KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2019/2020 ACADEMIC YEAR

SECOND SEMESTER EXAMINATIONS FOR THE DEGREE OF BACHELOR OF ECONOMICS, BACHELOR OF ECONOMICS AND FINANCE, AND BACHELOR OF ECONOMICS AND STATISTICS

EAE 401: MONETARY THEORY AND POLICY

DATE: 00/00/2020 TIME: 00:00 – 00:00

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) Suppose that the central bank buys bonds from the public worth Sh100 billion. The public, on the other hand, deposits the central bank's cheques with banks and withdraws Sh40 billion as currency holding and leaves Sh60 billion in banks as demand deposit. Suppose that the banks are required to maintain total cash reserves of 15% (including 10% as statutory reserve requirement and 5% as excess reserve) of their deposits.

Required:-

i) Calculate simple money multiplier. (2 marks)

ii) Compute complex money multiplier. (3 marks)

iii) The additional high powered money of 100 billion will increase total money supply in the economy by how much? (3 marks)

iv) How much money will be in cash and in cheques? (4 marks)

b) In a famous article, "The quantity Theory of Money: A Restatement, " Milton Friedman expressed his formulation of the demand for money as follows"

Required:-

i. State the factors that determine money demand in Milton Friedman's modern quantity theory? (4 marks)

ii. Explain how each factor affects money demand? (4 marks)

c) Why does an increase in the interest rate cause a decline in the bond price? What is its effect on the demand for money? (6 marks)

d) Define monetary base. What is the relationship between the monetary base and the money supply in fractional reserve banking? (4 marks)

QUESTION TWO (20 marks)

Consider the Tobin's Theory of Speculative Demand for Money.

i) Illustrate and explain Tobin's method of deriving the demand function for speculative money. (12 Marks)

ii) Demonstrate the substitution effect and the wealth effect (5 Marks)

iii) Does this method yield only a downward sloping demand-for-money curve? Explain. (3 Marks)

QUESTION THREE (20 marks)

a) Explain how a central bank may find it conflicting to achieve a stable rate of interest and control inflation simultaneously. (5 marks)

b) Describe the following channels of monetary policy transmission.

i. Traditional interest-rate effects (5 marks)

ii. ~~Assets price effects~~ Cashflow Channel (5 marks)

iii. Credit view effects (5 marks)

QUESTION FOUR (20 marks)

a) Derive the square-root rule and explain why it is a money demand function. (10 Marks)

b) Discuss the different mechanisms of the 'Asset Price Effects' of Monetary Transmission (6 Marks) ~~Set another question repetition~~

c) Describe the assets and liabilities of a Central Bank. (4 Marks)

QUESTION FIVE (20 marks)

a) According to Friedman, "Inflation is everywhere and at all times a monetary phenomenon'. Discuss the Keynesian criticism of this view and highlight the Keynesian view of inflation (8 Mark)

b) Some objectives of Monetary Policy have been found to be conflicting. Discuss these conflicts (8 Marks)

c) 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)