KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2016/2017

SECOND SEMESTER EXAMINATION FOR THE DEGREE OF BACHELOR OF ECONOMICS, ECONOMICS AND STATISTICS, ECONOMICS AND FINANCE, ARTS, COMMERCE AND EDUCATION

EET 301: MACROECONOMIC THEORY III

DATE: THURSDAY 11TH MAY 2017 **TIME: 11.00 A.M. - 1.00 P.M.**

INSTRUCTIONS

Answer Questions One and any other Two questions

Question One (30 marks)

a) Recently the government of Kenya introduced a law that imposed limits on bank lending and deposit rate. Assume that the new lending rate that is capped at four percentage points above the CBK benchmark rate is below the equilibrium rate. Also assume all other factors remain constant. Use the necessary graphs to illustrate how this interest rate capping affects the money market. (3 marks)

b) Briefly explain the following economic terms using graphical and mathematical illustrations where necessary.

i) Automatic stabilizers (2 marks)

ii) Non accelerating inflation rate of unemployment (NAIRU) (2 marks)

iii) Okun's Law (2 marks)

iv) Involuntary unemployment (2 marks)

v) Life cycle Income hypothesis (2 marks)

c) Demonstrate your understanding of equilibrium in the goods market and equilibrium in the money market. Explain how these are sustained and their relevance in macroeconomic analysis. (7 marks)

d) Use a graphical representation of the static model to illustrate the effect on real wage, real interest rate, price level and real output of a major earthquake that destroys substantial amount of capital stock in the country. (10 marks)

Question Two

Given the following functions for an imaginary economy:

$C=500+0.75y^d$, $i=30-50r$, $I=y-100r$, $g=45$, $t=0.3y$, M200, $P=20$, $nx=20-10r$

Where :

c is real consumption expenditure

i is real gross investment

G is government expenditure

I is real money demand

M is nominal money supply

Tax rate is 30%

nx is real net export

r is real interest rate

y is real output

i) Compute both the fiscal and monetary policy multipliers and interpret your results. (10 marks)

ii) Suppose equilibrium income increases by 80, by how much must real money stock increase for the new level of income to be in equilibrium? (10 marks)

Question Three

a) Using the static model, show how the decrease in price of crude oil (positive supply shock) would affect the economy. (6 marks)

b) Explain how you generate a downward sloping aggregate demand curve. Illustrate how your explanation is different from the one for individual demand curve you studied in microeconomic theory? (6 marks)

c) Explain the effectiveness of fiscal and monetary policies as demand management tools. When would it be the best moment to use the tools? (3 marks)

d) Suppose the Kenya economy is in recession. Use As-As model (Aggregate demand - Aggregate Supply Model) to illustrate the effect of an increase in government spending on Price level and real output.(5 marks)

Question Four

a) Use well-labeled diagrams to explain the concept of work-leisure decision-making by a rational worker. (10 marks)

b) With the aid of a well-labeled diagram, illustrate the effect of an expansionary fiscal polity on the static model? (6 marks)

c) Differentiate between the long run and short run Philip's curve (4 marks)

Question Five

a) Derive the demand for labour for monopolist and competitive firms. What is the fundamental difference between the two? (7 marks)

b) Demonstrate the impact of fiscal policy in cases of closed or open economies. When is fiscal policy most effective? (7 marks)

c) Use the four-sector diagram to illustrate how a decrease in price would affect the money market. (6 marks)