University of Colombo, Sri Lanka

Faculty of Arts

Masters in Economics- 2014/2015

Final Examination- Semester II

MECON 508: Financial Economics

Answer **Five (05)** Questions Only

Time Allowed: Three (03) Hours

Each question carries equal marks

Open Book Examination

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1. (i) What is information asymmetry? Why is it important? What is the relationship between market efficiency and information asymmetry?

   (ii) What are the issues related with information asymmetry. Explain how do financial markets help to overcome the issues related with information asymmetry?

   (iii) Why is interest rate so important? Explain the difference between interest rate and return.

   (iv) Using Present Value and Yield-to-Maturity method, explain the role of interest rate in valuation of assets.

2. (i) Explain the motives for liquidity according to the liquidity preference theory.

   (ii) Explain the reasoning of interest rate determination given in the liquidity preference theory.

   (iii) Explain the sources of demand for and supply of loanable funds. Do you believe that the Loanable Fund Theory is capable to forecast interest rate movements with certainty?

   (iv) Does an increase in money supply always lower interest rates? Explain your answer.

3. (i) X has deposited Rs. 5000/= today in a bank deposit at 11% annual interest rate. How much X will earn in six years? Compute the simple and compound interests.

   (ii) If the same person has deposited Rs. 10,000/= today at *r* percent interest per year. He gets Rs. 20,000/= in 10 years. Calculate the interest rate.

(iii) A bond sells for Rs. 93,500/= pays an annual coupon of Rs. 8000/= and it matures in 5 years. The face value of the bond is Rs. 100,000/=. Calculate its coupon rate, current yield and yield-to-maturity.

(iv) Explain the concept of present value. What is the relationship between the present value and future value of money?

4. (i) Why are economists interested in the term and risk structure of interest rates?

(ii) Examine the reasoning of expectations theory, providing examples.

(iii) "The market segmentation theory states that there is no relationship between the markets for bonds of different maturity lengths." Examine the statement providing examples.

(iv) Do you consider the fact that liquidity premium theory is more suitable to predict interest rate behaviour in the long run? Explain your answer.

5. (i) Distinguish between money and capital markets. Are they complementary or in competition?

(ii) Explain briefly the major type of money market instruments traded in Sri Lanka.

(iii) Do you see new trends in the money market of Sri Lanka? Explain

(iv) What are the most important things you should know about bonds?

6. (i) Distinguish between Generalised Dividend Valuation method and Gordon Growth model.

(ii) "Systematic risk cannot be diversified away without cost. In other words, investors need to be compensated by a certain risk premium for bearing systematic risk". Briefly explain the statement in the light of CAPM theory.

(iii) Explain the role of Beta in the CAPM theory. Explain why beta is the appropriate measure of risk for a single security?

(iv) Why companies issue stocks? Explain your answer.

7. (i) How do you explain monetary policy? What are the major tools of monetary policy you have studied?

(ii) Why are Open Market Operations more popular than the other methods of monetary policy?

(iii) Evaluate the advantageous and disadvantageous of monetary policy.

(iv) For how long do you think the present low interest rate in Sri Lanka would prevail?

8. (i) Using market model. explain how the foreign exchange rate is determined.
   (ii) Explain the factors that influence exchange rates in the medium to long run.
   (iii) What is law of one price? Explain the relationship between law of one price and efficient markets.
   (iv) Do you think law of one price always hold?

9. (i) The following stock quotes were given to you by a new investor. You are expected to explain all stock quotes given in the table to the investor.

YTD		-16.3
52 - week	High	43
	Low	36
Stock		JKH
Div.		0.33
YLD %		2.5
P/E		22
Vol 100s		1479
High		40
Low		37
Close		39
Net Change		0.027

   (ii) Explain how an investor lose money in a stock market?

10. (i) What are the basic assumptions of Capital Asset Pricing Model (CAPM)? What are the advantages of adopting CAPM model in the portfolio management?
   (ii) What is capital market diversification?
   (iii) What determines an asset's expected return?
   (iv) Consider the following information given in the table.

State of the Economy	*Probability*	*Return on Asset A*	*Return on Asset B*
Recession	0.40	25%	30%
Boom	0.60	-15%	-10%

a). Calculate the expected return for assets A and B

b). Calculate the standard deviation? What is the riskiest asset?

c). Assume that the market risk premium has been about 8.5%. The risk-free rate is currently 5%. Corporation A has a beta of 0.85. What return should you expect from an investment in Corporation A?

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