UNIVERSITY OF SWAZILAND

FACULTY OF SOCIAL SCIENCES

DEPARTMENT OF ECONOMICS

MAIN EXAMINATION

MAY 2018

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

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Question One (Compulsory) **(40 MARKS)**

1. (a) Suppose Country A is a small open economy with imperfect capital mobility operating under flexible exchange rates, and is at equilibrium.

(i) Draw and completely label a Mundell-Fleming diagram for this economy and identify the initial equilibrium and label it as "E*". [5]

(ii) Suppose now the Central Bank of Country A expands its money supply. Show on your diagram and explain the effect of this policy. Identify the temporary equilibrium and label it as "E_1". [3]

(iii) At E_1, how do interest rates, real income and the BOP compare to the initial equilibrium? Provide economic explanations for these changes. [5]

(iv) Describe carefully how Country A would arrive at a new equilibrium. Show this new equilibrium on your graph and label it as "E_2". [7]

(b) Briefly state the pros and cons of Swaziland maintaining a fixed exchange rate peg to the South African Rand. [20]

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

Question Two

2. (a) With the aid of a suitable diagram, illustrate how an increase in money demand affects the money supply if the Central Bank has an interest-rate target. [8]

(b) Briefly describe the "adverse selection problem" and explain why it is that financial intermediaries play an important role in channeling funds from lenders to borrowers.[14]

(c) Explain the difficulties faced by developing countries which keep their financial systems from operating efficiently and thus, causing financial instability. [8]

Question Three

3. (a) Describe dollarization and explain what motivates the implementation of such a policy. [10]

(b) Use the IS–LM model to predict the short-run effects of an increase in government taxes on income, the interest rate, consumption, and investment. Illustrate on your graph and also explain the effect of the central bank reacting to the fiscal policy action by intervening to keep the income level constant. [20]

Question Four

4. (a) Assume that at an MPC meeting the Central Bank of Swaziland decides to implement an expansionary monetary policy. What impact will this have on aggregate output? Motivate your answer by discussing the monetary transmission mechanism through the credit channel. In your answer, state the assumptions behind the credit rationing mechanism. [13]

(b) With the aid of a diagram, explain how monetary union overcomes the inconsistencies of the Impossible Trinity. Use the case of the EU to illustrate your answer. [10]

(c) What is the implication of the Impossible Trinity Principle on the conduct of monetary policy for the Central Bank of Swaziland? [7]