MACHAKOS UNIVERSITY

University Examinations for 2018/2019 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ECONOMICS

FOURTH YEAR SECOND SEMESTER EXAMINATION FOR

BACHELOR OF ECONOMICS & STATISTICS

BACHELOR OF ECONOMICS & FINANCE

BACHELOR OF ECONOMICS

BACHELOR OF COMMERCE

BACHELOR OF ARTS

EAE 401/411: MONETARY THEORY AND POLICY

DATE: 10/5/2019 **TIME:8.30-10.30 AM**

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 to increase supply of the dollar in the economy .

ii. The Central Bank increased the base lending rates.

Required:

a) Discuss the implication of increasing supply of a dollar and base lending rates in reducing inflation. (10 marks)

b) Suppose that the monetary base **(B)** is $ 500 billion, the reserve deposit ratio (**rr)** is 0.1 and the currency-deposit ratio (**cr)** is 0.6.You are required to calculate:

   i. Money Multiplier (2 marks)

   ii. Money Supply (2 marks)

c) Explain how money stock and money velocity causes inflation (4 marks)

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

e) State and briefly explain with the aid of a diagram two factors or events that can cause shifts in aggregate demand (6 marks)

QUESTION TWO (20 MARKS)

a) State and clearly explain three main objectives of monetary policy undertaken by Central

b) Bank of Kenya (6 marks)

c) Discuss the main idea of the Keynesian Demand for Money stating clearly three motives for holding money (8 marks)

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

QUESTION THREE (20 MARKS)

a) With aid of a well labeled diagram or diagrams, distinguish between expansionary and contractionary fiscal and monetary policies (8 marks)

b) Using the classical quantity theory of money, explain the determinants of money demand. (6 marks)

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

QUESTION FOUR (20 MARKS)

a) Explain how four instruments of monetary policy can be used to control and regulate money supply in the economy as applied by the central bank of a given country. (8 marks)

b) Graphically explain the Cambridge Cash Balance Approach of money demand giving its strengths and weaknesses (12 marks)

QUESTION FIVE (20 MARKS)

a) Assuming that an individual is paid KShs 24,000 salary at the 1st 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) Explain the following terms as used in the money supply model.

   i. The monetary base (2 marks)

   ii. The reserve-deposit ratio (2 marks)

   iii. The currency-deposit ratio (2 marks)

c) Discuss three main types of financial markets (6 marks)