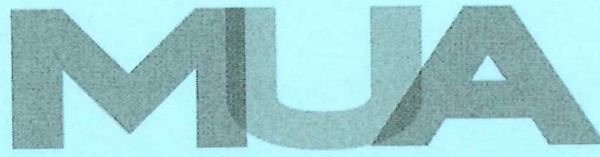


The
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UNDERGRADUATE UNIVERSITY EXAMINATIONS
SCHOOL OF MANAGEMENT AND LEADERSHIP
DEGREE OF BACHELOR OF COMMERCE

FIN 411: MONETARY THEORY AND PRACTICE

DATE: 16TH DECEMBER 2024

DURATION: 2 HOURS

MAXIMUM MARKS: 70

INSTRUCTIONS:

1. Write your registration number on the answer booklet.
2. **DO NOT** write on this question paper.
3. This paper contains **SIX (6)** questions.
4. Question **ONE** is compulsory.
5. Answer any other **THREE** questions.
6. Question **ONE** carries **25 MARKS** and the rest carry **15 MARKS** each.
7. Write all your answers in the Examination answer booklet provided.

QUESTION ONE

Read the Case Study below carefully and answer the questions that follow:

CENTRAL BANKS POLICIES

Monetary policy has lived under many guises. However, it may appear, it generally boils down to adjusting the supply of money in the economy to achieve some combination of inflation and output stabilization.

Most economists would agree that in the long run, output—usually measured by gross domestic product (GDP)—is fixed, so any changes in the money supply only cause prices to change. But in the short run, because prices and wages usually do not adjust immediately, changes in the money supply can affect the actual production of goods and services. This is why monetary policy—generally conducted by central banks such as the Central Bank of Kenya or the European Central Bank (ECB)—is a meaningful policy tool for achieving both inflation and growth objectives.

In a recession, for example, consumers stop spending as much as they used to; business production declines, leading firms to lay off workers and stop investing in new capacity; and foreign appetite for the country's exports may also fall. In short, there is a decline in overall, or aggregate, demand to which government can respond with a policy that leans against the direction in which the economy is headed. Monetary policy is often that countercyclical tool of choice.

Such a countercyclical policy would lead to the desired expansion of output (and employment), but, because it entails an increase in the money supply, would also result in an increase in prices. As an economy gets closer to producing at full capacity, increasing demand will put pressure on input costs, including wages. Workers then use their increased income to buy more goods and services, further bidding up prices and wages and pushing generalized inflation upward—an outcome policymakers usually want to avoid.

Required:

- a) "Monetary policy has lived under many guises. However it may appear, it generally boils down to adjusting the supply of money in the economy to achieve some combination of inflation and output stabilization." Explore how the two objectives of monetary policy identified in this statement are achieved. (6 Marks)
- b) "Most economists would agree that in the long run, output—usually measured by gross domestic product (GDP)—is fixed, so any changes in the money supply only cause prices to change." Identify and explain the theory of Demand for Money that has the similarities to this statement. (6 Marks)
- c) "Monetary policy is often that countercyclical tool." Evaluate this statement. (5 Marks)
- d) Explain four causes of inflation and suggest a solution for each cause. (8 Marks)

QUESTION TWO

- a) Assess the role of governments and central banks in establishing and maintaining fiat currencies. (7 Marks)
- b) Discuss FOUR factors that influence money supply determination. (8 Marks)

QUESTION THREE

- a) Assess the below criticisms leveled against Cash Balance Approach
- i. Elasticity of Demand for Money not Unity. (3 Marks)
 - ii. Demand for Money not Interest Inelastic. (3 Marks)
- b) Explore the role of central banks in controlling the money supply and the implications for inflation and economic activity. (9 Marks)

QUESTION FOUR

- a) Assess the implications of Quantity Theory of Money and its equation of value on inflation and monetary policy. (6 Marks)

- b) Highlight three limitations of physical money that digital and mobile money has overcome. **(3 Marks)**
- c) Explore the relationship of demand for money and the primary role of money. **(6 Marks)**

QUESTION FIVE

- a) Assess the contribution of austerity measures and changes in the structure of capital markets to deflationary pressure. **(6 Marks)**
- b) Explore three steps Kenya has made in the financial sector that have enabled it overcome limitations of monetary policies faced by developing countries. **(6 Marks)**
- c) Explore the concept and implementation of Fixing Margin Requirements as a selective monetary policy tool. **(3 Marks)**

QUESTION SIX

- a) Differentiate between creeping inflation and galloping inflation by definition and characteristics. **(6 Marks)**
- b) Analyze the below criticisms leveled against Friedman's reformulation of the quantity theory of money that evoked much controversy and led to empirical verification on the part of the Keynesians and the Monetarists.
- i. Very Broad Definition of Money. **(2 Marks)**
 - ii. Money not a Luxury Good. **(2 Marks)**
- c) The income-expenditure theory of money is considered superior to the quantity theory of money as it succeeds to explain various concepts. Expound on the below concepts as explained by the income-expenditure theory of money.
- i. Business Cycles. **(3 Marks)**
 - ii. Velocity of Circulation of Money. **(2 Marks)**