KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2018/2019

SECOND SEMESTER EXAMINATION FOR DEGREE OF BACHELOR OF ECONOMICS, BACHELOR OF ECONOMICS AND FINANCE AND BACHELOR OF ECONOMICS AND STATISTICS

EAE 401: MONETARY THEORY AND POLICY

DATE: Wednesday 27th March 2019 **TIME: 8.00a.m -10.00a.m**

INSTRUCTIONS:

*Answer questions **one** and any other **two**.*
*Question one is **compulsory** and carries 30 marks.*
All other questions carry 20 marks each.

QUESTION ONE (*COMPULSORY*) – (30 Marks)

a) Outline the Baumol-Tobin transaction demand for money model and discuss the "square-root rule". (10 marks)

b) Using the square root rule as in (a) above:-

i) Determine the monthly optimal strategy for cash management for a person who earns Ksh160,000 per month, can earn 0.5 percent interest per month in a saving account, and has a transaction cost of Ksh100. (*Hint:* please use the interest rate as 0.5 in your calculation.) (3 marks)

ii. What is the individual's average cash balance? (3 marks)

iii. Suppose income rises to Ksh180,000. By what percentage does the individual's demand for money change? (3 marks)

c) What factors determine money demand in Milton Friedman's modern quantity theory? Explain how each factor affects money demand? (8 marks)

d) If the cash-to-deposit ratio is 0.2 and the reserve requirement is 0.1, what happens to the money supply when the central bank of Kenya sells Ksh100 million worth of bonds? (3 marks)

QUESTION TWO (20 marks)

a) Describe the effectiveness of monetary policy under the following foreign exchange rate regimes:-

i) Fixed exchange rate regime (5 Marks)

ii) Floating exchange rate regime (5 Marks)

b) Selective credit control is one of the several instruments of monetary control employed by the central bank to encourage those sectors of economic activity considered essential and to discourage those which are of lower priority. State and explain the measures that have been used by the Central Bank of Kenya to achieve this giving relevant examples. (10 marks)

QUESTION THREE (20 marks)

a) Consider the complex money multiplier:-
   i) Discuss how actions of the public and commercial banks can cause the money multiplier to rise or fall. (5 Marks)
   ii) Does the fact that the public and commercial banks can affect the money multiplier imply that the central bank cannot control the money supply? Why or why not? (5 Marks)

b) Citing relevant examples, explain why monetary policy in developing countries is limited in its effectiveness? (10 Marks)

QUESTION FOUR (20 marks)

a) Explain the similarities and differences of the following theories with the Keynesian theory of money demand.
   i) Tobin's speculative demand for money theory (5 Marks)
   ii) Friedman theory of money demand (5 marks)

b) The Monetarists' quantity theory of money can be specified as follows:

$$MV = Py$$

Show that nominal income is determined solely by the supply of money (4 Marks)

c) Why is it difficult for monetary policy to be effective when interest rates are low? (6 Marks)

QUESTION FIVE (20 marks)

a) Briefly explain the four main pairs of the monetary policy objectives which have been widely viewed to be conflicting and mutually contradictory. (10 Marks)

b) Explain the credit view effects of the transmission channels of Monetary Policy. (10 Marks)