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Date: October 27, 2006
To: Econ 423 Students
From: Michael Salemi
Subject: Exercise One

Here is some feedback about exercise one. On average, I was disappointed with what I read. Many of you had some serious misunderstandings about the real rate of interest and the effect of inflation on yields to maturity. The positive aspect of the exercise, then, is that it gives you an opportunity to correct your understanding before the stakes get higher.

I also was somewhat surprised that so few of you thought to include graphs that represented your attempts to check your thinking. In case you do not know, it is quite easy to copy an excel chart and drop it into a word document.

I am not sure how much time the “average” student spent on this exercise. I am sure that it was too little.

Here are a few specific points.

1. It does not make sense to say that the expected inflation component will not be present in short maturity yields. Would you lend at 5 percent for even a month if the inflation rate were 10 percent? Of course not. It is true that the inflation rate is less likely to change over a 90 day horizon than over a 30 year horizon. That, however, is different from implying, as some of you appeared to imply, that the 3 month T Bill rate should have been the same in the late 1970's as it is today. The inflation component will affect all nominal yields--every one of the nine yields except the yield on the inflation indexed bond.
2. The best candidate for a measure of the real rate is the yield on the inflation indexed bond. There is no payment risk and the “real value” of the payments stream is guaranteed. One might argue that there is some interest rate risk with an inflation indexed bond so that its yield includes a (presumably small) risk premium.
3. It makes no sense at all to think of the 90 day T Bill rate as the real rate. Indeed, it seems to me that many are still confused about what a real rate is. I recommend serious remediation.
4. Most students understood how to check for the presence of a risk premium and did so by comparing the yields on long and short maturity bonds and on AAA and Baa corporate bonds. I have little objection to what I read about risk premia.