

Economics 314
Daily Question #22

Spring 2014
April 3

Suppose that $\Pi(P_i; P, M)$ is a function giving firm i 's operating profits (not considering price-adjustment costs) when the firm sets price P_i , all other firms set price P , and aggregate demand is at level M . All firms initially have price equal to P_0 . The long-run optimal (profit-maximizing in the absence of adjustment costs) price is P^* , which depends on aggregate demand M .

1. Explain the macroeconomic meaning of each of the following expressions:

a. $\Pi(P^*, P_0; M) - \Pi(P_0, P_0; M)$

b. $\Pi(P^*, P^*; M) - \Pi(P_0, P^*; M)$

2. If Z is the menu cost of adjusting price, what is the firm's optimal price strategy (adjust or non-adjust price) if other firms do not adjust price and $\Pi(P^*, P_0; M) - \Pi(P_0, P_0; M) < Z$?