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(University of Choice)

MASINDE MULIRO UNIVERSITY OF SCIENCE AND TECHNOLOGY (MMUST)

MAIN CAMPUS

UNIVERSITY EXAMINATIONS 2022/2023 ACADEMIC YEAR

MAIN EXAM

THIRD YEAR SEMESTER ONE EXAMINATIONS

FOR THE DEGREE OF BACHELOR OF COMMERCE

COURSE CODE: BCF 307

COURSE TITLE: MONETARY THEORY AND PRACTICE

DATE: MONDAY 19TH DECEMBER 2022 **TIME:** 3-5PM

INSTRUCTIONS TO CANDIDATES

Answer **QUESTION ONE** and **ANY OTHER TWO (2)** questions

TIME: 2 Hours

MMUST observes ZERO tolerance to examination cheating

This Paper Consists of 3 Printed Pages. Please Turn Over.

QUESTION ONE: 30 MARKS (COMPULSORY)

CBK announces sharp rise in interest rate to fight inflation

"The Central Bank of Kenya (CBK) on Thursday raised the key lending rate by 75 basis points to 8.25 percent, matching the Federal Reserve hike last week as central banks struggle to tame inflation. The Monetary Policy Committee (MPC) increased the benchmark rate saying the rising inflation, global risks and their impact on the domestic economy call for tightening of the monetary policy.

The inflation — a measure of annual changes in the cost of living— hit 8.5 percent in August from 8.3 percent in July, the Kenya National Bureau of Statistics reported last month. The MPC last raised the rate by 50 basis points at its sitting in May to stem rising inflation and stabilize the shilling. "The Committee noted the sustained inflationary pressures, the elevated global risks and their potential impact on the domestic economy and concluded that there was scope for a tightening of the monetary policy in order to further anchor inflation expectations," CBK said in a statement on Thursday.

"In view of these developments, the MPC decided to raise the Central Bank Rate (CBR) from 7.50 percent to 8.25 percent." Central bankers around the world are increasing lending rates sharply as they try to rein the rising cost of living. Last week the US Federal Reserve hiked interest rates by another three-quarter of a percentage point, the third time it was doing so in a row. This week, a majority of Bank of England's nine-member MPC increased the base rate by 0.5 percentage points to 2.25 percent.

CBK's inflation-targeting Monetary Policy Committee (MPC) said that while the economy shows strong resilience, shocks from food shortages, a weak shilling, and imported inflation in the form of surging food prices could lead to a spike in consumer goods prices if the liquidity is not tightened."

Business Daily; Thursday September 29th,2022

Required;

A. "The Committee noted the sustained inflationary pressures, the elevated global risks and their potential impact on the domestic economy and concluded that there was scope for a tightening of the monetary policy in order to further anchor inflation expectations,". What do you understand by `tightening of monetary policy`? Discuss in detail what it entails using appropriate policy tools. (12 Marks)

B. Explain with appropriate illustrations the transmission mechanism of the above policy measures. (8 Marks)

C. Demonstrate using an appropriate theory the relationship between money supply, inflation and the purchasing power of money. (10 Marks)

QUESTION TWO: (20 MARKS)

A. The money supply(M) in country Y has been growing at 10% per year, and the nominal GDP has been growing at 20% per year. The data are as follows (in billions of shillings).

Year	2012	2013	2014
M	200	210	221
GDP	2000	2200	2440

Required;

a) Calculate the velocity in each year (4 Marks)

b) Determine what happens to nominal GDP if the money supply grows by 20% but velocity declines by 30%. (4 Marks)

c) Critique the above theory. (4 Marks)

B. Bonds are assumed to be one of the main substitutes for money. Therefore, equilibrium in the bond market is synonymous with equilibrium in the money market. Discuss. (8 Marks)

QUESTION THREE: (20 MARKS)

A. Discuss how the cash balances approach is a sister theory to the quantity theory of Money by Irving Fisher. What are some of the weaknesses of this theory? (12 Marks)

B. Discuss the main variables that determine the amount of money in circulation an economy at any particular point in time. (8 Marks)

QUESTION FOUR: (20 MARKS)

A. Define liquidity trap. "It is because of the existence of liquidity trap that monetary policy becomes ineffective to tide over economic depression". Discuss this statement. (12 Marks)

B. Discuss the main variables influencing the demand for money according to the modern quantity theory of money by Prof. Friedman. (8 Marks)