

Suppose that you are a widget maker. Each week a “Walrasian auctioneer” endowed with magical insight calls you first thing Monday morning and informs you of the market equilibrium price at which widgets will sell. Then you decide you much to work that week and how many widgets to make and sell.

Suppose that the auctioneer today announces a price that is higher than the one you expected. This could be an increased *relative price of widgets* reflecting a greater scarcity of widgets this week. Or it could be *inflation of all prices*, with the relative price of widgets staying the same. (Or it could be some of both.) Aggregate price indexes are only published with a lag, so you do not have access to information about other prices in order to tell the difference.

1. How would you decide how much the relative price of widgets had increased? Would your decision be different in, for example, stable-inflation Germany than in variable-inflation Argentina?
2. If you decided that the increase in the widget price was a relative-price increase, how would you change your work/production decision?
3. If you decided that the increase in the widget price was just inflation, how would you change your work/production decision?
4. What would happen if the actual cause of the increase in the nominal price of widgets was inflation, but you (and other producers) mistook it for a relative-price increase? What would the short-run aggregate-supply relationship between price and output look like?
5. How would the elasticity of the short run aggregate-supply curve vary between Germany and Argentina? Why?
6. Would the same aggregate-supply relationship be present in the long run, when the change in the nominal widget price was known to be caused by aggregate inflation?