University of Colombo- Sri Lanka

Faculty of Arts

Masters in Economics - 2016/2017

Final examination- Semester II

MECON 508- Financial Economics

Time Allowed: Three (03) hours only

Answer any five (05) questions only. All answers carry equal marks.

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1. (i) Explain briefly the nature of information asymmetry and the relationship between market efficiency and information asymmetry?

   (ii) Explain the major issues related with information asymmetry and discuss how do financial markets help to overcome them.

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

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

2. (i) "According to the liquidity preference theory demand for liquidity is the basis of interest rate determination". Do you agree with the statement? Explain your answer.

   (ii) Liquidity preference theory predicts that increase in money will result in low interest rate. Do you think that this prediction always will hold? Explain your answer.

3. (i) Explain the sources of demand for and supply of loanable funds according to the loanable fund approach.

   (ii) Do you think that the Loanable Fund Theory is capable of forecasting interest rate movements with certainty?

4. (i)   Mr. X has deposited Rs. 5000/= today in a bank deposit at 11% annual interest rate. How much Mr. X will earn in six years?

    (ii) If the same person has deposited Rs. 10,000/= today at r percent interest per year, he is to get Rs. 18,000/= 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?

5. (i)   Critically examine the reasoning of the expectations theory providing examples where necessary.

    (ii) "The market segmentation theory states that investors' time preference is very strong". Critically examine the statement providing examples where necessary.

6. (i)   The liquidity premium theory provides a moderate approach to understand interest rate behaviour in the long run. Do you agree with the statement? Explain your answer.

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

7. (i)   Distinguish between money and capital markets. Are they complementary or in competition? Explain your answer.

    (ii) Both money market and the banking system provide short term financing requirement of investors. Explain the necessity of two structures for one purpose?

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

    (ii) What are the new trends in Sri Lanka's money market you have observed lately?

9. (i) What are the major tools of monetary policy you have studied?

(ii) Why do 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 and inflation in Sri Lanka would prevail? Explain your answer.

10. (i) Using market model, explain how the foreign exchange rate is determined.

(ii) Explain the factors that influence the behavior of foreign exchange rates in the medium to long run.

(iii) What is law of one price? Explain the relationship between law of one price and exchange rate determination.

(iv) Do you think law of one price always hold?

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