Chapter 6

Determining Market Interest Rates
Views of Bond Market

- Bond is the good.
- Use of funds is the good.

Bond Is the Good

- Buyer: Lender who buys bond
- Seller: Borrower issuing bond
- Price: Bond price
Use of Funds Is the Good

- Buyer: Borrower raising funds
- Seller: Lender supplying funds
- Price: Interest rate

Figure 6.1 Demand for Bonds
Figure 6.2  Supply of Bonds

(a) Bond Market Perspective

(b) Loanable Funds Perspective

Figure 6.3  Market Equilibrium

(a) Bond Market Perspective

(b) Loanable Funds Perspective
Factors Shifting Increasing Bond Demand

- Higher wealth
- Higher expected returns on bonds
- Lower expected inflation
- Lower expected return on other assets
- Lower relative riskiness of bonds
- Higher relative liquidity of bonds
- Lower relative information costs of bonds

Figure 6.4 Shifts in Bond Demand
Factors Increasing Bond Supply

- Higher expected profitability of capital
- Lower business taxes
- Lower expected inflation
- Higher government borrowing

Figure 6.5
Shifts in the Supply of Bonds

(a) Bond Market Perspective

(b) Loanable Funds Market Perspective
Figure 6.7
Expected Inflation and Interest Rates

(a) Bond Market Perspective

1. Higher expected inflation reduces supply of bonds.
2. Higher expected inflation increases demand for bonds.

(b) Loanable Funds Perspective

1. Higher expected inflation reduces supply of loanable funds.
2. Higher expected inflation increases demand for loanable funds.
3. Interest rate rises.