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KIRIRI WOMENS' UNIVERSITY OF SCIENCE AND TECHNOLOGY

UNIVERSITY EXAMINATION, 2023/2024 ACADEMIC YEAR
THIRD YEAR, SECOND SEMESTER EXAMINATION
FOR THE DEGREE OF BACHELOR OF SCIENCE
(BUSINESS ADMINISTRATION)

Date: 17th April, 2023
Time: 2.30pm –4.30pm

KFI 303 - MONETARY THEORY AND POLICY

INSTRUCTIONS TO CANDIDATES

ANSWER **QUESTION ONE (COMPULSORY)** AND **ANY OTHER TWO** QUESTIONS

QUESTION ONE (30 MARKS)

a) An American economist Milton Friedman received the 1976 Nobel Prize in Economic sciences .Milton asserted that ''the quantity theory is in the first instance a theory of the demand for money. It is not a theory of output, or of money income, or of the price level''. According to Milton, the demand for money can be formulated as follows: $(M_d/P)=f(Yp, r_b - r_m, r_e - r_m, \pi^e - r_m; \mu)$

Required:

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

ii) Explain how each factor in the money demand in Milton Friedman's modern quantity theory affects money demand. (4 marks)

iii) How does an increase in the interest rate cause decline in the bond price? What is the effect on the demand for money? (6 marks)

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

b) The Central Bank of Kenya Monetary Policy Committee (MPC) met on May 30, 2022, against a backdrop of a changed global outlook, with elevated global inflationary pressures, heightened geopolitical tensions, rising commodity prices, the COVID-19 (coronavirus) pandemic and measures taken by authorities around the world in response to these developments. The MPC reviewed the outcomes of its previous decisions and the measures implemented to mitigate the adverse economic impact and the financial disruptions. One of the major issues they were handling was a rise in overall inflation that had increased to 6.5 percent in April 2022 from 5.6 percent in March, mainly due to higher food and fuel prices. One of the suggestions on discussion to handle the rising inflation level was by the use of monetary policy.

Required:

i) Explain three other objectives of monetary policy besides containing the rising inflation that the Central Bank of Kenya Monetary Policy Committee (MPC) meeting on May 30, 2022 was seeking to achieve (6 marks)

ii) Explain two monetary policy tools that the Central Bank of Kenya Monetary Policy Committee (MPC) meeting on May 30, 2022 would use to attain its objectives. (4 marks)

QUESTION TWO (20 MARKS)

a) Explain how Cambridge cash Balance approach differs from Fisher's transaction approach in relation to money demand. (6 marks)

b) Explain four reasons why Open Market Operations is limited as a monetary policy instrument in developing countries. (8 marks)

c) Explain the effectiveness of monetary in the liquidity trap phenomenon. (6 marks)

QUESTION THREE (20 MARKS)

a) What are the factors that determine the effectiveness of monetary policy. (6 marks)

b) How are interest rates and inflation related? (8 marks)

c) Explain the three transmission mechanisms for monetary policy. (6 marks)

QUESTION FOUR (20 MARKS)

a) Explain how central bank may find it conflicting to achieve a stable rate of interest and control inflation simultaneously. (4marks)

b) Explain the Baumol –Tobin transaction demand for money model. (4marks)

c) Citing relevant examples, explain why monetary policy in developing countries is limited in its effectiveness? (8 marks)

d) Explain the following terms;

i) High powered money

ii) Inflation (4 marks)

QUESTION FIVE (20 MARKS)

a) How is Tobin's approach to speculative demand for money different from Keynes approach? (8 marks)

b) How does an expansionary monetary policy influence the exchange rate? (6 marks)

c) Distinguish between nominal and real interest rates. (4 marks)

d) Explain two monetary methods to control inflation. (2 marks)