



KENYATTA UNIVERSITY
UNIVERSITY EXAMINATIONS 2016/2017
SECOND SEMESTER EXAMINATION FOR THE DEGREE OF
DOCTOR OF PHILOSOPHY (ECONOMICS)
EAE 912: MONETARY ECONOMICS II

DATE: Wednesday, 17th May 2017

TIME: 9.00 a.m. - 12.00 p.m.

INSTRUCTIONS:

Answer ALL the questions

QUESTION ONE

- i) According to George Stigler (1971), regulation is acquired by the industry and is designed and operated primarily for its benefit'. Discuss the benefits of regulation according to Stigler's theory. (6 Marks)
- ii) According to the Dewatripont-Tirole model of financial sector regulation, show that continuing is optimal under incomplete information if and only if:

$$\frac{f(u|\bar{e})}{f(u|e)} \left\{ 1 + \frac{D(u)}{\mu B} \right\} \geq \frac{g(v|\bar{e})}{g(v|e)} \quad (6 \text{ Marks})$$

- iii) Recent developments in financial inclusion have led to the establishment of a strong microfinance movement in developing countries. Discuss the impact of Microfinance in economic development (3 Marks)

QUESTION TWO

- i) According to Cameron (1967), financial intermediaries have important features that aid in the growth of an economy. Discuss these features. (4 Marks)
- ii) Financial sector regulation can be justified based on the characteristics of banks that make their failure generate a strong negative externality on other economic agents. Give a **critical** analysis of these characteristics. (6 marks)
- iii) Discuss the approaches employed by international money market players to indulge in illicit capital flows (5 Marks)

QUESTION THREE

- i) You have been given the following production function of the Solow type:

$$Y_t = A_t K_t^\alpha L_t^{1-\alpha} \quad 0 < \alpha < 1 \quad (1)$$

Assume that $\alpha = 1$, which yields:

$$Y_t = A_t K_t \quad (2)$$

Given equation (1) and (2), derive a steady-state growth equation that reveals concisely how financial development can affect growth and interpret a raise in α and an increase A .

(7 Marks)

- ii) Suppose that today's exchange rate (quoted in American terms) is \$1.10 per euro, but that you expect the rate to be \$1.165 per euro in a year. Suppose also that the dollar interest rate is 10 percent per year while the euro interest rate is 5 percent per year. Which of these deposits offer the higher return?

(3 Marks)

- iii) Consider a model in which firms seek to finance investment projects of a size normalized to 1. The riskless rate of interest is normalized to zero. Firms have a choice between a good technology, which produces G with probability π_G (and zero otherwise), and a bad technology, which produces B with probability π_B . Assume that only good projects have a positive net (expected) present value (NPV), $\pi_G G > 1 > \pi_B B$, but that $B > G$, which implies $\pi_G > \pi_B$. Assume also that the success of the investment is verifiable by outsiders, but not the firm's choice of technology nor the return. Thus the firm can promise to repay some fixed amount R (its nominal debt) only in case of success. The firm has no other source of cash, so the repayment is zero if the investment fails. Show that equilibrium is only possible when the G technology is implemented and moral hazard is not too important.

(5 Marks)

QUESTION FOUR

- i) In a two country context and in a situation of exchange rate flexibility, show that currency depreciation is expected to offset the international inflation difference and that the interest rate difference must equal the expected inflation difference.

(5 Marks)

- ii) 'Deposit insurance seems to have a positive regulatory effect on the banking industry'. Discuss the empirical validity of this statement. (5 Marks)
- iii) From the financial approach of exchange rate determination, show that the domestic currency can be strong when domestic interest rates are high; and vice - versa. (5 Marks)