EC1010: Tutorial Questions 5

February 19, 2010

1. It has been argued that capital inflows from Asia to the U.S. led to a fall in savings by U.S. residents *and* a rise in residential investment (i.e., building of new homes.) Using the loanable funds theory, explain how this might have occurred.

2. Suppose there are two closed economies, A and B, in the world, identical in all respects except that level of savings is higher in economy A. Illustrate graphically the equilibria in each economy. In which economy is the real interest rate highest? Now suppose the economies opened up to capital flows. What do you think might happen? What are the implications of your answer for real interest rates in a globalized world?

3. Over long periods of time, despite increases in the stock of savings, the real interest rate is approximately constant. Explain graphically how this might be the case.

4. Suppose that savers become more sensitive to changes in interest rates when interest rates rise above some critical rate, r'. Illustrate this savings curve graphically. Explain why we get different changes in equilibrium interest rates if investment demand rises and the initial interest rate is a) above r' b) below r'.

5. Suppose *nominal* interest rates in 1990 in an economy were higher than in 1960. In which year was it better to invest?

6. Suppose the price of a bond paying 100 next year falls. What happens to the return on the bond? Give one reason why the price might fall.

7. Which would you expect to be cheaper: a bond paying 100 in 10 years or a bond paying 100 in 1 year?

8. Suppose that everyone expects inflation over the next year. What happens to the price of nominal bonds paying 100 in a year's time?

9. Suppose a firm's dividends fall but its stock price rises. If you were holding the firm's stock, what happens to your stock return?

10. George Bush once claimed that investing tax revenues in the stock market would be a good idea because they pay relatively high returns. Is this view correct?

11. Suppose a pharmaceutical company announces it has developed a new "blockbuster" drug, which will be on shelves in 5 years time. Given that dividends typically rise as firms' profits rise, what would happen to future dividends for stockholders of the company? According to the *efficient markets hypothesis*, what are the implications for the firm's stock price *today*? Why does this occur?

12. Examine Figure 1, which shows 1) the interest rate on Greek government bonds that pay off in 10 years time and 2) demographic projections across some developed economies.

i.) Why have bond returns/yields in Greece risen? What happened to the price of Greek bonds?

ii.) If Greece was a closed economy and everyone expected inflation over the next few years in Greece, what would happen to bond returns?

iii.) What implications does the graph entitled "Age Wage" have for future real interest rates in the U.S. economy? Explain.

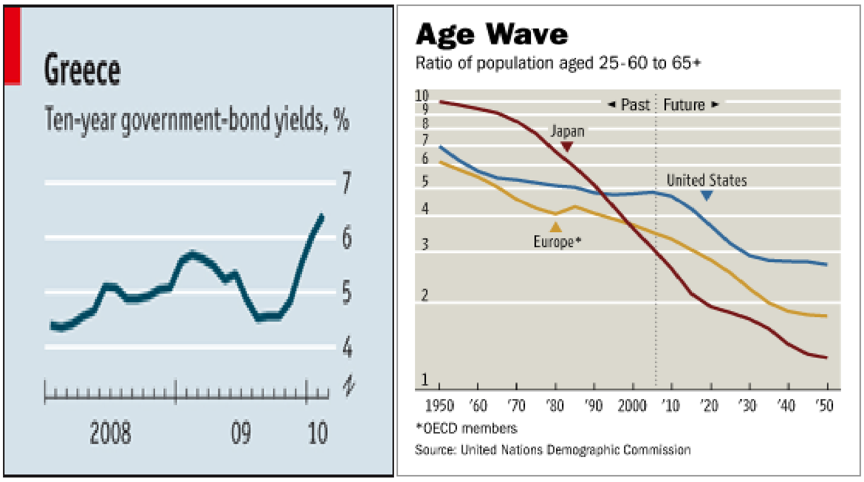

Figure 1: The Interest Rate on Greek Ten-Year Government Bonds and Demographic Projections for Developed Economies.