LAIKIPIA UNIVERSITY COLLEGE (NAIVASHA CAMPUS)

BCOM 331: MONEY AND BANKING

APRIL2012 END OF SEMESTER EXAMINATION TIME: 2 HRS

**ATTEMPT QUESTION ONE, AND CHOOSE THREE OTHER QUESTIONS**

1.

a. What is the equation of exchange? Is the equation of exchange a theory? Briefly explain. (4 mks)

b. What is the quantity theory of money? What does the quantity theory indicate is the cause of inflation? (4 mks)

c. What is purchasing power? How is it affected by inflation? (2 mks)

d. What is a hyperinflation? What is the cause of hyperinflation? (2 mks)

e. Briefly discuss the pros and cons of a central bank being independent of the rest of the government. (8 mks)

2.

a. Does the existence of reserve requirements make it easier for banks to deal with bank runs? Explain. (4 mks)

b. Briefly explain whether you agree with the following statements:

i. “A bank that expects interest rates to increase in the future will want to hold more rate-sensitive assets and fewer rate-sensitive liabilities.”(4 mks)

ii. “A bank that expects interests to fall will want the duration of its assets to be greater than the duration of its liabilities—a positive duration gap.”(4 mks)

iii. “If a bank manager expects interest rates to fall in the future, he should increase the duration of his bank’s liabilities.”(4 mks).

c. What is liquidity risk? How do banks manage liquidity risk? (4 mks).

3.

a. What are the Central Bank of Kenya three traditional monetary policy tools? Briefly describe each of the three. Which in your opinion is the most important and why? (8 mks)

b. Describe the term quantitative easing. When is quantitative easing appropriate as a monetary policy tool? (3 mks)

c. What is the difference between dynamic open market operations and defensive open market operations? What are the differences in the ways these two types of open market operations are carried out? (7 mks)

d. What is inflation targeting? Does the Central Bank of Kenya have an explicit inflation target? (2 mks)

4.

a. Suppose the money supply (M) has been growing at 10% per annum, and the nominal GDP (i.e. P multiplied by Y, (PY)) has been growing at 20% per annum. The data are as follows (in billions of shillings)

|  |  |  |  |
| --- | --- | --- | --- |
|  | 2010 | 2011 | 2012 |
| M | 100 | 110 | 121 |
| PY | 1000 | 1200 | 1440 |

Compute the velocity (V) for each year, and determine the rate at which velocity is growing. (5 mks)

b. If velocity and aggregate output are reasonably constant, what happens to price level if money supply rises from Ksh. 4 billion (in the year 2012 above) to Ksh. 6 Billion in the year 2013? (4 mks)

c. Compare and contrast Keynes’s and Friedman’s theories of demand for money. (8 mks)

d. Why does the Friedman’s view of the demand for money suggest that velocity is predictable, whereas Keynes’s view suggests the opposite? (3 mks)

5.

a. Briefly highlight the structure of the Central Bank of Kenya, mentioning its key departments or divisions. (8 mks)

b. What is the monetary policy committee and what role does it play? Who are its members? (6 mks).

c. The Central Bank can use expansionary or contractionary policy to shift the aggregate demand curve. Use a graph to show how monetary policy should be used to return output to potential GDP when:

i. the aggregate demand curve intersects the short-run aggregate supply curve to the left of potential GDP. Briefly explain how the Central Bank would carry out this policy. (3 mks).

ii. The aggregate demand curve intersects the short-run aggregate supply curve to the right of potential GDP. Briefly explain how the Central Bank would carry out this policy. (3 mks).