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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: 4th December, 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) James Tobin as an American economist who served on the Council of Economic Advisers and consulted with the Board of Governors of the Federal Reserve System. He contributed to the development of key ideas in the Keynesian economics of his generation and advocated government intervention in particular to stabilize output and avoid recessions. His academic work included pioneering contributions to the study of investment, monetary and fiscal policy and financial markets. Tobin received the 1981 Nobel Prize "for his analysis of financial markets and their relations to expenditure decisions, employment, production, and prices." Many people regard Tobin as America's most distinguished Keynesian economist.

Required;

i) As a Keynesian economist and based on his argument on investment, monetary and financial markets mentioned above, Tobin outlined individuals demand for money. Outline the Baumol-Tobin transaction demand for money model. (6 marks)

ii) Based on his analysis of financial markets and their relations to expenditure decisions, employment, production, and prices, other economists such as Milton Friedman weighed in on money demand. Describe Friedman theory of demand for money. (6 marks)

iii) Tobin's argument on investment, monetary and financial markets mentioned above was based on the pioneering work of John Maynard Keynes on monetary policy. Explain the ineffectiveness of monetary policy in Keynes view. (6 marks)

b) The Federal Reserve has opted to maintain its benchmark interest rate at its current target range of between 5.25% and 5.5% while indicating that it's not done raising rates in 2023. The hold by the central bank's Federal Open Market Committee (FOMC) comes after the policy panel raised the Fed's key federal funds rate by a quarter of one percentage point at the last meeting in July in an ongoing effort to combat inflation. The Fed's September pause doesn't necessarily mean interest rates have peaked, but a growing number of investors are optimistic the central bank will have no need to raise rates further in this cycle. Even so, projections released by the FOMC signal one more rate hike this year.

A combination of pent-up consumer demand, supply chain disruptions and a tight labor market sent inflation soaring to 40-year highs in 2022. The FOMC has been raising interest rates since March of last year in an attempt to slow down the economy and ease inflation

Required:

i) The central bank's Federal Open Market Committee (FOMC) has suggested the use of the open market operations as a monetary policy tool to deal with inflation. Discuss in detail what you think a central banker should do in such a circumstance. (6 marks)

ii) Discuss any limitation of this monetary tool employed by the central bank's Federal Open Market Committee (FOMC) (3 marks)

iii) Discuss any other measure that the central bank's Federal Open Market Committee (FOMC) can adopt to control inflation. (3 marks)

QUESTION TWO (20 MARKS)

a) Distinguish the following terms as used in monetary economics

i) Floating exchange rate and fixed exchange rate (6 marks)

ii) Speculative money demand and money supply (6 marks)

b) Explain how Cambridge cash Balance approach differs from Fisher's transaction approach in relation to money demand. (8 marks)

QUESTION THREE (20 MARKS)

a) Explain how central bank may find it conflicting to achieve a stable rate of interest and control inflation simultaneously. (8 marks)

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

c) Explain the following terms;

i) High powered money

ii) Inflation (6 marks)

QUESTION FOUR (20 MARKS)

a) i) State the factors that determine money demand in Milton Friedman's theory of money demand. (4 marks)

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

b) Explain the concept of liquidity trap. (6 marks)

c) Using the Keynesian theory, explain how an increase in money supply affects interest rates in the economy. (6 marks)

QUESTION FIVE(20 MARKS)

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

b) Illustrate the link between a country's balance of payments and its money supply that suggests that fluctuations in central bank reserves can be thought of as the result of changes in the money market. (8 marks)

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