The four fundamental factors that affect the cost of money.
1. production opportunities
2. time preferences for consumption
3. risk
4. inflation

Determinants of market interest rates
Quoted interest = \( r = r^* + IP + DRP + LP + MRP \)
\( r_f = r^* + IP \)

\( r^* \) (real rate of interest), Inflation premium (IP), Default risk premium (DRP), Liquidity premium (LP), Maturity risk premium (MRP)

Quoted (nominal) rate of interest versus real rate of interest
- short-term Treasury securities include only an inflation premium.
- long-term Treasury securities contain an inflation premium plus a maturity risk premium.
- The rate on short-term corporate securities is equal to the real risk-free rate plus premiums for inflation, default risk, and liquidity.
- The rate for long-term corporate securities also includes a premium for maturity risk. Thus, long-term corporate securities generally carry the highest yields of these four types of securities

Term structure of interest rates is the relationship between interest rates, or yields, and maturities of securities. When this relation is plotted, the resulting graph is called a yield curve.

The two key factors advanced to explain the shape of the yield curve:
1. the expectations theory and
2. perceptions of relative riskiness of securities of different maturities

Additional factors:
Federal Reserve policy
Budget deficits or surpluses
International factors
Business activity

Example problem
Assume that \( r^* = 2.0\% \); the maturity risk premium is found as \( MRP = 0.1\%(t-1) \) where \( t \) = years to maturity; the default risk premium for corporate bonds is found as \( DRP = 0.05\%(t-1) \); the liquidity premium is 1.0 percent for corporate bonds only; and inflation is expected to be 3 percent, 4 percent, and 5 percent during the next three years and then 6 percent thereafter. What is the difference in interest rates between 10-year corporate and Treasury bonds?