MACHAKOS UNIVERSITY

University Examinations for 2016/2017 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARMENT OF ECONOMICS

THIRD YEAR FIRST SEMESTER EXAMINATION FOR BACHELOR OF ECONOMICS AND FINANCE

EAE 302: ECONOMICS OF MICRO FINANCE

DATE: 25/7/2017 **TIME: 8:30 – 10:30 AM**

INSTRUCTIONS

Answer question one and any other two questions. Question one carries 30 marks and the other questions carry 20 marks each.

QUESTION ONE (COMPULSORY) (30 MARKS)

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

(i) Declining balance method and Flat rate method of calculating interest

(ii) Adverse selection problems and moral hazard

(iii)Ex ante and ex post moral hazard

(iv)Microcredit and microfinance

(v) Capital adequacy and minimum capital requirement

b) Use the principal of marginal returns to capital to explain the difference in returns between a large entrepreneur and a small one. (5 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)

d) 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? (5 marks)

Give and explain three reasons which account for differences in interest rates charged by the two money lenders in (d) above (3 marks)

e) State any four functions of local and international donors (2 marks)

QUESTION TWO

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? (6 marks)

b) If you compare the main disadvantages of ROSCAS and Credit Cooperatives, give five reasons why ROSCAS more common than Credit Cooperatives (5 marks)

c) Suppose when you graduate you decide to take advantage of the government youth enterprise fund to become self-employed. The programme offers you a chance to borrow Kshs. 200,000 at a subsidized interest rate of 6% per annum. State which of the following strategies you would choose and why (9 marks)

i) Invest the Kshs 200,000 in your family business and obtain a return of 15% per annum but incur an effort cost equivalent to KShs. 26670 per annum

ii) Deposit the money in a nearby bank that will pay you yearly rate of 7%
(Clearly show all your calculations)

QUESTION THREE (20 MARKS)

a) Explain the five main components of the cost structure of microfinance institutions that are used to determine the marginal cost and interest rate of loans (10 marks)

b) Assume that Ann borrows 10,000/= from a microfinance institution which charges an annual interest rate of 10%. If the loan term is 4 years, compute the loan repayment schedule using the flat rate method. Show all your workings (6 marks)

c) How does group lending mitigate the problems of adverse selection and moral hazard (4 marks)

QUESTION FOUR (20 MARKS)

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

b) Kenya has a very large informal sector which has been growing over the years. Explain four reasons responsible for this situation. (8 marks)

c) Are Shylocks (money lenders) efficient in the capital markets? Explain your answer using a well labeled diagram. (6 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) State and explain the five risk factors that a regulator of microfinance institutions looks out for (10 marks)

c) Explain two types of forms of self-employment (4 marks)