UNIVERSITY EXAMINATIONS

UNIVERSITEITSEKSAMENS

UNISA university of south africa

ECS301D
ECO3M4E

May/June 2009

MONETARY ECONOMICS (ECONOMICS 301)

Duration 2 Hours

100 Marks

EXAMINERS :

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SECOND	MS LA BRAIMOH
EXTERNAL	DR SL MOLLENTZE

This paper consists of 8 pages

TWO GROUPS OF STUDENTS ARE WRITING THIS EXAM, THEY ARE:

1 All students who registered for ECS301D for the year 2009
These students must complete **EXAMINATION PAPER I** starting on page 2

2 All supplementary examination students for ECS301D
These students must complete **EXAMINATION PAPER II** starting on page 5

Every student must complete only ONE exam paper, that is, either exam paper I or exam paper II

[TURN OVER]

EXAMINATION PAPER I

Paper I is based on the (new) textbook
Mishkin The Economics of Money, Banking and Financial markets
Students who are registered for ECS301D for the first semester 2009 must answer paper I

Please indicate very clearly that you are writing the paper based on Mishkin by writing
"MISHKIN"
LARGE and CLEAR at the top of the first page of your answer book.

Part 1: Definition and functions of money (15)

1 1 List and define three commonly used measures of the aggregate price level. (5)

1 2 Briefly explain the functioning of two of the following money market instruments Treasury bills, Negotiable Bank Certificates of Deposit (NCD's) and Banker's Acceptances (BA's) (2x4=8)

1 3 Explain the meaning of fiat money (2)

[15]

Part 2: Financial markets (15)

Answer **ONE** question of questions (2 1 and 2 2), plus question 2 3

2 1 In principle, explain the rationale of discounting future cash flows Then explain the meaning of the formula $PV = CF/(1+i)^n)$ (5)

2 2 Explain the meaning of the return on a security Also provide the relevant formula/s (5)

2 3 Explain the meaning of the term structure of interest rates and the yield curve Illustrate a normal yield curve and explain why its shape applies List three empirical facts which apply to the yield curve (10)

[15]

Part 3: Financial institutions (20)

Answer any **TWO** of the four questions 3 1 – 3 4

3 1 Explain why marketable securities (debt & equity) are not the primary source of financing for non-financial businesses and how financial intermediaries and government regulation can partly overcome the problem of asymmetric information (adverse selection) (10)

3 2 Explain in general why indirect financing is more important than direct financing and in particular why banks are the most important source of external finance for financing businesses Then comment briefly on the two statements "The role of banks in lending will probably decline in future" and "The more established a firm is, the more likely it will issue securities to raise funds" (10)

3 3 Explain why financial crises occur (their causes) and why they lead to an economic contraction (10)

3 4 (a) Explain the implications of a bank which incurs accounting losses on a non-performing loan (6)

(b) List the ways how banks can manage their credit risk. (4)

(10)

[20]

Part 4: Central banking and the conduct of monetary policy (25)

Please answer ONE question of questions (4 1 and 4 2) plus ONE question of questions (4 3 and 4.4)

4 1 Derive the simple multiple deposit creation formula $\Delta D = (1/r)\Delta R$ Explain its meaning, the underlying logic of the process, its simplifying assumptions and its critique (15)

4 2 Explain and illustrate how the market for reserves operates in South Africa Also explain in principle how the tools for monetary policy (open market operations, borrowed reserves and the required reserve ratio) are used in South Africa (15)

4 3 Briefly explain why the price stability goal in South Africa is desirable (in spite of other pressing economic problems) Also explain the nature of the time-inconsistency problem (10)

4 4 Explain in more detail how monetary policy is conducted in South Africa with respect to open market operations (OMOs) Explain the manner in which OMOs are used by the South African Reserve Bank as well as the operation of other tools used to supplement OMOs (10)

[25]

Part 5: Not prescribed.

No questions are asked on Part 5

Part 6: Monetary theory (25)

Answer ONE of questions (6 1 and 6 2) plus question 6 3

6 1 Explain the major findings of empirical evidence on the demand for money function and its implication for monetary policy (5)

6 2 Explain the effect of a stronger exchange rate on the domestic inflation rate (5)

6 3 Briefly discuss the following counter-inflationary policy measures (20)

(a) Price controls and its disadvantages (6)
(b) A voluntary social contract between business, labour and government and whether it is likely to be effective (4)
(c) Tight monetary policy and whether it is necessarily reliable (10)

[25]

EXAMINATION PAPER II

Paper 2 is based on the (previous) self-contained study guide for ECS301D Monetary Economics Students who are writing a supplementary examination for ECS301D or who were registered prior to 2009 and postponed their ECS301D examination to May 2009, must answer paper II

Please indicate very clearly that you are writing paper II based on the self-contained study guide (used up to 2008) by writing

"2008 STUDY GUIDE"

LARGE and CLEAR at the top of the first page of your answer book

Please answer 6 of the 8 questions as indicated below

Section A	**Section B.**	**Section C**
Answer question A1	Monetary theory Answer **any 3** of the 4 questions B2 to B5	Monetary policy Answer **any 2** of the 3 questions C6 to C8
[25 marks]	[3 x 15 = 45 marks]	[2 x 15 = 30 marks]

[Total = 100 marks]

The best approach to answer these questions is

1 Your answer must show evidence that you understand the work. This is the ultimate criterion according to which marks are awarded

2 Answer what is asked Questions are asked in the following ways

- a Explain give a **short and to-the-point** explanation
- b List give a list of things **without further explanation.**
- c Define give a **complete** but **to-the-point** definition
- d List and explain give a list of things and provide a **short and to-the-point** explanation of these things
- e Critically evaluate Explain and critically evaluate

3 Provide sufficient detail

- a In general, one mark is awarded per correct explanation given, assumption mentioned, interpretation provided or conclusion made
- b You should spend about 15 minutes to answer a 15 mark question
  7 x 15 minutes = 1¾ hours
- c A 15 mark question requires at least a one page answer
- d Typical sections of an answer to an essay-type question, like an introduction, an analysis, a conclusion etc , are not required

Section A: Please answer question A1 [25 marks]

Question A1 (25 marks)

(a) Bnefly explain the meaning of the monetary transmission mechanism and the distinction between a direct and indirect transmission mechanism in the case of an initial ΔM When is money neutral? (6)

(b) Explain the nature of the Post-Keynesian monetary transmission mechanism *(for example* $\uparrow\Delta M \rightarrow \downarrow\Delta P \rightarrow \uparrow\Delta i \rightarrow \downarrow\Delta YP$*) where .),* the meaning of and reasons for endogenous money and its implications for monetary policy (9)

(c) Define the flow of funds equation (ΔM =) in an open economy Explain the meaning of its components and explain how each of these can lead to an **increase** in M Which component has the largest impact on ΔM in practice? (10)

[25]

Section B: Please answer **any 3** of the 4 questions B2 to B5 [3 x 15 = 45 marks]

Question B2 (15 marks)

Bnefly discuss the views of the monetanst school of thought

(a) First explain why the Keynesian school of thought maintained that monetary policy is relatively unimportant (3)

(b) Cntically explain the nature of the monetanst monetary transmission mechanism (Graphical illustrations are not required) (9)

(c) List the policy implications of the monetanst school (3)

[15]

Question B3 (15 marks)

Bnefly discuss Tobin's general equilibnum (GE) approach to monetary theory (15)

- Explain the meaning of GE versus partial equilibnum
- Explain why GE models improve on the IS-LM model
- Explain the general approach (model) developed by James Tobin
- Explain the meaning of the valuation ratio and its relevance for monetary policy

(Hint It is not required that you explain either the Neo-Keynesian or monetanst version of the model although the pnnciples thereof are relevant)

[15]

Question B4 (15 marks)

(a) Explain the meaning of exogenous money by referring to the credit multiplier model (Hint It is not required that you derive the credit multiplier model from first principles Only explain what the model predicts, explain the meaning of the formula and the principles upon which the model rests) (7)

(b) Explain in principle why the refinancing system in South Africa supports an endogenous money supply (8)

[15]

Question B5 (15 marks)

(a) Explain the meaning of a yield curve Provide a definition, and then provide a graphical illustration (label the axes) of an upward sloping yield curve and explain its meaning (7)

(b) List and explain four factors (other than the term to maturity) that explain differences in interest rates of bonds (8)

[15]

Section C
Answer any **two** of the three questions C6 to C8 [2 x 15 = 30 marks]

Question C6 (15 marks)

Explain

(a) List and explain three advantages of monetary targets (3x2=6)

(b) Explain why monetary targets (guidelines as applied in 1985-1999) ultimately failed in South Africa (9)

[15]

Question C7 (15 marks)

Explain

(a) why the Reserve bank always has to ensure that a money market liquidity shortage exists and how the Reserve bank can use open market operations to bring this about (6)

(b) how the Reserve Bank uses Tax and Loan accounts to **increase** the money market liquidity shortage (5)

(c) how the Reserve Bank intervenes in foreign exchange markets to **increase** the money market liquidity shortage (4)

[15]

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Question C8 (15 marks)

(a) Explain why and how inflation gives rise to redistribution costs (9)

(b) Explain how the interest rate channel of the monetary policy transmission mechanism operates in South Africa in the case of a contractionary monetary policy (6)

[15]

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