Finance

Name

Institution

**1. How the United States Government Gets Its Finance**

The federal government makes money primarily through taxation. The main taxation types include individual income tax, corporate income tax, and payroll taxes (Andersson, & Brambor, 2019). The personal income tax is the largest source of federal income, which amounts up to half of the total federal revenue. Corporate tax amounts up to seven percent of the government revenue. Payroll taxes, also known as social insurance, include taxes on earnings and wages that fund the hospital insurance program, which is Medicare and social security, making up the most significant portion of social insurance receipts (Andersson, & Brambor, 2019). Other payroll taxes include taxes on the unemployment insurance program, the railroad retirement system, and taxes on the contributions of federal workers. The total amount of payroll taxes amount to 36% of the total national revenue (Andersson, & Brambor, 2019). However, the federal government also imposes tariffs on custom duties, estate, and gift taxes, income from the Federal Reserve System, and other charges. The government also issues debt instruments such as treasury bills, treasury notes, and treasury bonds to generate revenue. Another traditional method of generating revenue that is less applied is the imposition of “inflation tax” when the Federal Reserve prints more money.

**2. Fixed Coupon Bond**

Face value = 1,000

Coupon rate; 8%

Coupon frequency; semi annual

Maturity 05/06/04

The coupon cash flow is equal to $40

8% x 1000 = $40

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It is deliverable on the following dates; 05/06/02, 11/06/02, 05/06/03, 11/06/03, and 05/06/04. The redemption value is equal to the face value that is $ 1000, and is delivered on 05/06/04, the maturity date.

The Federal Reserve System is responsible for managing the supply of money (Livingston, 2018). One of the main ways of managing money supply is through reserve ratios. The reserve ratio acquires banks to maintain a specific proportion of their deposits as a “reserve” against potential withdrawals (Livingston, 2018). The Federal Reserve controls the amount of money in circulation through the varying reserve ratio. The Federal Reserve System is the national bank for the state and is responsible for ensuring enough currency flow from the government.

**3. Potential Risk of the Corporate Bond vs. Government Bond.**

Corporate bonds refer to debt securities that are issued by a firm and directly sold to investors. When the firm acquires its capital target, the investor is paid pre-established interest payments at either fixed or variable interest rates. On the other hand, a government bond refers to debt that the government issues to support its obligations and spending (Bai, Bali, & Wen, 2019). Bonds issued by the government accrue period interests called coupon payments. The government issues bonds when they want to raise capital as it accrues interests paid in layers or after the agreed time. There are potential risks of investing in corporate bonds versus government bonds. Corporate bonds are somewhat riskier than federal government bonds. Corporate bonds have a high level of default risk while the Treasury bond has no default risk; thus, corporate bonds attract a higher interest than government bonds (Bai, Bali, & Wen, 2019). Also, an increase in interest rate decreased the value of the bond, and the coupon rate and bonds maturity affect the interest rate.

Also, corporate bonds attract a market risk when an individual is selling or buying the bonds on a secondary market. When buying or selling occurs before the maturity date, the value of the bond in the market changes, and in most cases, it decreases. On the other hand, treasury bonds do not vary depending on the maturity period, and their interest rate does not increase or decrease based on various aspects (Bai, Bali, & Wen, 2019). The interest rate for treasury bonds remains that which was agreed. Also, corporate bonds have credit risk as in most cases, and the corporates cannot repay their loan or an outstanding debt; hence the investor might lose all their investment depending on the corporate situation. When issuing treasury bonds, the capital circulated is continuously monitored; thus, the treasury can repay the debt without losing investment.

**4. The Origin of Negative Government Bonds and Reasons Investors Want To Invest In Negative Government Bonds**

A negative bond yield occurs when an investor earns less money than the original purchase price for the bond at the bond’s maturity (Ueno, 2017). This meaning that the investor losses money at maturity. However, traders are more willing to buy the negative yield bonds more so if the bond is expected to get deeper into the negative-yielding. When a bond gets more negative, the fixed income yields and prices move more inversely, and the bond price rallies allowing the trader to make profits. Market participants argue that the negative government bonds effectively deteriorate the American economy and geopolitical tensions (Ueno, 2017). The negative bonds have been proved to rally even in market distress times. Also, investors argue that the negative bonds have few bolt holes and that the assets are safe. The realization of the high-quality income in fixed portfolios has resulted in investors moving to negative government bonds. However, negative yields do not always attract negative income. Investors in America are often paid to reduce the fluctuation of foreign currencies because the interest rates are higher in the United States than in other developed countries such as Japan and Europe. Thus, American investors still earn money from a negative-yielding government bond. However, investing in negative yields helps in maintaining the purchasing power. Investors willingly choose to invest in negative bonds when there is deflation or a drop in the price levels for services and goods (Ueno, 2017). A decline in prices for goods and services means that the investor will have more purchasing power than fixed-income security.

**5. Does A Greater Risk Imply A Bad Investment?**

Risk is the chance of irreversible loss of capital in an investment. The higher the risk, the higher the likelihood of permanently losing money. The high-risk investment offers investors a chance for significant income returns to accept the associated risk levels. Higher risk is associated with the possibility of higher return, and similarly, the lower risk is related to the probability of smaller return. When considering investment decisions, an investor must face the reality of the risks and return. Although high-risk investments can attract high-income returns and offer substantial income, small investors must lay a financially stable foundation before considering investing in high-risk environments. Therefore, a more significant risk does not imply a bad investment, as in most cases, a more substantial risk attracts high income, especially for large investors. An example is Amazon and Netflix, where investors put their capital at increased risk of investment, but the yields are high with no significant loss but instead high income.

**6. What Are The Four Main Uses Of Interest-Rate Swaps?**

An interest rate swap is a derivative contract where two counterparties exchange a stream of future investments for another based on a specified principal amount (Jermann, & Yue, 2018). In most cases, there is an exchange of floating or fixed interest rates. There are various advantages of using swaps. For instance, the use of trades helps to avoid transaction costs, the works can be used in exposures of hedging risk, and there is access to more securities when using swaps. The interest rate swaps are used in party loan agreements. One party is based on a floating rate agreement, while the other party is based on fixed-rate payment, and both parties agree to take advantage of the situation. Also, interest rate swaps are used to swap interest payments as they are derivative contracts (Jermann, & Yue, 2018). The party’s do not own the other partner’s debt; instead, they agree to pay the difference in their loan payments as described by the contract. The terms of agreement for the parties are stated by the interest swap contract, including the rates of payment and the payment schedule.

**7. A Credit Default-Swap**

A credit default swap is a financial contract that allows investors to offset their credit risks with another investor. For instance, if the lender is worried about the borrower defaulting the loan, he can use the credit default swap to offset the risk. Credit default swaps are widely used in the world markets as they are powerful, and there is the assurance of payment in case of default. The CDS protects the buyer of the contract, who own underlying credit asset with protection against a downgrade and default credit rating or another adverse event.

References

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