MACHAKOS UNIVERSITY

University Examinations for 2016/2017

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ECONOMICS

THIRD YEAR FIRST SEMESTER EXAMINATION FOR DEGREE IN

BACHELOR OF COMMERCE

EAE 302: ECONOMICS OF MICROFINANCE

DATE: 5/6/2017 **TIME: 2:00 – 4:00 PM**

INSTRUCTIONS:

Answer Question ONE and Any Other Two Question

QUESTION ONE (COMPULSORY) (30 MARKS)

a) Distinguish between the following pairs of terms (10 marks)

i. Informal and the formal sector

ii. Adverse selection problems and moral hazard

iii. Microcredit and microfinance

iv. Limited liability and group lending

v. Financial intermediation and social intermediation.

b) Explain the principal of marginal returns to capital and why capital doesn't capital flow naturally to the poor as suggested by economic theory (6 marks)

c) State and explain the five risk factors that a regulator of microfinance institutions looks out for (10 marks)

d) Distinguish between ex ante and ex post moral hazard (4 marks)

QUESTION TWO (20 MARKS)

a) If being a money lender is as profitable as many people think, why don't moneylenders face greater competition as suggested by economic theory? (8 marks)

b) What are the main differences between ROSCAS and Credit Cooperatives (4 marks)

c) If you compare the main disadvantages of ROSCAS and Credit Cooperatives, why are ROSCAS more common than Credit Cooperatives (8 marks)

QUESTION THREE (20 MARKS)

a) What are the five main components of the cost structure of microfinance institutions that are used to determine the marginal cost and interest rate of loans (5 marks)

b) Highlight five factors responsible for the emergence of the informal Sector. (10 marks)

c) Since most MFI's lend to low-income clients, the normal collateral such as property, land, machines, vehicles and other capital/financial assets are not available to be used as collateral. Innovative collateral substitutes and/or alternatives forms of collateral are used instead. Briefly explain them. (5 marks)

QUESTION FOUR (20 MARKS)

a) Why has there been a need for the emergence of microfinance when ROSCAs have been in existence for a long time and are wide spread all over the globe (10 marks)

b) Define the term effective interest rates and state any five variables of micro loans that influence the effective rate (6 marks)

c) Explain any four functions of local and international donors (4 marks)

QUESTION FIVE (20 MARKS)

a) Agency problems refer to the lender's inability to observe the borrower's characteristics, such as the borrower's effort to execute/implement the project or the project's riskiness. Explain, using relevant examples, the three stages in which the agency problem manifests itself. (6 marks)

b) If you have two money lenders:

One money lender in the Gikomba market of Nairobi, whose clients are reliable with nil default rate, charges 10% interest rate per annum.

The second money lender in the rural area of Bungoma County, expects half his clients to default. At what interest rate will the Bungoma money lender charge his clients in order to cover his projected losses due to defaulters and make a rate of return equivalent to that of Gikomba market? (8 marks)

c) Give and explain three reasons which account for differences in interest rates charged by the two money lenders in (b) above (6 marks)