KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2016/2017

DIGITAL SCHOOL OF VIRTUAL AND OPEN LEARNING

SECOND SEMESTER EXAMINATION FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN ECONOMICS

EAE 916: INTERNATIONAL ECONOMICS II

DATE: MONDAY 15TH MAY 2017 **TIME: 2.00 P.M. - 5.00 P.M.**

INSTRUCTIONS: **Attempt ALL questions**

Question One

Provide clear explanations for the following predictions of the flexible price monetary approach to exchange rate determination. Make sure that you relate your explanation of these predictions to the theory's underlying view of the exchange rate as the price of an asset.

i. An increase in domestic money supply depreciates the domestic currency in the same proportion. (5 marks)

ii. A country that grows relatively slower than her trading partners can expect her currency to depreciate relative to those of her trading partners'. (5 marks)

iii. Given the world expected rate of inflation a higher expected domestic inflation rate will induce domestic currency depreciation. (5 marks)

Question Two

With the aid of relevant economic methodology, explain the causes and timing of the currency crises using the following models. Remember to state the underlining assumptions.

i. First Generation Models (8 marks)

ii. Second Generation Models (7 marks)

Question Three

i. Explain how political considerations would influence the effectiveness of exchange rate as an instrument for balance of payment adjustments (7 marks)

ii. Explain four political factors that are required to enhance policy credibility in the formation of monetary unions (8 marks)

Question Four

Given equations describing the Uncovered Interest Parity (UIP) and Covered Interest Parity (CIP) in the exchange rate market as;

UIP $$1+i=\frac{(1+i^{*})S^{e}}{S}$$

CIP $$1+i=\frac{(1+i^{*})F}{S}$$

$$F=S^{e}$$

If the excess market return on asset i is given as $Z_{i,t}=x_{i,t}-E(\overline{x_{i,t}}/I_{t-1})$

Where;

$i-$ *Domesttic* int. *rate*

$i^{*}-$ *Foreign* int. *rate*

$S^{e}-$ *Expected spot price (exchange rate)*

$S-$ *Spot price (exchange rate)*

$F-$ *Forward rate*

Z -- *Excess market return*

$I_{t-1}-$ *Information set*

$x_{i,t}-$ *One period percentage return*

$\bar{x}_{i,t}-$ *Equilibrium value of* $x_{u,t}$

Define and explain the following concepts;

i. Pure speculation (7 marks)

ii. Efficient Markets Hypothesis (EMH) (8 marks)