MACHAKOS UNIVERSITY

University Examinations for 2017/2018

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ECONOMICS

FOURTH YEAR SECOND SEMESTER EXAMINATION FOR

BACHELOR OF FINANCE AND ECONOMICS

BACHELOR OF COMMERCE

EAE 401: MONETARY THEORY AND POLICY

DATE: 13/12/2017 **TIME: 11:00 – 1:00 PM**

INSTRUCTIONS:

Answer **question one** and any **other two** questions

Question one is **compulsory** and carries **30Marks**

All other questions carry **20Marks each**

QUESTION ONE(COMPULSORY) (30 MARKS)

a) Explain the following terms as used in monetary theory and policy (4 marks)
   i) Monetary policy
   ii) Money illusion
   iii) Exchange rate
   iv) Liquidity preference

b) Briefly explain any five factors that limit the effectiveness of the instruments of controlling money supply in Kenya. (10 marks)

c) Describe any four functions of the Central Bank of Kenya (4 marks)

d) Briefly highlight 2 similarities and 2 differences between the Tobin and Baumol's approaches to money demand. (4 marks)

e) State and explain briefly any 4 objectives of monetary Policy (8 marks)

QUESTION TWO (20 MARKS)

a) What limitations do monetary policy makers encounter in less developed countries (10 marks)

b) Explain why the interest rate and the price of bonds are inversely related (show your working) (5 marks)

c) Show the money demand curve graphically and explain why it slopes downward. Show how the money demand curve shifts when income increases. (5 marks)

QUESTION THREE (20 MARKS)

a) Does monetary policy become more or less effective when investment or net exports become more responsive to changes in the interest rate? Explain. (5 marks)

b) Derive the Baumol square root for money demand function and interpret it (8 marks)

c) How does the function in (ii) above differ from the Keynesian and Tobin's transaction money demand specification. (7 marks)

QUESTION FOUR (20 MARKS)

a) State the balance of payments surplus equation and explain it. (5 marks)

b) How does the expansionary monetary policy influence the exchange rates? (5 marks)

c) The central bank is responsible for a sound financial system in any country. Briefly explain any five ways with which it undertakes this. (10 marks)

QUESTION FIVE (20 MARKS)

a) The experience of underdeveloped countries reveals that monetary policy plays a limited role in such economies. Discuss (8 marks)

b) Why is money important if it is? (4 marks)

c) Briefly explain the 5 instruments of monetary policy. (5 marks)

d) Give three limitations of open market operations as an instrument of MP. (3 marks)