MACHAKOS UNIVERSITY

University Examinations for 2018/2019 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ECONOMICS

THIRD YEAR …….. SEMESTER XAMINATION FOR

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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 working clearly**

QUESTION ONE (COMPULSORY) (30 MARKS)

It all started with the depreciating shilling and Kenyans watched as the shilling continued to weaken against the dollar. This was later to be followed by rising inflation and nobody would exactly tell what was wrong. Some blamed it on the fuel (high cost of imported oil) while others blamed the Central bank accusing the Governor of incompetence and inability to control the shilling (tame the weakening shilling). Then it was time to act, serious drastic measures were adopted:

i) The Central Bank suspended the dollar transactions by the commercial banks whom it

Accused of hoarding the dollar for speculative purpose and instead decided to carry out the transactions.

ii) The Central Bank increased the base lending rates.

Required:

a) Discuss the implications of the above measures and how they have succeeded to taming the shilling as well as reducing inflation. (15 marks)

b) In the attempt to solve the exchange rate, the rate of inflation could increase. Explain. (5 marks)

c) Explain the determinants of money supply in the economy. (6 marks)

d) Describe the contributions of Milton Friendman's to the quantity theory of money. (4 marks)

QUESTION TWO (20 MARKS)

a) Describe the Cambridge theory of money demand or the cash balance approach and clearly explain the variables involved. (6 marks)

b) Discuss the consequential economic impacts of high and rising rates of interest.(6 marks)

c) Explain any 4 functions of money in the economy. (8 marks)

QUESTION THREE (20 MARKS)

a) Explain four measures of money supply (8 marks)

b) Is foreign currency a store of value or a medium of exchange? Explain your answer. (5 marks)

c) Using the classical quantity theory of money, explain the determinants of money demand. Demonstrate also using the equation of exchange the cause of inflation. (7 marks)

QUESTION FOUR (20 MARKS)

a) Distinguish between monetary policy and monetary theory. (4 marks)

b) Discuss four instruments of monetary policy used to control and regulate money supply by the central banking authority. (8 marks)

c) Suppose that CBK decides to sell KShs. 89 billion of its foreign assets in exchange for $US1 billion currency. Use T- Accounts to explain the effect of the CBK's purchase of dollars . (4 marks)

d) Define the concept "Balance of Payments" and explain its components. (4 marks)

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QUESTION FIVE (20 MARKS)

a) Assuming that an individual is paid KShs 24,000 salary at the 1^{st} day of every month. Supposing that he gets half of it cashed and saves the rest in a savings account earning an interest of 10%. Given that the brokerage fee is KShs 50 per transaction, calculate the total cost incurred by the individual as well as the optimal cash holdings that minimize the transaction costs. Show all you workings. (8 marks)

b) What is money multiplier? Derive the expression for the complex money multiplier (6 marks)

c) Explain Tobin's theory of money demand (6 marks)