UNIVERSITY OF SWAZILAND

FACULTY OF SOCIAL SCIENCES

DEPARTMENT OF ECONOMICS

MAIN EXAMINATION

MAY 2017

TITLE OF PAPER:	**MONETARY POLICY**
COURSE CODE:	**ECON 404**
TIME ALLOWED:	**2 HOURS**
INSTRUCTIONS:	**ANSWER QUESTION ONE (1) AND ANY TWO (2) OTHER QUESTIONS**
	QUESTION ONE CARRIES 40 MARKS
	THE REST OF THE QUESTIONS CARRY 30 MARKS EACH

Question One (Compulsory) **(40 Marks)**

1. (a)(i) The small economy of Suburbia, due to outstanding economic policy run by President Smith stays at full employment. After another sleepless night, President Smith has decided to change the structure of demand in order to increase government spending. Using a suitable diagram, illustrate the effect of expansionary fiscal policy if there is no international capital mobility and the economy has fixed exchange rates. [20]

(ii) As a policymaker, which policy would you recommend to the President that would increase output if the nation still maintains no international capital mobility and fixed exchange rates? [20]

Answer Any Two Questions From The Following: **(30 Marks Each)**

Question Two

2. (a)(i) Describe how the exchange rate channel of monetary policy affects output and prices in the short run. [7]

(ii) Assuming sticky prices in the long run, how would a nominal depreciation affect prices, aggregate demand and aggregate supply? [8]

(b) In your opinion, is the channel in (a) above an effective transmission mechanism in Swaziland? Give reasons to support your answer. [5]

(c) (i) Explain why the transmission of monetary policy is often difficult in developing and transitional economies. [6]

(ii) What policy tools can monetary authorities in these countries use? [4]

Question Three

3. (a) Distinguish between monetary targeting and inflation targeting. Be sure to highlight the pros and cons of each regime. [15]

(b) Briefly state the challenges that monetary authorities face in the pursuit of the broad monetary policy goals. [5]

(c) Explain how monetary policy can still be effective in an environment with zero-bound interest rates. [10]

Question Four

4. (a) Explain the Interest Parity Condition [10]

(b) Outline the determinants of capital mobility [10]

(c) (i) From time to time, asset prices increase to surprisingly large levels, think for instance of the dot.com bubble in the early years of the present millennium. There are two types of such asset-price bubbles. To which type should a central bank respond and why? [6]

(ii) The use of monetary policy, i.e. the interest rate, to deflate this one type of asset-price bubbles, however, has potentially strong disadvantages. State these disadvantages. [4]