1. Assume the economy of Vanderlandia is in short-run equilibrium with a real GDP of \$500 million. The full-employment level of real GDP is \$550 million.

(b) Assume no policy action is taken to restore full employment.

(i) Explain how the economy will adjust in the long run.
(ii) Following the long-run adjustment process, will the price level in Vanderlandia be greater than, less than, or equal to PL_1 shown on your graph in part (a)?

(c) Assume instead that policymakers in Vanderlandia are considering changing government spending to restore full employment in the short run and that the marginal propensity to save is 0.2.

(i) Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
(ii) On your graph in part (a), show the short-run effect of the change in government spending in part (c)(i), labeling the new equilibrium price level PL_2.

(e) Based on the change in the real interest rate shown on your graph in part (d), what will happen to each of the following?

(i) The price of previously issued bonds
(ii) The rate of economic growth in the long run. Explain.

Begin your response to this question at the top of a new page in the separate Free Response booklet and fill in the appropriate circle at the top of each page to indicate the question number.