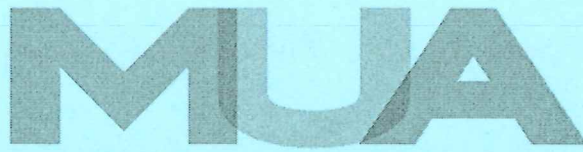


The
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UNDERGRADUATE UNIVERSITY EXAMINATIONS

SCHOOL OF MANAGEMENT AND LEADERSHIP

DEGREE OF BACHELOR OF LEADERSHIP AND MANAGEMENT
AND BACHELOR OF COMMERCE

BML 205/BCM214: MACRO-ECONOMICS

DATE: 26TH JULY 2021

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 our answers in the Examination answer booklet provided.

QUESTION ONE

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

MONETARY POLICIES IN THE TIME OF INFLATION

Before 1993, there was no monetary policy and the economy operated under a fixed exchange rate regime, which made it difficult to have a coherent policy that could control events. After 1993, significant changes in the institutional framework, operating procedures and instruments took place, which gave way to elaborate conduct of monetary policy. Over the years, both the institutional framework and tools employed in execution of monetary policy have undergone refinements. The CBK, being the monetary authority, has employed a monetary-targeting framework to pursue the inflation objective. Essentially, monetary-targeting is all about controlling the amount of money that banks create in the economy. If lenders create too much money, then this can heat up the economy as demand will outstrip supply of goods and services and push prices upwards. Conversely, if banks' money creation momentum slows down, there will be slack and that can exert downward pressure on prices. Central Bank then uses a base interest rate as a signaling tool to banks. If it raises its base rate, then financiers are supposed to heed by slowing down the pace at which they create money, and the converse holds. Generally this can be referred to as a conventional monetary policy. Unfortunately, it has come under attack and may not deliver in unusual circumstances, such as the current Covid-19 pandemic. Conventional monetary policy, such as the one practiced by CBK, is facing a trinity of impossibility. First, there is the

issue of fiscal dominance, where the government's aggressive borrowing has forced Central Bank to keep interest rates low because otherwise it would raise the State's credit costs. Second, the Central Bank has continued to signal an expansionary policy stance, where it wants banks to up the money creation momentum to salvage the economy. Unfortunately, due to the elevated risks in the economy, lenders have refused to oblige. Third, the foreign exchange rates market has become chaotic over the past one year, largely due to Covid-19 overhang that has seen the US dollar strengthen. However, the Central Bank has sought to keep nominal exchange rates at a particular level with brute force. Essentially, monetary policy is being held hostage. The Central Bank wants to keep the government's borrowing rates low, stimulate credit to the economy and at the same time tighten the exchange rate channel. It is just impossible to achieve the three at the same time. Consequently, monetary policy, in its current conventional form, will not provide relief to the economy. In fact, there is a now big risk of prices decelerating.

Required:

- I. From the case study, identify and briefly explain reasons why conventional monetary policies may not deliver the intended results during a pandemic such as the COVID-19. (6 Marks)
- II. Differentiate between an expansionary monetary policy and a contractionary monetary policy and give an example for each. (4 Marks)

- III. The CBK, being the monetary authority, has employed a monetary-targeting framework to pursue the inflation objective. Critique (4 Marks)
- IV. Differentiate between a fixed exchange rate and a flexible exchange rate. (4 Marks)
- V. A theoretical Country Z continues to have low interest rates, the Central Bank of country Z has held interest rates at 0.5% since March 2009. During this period of low interest rates economic activity has gradually recovered whereas inflation rates have fluctuated from highs of 5.1% (CPI) to even a short period of deflation." Evaluate the extent to which monetary policy is always able to both stimulate economic activity and achieve price stability. (7 Marks)

QUESTION TWO

- I. Below are economic figures for a theoretical country z. Use the data to calculate the gross domestic product for the country. (4 Marks)

| Description | Amount in Billions |
|--|--------------------|
| Salaries, wages and other additional labour income [Employee Income] | 550 |
| Indirect taxes | 120 |
| Subsidies | 30 |
| Farmers' income | 20 |
| Depreciation | 60 |

- II. Commercial banks can be called credit creators, briefly explain the credit creation process for commercial banks. (4 Marks)

- III. Explain the effects of increase in money supply on aggregate output and interest rates. (7 Marks)

QUESTION THREE

- I. Discuss the theory of consumption as advanced by James Duesenberry (1949). (8 Marks)
- II. Identify the factors that might cause a shift in Aggregate Demand. (2 Marks)
- III. Calculate the gross domestic product of any economy with details as provided: (5 Marks)

Consumption (80% of disposable or after tax income) + \$300
 Tax (20% of income)
 Investment \$800
 Government Spending \$700
 Exports \$400
 Imports $0.1(Y - T)$

QUESTION FOUR

- I. Differentiate between induced investment and autonomous investment. (3 Marks)
- II. Assess the view that the control of inflation should be the main priority of any government. (5 Marks)
- III. Derive the tax multiplier when tax is a function of income. (5 Marks)
- IV. Using the tax multiplier derived in Question 4 (III) above calculate the effect of a tax increase of 3% on national income when the consumption function is.

$$c=4000+0.62 yd \quad (2 \text{ Marks})$$

QUESTION FIVE

- I. Sudan's central bank has sharply devalued its currency, the Sudanese pound, in an attempt to get debt relief, crack down on the black market, and attract money back to the country. The bank unified the price of the currency with the black market at 370 pounds for one U.S. dollar. Sudan's annual inflation rate is more than 300%, one of the world's highest, and sparked protests over the struggling economy. Briefly explain the effects of Sudan devaluing its currency. (6 Marks)
- II. Given Marginal Propensity to save equal to 0.25, determine the increase in National Income, if investment increases by Ksh. 125,000? (2 Marks)
- III. Explain three factors that affect the size of national income of a country. (6 Marks)
- V. State the main determinants of consumer spending. (1 Mark)

QUESTION SIX

- I. Explain the nature of the long run aggregate supply curve and factors that affect it. (5 Marks)
- II. Discuss five policies that can be used to lower unemployment rates in Kenya. (10 Marks)