

ECO 120-04

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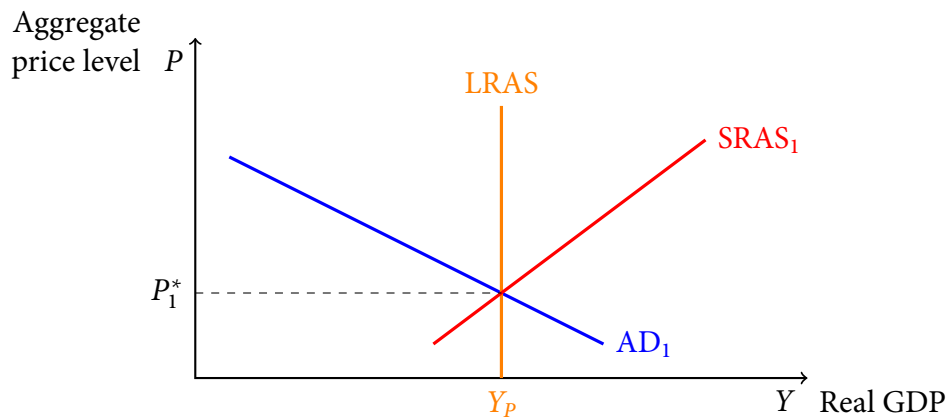
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## Assignment 10: Stagflation

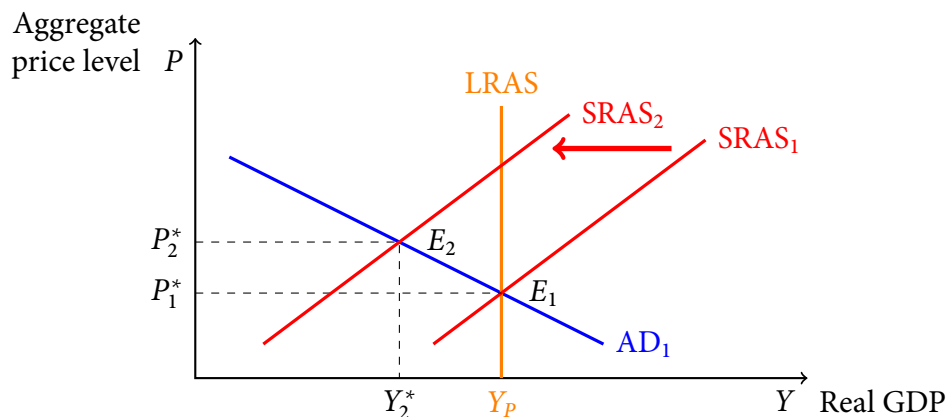
*Due Monday 28 November.* Please submit hardcopy at the beginning of class (11:00 a.m.), or if you prefer, under the door of Wimberly Hall 339C by 10:50 a.m.

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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  $P_1^*$ ?