

EC132.02

Principles of Macroeconomics

Boston College

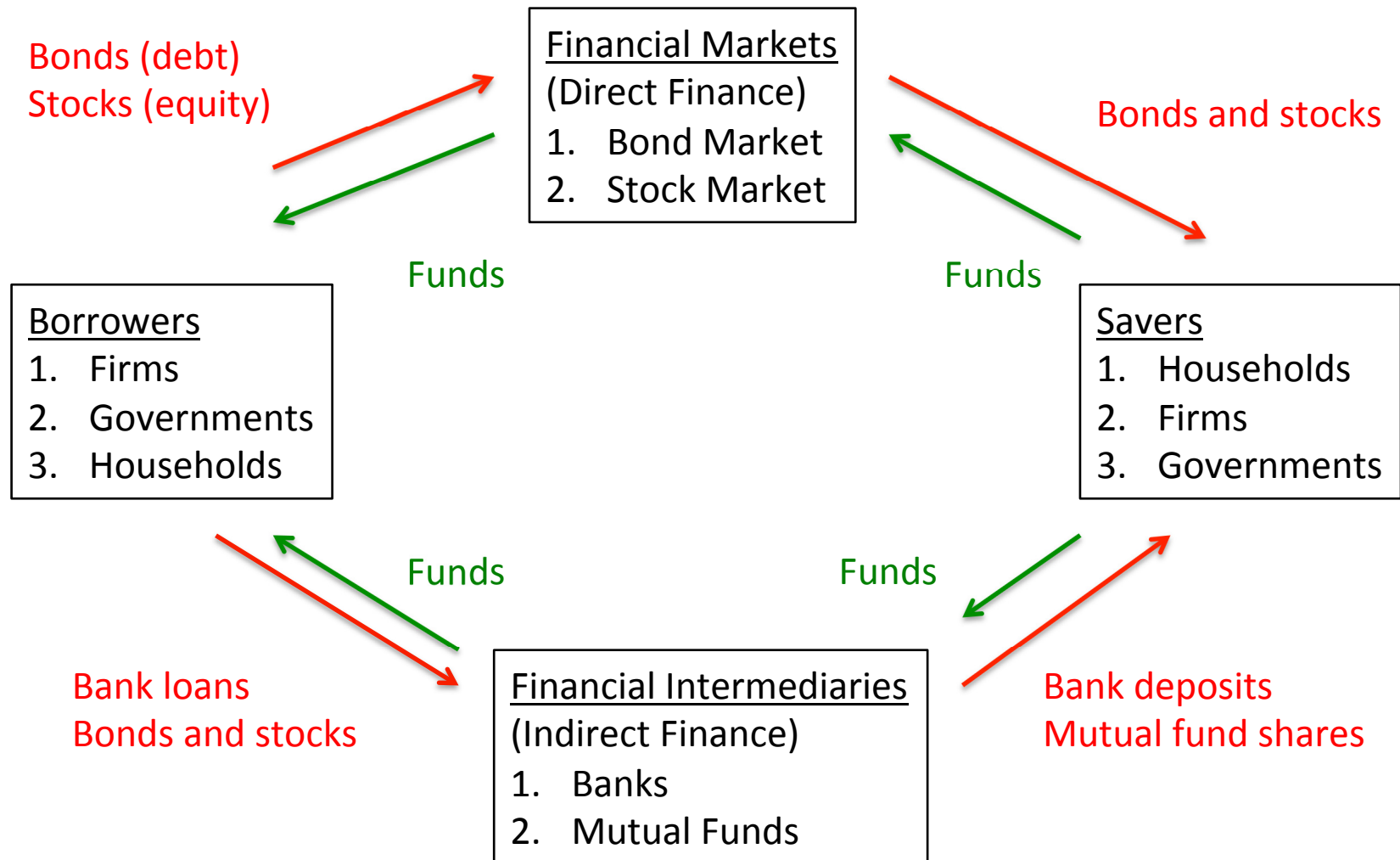
Tuesday, February 26

Announcements and Reminders

Aplia homework on Production and Growth due this Friday, March 1, at 9am.

This week, and continuing after Spring Break:
Ch 26 Saving, Investment and the Financial System.

Financial Institutions in the US



Ch 26 Saving Investment and the Financial System

1. Financial Institutions in the US Economy
 - A. Financial Markets
 - B. Financial Intermediaries
2. Saving and Investment in the National Income Accounts
3. The Market for Loanable Funds
 - A. Supply and Demand for Loanable Funds
 - B. Public Policies and the Market for Loanable Funds

The Bond Market

A **bond** is a certificate of indebtedness that specifies the borrower's obligations to the holder of the bond, in particular:

The **date of maturity** when the **principal** or amount borrowed is to be repaid.

The **rate of interest** paid periodically until the date of maturity.

The Bond Market

Example: Ford Motor Company issues a \$1000 bond with maturity date December 2033 and 5% rate of interest.

This bond will make annual interest payments of \$50 per year each year until the end of 2033.

In December 2033, the final interest payment gets made and the \$1000 principal is returned.

The Bond Market

Three Characteristics of Bonds:

1. The bond's **term** is the length of time until maturity.

Usually ranges from 3 months to 30 years.

Typically, longer term bonds have higher interest rates.

The Bond Market

Three Characteristics of Bonds:

2. The bond's **credit risk** refers to the probability that the borrower will be unable to make a payment of interest or principal when due.

Then the borrower is said to **default** and enters **bankruptcy**.

Typically, bonds with more credit risk pay higher rates of interest:

- US Government bonds have lower interest rates than corporate bonds.
- **Junk bonds**, also called **high yield** bonds, are issued by firms with high credit risk and pay the highest interest rates of all.

The Bond Market

Three Characteristics of Bonds:

3. Bonds also differ in the **tax treatment** of their interest payments.

Municipal bonds, issued by state and local governments, pay interest that is exempt from federal income tax.

Savers are typically willing to accept lower interest rates on municipal bonds as a result.