

MAASAI MARA UNIVERSITY

**REGULAR UNIVERSITY EXAMINATIONS**

**2016/2017 ACADEMIC YEAR**

***THIRD* YEAR *FIRST* SEMESTER**

**SCHOOL OF BUSINESS AND ECONOMICS**

**BACHELOR OF BUSINESS MANAGEMENT**

**COURSE CODE: BBM 413**

**COURSE TITLE:** **FINANCIAL ECONOMICS**

**DATE: 1ST FEBRUARY 2017 TIME: 8.30-10.30AM**

**INSTRUCTIONS TO CANDIDATES**

1. Answer Question **ONE** and any other **THREE** questions

*This paper consists of* ***THREE***  *printed pages. Please turn over.*

**QUESTION 1**

1. Suppose you have invested only in two stocks, *A* and *B.* You expect that returns on the stocks depend on the following three states of economy, which are equally likely to happen.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| State of the Economy  | Return on Stock A (%) | Probability of Outcome A | Return on Stock B (%) | Probability of Outcome B |
| Bear  | 6.3% | 20% | -3.7% | 15% |
| Normal  | 10.5% | 50% | 6.4% | 65% |
| Bull  | 15.6% | 30% | 25.3% | 20% |

|  |  |
| --- | --- |
| 1. Calculate the expected return of each stock
 | (**8 mark**) |
| 1. Comment on the relationship between the return on each of the stocks and the state of the economy
 | (**2 marks**) |
| 1. Calculate the standard deviation of returns of each stock
 | (**3 marks**) |
| 1. Explain six roles of financial intermediaries in Kenya
 | (**12 marks**) |

**QUESTION 2**

1. Explain with examples the following types of foreign exchange exposures
2. Translation exposure
3. Economic exposure
4. Transaction exposure (**6 marks**)
5. A financial economist used regression analysis to measure its economic exposure to foreign exchange rate fluctuations. The following was the output of the regression analysis.

|  |
| --- |
| Dependent Variable: Cash Flow Exposure  |
| Variable | Coefficient | Std. Error | t-Statistic | Prob.   |
| Domestic Inflation  | -0.046449 | 0.090850 | -0.511273 | 0.0128 |
| Foreign Currency Exchange Rate | -0.001946 | 0.042585 | -0.045705 | 0.0638 |
| Political Stability | 0.010962 | 0.109932 | 0.099718 | 0.0012 |
| Adjusted R-squared | 0. 510531 |     S.D. dependent  | 0.160846 |

1. Interpret the coefficients and magnitudes of Domestic Inflation, Foreign Currency Exchange Rate, and Political Stability. (**6 marks**)
2. Comment on the relationship between the country’s cash flow exposure and political stability. (**2 marks**)
3. Explain the implication of the adjusted R-squared (**1 marks**)

**QUESTION 3**

1. Explain 4 tools used by the central bank of Kenya to control money supply in the economy (**8 marks**)
2. Discuss 3 roles of financial institutions in the context of Kenya (**6 marks**)
3. Give two examples of non-banking institutions in Kenya that have been promoting financial development (**1 mark**)

**QUESTION 4**

1. Rose, a financial analyst at Zoo Ltd, is thinking about recommending that Hybrid LLC invests in a piece of land that currently costs Ksh. 105,000. She is certain that next year the land will be worth Ksh. 91,000. Given that the guaranteed interest rate in the bank is 10 percent, should Hybrid LLC undertake the investment in land? **(7 marks)**
2. Suppose there are only two stocks in the world: Stock and Stock. The expected returns of these two stocks are 8 percent and 12 percent, while the standard deviations of the stocks are 5 percent and 15 percent, respectively. The correlation coefficient of the two stocks is zero.
3. Calculate the expected return and standard deviation of a portfolio that is composed of 35 percent and 65 percent
4. Calculate the expected return and standard deviation of a portfolio that is composed of 90 percent and 10 percent

**(8 marks)**

**QUESTION 5**

1. Explain the following terms as used in financial economics
2. Primary markets
3. Secondary markets
4. Adverse selection
5. Moral hazards **(8 marks)**
6. Use a well labeled diagram to explain the consumption and investment decision making by individuals in the absence of capital markets (**7 marks**)

**FINANCIAL ECONOMICS FORMULAE**