I.E. Nie... 22/1/2020

KENYATTA UNIVERSITY

DEPARTMENT OF APPLIED ECONOMICS

EAE 912: MONETARY ECONOMICS II

INSTRUCTIONS

Answer ALL the questions. All questions carry 15 marks each.

QUESTION ONE

i) 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. Show that in the absence of monitoring, a competitive equilibrium of the credit market is only obtained for R such that: $\pi(R)R = 1$ (5 Marks)

ii) In some cases, banks are limited in effecting financial contracts because of information asymmetry.

a) Explain how information asymmetry can cause financial crises (6 Marks)

b) Discuss the possible solutions to the information asymmetry risk in the debt market (4 Marks)

QUESTION TWO

i) Discuss the different forms of solvency regulations that can be used by the monetary authority. (6 Marks)

ii) 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)

iii) Discuss the distinct role of the various types of financial institutions engaged in international finance. (4 marks)

QUESTION THREE

i) Using a stage by stage derivation of the AK model of endogenous growth, show how financial development can affect growth and present some empirical backing for this theory 4 (6 Marks)

ii) Discuss the approaches employed by international money market players to indulge in illicit capital flows (5 Marks)

iii) By considering the Allen and Gale (2007) model, show that the necessary and sufficient condition for a bank run is that the incentive constraint is violated.

(4 Marks)

QUESTION FOUR

i) In the financial approach to exchange rate determination, discuss the requisite characteristics of the foreign exchange market. (5 Marks)

ii) 'Deposit insurance seems to have a positive regulatory effect on the banking industry'. Discuss the empirical validity of this statement. 4

(5 Marks)

iii) According to the Dewatripont-Tirole model of financial sector regulation, show that check continuing is optimal under incomplete information if and only if:

$$\frac{f(u\,|\,\bar{e})}{f(u\,|\,\underline{e})}\left\{1+\frac{D(u)}{\mu B}\right\} \geq \frac{g(v\,|\,\underline{e})}{g(v\,|\,\bar{e})}$$

(5 Marks)