KENYATTA UNIVERSITY

UNIVERSUTY EXAMINATIONS 2016/2017

SECOND SEMESTER FOR THE DEGREE OF BACHELOR OF ECONOMICS, ECONOMICS AND STATISTICS, ECONOMICS AND FINANCE, ARTS, COMMERCE AND EDUCATION.

EET 301: MACROECONOMIC THEORY III

DATE: THURSDAY 11TH MAY 2017 **TIME: 11:00 a.m. – 1:00 p.m.**

INSTRUCTIONS : ATTEMPT QUESTION ONE AND ANY OTHER TWO QUESTIONS

Question One(30marks)

a) Recently the government of kenya introduced a law that imposed limits on bank lending and deposit rates. Assume the new lending rate is capped at four percentage points above the CBK benchmark rate is below the equilibrium rate. Also assume all other factors remain constant. Use the necessary graphs to illustrate how this interest capping affects the money market. (3marks)

b) Briefly explain the following economic terms using graphical and mathematical illustrations where necessary.
   i) Economic stabilizers (2marks)
   ii) Non accelerating inflation rate of unemployment (2marka)
   iii) Okun's law (2marks)
   iv) Involuntary unemployement (2marks)
   v) Life cycle income hypothesis (2marks)

c) Demonstrate your understanding of equilibrium in the goods market and equilibrium in the money market. Explain how these are sustained and their relevance in macroeconomic analysis. (7marks)

d) Use graphical representation of the static model to illustrate the effect on real wage, real interest rate, price level and real output of a major earthquake that destroys the substantial amount of capital stock in the country. (10marks)

Question Two

Given the following functions for an imaginary economy:

C=500+ 0.75Y^d , I= 30 – 50r , l= y – 100r ,g=45, t=0.3y, M=200, P=20, nx= 20 – 10 r

Where: c is real consumption

I is real gross investment

L is real money balances

G is government expenditure

M is nominal money supply

Tax rate is 30%

Nx is net real export

R is interest rate

Y is real output

i) Compute both the fiscal and monetary policy multipliers and interpret your results. (10marks)

ii) Suppose equilibrium income increase by 80, by how much must real money stock increase for the new level of income to be in equilibrium? (10marks)

Question Three

a) Using the static model, show how the decrease in price of crude oil(positive supply shock) would affect the economy. (6marks)
b) Explain how you generate a downward sloping aggregate demand curve. Illustrate how your explanation is different from the one for individual demand curve you studied in microeconomic theory. (3marks)
c) Explain the effectiveness of fiscal and monetary policies and demand management tools. When would be the best moment to use the tools? (3marks)
d) Suppose the Kenyan economy is in recession. Use AD – AS model to illustrate the effect of an increase in government spending on price level and real output. (5marks)

Question Four

a) Use well labeled diagrams to explain the concept of work – leisure decision making by a rational worker. (10marks)
b) With the aid of well labeled diagrams, illustrate the effect of an expansionary fiscal policy on the static model. (6marks)
c) Differentiate between and shirt run Philips curve (4marks)

Question Five

a) Derive the demand for labour for monopolistic and competitive firms. What is the fundamental difference between the two. (7marks)
b) Demonstrate the impact of fiscal policies in cases of open or closed economies.when is the fiscal policy most effective? (7marks)
c) Use four sector diagram to illustrate how a decrease in price would affect the money market. (6marks)