frac{280.51}{200} \quad \rightarrow \quad 1+i = \left(\frac{280.51}{200}\right)^{\frac{1}{5}}$$

$$1+i = 1.07 \quad \rightarrow \quad i = 7\%$$

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Yield to Maturity

- **Yield to maturity:** the annual interest rate that equates the present value of cash flow of payments received from a debt instrument with its current day value.
- Example: yield to maturity for a simple loan.
  - PV = Cash borrowed = \$200.
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Yield to Maturity: Coupon bond

- Present value of a coupon bond for,
  - Coupon payment = CF.
  - Face value = F.
  - Years to maturity = T.

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$$PV = \sum_{t=1}^{T} \frac{CF}{(1+i)^t} + \frac{F}{(1+i)^T}$$

- To find yield to maturity, set $PV = F$, solve for i. Impossible to do algebraically → use financial calculator.

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Rate of Return

- **Rate of return:** the total benefits received from holding a security, expressed as a percentage of purchase price.
- Rate of return includes interest payments *plus capital gains*.
- Rate of return for holding a bond from time t to $t+1$ is,

$$R = \frac{CF + P_{t+1} - P_t}{P_t}$$

  - R: rate of return.
  - P_t: price of bond at time t.
- Can also express rate of return as the sum, $R = i + g$, where,

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Coming up next...

- MyEconLab homework on interest rates.
- Analyzing behavior of interest rates and asset markets using supply and demand model.
- Reading: Chapter 5.