MACHAKOS UNIVERSITY

University Examinations for 2022/2023 Academic Year

SCHOOL OF BUSINESS, ECONOMICS AND HOSPITALITY AND TOURISM MANAGEMENT

DEPARTMENT OF ECONOMICS

THIRD YEAR FIRS………… SEMESTER EXAMINATION FOR

BACHELOR OF ECONOMICS

EAE 308: INTERNATIONAL ECONOMICS II

DATE: **TIME:**

INSTRUCTIONS:

- **(i) Answer question one (Compulsory) and any other two questions**
- **(ii) Do not write on the question paper**
- **(iii) Show your workings clearly**

QUESTION ONE (COMPULSORY) (30 MARKS)

(a) An economy is described by the following equations:

$C^d = 360 - 200r + 0.1Y$

$I^d = 120 - 400r$

$G = 120$

Required

(i) Find an equation for desired national saving, in terms of output Y and the real interest rate r (2 marks)

(ii) What value of the real interest rate clears the goods market when Y = 550? (2 marks)

(b) The economy of Kenya is characterized by the following set of equations :

$\bar{Y} = 2400$

$\frac{MD}{P}$ = 1470 + 0.4Y − 10000(r + πe) (πe = 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 investments)

NX = 300 − 0.2Y + 0.01Y_{for} + 10000(r − r_{for}) (Net exports)

Y_{for} = 12000 (Foreign real ouput)

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

G = 900 (Government spending)
T R = 200 (Government transfers)

Answer the following questions:

(i) Find the IS equation and the LM equation **(**4 marks)

(ii) Find the short-run equilibrium values of interest rate and output. Is the economy above or below its full output? (3 marks)

c) Explain using uncovered interest rate parity to determine when it is advisable for an investor to invest in dollar denominated assets and when it is advisable to invest in Kenya shilling denominated assets (6 marks)

d) Graphically explain how balance of payment deficit is corrected using exchange rate changes (7 marks)

e) (i) Distinguish between a Swap and an Option (2 marks)

(ii) Explain two differences between a Futures contract and and Forward contract

(4 marks)

QUESTION TWO (20 MARKS)

a) Assume a country using fixed exchange rate regime. Explain graphically the effect of fixing exchange rate above the equilibrium. Also explain the steps that government can undertake to maintain balance between demand and supply of the foreign currency

(8 marks)

b) Explain five stages of economic integration (6 marks)

c) Clearly explain the law of one price and explain why in reality it is not applicable in many countries (6 marks)

QUESTION THREE (20 MARKS)

a) Graphically explain welfare effects of economic Integration in a small country (8 marks)

b) Explain three factors that can lead to an outward shift of IS curve in an open economy (6 marks)

c) Using a relevant example, explain the concept of arbitrage (6 marks)

QUESTION FOUR (20 MARKS)

(a) Clearly explain relative purchasing power parity and show how inflation influences change in exchange rate (6 marks)

(b) Explain three main functions of foreign exchange Market (6 marks)

(c) Use the supply and demand model of the foreign exchange market to analyze the effects of a rise in the price level of the USA relative to that of Kenya Under a flexible exchange rate regime (8 marks)

QUESTION FIVE (20 MARKS)

a) Explain the effect to the economy when savings are greater than investments in the goods market and explain how the equilibrium can be restored. (6 marks)

b) Explain three reasons why residents of a country desire to hold currency of another country (6 marks)

c) With the help of the BP curve, explain the effect of increasing the level of income with no change in interest rate (8 marks)