MACHAKOS UNIVERSITY

University Examinations for 2019/2020 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ECONOMICS

FOURTH YEAR SECOND SEMESTER EXAMINATION FOR

BACHELOR OF ECONOMICS AND STATISTICS

BACHELOR OF ECONOMICS AND FINANCE

BACHELOR OF ECONOMICS

EAE 411: MONETARY THEORY AND POLICY

DATE: 27/10/2020 **TIME: 8:30 – 10:30 AM**

INSTRUCTIONS:

(i) Answer question one (Compulsory) and any other two questions

(ii) Do not write on the question paper

(iii) Show your working clearly

QUESTION ONE (COMPULSORY) (30 MARKS)

a) The main purpose for holding of money in the classical economists is to carry out transactions. Therefore, the simple quantity theory of money has basis on the theory of exchange.

i. Derive the simple quantity theory of money explaining each step (7 marks)

ii. Ceteris peribus , explain the effect of price changes in the economy (3 marks)

b) Assuming that an individual is paid KShs 24,000 salary at the 1st day of every month. Supposing that he gets half of it cashed and saves the rest in a savings account earning an interest of 10%. Given that the brokerage fee is KShs 50 per transaction, calculate the total cost incurred by the individual as well as the optimal cash holdings that minimize the transaction costs. Show all your workings (6 marks)

c) The experience of underdeveloped countries reveals that monetary policy plays a limited role in such economies. Discuss (4 marks)

d) Suppose that the monetary base **(B)** is Ksh 1000 billion, the reserve deposit ratio **(rr)** is 0.2 and the currency-deposit ratio (**cr**) is 1.2.You are required to calculate:

i. Money Multiplier (2 marks)

ii. Money Supply (2 marks)

e) Briefly discuss with examples the three types of financial Markets in Kenya. (6 marks)

QUESTION TWO (20 MARKS)

a) State and clearly explain three main objectives of monetary policy undertaken by Central Bank of Kenya (6 marks)

b) Discuss the main idea of the Keynesian Demand for Money stating clearly three motives for holding money (8 marks)

Discuss the consequential economic impacts of high and rising rates of interest. (6 marks)

QUESTION THREE (20 MARKS)

a) With aid of a well labeled diagram or diagrams, distinguish between expansionary and contractionary fiscal and monetary policies (8 marks)

b) Discuss the various financial instruments applicable in East Africa (6 marks)

c) What is money multiplier? Derive the expression for the complex money multiplier (6 marks)

QUESTION FOUR (20 MARKS)

a) Explain how four instruments of monetary policy can be used to control and regulate money supply in the economy as applied by the central bank of a given country. (8 marks)

b) Graphically explain the Cambridge Cash Balance Approach of money demand giving its strengths and weaknesses (12 marks)

QUESTION FIVE (20 MARKS)

a) Explain the following terms as used in the money supply model.

i. The monetary base (2 marks)

ii. The reserve-deposit ratio (2 marks)

iii. The currency-deposit ratio (2 marks)

iv. Money illusion (2 marks)

b) At war time during occurrence of natural catastrophes like recent emergence of Covid-19 pandemic, there is a significant reduction in the level of investment, massive job losses and decreased level of output. Central Bank Governors of various countries in a quest to reverse the situation, they decided to reduce their interest rates so as to encourage commercial banks borrow more from central bank and lend to their customers at low interest rates. The decision was found to work well in most developed countries unlike developing countries. Explain four factors which must have contributed onto this. (8 marks)

c) The quantity of money circulating in any economy must be commensurate to the level of production in the country but this is not the case in most developing countries. Explain the effects of supplying more or less money than its level of production. (4 marks)