



*"Investing in Africa's Future"*

## **COLLEGE OF BUSINESS, PEACE, LEADERSHIP AND GOVERNANCE**

**MEC 102: ECONOMIC PRINCIPLES 11 EXAM 2**

**END OF SECOND SEMESTER EXAMINATIONS**

**APRIL/MAY 2019**

**LECTURER: G Mandewo**

**DURATION: (3 HRS)**

Question Number 1 and Any Other Three Questions.

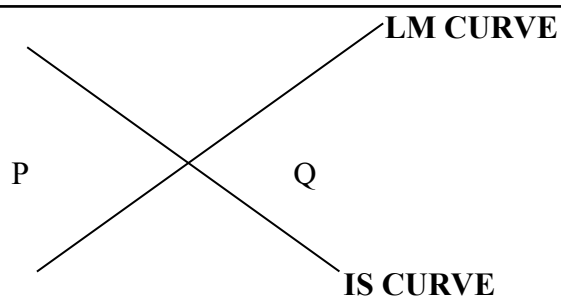
Write on a new page in your answer Booklet. Credit will be awarded for logical, systematic and neat presentations

Answers in parenthesis.

Calculator is permitted

**DO NOT BEGIN UNTIL YOU ARE TOLD TO BEGIN THE EXAM**

1. (a) Interest rate



- i. In the context of the ISLM model implement an expansionary fiscal policy and determine the changes in interest rates and income and Why.  
**[4 marks]**
- ii. In the framework of the ISLM model implement simultaneously a contractionary monetary policy and contractionary fiscal policy and determine the changes in interest rates and income and Why. **[4 marks]**
- iii. Explain in detail the policy you will implement to foster equilibrium in both the goods market and the money market for point Q **[4 marks]**

**(b)** You are given the following Account for Time Bank. The required reserve is 10%. An Initial deposit of 15 000 US Dollars is made to this bank.

- i. Suppose a depositor comes to the bank and withdraws \$200 in cash. Show how this will affect the bank's credit creation capacity **[4 marks]**
- ii. Explain three tools that can be used by the central bank to control money supply in the economy. **[4 marks]**

**(c)** Explain the following concepts and illustrate algebraically or in diagrams where possible

- i. Liquidity trap **[4 marks]**
- ii. Quantity theory of money **[4 marks]**
- iii. Life cycle hypothesis **[8 marks]**

**(d)** Poor people tend to have a higher marginal propensity to consume compared to rich people. This means that generally poor people consume more. State whether this statement is TRUE/FALSE/UNCERTAIN. Justify your answer. **[4 marks]**

**2.** Explain and Illustrate the following concepts in detail

- (a) Life cycle hypothesis of consumption **[4 marks]**

- (b) Equivalence of methods of calculating the Gross Domestic Product **[4 marks]**
- (c) Inflationary gap **[4 marks]**
- (d) Deflationary gap **[4 marks]**
3. (a) Discuss the different forms of unemployment **[4 marks]**
- (b) Suggest practical ways of resolving the problem of unemployment? **[4 marks]**
- (c) What is the difference between demand pull and cost push inflation? **[4 marks]**
- (d) Using a relevant diagram illustrate the effect of money supply increases to the purchasing power of money and price level. **[4 marks]**
- (e) Critically evaluate policies used to reduce inflation. **[4 marks]**
4. (a) You are given the following information from Zambia's national accounts. Use the information to calculate the country's GDP at market prices using the income approach; **(7 marks)**

Description	Amount in Millions
Wages, Salaries and supplementary income	650 000
Corporation Profits before taxes	180 000
Government Businesses Profits before taxes	10 000
Interest and investment income	60 000
Accrued net income of farm operators from farm production	2 000
Net income of non-farm unincorporated business, including rent	80 000
Inventory valuation adjustment	1000
Taxes less subsidies	150 000
Capital consumption allowances (Depreciation)	175      0

- (b) Calculate the GDP for Malawi at market prices using the expenditure approach given the following figures from its national accounts **(7 marks)**

Description	Amount in Millions
Personal Expenditure on Consumer Goods and Services	
Government Current Expenditure on Goods and Services	
Government Gross fixed capital formation	
Government Investment in Inventories	
Business Gross fixed capital formation	
Government Investment in Inventories	
Exports of Goods and Services Imports of Goods and Services	

- (c) Briefly discuss the challenges that may be encountered in computing information needed to calculate a country's GDP. What are the major

weaknesses or deficiencies of using the GDP as a measure of economic and social well-being **(6 marks)**

5. (a) Explain how (i) the government (ii) the foreign sector and (iii) financial institutions fit into the circular flow of income and spending in the economy. List the main injections into the circular flow of income and spending and the main leakages from this flow **(4 marks)**
- (b) In a speech that Senator Robert Kennedy gave when he was running for president in 1968, he said the following about GDP: “It does not allow for the health of our children, the quality of their education, or the joy of their play. It does not include the beauty of our poetry or the strength of our marriages, the intelligence of our public debate or the integrity of our public officials. It measures neither our courage, nor our wisdom, nor our devotion to our country. It measures everything, in short, except that which makes life worthwhile, and it can tell us everything about America except why we are proud that we are Americans” Was Robert Kennedy right? If so, why do we care about GDP? Outline any four weaknesses of using GDP as a measure of well-being **(6 marks)**
- (c) Briefly explain the 3 main motives for holding money and 4 main functions of money in any economy **(4 marks)**
- (d) Distinguish between monetary policy and fiscal policy. Outline the main tools of each policy **(6 marks)**
6. (a) Suppose the government increases its expenditure by \$1bn and leaves the money supply unchanged. With the aid of an appropriate Keynesian frame diagram explain the “crowding out effect” of this increased government expenditure. Use the arrow notation to illustrate the transmission mechanism of the crowding out effect **(4 marks)**
- (b) Briefly explain any four determinants of consumption expenditure. **(4 marks)**

(c) FBC Bank has the following balance sheet as at 31 December 2014

<b>Assets</b>		<b>Liabilities</b>	
	<b>\$</b>		<b>\$</b>
Cash Reserves	110 000	Current Account Deposits	100 000
Property and Buildings	240000	Ordinary Shares	250000
<b>TOTAL</b>	<b>350 000</b>	<b>TOTAL</b>	<b>350000</b>

If the required reserve ratio is 20%, calculate the excess reserves for FBC Bank. What is the money multiplier for this economy? If FBC was part of multiple bank system in the country and does not keep any excess reserves, what is the maximum amount of new current account deposits can be created by the banking system **(6 marks?)**

(d) Suppose that the economy faces a recession and unemployment briefly explain how the Central Bank can use the following monetary policy instruments:

- Discount rate **(2 mark)**
- Moral Suasion **(2 mark)**

(e) Outline and explain any FIVE functions of the Central Bank **(4 marks)**

7.(a) A farmer produces 1000kgs of wheat which he sells to the miller at \$10 per bag yielding a total of \$10 000. The miller processes the wheat into flour which he then sells to the baker for \$12 500. After baking the bread with the flour, the baker sells it to the shop for \$18 000. The shop subsequently sells the bread to the final consumers for \$21 000. What is the value added by each of the participants to the GDP? **( 4 marks)**

- Briefly explain the 3 methods of calculating a country's GDP? **(4 marks)**
- Assume that the consumption schedule for a private open economy is such that consumption  $C = 50 + 0.8Y$ . Assume further that planned investment  $I$  and net exports  $NX$  are autonomous and constant at  $I = 30$  and  $NX = 10$ 
  - Calculate the equilibrium level of income or real GDP for this economy **( 4 marks)**
  - What happens to equilibrium  $Y$  if  $I$  changes to 10? What does this outcome reveal about the size of the multiplier? **(4 marks)**

- c. Briefly explain the three main determinants of money demand and illustrate with the arrow notation the effect of an expansionary fiscal policy on interest rates of the Central Bank does not accommodate the increase in money demand **(4 marks)**

7. **(a)** Inflation and unemployment are the twin evils all governments would like to fight because they may cause poverty among a country's citizens:

- a. Outline the two main forms of inflation and any one cause of each type of inflation **(4 marks)**
- b. Discuss the three main types of unemployment and explain one cause of each type of inflation **(6 marks)**
- c. Suggest practical solutions to resolve the problem of inflation and for each method explain how inflation is solved [ **10 Marks**]

8. Stating your assumptions clearly:

- (a) Deduce the equilibrium income for a two sector model **[4 marks]**
- (b) Deduce the multiplier for a Three sector model **[4 marks]**
- (c) Derive the equilibrium income for a four sector model **[4 marks]**
- (d) Determine the effect of increasing the following on equilibrium income and give the economic intuition
  - (i) Marginal propensity to save **[2 marks]**
  - (ii) Marginal propensity to tax **[2 marks]**
  - (iii) Marginal propensity to import **[2 marks]**
  - (iv) Transfer payments **[2 marks]**

**[END**

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