

University of Colombo- Sri Lanka

Faculty of Arts

Third Year Examination in Arts (Economics)-2018

(Second Semester Final)

ECN 3264- Economics of financial markets and policy

Time Allowed: Two (02) hours only

Answer any three (03) questions only.

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1. (i) Critically examine the nature of the relationship between risk, transaction cost and information asymmetry associated with financial transactions. (8 marks)
- (ii) "Information asymmetry retards financial market efficiency while promoting adverse selection and moral hazards both by customers and financial institutes". Critically examine the statement. (6 marks)
- (iii) Do you think that a well-developed financial system can efficiently overcome information asymmetry and its associated issues? Explain your answer. (6 marks)
2. (i) "When people start to move between bonds and money interest rate becomes volatile". Critically examine the statement considering Keynes' Liquidity Preference Theory (LPT). (8 marks)
- (ii) How do you explain liquidity effect given in LPT? Can increase in money always result in lower interest rate? Explain your answer. (6 marks)
- (iii) Explain reasons, using LPT, how the demand for money function shifts. (6 marks)

3. (i) "The expectations theory provides very useful mechanism to understand and forecast interest rates". Explain how the rate of interest is determined in the expectations theory. (8 marks)
- (ii) "The market segmentation theory of interest rate determination provides a more realistic approach to interest rate determination than the expectations theory". Do you agree with the statement? Explain your answer. (6marks)
- (iii) The liquidity premium theory explains the term structure of the interest rate and the yield curve much better than the other two theories explained above. Explain your answer. (6 marks)
4. (i) Banking system can multiply deposits and provide increasing amount of credit to the economy. Using the simple deposit creation process, explain how banking system multiply deposits. (6 marks)
- (ii) "Money Multiplier Approach is a very sophisticated method to understand and forecast quantity of money in the economy with certainty". Do you agree with the statement? Explain your answer. (7 marks)
- (iii) "Money multiplier approach indicates that the monetary authority can successfully control the money supply". Do you agree with the statement? Explain your answer. (7 marks)
5. (i) "The determination of foreign exchange rate and its future behaviour can be explained efficiently using market model". Do you agree with the statement? Explain your answer. (7 marks)
- (ii) "Purchasing Power Parity model can predict exchange rate behaviour with more accuracy". Do you agree with the statement? Explain your answer. (7 marks)
- (iii) What factors do you consider useful to understand the exchange rate behaviour in the long run? Explain your answer. (6 Marks)

- 6 (i) Money market and the banking system provides short term fund requirements of the economy. Explain the advantageous of having two systems for the same purpose? (6 marks)
- (ii) Explain major money market instruments available in Sri Lanka providing examples where necessary. (7 marks)
- (iii) Critically examine the recent trends you have observed both in money and bond markets in Sri Lanka. (7 marks)
- 7 (i) "Monetary policy is a very important demand management policy" Examine the working of monetary policy and its impact on the economy, using examples where ever necessary. (8 marks)
- (ii) Why do open market operations have become the most favoured monetary management technique than the other methods? Explain your answer. (7 marks)
- (iii) On what basis a Central Bank determines intermediate monetary targets to drive the economy towards the set goals? Explain your answer. (5 marks)
8. Critically examine any four of the following
- (i) Risk structure of interest rate
- (ii) The income and price level effects on interest rate
- (iii) Expected inflation effect on interest rate
- (iv) Loanable fund Approach
- (v) Evidence against market efficiency
- (vi) Disadvantageous of statutory reserve requirement

-----End of the Examination-----