MACHAKOS UNIVERSITY

University Examinations for 2022/2023 Academic Year

SCHOOL OF BUSINESS, ECONOMICS AND HOSPITALITY AND TOURISM MANAGEMENT

DEPARTMENT OF ECONOMICS

THIRD YEAR FIRST SEMESTER EXAMINATION FOR

BACHELOR OF ECONOMICS AND FINANCE

BACHELOR OF ECONOMICS AND STATISTICS

BACHELOR OF ECONOMICS

BACHELOR OF COMMERCE

EAE 401: MONETARY THEORY AND POLICY

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) Using the equation of exchange and Cambridge equation, explain how quantity of money is related to price level. Also explain how money velocity and a measure of a proportion of nominal income are related. (8 marks)

b) Explain the criticisms laid upon the fiscal and monetary policies. As a result state the most effective type of fiscal policy and monetary policy to be employed (6 marks)

c) Explain two sets of conflicting objectives of monetary policy (4 marks)

d) Using the transmission mechanism, explain how central bank reduces inflation in a country. (4 marks)

e) Graphically explain the relationship between money supply and high powered money

(4 marks)

f) Graphically explain why monetary policy is not effective at the liquidity trap (4 marks)

QUESTION TWO (20 MARKS)

a) If the required reserve ratio is 10 percent, currency in circulation is 400 billion, checkable deposits and excess reserves total 0.8 billion. Calculate the money supply, monetary base and the money multiplier (6 marks)

b) Explain three main lags of monetary policy (6 marks)

c) Explain Fisher‘s quantity theory of money with the help of two diagrams to show a relationship between price level and quantity of money as well as between value of money and the quantity of money (8 marks)

QUESTION THREE (20 MARKS)

a) In the Baumol Transaction Demand for money model, money demand is determined by a number of factors. Mercy earns 50,000 shillings per month and can invest the money in interest earning ventures at 5 percent per year. What must be the per transaction cost be to ensurethat the average holdings are 10 shillings per month? (6 marks)

b) Explain three limitations of monetary policy in developing countries (6 marks)

c) Based on Cambridge Economists, graphically show the relationship between quantity of money and price level using the aggregate demand – aggregate supply model. (8 marks)

QUESTION FOUR (20 MARKS)

a) Explain four factors influencing money supply in Kenya (8 marks)

b) Explain three factors influencing demand for money in Kenya (6 marks)

c) Explain three factors that can limit the quantity of deposits commercial banks can create (6 marks)

QUESTION FIVE (20 MARKS)

a) Compare the analysis of trade-off in monetary policy using Phillips curve, Friedman Phelps view of the Phillips curve and the Taylor curve. (6 marks)

b) Given that the cash reserves ratio is 20 percent. Demonstrate how a commercial bank uses initial deposit of 4000 shillings to create credit. Also calculate the maximum primary deposits that can be created, maximum cash reserves to be created and maximum secondary deposits to be created (6 marks)

c) Graphically demonstrate Cambridge’s cash balance approach to quantity theory of money (8 marks)