Chapter 4: Why do interest rates change?

Asset is piece of property that stores value

Wealth is the total resources owned by the individual (includes assets)

Expected return (the return expected over the next period) on one asset relative to alternative assets.

Risk (the degree of uncertainty associated with the return) of one asset relative to alternative assets

Liquidity (the ease and speed of which an asset can be turned into cash) relative to alternative assets.

Standard deviation - returns on a asset

higher standard deviation σ, greater risk of an asset.

Theory of portfolio choice - tells us how much of an asset people want to hold in their portfolio.

demand curve - shows the relationship between the quantity demanded and the price when all other economic variables are held constant.

Supply curve - shows the relationship between the quantity supplied and the price when all other economic variables are held constant.

Market equilibrium - when the amount that people are willing to buy (demand) equals the amount that people are willing to sell (supply) at a given price.

excess supply - the quantity of bonds supplied exceeds the quantity of bonds demanded

excess demand - the quantity demanded ~~at~~ is greater than the quantity supplied at point F.

The asset market approach - to understanding behavior in financial markets which emphasizes stocks of asset rather than flows in determining asset prices. is the dominant methodology used by economists

When expected inflation rises, interest rates will rise – Fisher effect

Econometric models – an alternative method of forecasting interest rates, whose equations are estimated with statistical procedures using past data.