Question 2

8 points \((3 + 3 + 2)\)

(a) 3 points:
- One point is earned for a correctly labeled graph.
- One point is earned for showing a rightward shift of the money demand curve.
- One point is earned for showing that the nominal interest rate is increasing.

(b) 3 points:
- One point is earned for a correctly labeled graph.
- One point is earned for showing a rightward shift of the supply curve for loanable funds.
- One point is earned for showing that the real interest rate is decreasing.

(c) 2 points:
- One point is earned for indicating that the nominal interest rate is 8 percent.
- One point is earned for indicating that the real interest rate is 6 percent.
Write in the box the number of the question you are answering on this page as it is designated in the examination.

a) Money market

\[ \text{Supply} \]

\[ \text{Demand} \]

\[ \text{Interest rate} \]

\[ i_1 \]

\[ i_2 \]

\[ \# \text{ of } \$

b) Loanable funds market

\[ S_1 \]

\[ S_2 \]

\[ \text{Interest rate} \]

\[ i_1 \]

\[ i_2 \]

\[ Q \text{ of loanable funds} \]

\[ Q_1 \]

\[ Q_2 \]

\( i \)

\( D \)

\( a \)

\( b \)

\( c \)

\( e \)

\[ \text{interest rate} \]

\[ \text{nominal interest rate} \]

\[ \text{inflation rate} \]

\[ \text{real interest rate} \]

\[ \text{new nominal interest rate} \]

\[ \text{nominal interest rate} \]

\[ \text{inflation rate} \]

\[ \text{real interest rate} \]

\[ \text{nominal interest rate} \]

\[ \text{inflation rate} \]

\[ \text{nominal interest rate} \]

\[ \text{inflation rate} \]
Write in the box the number of the question you are answering on this page as it is designated in the examination.

2B

Money Market

a) Interest Rates

Lentable Funds Market

b) Interest Rate

c) New nominal interest rate 8%
   New real interest rate 6%
Write in the box the number of the question you are answering on this page as it is designated in the examination.

(a) [Diagram]

As the income level increases, the supply of money will increase (shift to the right), and bring the nominal interest rate down in the short run.

(b) [Diagram]

- As saving increases, the supply of money will decrease in the short run. This decrease in the supply of money will cause the real market interest rate to increase in the short run.

(C) i. The New Nominal Interest Rate = \text{adverse for inflation.}

\[ 6\% \text{ (inexp. mt)} + 2\% \text{ (act. inflation)} = 8\% \text{ nominal} \]

ii. The New Real Interest Rate = \boxed{2\% \text{ real int. rate}}
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2006 SCORING COMMENTARY

Question 2

Overview

The question tested students’ ability to use the money demand/money supply framework to show changes in the equilibrium nominal interest rate and the loanable funds framework to show changes in the real interest rate. The last part of the question asked students to determine the effect of a change in expected inflation on the real and nominal interest rates.

Sample: 2A
Score: 8

The student received full credit.

Sample: 2B
Score: 6

The student lost 2 points in part (a): 1 point for incorrectly labeling the horizontal axis “income,” and 1 point for shifting the supply of money curve instead of the demand for money curve.

Sample: 2C
Score: 3

The student lost 1 point in part (a) for shifting the supply of money curve instead of the demand for money curve. All 3 points were lost in part (b) for using a diagram of the money market to explain the effect of an increase in household savings. A point was lost in part (c) because the incorrect real interest rate is asserted.