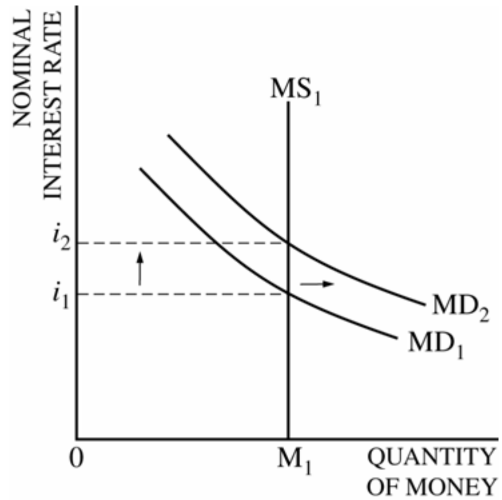
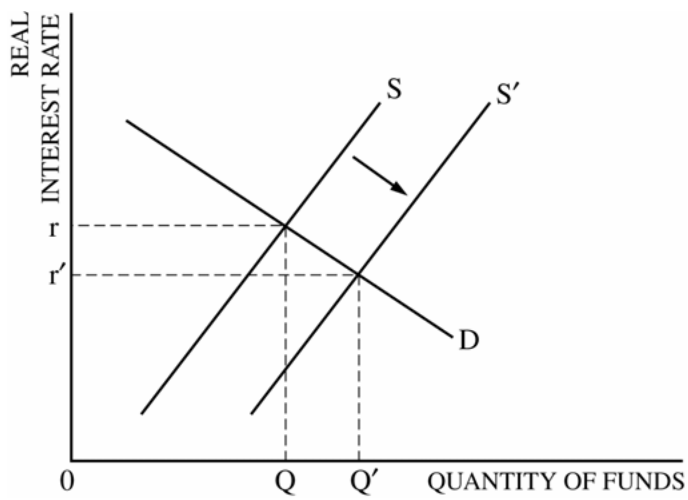
Question 2

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.

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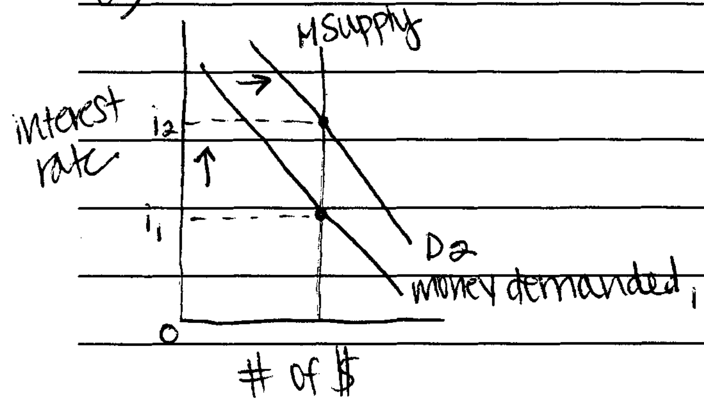
Write in the box the number of the question you are answering on this page as it is designated in the examination.

2

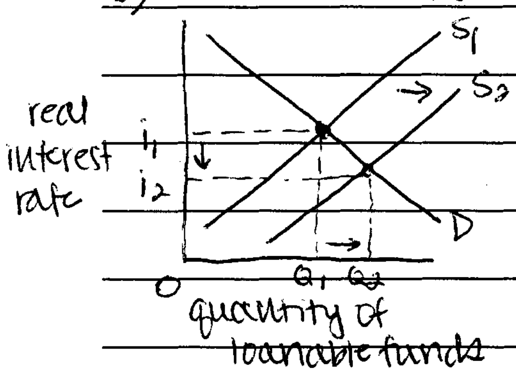
2A

a) Money market



raises the nominal interest rate

b) loanable funds market



lowers interest rate

c) (i) The 6% nominal interest rate plus an 2% increase in inflation makes the new nominal interest rate 8%.

(ii) 6%, because real interest rate is nominal interest rate (now 8%) minus inflation rate (2%)

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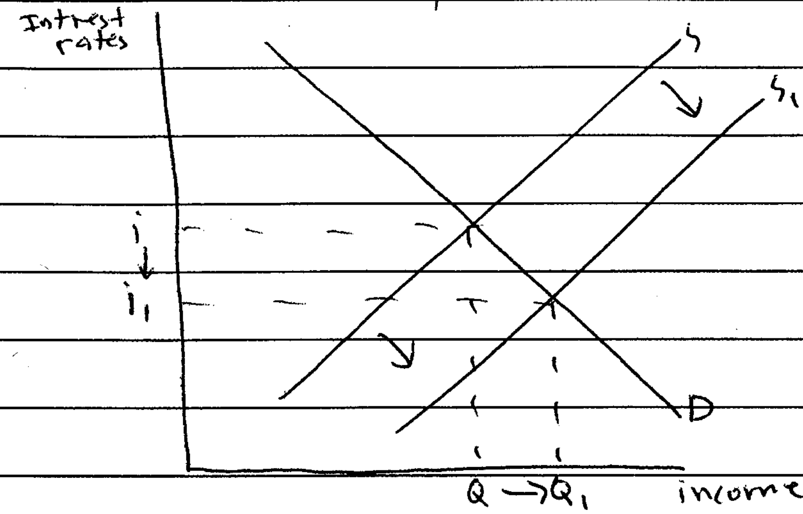
2

2B

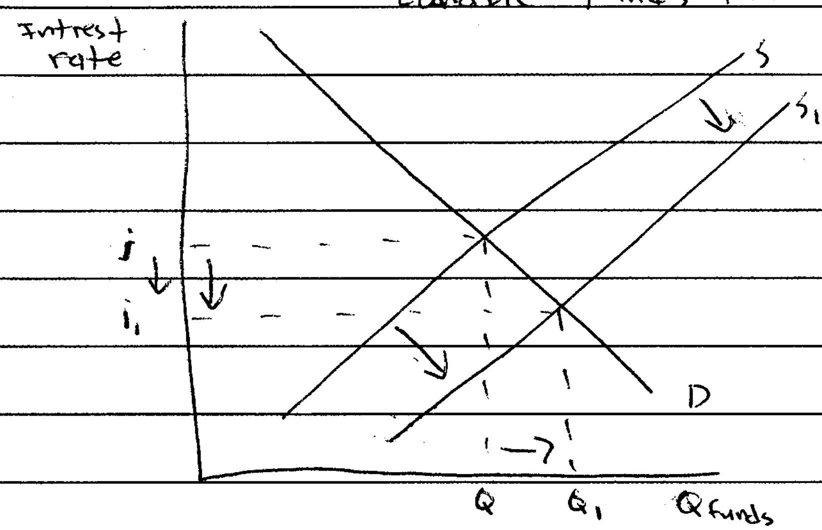
Money Market

a)



Loanable Funds Market

b)



c) new nominal intrest rate 8%
new real intrest rate 6%

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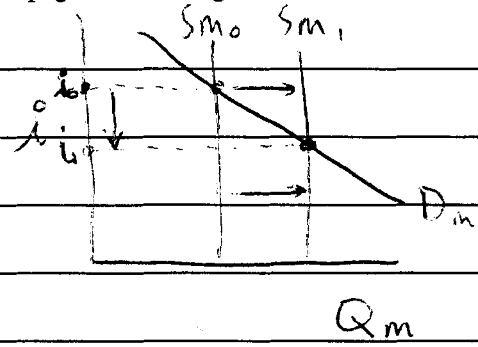
2

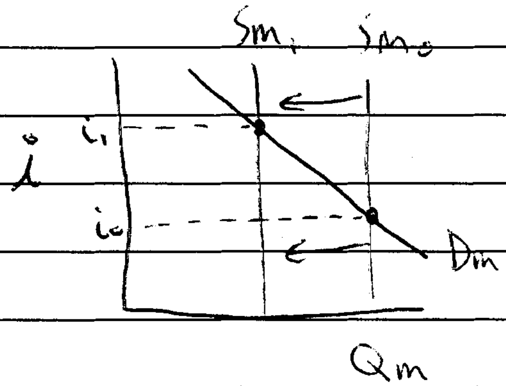
2C

(a)



- 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)



- 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 → adjusted for inflation.

6% (no exp. inf) + 2% (act. inflation) = $\boxed{8\%\ i_{nominal}}$

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

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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.

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