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KIBABII UNIVERSITY

UNIVERSITY EXAMINATIONS

2015/2016 ACADEMIC YEAR

FIRST YEAR FIRST SEMESTER

MAIN EXAMINATION

FOR THE DEGREE OF MASTER IN BUSINESS ADMINISTRATION (FINANCE OPTION)

COURSE CODE: MBA 831

COURSE TITLE: FINANCIAL ECONOMICS

DATE: 11.5.2016

TIME: 2 P.M.

INSTRUCTIONS TO CANDIDATES

Answer Question One in Section A and Any other THREE (3) Questions in Section B
TIME: 2 HOURS

KIBUCO observes ZERO tolerance to examination cheating

This Paper Consists of 4 Printed Pages. Please Turn Over. 

JK
[Signature]
24/4/16

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QUESTION ONE (1) CARRIES 24 MARKS AND THE REST 12 MARKS EACH.

Equations are numbered in []

Question One (Compulsory)

a) Read the following article from *Daily Nation Wednesday April 13, 2016*

Former CBK boss Ndung'u faces probe over banking crisis

Parliament Tuesday turned its guns on the past Central Bank of Kenya leadership with a demand that it should be investigated in the wake of massive fraud, poor governance and weak oversight that has seen three banks collapse in nine months. The demand came after National Assembly Speaker Justin Muturi ordered the Finance, Trade and Planning Committee to investigate the recent closure of banks and report to the House in 30 days.

Mr. Muturi was responding to Leader of Majority Aden Duale's request for a parliamentary investigation into the activities of Dubai, Imperial and Chase Bank directors that have caused the lenders to go into receivership or statutory management within a year of regime change at the CBK. Mr Duale said recent events had demonstrated that the closure of banks had a lot to do with the past Central Bank of Kenya leadership, which should be made to account. "The committee must investigate the regulatory issues that rendered the CBK incapable of intervening before the banks collapsed. The committee must also come up with amendments to the deposit protection fund and how to better safeguard depositors," he said.

Investigating the past Central Bank of Kenya (CBK) regime effectively puts the tenure of Prof Njuguna Ndung'u, who left office in March last year, under the spotlight – a move that may pull him back to the public limelight. Mr Duale, supported by members from both sides of the House, demanded that the scope of the committee's work extends to determining the role that the CBK's bank inspection department, the auditors and directors played in the loss of billions of depositor funds causing the current crisis.

MPs called for stiffer penalties against corporate thieves, arguing that without strong deterrence the country is unlikely to get out of the circle of looting in both public and private sectors. "We should think of death sentence for people who collect people's money and run away with it," Seme MP James Nyikal said. The CBK last Thursday placed Chase Bank in receivership locking out thousands of depositors from accessing their money. The shutdowns have mostly affected small savers, including farmers and small businesses, with the deposits in the troubled banks causing a general flight from small banks. The investigations come barely six months after National Assembly's Public Investment Committee (PIC) investigated National Bank following reports that it had disposed of 12 prime properties and declared the proceeds as profits.

The committee chaired by Elda's MP Adan Keynan is yet to submit a report. While granting Mr. Duale's request, Mr. Muturi asked the committee to investigate all problems facing the financial sector, including corporate governance. The committee will also investigate liquidity issues in all other banks and the reasons behind President Uhuru Kenyatta's failure to constitute the CBK board of directors. "We must invite the CBK to speak to the people's representatives and the directors of three collapsed banks," Mr. Duale said.

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Samuel Chepkonga, who chairs the Justice and Legal Affairs committee, wondered why CBK governor Patrick Njoroge was referring to "outright theft" as insider lending. "I wonder when I hear the governor say there was insider lending. When people steal money in government its corruption, when they steal in banks it is called insider lending. Stealing is stealing and we should call a spade by its name," he said. John Mbadi (Suba) said the finance committee should focus more on CBK as the regulator of the financial services sector even as he criticised the PIC and the Finance committee for failing to submit its findings on National Bank.

- i) With reference to the above article discuss the major causes of bank crisis in Kenya and what is its effect on the depositors, shareholders and the financial institutions (6 marks)
 - ii) What reforms can you recommend to the regulator (Central bank) to avoid the incidence from re-occurring? (4 marks)
 - iii) As a financial economist what conditions can you give for the re-opening of the collapsed banks? (4 marks)
- b) "Central banks have discretion to set inflation and if they only face short-run output-inflation trade-off, then it gives rise to excessively expansionary policy. Intuitively, when expected inflation is low, the marginal cost of additional inflation is low. Therefore, the promise of central bank to follow low inflation is not credible"
- i) As a financial economist, discuss the problem of dynamic inconsistency of low inflation monetary policy (Full commitment and discretion policy), highlighting when the economy does well.
 - ii) Outline the solutions to address the problem of time-inconsistency. (10 marks)

Question Two

- a) In the context of Kenya's Central Bank, discuss the conduct of monetary policy, highlighting its objectives, targets and indicators and the constraints faced by the Bank. (9 marks)
- b) Discuss the criteria used to test for effectiveness and efficiency of the instruments and targets used by the Central banks in any economy (3 marks)

Question Three

Consider the monetary and expenditure sectors together under price regime. Specification of the simultaneous equilibrium is given as:

$$\text{Expenditure sector; } Y = C_0 + C(Y - T, r) + I_0 + I(Y, r) + G_0 \quad [3.1]$$

$$\text{Monetary sector; } L_0 + L(Y, r) = M_0 \quad [3.2]$$

- i) Express the model in the differential matrix version

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- ii) Provide a solution for National income (Y) and interest rate (r) equilibrium
- iii) Give the comparative static prediction for :
- Impact of exogenous spending (G_0) on income and interest rate
 - Impact of taxation (T_0) on Income and interest rate
 - Impact of money supply (M_0) on Income and interest rate (12 marks)

Question Four

"Financial economics is the branch of economics characterized by a concentration on monetary activities", in which "money of one type or another is likely to appear on both sides of a trade".

From the above quotation

- Discuss its concerns highlighting its major areas of focus.
- Discuss the underlying economics in these branch of science (12 marks)

Question Five

- a) You are given the following information about the commodity and Money markets of a closed economy without government intervention.

The commodity market

Consumption function $C = 50 + 2/5Y$ [4.1]

Investment function $I = 790 - 21r$ [4.2]

The Money Market

Precautionary and Transactions demand for money $M_{DT} = 1/6 Y$ [4.3]

Speculative demand for money $M_{DS} = 1200 - 18r$ [4.4]

Money supply $M_S = 1250$ [4.5]

Required:

- Provide for the IS and LM equations for the markets (2 marks)
 - Determine the equilibrium levels of income and interest rate for this economy. (4 marks)
 - Using a well labeled diagram, illustrate the equilibrium condition in part (ii) above. (2 marks)
- b) Using an illustration and on separate graphs, discuss the effect of monetary and fiscal policy on the IS-LM Model (4 marks)

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Question Six

- a) The currencies in circulation (C) together with reserves (R) constitute monetary base or high-powered money (MB). [6.1]

$$MB = C + R$$

The central bank controls the monetary base through its purchase or sale of government securities in the open market (open market operations), and through its extension of loans to banks.

- i) Derive the money multiplier and explain why its greater than unity (5 marks)
- b) Discuss the quantity theory of money outlining its major conclusions, assumptions (5 marks)
- c) If money supply in a given economy equals 500 while the velocity and price equal 8 and 2 respectively, determine the level of real and nominal output. (2 marks)

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