MACHAKOS UNIVERSITY

University Examinations for 2021/2022 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ECONOMICS

THIRD YEAR SECOND SEMESTER EXAMINATION FOR

BACHELOR OF ECONOMICS

BACHELOR OF ARTS

EAE 308: INTERNATIONAL ECONOMICS II

DATE: 10/12/2021 **TIME: 2.00-4.00 PM**

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) Suppose you are a Kenyan importer who has ordered for **100** computers from the USA at a price of **US$ 1,000** each. The total payment of **US$ 100,000** is due in **100** days' time after all the computers have been delivered in Kenya. Since the contract is written in dollars, there is a possibility of a change in the **Ksh** exchange rate during the period. Using this information demonstrate the concept of hedging by giving out two possible options the Kenyan importer should consider. (4 marks)

b) Given that Kenya is the domestic country and USA is the foreign country, clearly demonstrate the relative form of purchasing power parity. Also explain what will happen to Kenya's currency in a situation whereby there is a 15 *per cent* increase in Kenya's overall price level and a 2 *per cent* increase in USA's price level. (6 marks)

c) In a free market economy with a flexible exchange rate regime, forces of demand for and supply of foreign exchange determine the equilibrium position. Using a well labeled diagram demonstrate the equilibrium condition in an economy with this kind of exchange rate regime and explain what happens in case there is excess supply of foreign currency. (8 marks)

d) Using the concept of Covered Interest Arbitrage, demonstrate when it is appropriate to invest in Kenya Shilling denominated assets and when it is appropriate to invest in dollar denominated assets. (4 marks)

e) The economy of the United Kingdom can be characterized by the following set of equations:

$\bar{Y} = 2400$

$\frac{MD}{P} = 1470 + 0.4Y - 10000(r + \pi_e)$ $(\pi_e = 0.03)$ (Real Money Demand)

$\frac{MS}{P} = 2000$ (Real Money Supply)

$C^d = 388 + 0.6(1 - t)Y - 50000r$ (t = 0.4) (Desired consumption)

$I^d = 600 - 12000r$ (Desired savings)

$NX = 300 - 0.2Y + 0.01Y_{for} + 10000(r - r_{for})$ (Net Exports)

$r_{for} = 0.02$ (Foreign real interest rate)

$Y_{for} = 12000$ (Foreign real output)

G = 900 (Government spending)

T R = 200 (Government transfers)

Find the IS equation, the LM equation, the short-run equilibrium values of interest rate and output. Is the economy above or below its full output? (8 marks)

QUESTION TWO (20 MARKS)

a) Clearly explain three determinants affecting demand for foreign currency. (6 marks)

b) With aid of a well labeled diagram explain the welfare effects of economic integration in a small country (8 marks)

c) Demonstrate the derivation of the IS curve. (6 marks)

QUESTION THREE (20 MARKS)

a) Clearly explain three differences between forward and future contracts. (6 marks)

b) Discuss two criticisms labeled against each of the three Bretton Woods Institutions (6 marks)

c) With aid of a well labeled diagram demonstrate Balance of Payments equilibrium and explain the effect to this equilibrium when there is a change in interest rate and income. (8 marks)

QUESTION FOUR (20 MARKS)

a) Demonstrate the derivation of the LM curve (6 marks)

b) With aid of a well labeled diagram demonstrate the equilibrium position for a country using fixed exchange rate regime and explain what happens if the central bank of that country fixes the exchange rate at a point lower than the equilibrium exchange rate. (8 marks)

c) Clearly explain the International Fischer Effect (6 marks)

QUESTION FIVE (20 MARKS)

a) Assess the effectiveness of currency depreciation and fiscal contraction as a way of easing a current account deficit. (6 marks)

b) Explain three differences between futures and forward contracts. (6 marks)

c) Graphically demonstrate and explain the balance of payment disequilibrium under fixed exchange rate regime. (8 marks)