



MACHAKOS UNIVERSITY

University Examinations for 2019/2020 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ECONOMICS

THIRD YEAR SECOND SEMESTER EXAMINATION FOR

BACHELOR OF ECONOMICS AND STATISTICS

BACHELOR OF ECONOMICS AND FINANCE

BACHELOR OF COMMERCE

BACHELOR OF ECONOMICS

BACHELOR OF ARTS

EAE 310: ECONOMICS OF MONEY AND BANKING

DATE: 11/11/2020

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) Assuming that an individual is paid kshs 96,000 salary at the 1st day of every month. Supposing that he gets a quarter of it cashed and saves the rest in a savings account earning an interest of 20%. Given that the brokerage fee is kshs.100 per transaction, calculate the total cost incurred by the individual as well as the optimal cash holdings that minimize the transaction costs. Show all you workings.
(6 marks)
- b) With aid of a well labeled diagram explain the money multiplier theory showing how money supply is a multiple of high powered money (6 marks)
- c) i) Derive the real world money multiplier (5 marks)

- ii) Determine the real-world money multiplier given that currency held by the public = \$800 billion, checking deposits = \$1600 billion, excess reserves = \$0.16 billion, $M1 = C + D = \$2400$ billion and required reserve ratio = 20%. (3 marks)
- d) Explain the Cambridge cash balance approach giving its strengths and weaknesses (6 marks)
- e) Explain the limitations of open market operations (4 marks)

QUESTION TWO (20 MARKS)

- a) Discuss the consequential economic impact of high and rising rate of interest (6 marks)
- b) Explain core principals of money and banking. (6 marks)
- c) Explain the classical theory of demand for money while highlighting its main assumptions and weaknesses in empirical research (8 marks)

QUESTION THREE (20 MARKS)

- a) Graphically explain speculative demand for money and explain why monetary policy fails at the liquidity trap (6 marks)
- b) Clearly explain the response of money supply with increase in required reserve ratio, monetary base, currency deposit ratio and expected deposit outflows. (8 marks)
- c) Explain three conflicting objectives of monetary policy (6 marks)

QUESTION FOUR (20 MARKS)

- a) Explain various limitations of credit creation (6 marks)
- b) Graphically explain the expansionary and contractionary monetary and fiscal policies (8 marks)
- c) Explain the differences between commercial banks and non-bank financial institutions (6 marks)

QUESTION FIVE (20 MARKS)

- a) Explain the consequential effect of increase in money supply on economic activity (6 marks)
- b) Graphically explain the effect of interest rate on investment (6 marks)
- c) Explain factors influencing demand for money as per the Friedman theory of money demand. (8 marks)