ECO 120-04
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Wednesday 23 November 2022 Your full name: ______________________________

Assignment 10: Stagflation

Due Monday 28 November. Please submit hardcopy at the beginning of class (11:00 a.m.), or if you prefer, under the door of Wimberly Hall 339C by 10:50 a.m.

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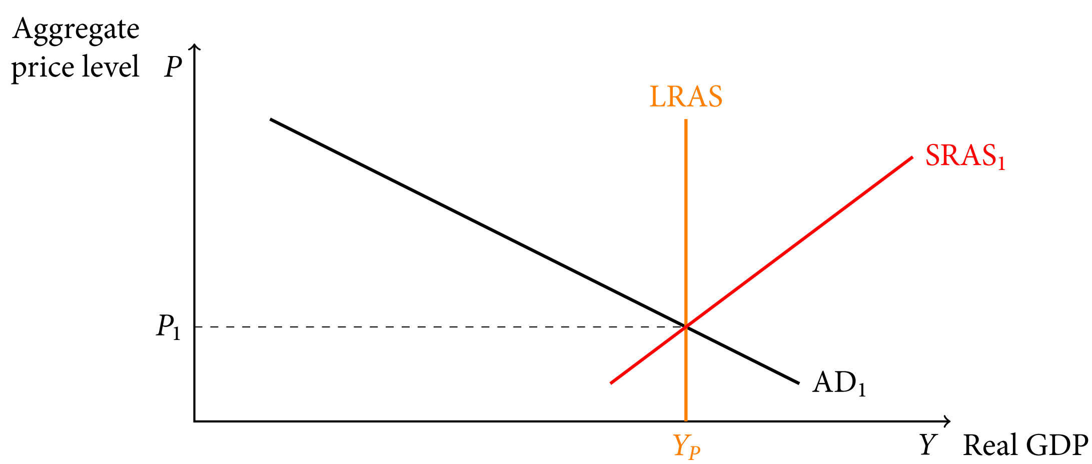
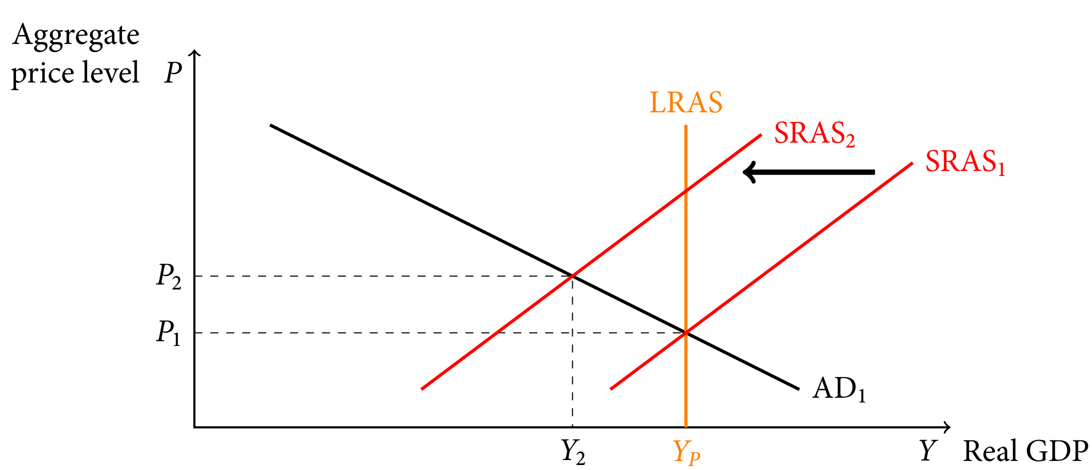
Suppose that the U.S. economy is initially in long-run equilibrium, producing its potential output Y_P, as depicted directly below.



A multinational effort to sanction Russian oil and natural gas results in a negative shock to short-run aggregate supply from SRAS_1 to SRAS_2 as depicted below. U.S. economic output falls from Y_P to Y_2, and the aggregate price level rises from P_1 to P_2. This results in a period of *stagflation*—lower economic output coupled with inflation.



1. Please illustrate how fiscal policy could be used to maintain economic growth.
   Hint: Reproduce the second graph here. Illustrate a change in fiscal policy that restores output to Y_P.

2. Please illustrate how fiscal policy could be used to stabilize prices.
   Hint: Reproduce the second graph here. Illustrate a change in fiscal policy that restores the price level to P_1.

3. Can fiscal policy remedy stagflation? Please explain with a complete sentence.
   Hint: Can a change in fiscal policy restore both output to Y_P and the price level to P_1?