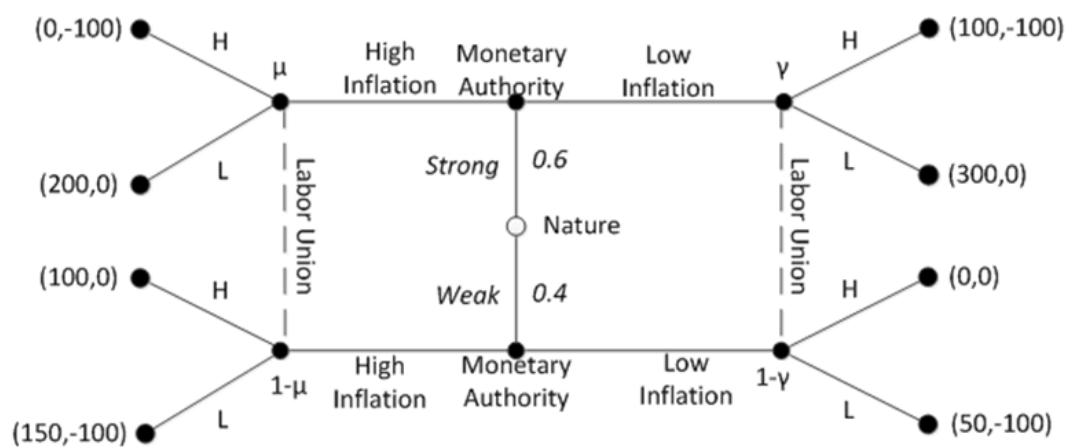


Monetary authority game

- The game tree that represents this incomplete information game is, hence, as follows:



PBEs-Monetary Authority

- Before starting to find all possible PBEs...
 - Let us briefly set up our "road map"
- That is, let's recall the 5-step procedure that we need to follow in order to find PBEs.

Procedure to find PBEs

1. Specify a strategy profile for the privately informed player, either separating or pooling.
 - In our above example, there are only four possible strategy profiles for the privately informed monetary authority: two separating strategy profiles, $High^S Low^W$ and $Low^S High^W$, and two pooling strategy profiles, $High^S High^W$ and $Low^S Low^W$.
 - (For future reference, it might be helpful to shade the branches corresponding to the strategy profile we test.)
2. Update the uninformed player's beliefs using Bayes' rule, whenever possible.
 - In our above example, we need to specify beliefs μ and γ , which arise after the labor union observes a high or a low inflation announcement, respectively.

Procedure to find PBEs - Cont'd

3. Given the uninformed player's updated beliefs, find his optimal response.
 - In our above example, we first determine the optimal response of the labor union (H or L) upon observing a high-inflation announcement (given its updated belief μ),
 - we then determine its optimal response (H or L) after observing a low-inflation announcement (given its updated belief γ).
 - (Also for future reference, it might be helpful to shade the branches corresponding to the optimal responses we just found.)

Procedure to find PBEs - Cont'd

4. Given the optimal response of the uninformed player, find the optimal action (message) for the informed player.
 - In our previous example, we first check if the Strong monetary authority prefers to make a high or low inflation announcement (given the labor union's responses determined in step 3).
 - We then operate similarly for the Weak type of monetary authority.

Procedure to find PBEs - Cont'd

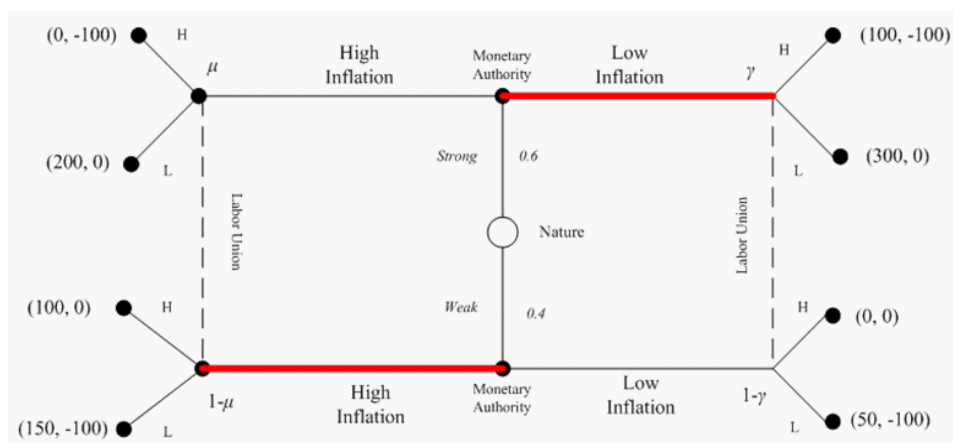
5. Then check if this strategy profile for the informed player coincides with the profile suggested in step 1.
 - If it coincides, then this strategy profile, updated beliefs and optimal responses **can** be supported as a PBE of the incomplete information game.
 - Otherwise, we say that this strategy profile **cannot** be sustained as a PBE of the game.

Procedure to find PBEs - Cont'd

- Let us next separately apply this procedure to test each of the four candidate strategy profiles:
 - two separating strategy profiles:
 - $High^S Low^W$, and
 - $Low^S High^W$.
 - And two pooling strategy profiles:
 - $High^S High^W$, and
 - $Low^S Low^W$.

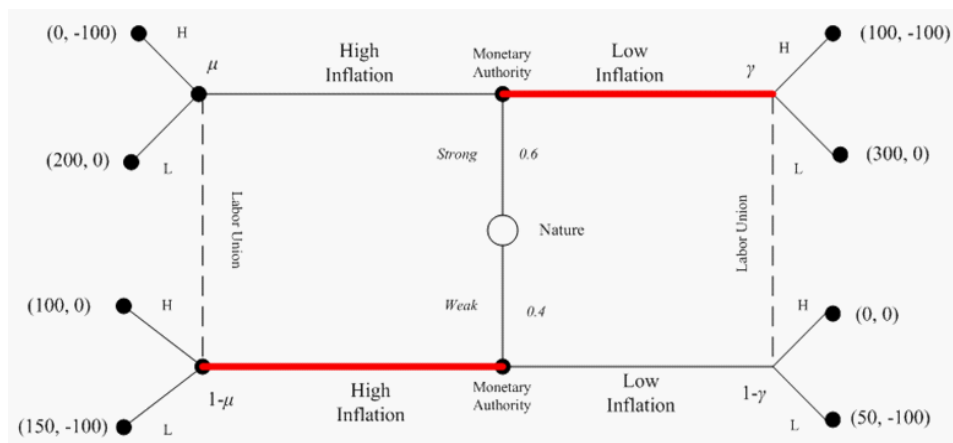
Separating equilibrium with (Low,High)

- Let us first check separating strategy profile: $Low^S High^W$.



- Step #1:** Specifying strategy profile $Low^S High^W$ that we will test.
 - (See shaded branches in the figure.)

Separating equilibrium with (Low,High)

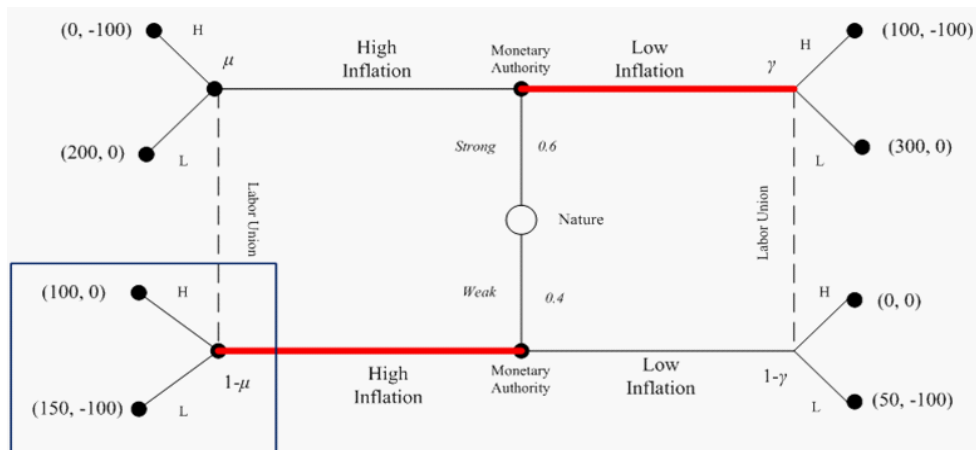


• Step #2: Updating beliefs

- (a) After high inflation announcement (left-hand side)

$$\mu = \frac{0.6\alpha^{Strong}}{0.6\alpha^{Strong} + 0.4\alpha^{Weak}} = \frac{0.6 \times 0}{0.6 \times 0 + 0.4 \times 1} = 0$$

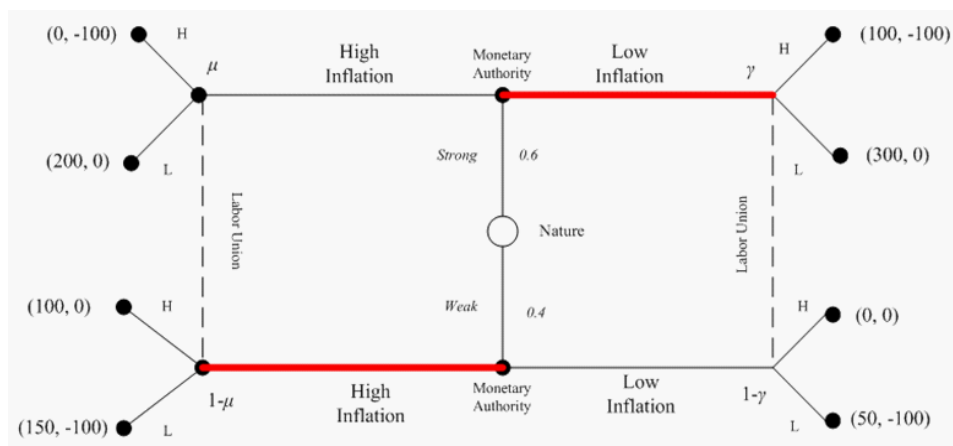
Separating equilibrium with (Low,High)



• Step #2: Updating beliefs

- This implies that after high inflation...
- the labor union restricts its belief to the lower left-hand corner (see box), since $\mu = 0$ and $1 - \mu = 1$

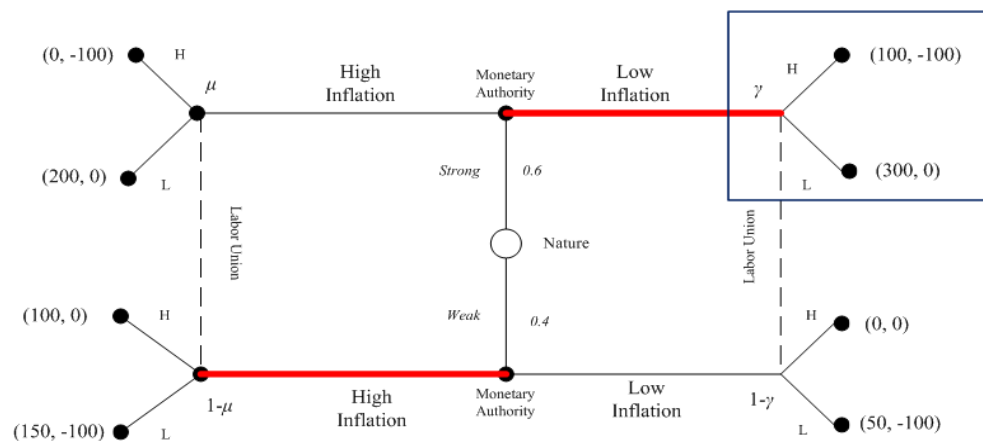
Separating equilibrium with (Low,High)



- **Step #2:** Updating beliefs
 - (b) After low inflation announcement (right-hand side)

$$\gamma = \frac{0.6 (1 - \alpha^{Strong})}{0.6 (1 - \alpha^{Strong}) + 0.4 (1 - \alpha^{Weak})} = \frac{0.6 \times 1}{0.6 \times 1 + 0.4 \times 0} = 1$$

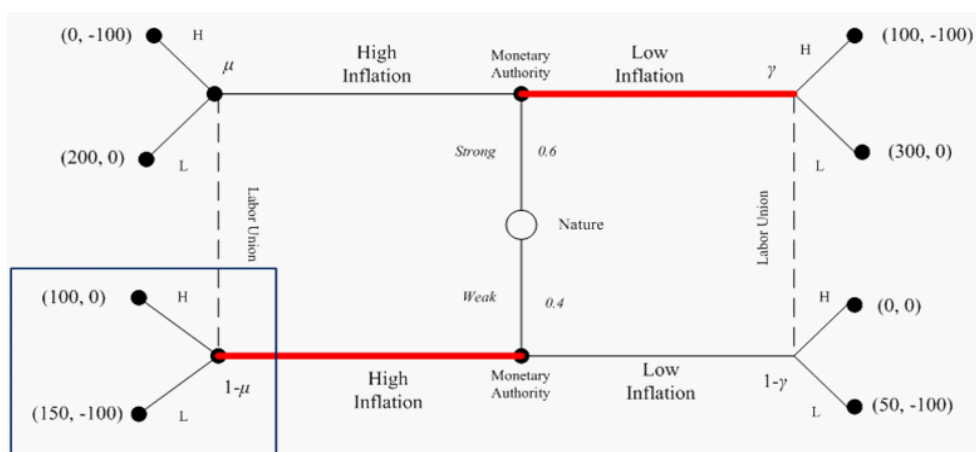
Separating equilibrium with (Low,High)



• Step #2: Updating beliefs

- This implies that, after low inflation...
- the labor union restricts its belief to the upper right-hand corner (see box), since $\gamma = 1$ and $1 - \gamma = 0$.

Separating equilibrium with (Low,High)



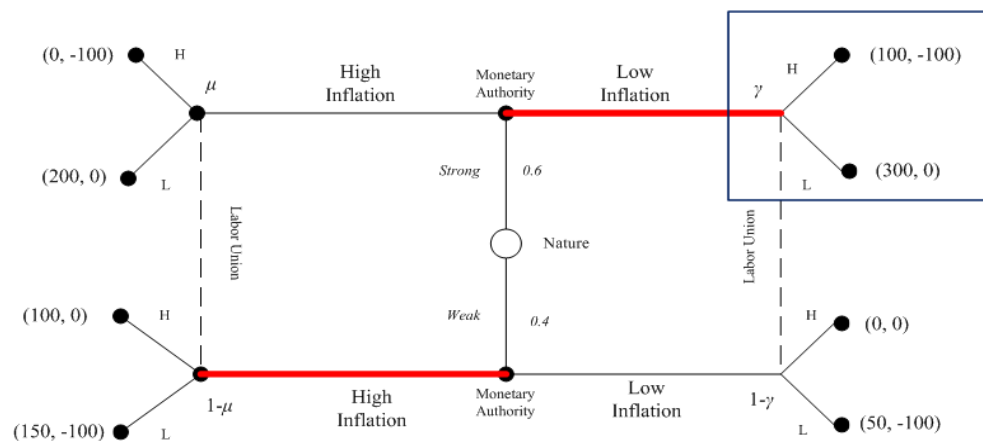
- **Step #3:** Optimal response

- (a) After high inflation announcement, respond with H since

$$0 > -100$$

in the lower left-hand corner of the figure (see blue box).

Separating equilibrium with (Low,High)



- **Step #3: Optimal response**

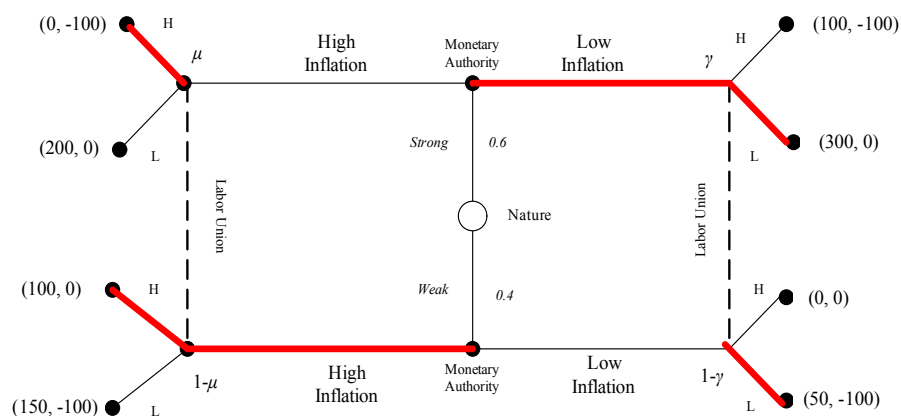
- (b) After low inflation announcement, respond with L since

$$0 > -100$$

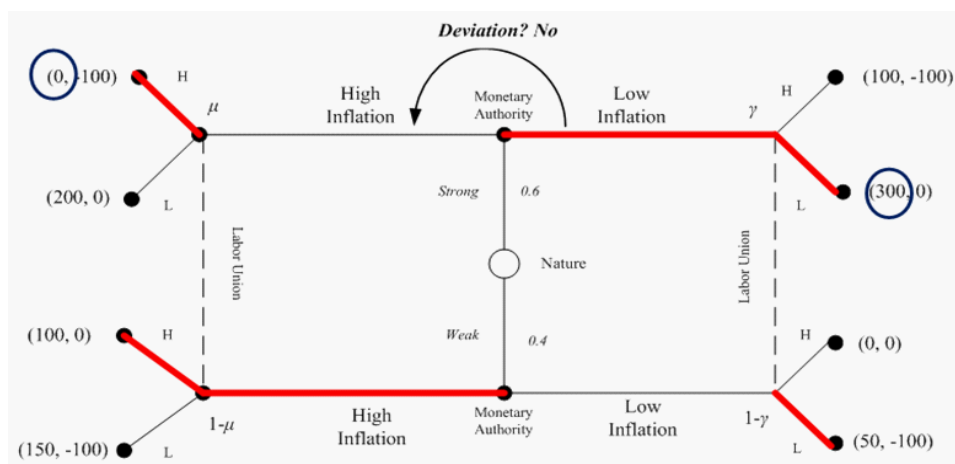
in the upper right-hand corner of the figure (see box).

Separating equilibrium with (Low,High)

- We can hence summarize the optimal responses we just found, by shading them in the figure:
 - H after high inflation, but L after low inflation.

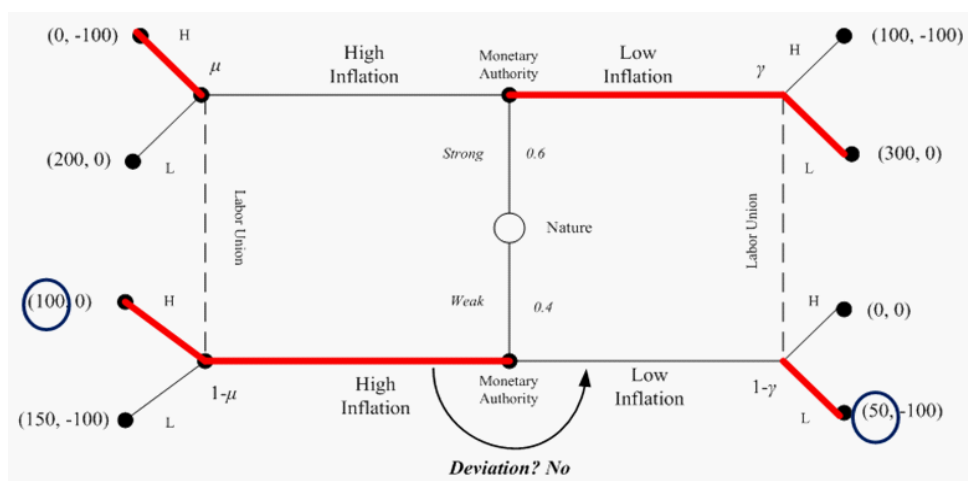


Separating equilibrium with (Low,High)



- **Step #4:** Optimal messages by the informed player
 - (a) When the monetary authority is Strong, if it chooses Low (as prescribed), its payoff is \$300,
 - while if it deviates, its payoff decreases to \$0.
 - (No incentives to deviate).

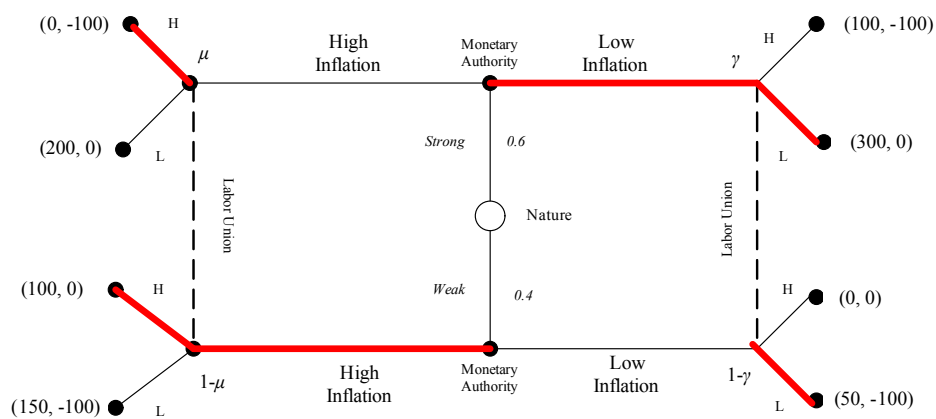
Separating equilibrium with (Low,High)



• Step #4: Optimal messages

- (b) When the monetary authority is Weak, if it chooses High (as prescribed), its payoff is \$100,
- while if it deviates, its payoff decreases to \$50.
- (No incentives to deviate either).

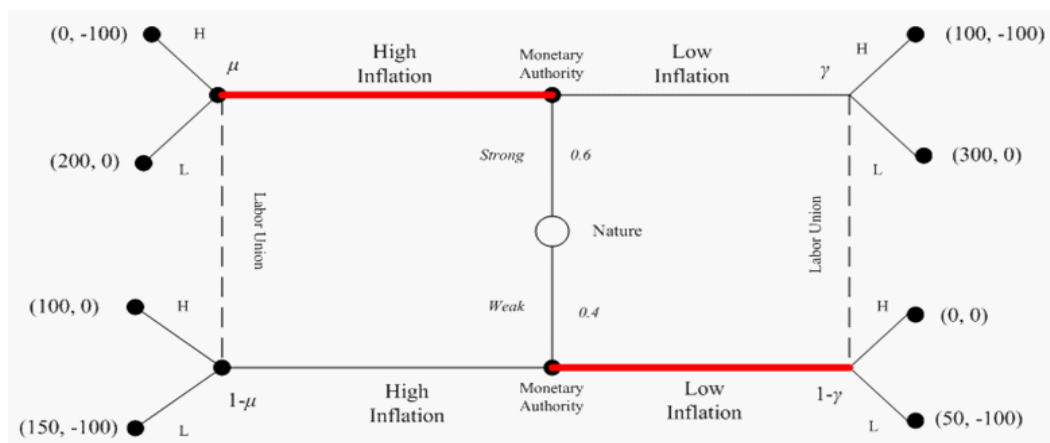
Separating equilibrium with (Low,High)



- Since no type of privately informed player (monetary authority) has incentives to deviate,
 - The separating strategy profile $Low^S High^W$ **can** be sustained as a PBE.

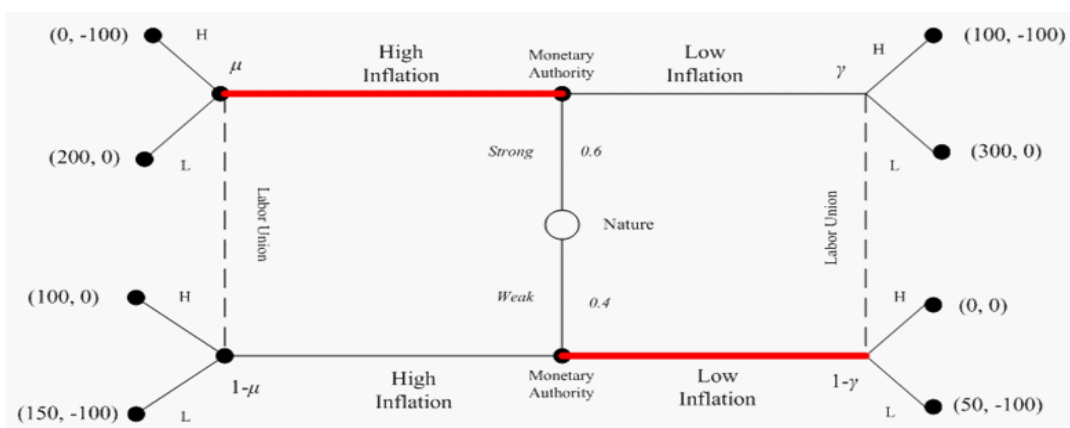
Separating equilibrium with (High,Low)

- Let us now check the opposite separating strategy profile: $High^S Low^W$.



- Step #1:** Specifying strategy profile $High^S Low^W$ that we will test.
 - (See shaded branches in the figure.)

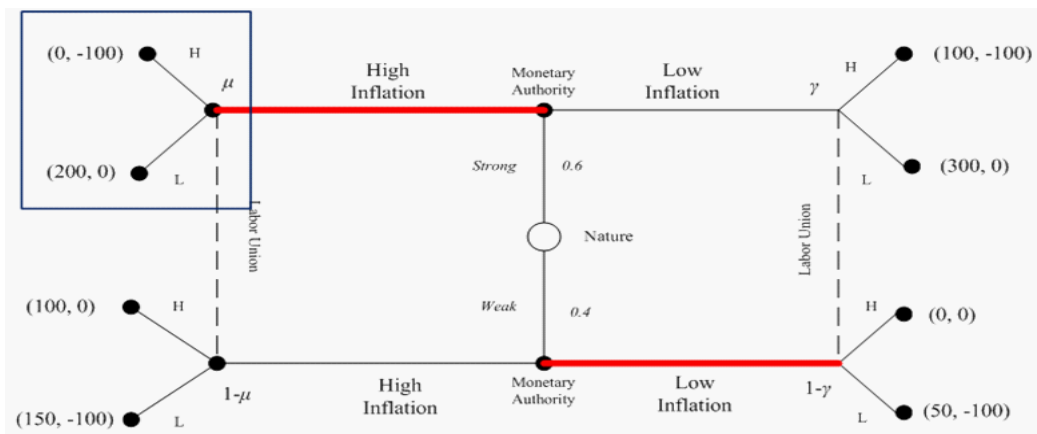
Separating equilibrium with (High,Low)



- **Step #2:** Updating beliefs
 - (a) After high inflation announcement

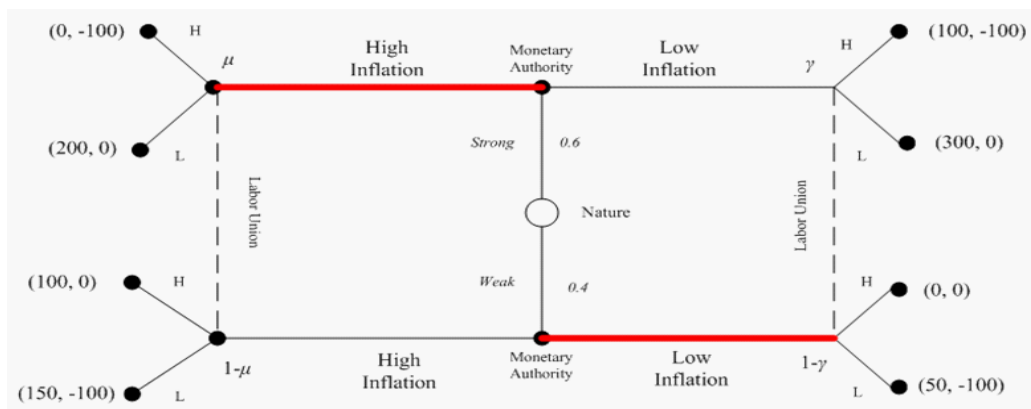
$$\mu = \frac{0.6\alpha^{Strong}}{0.6\alpha^{Strong} + 0.4\alpha^{Weak}} = \frac{0.6 \times 1}{0.6 \times 1 + 0.4 \times 0} = 1$$

Separating equilibrium with (High,Low)



- **Step #2:** Updating beliefs
 - Hence, after high inflation...
 - the labor union restricts its beliefs to $\mu = 1$ in the upper left-hand corner (see box).

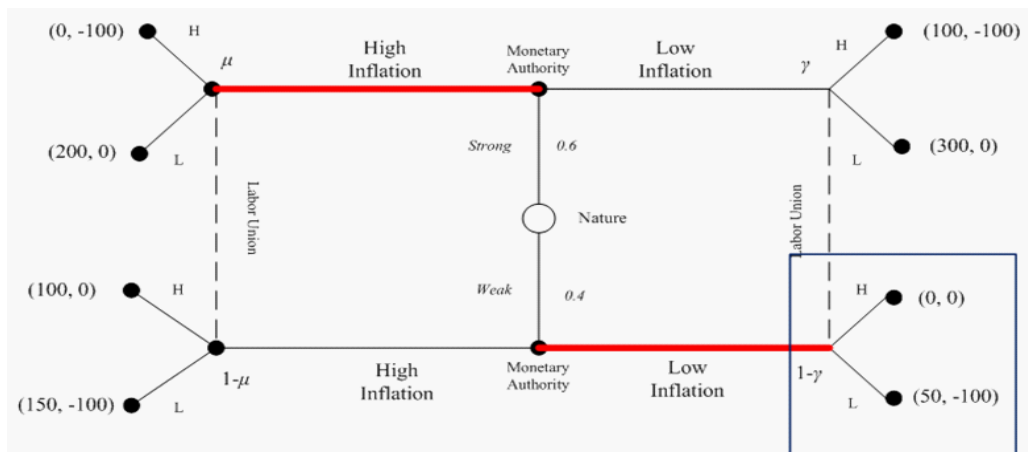
Separating equilibrium with (High,Low)



- **Step #2:** Updating beliefs
 - (b) After low inflation announcement

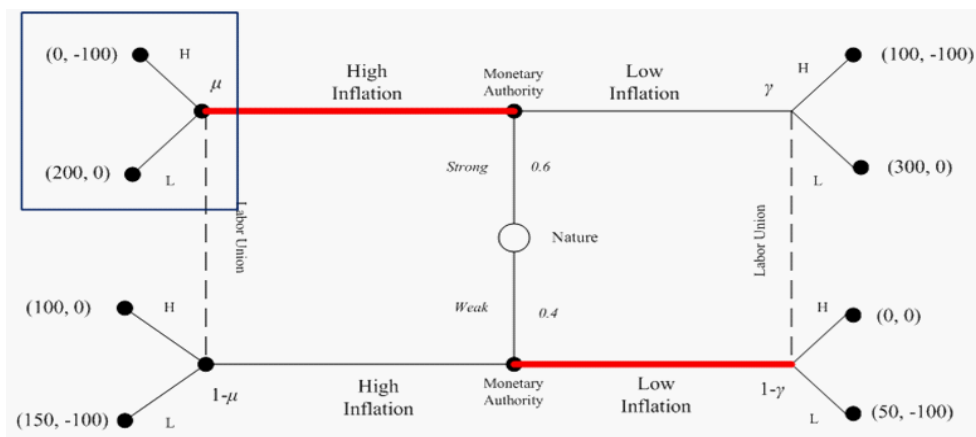
$$\gamma = \frac{0.6 (1 - \alpha^{Strong})}{0.6 (1 - \alpha^{Strong}) + 0.4 (1 - \alpha^{Weak})} = \frac{0.6 \times 0}{0.6 \times 0 + 0.4 \times 1} = 0$$

Separating equilibrium with (High,Low)



- **Step #2:** Updating beliefs
 - Hence, after low inflation...
 - the labor union restricts its beliefs to $\gamma = 0$ (i.e., $1 - \gamma = 1$) in the lower right-hand corner (see box).

Separating equilibrium with (High,Low)



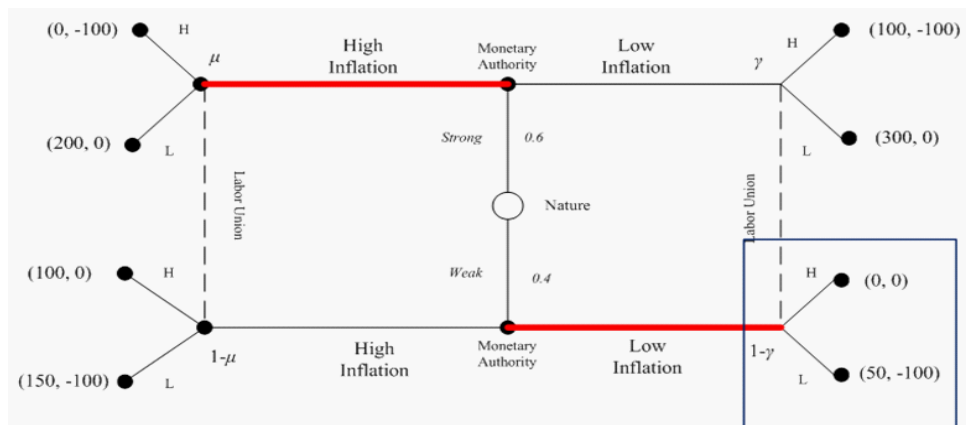
- **Step #3:** Optimal response

- (a) After high inflation announcement, respond with L since

$$0 > -100$$

in the upper left-hand corner of the figure (see box).

Separating equilibrium with (High,Low)



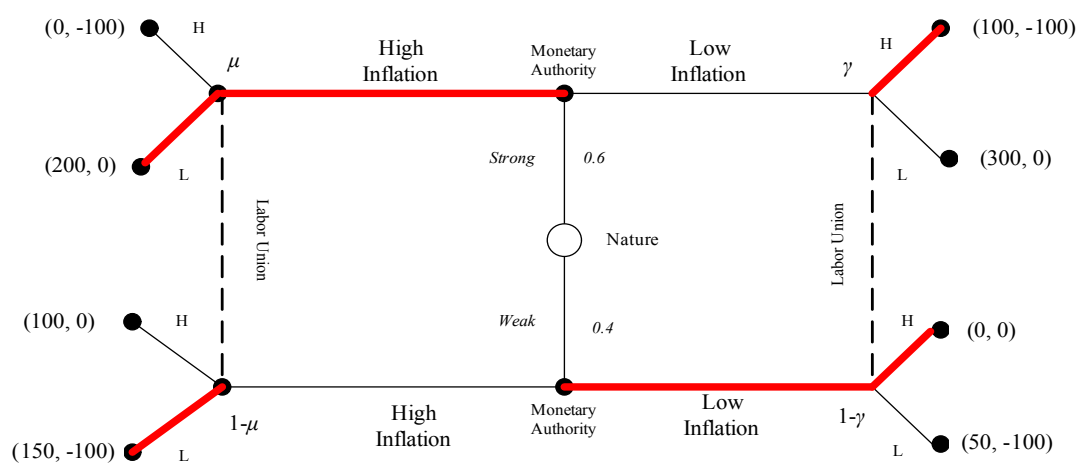
- **Step #3:** Optimal response
 - (a) After low inflation announcement, respond with H since

$$0 > -100$$

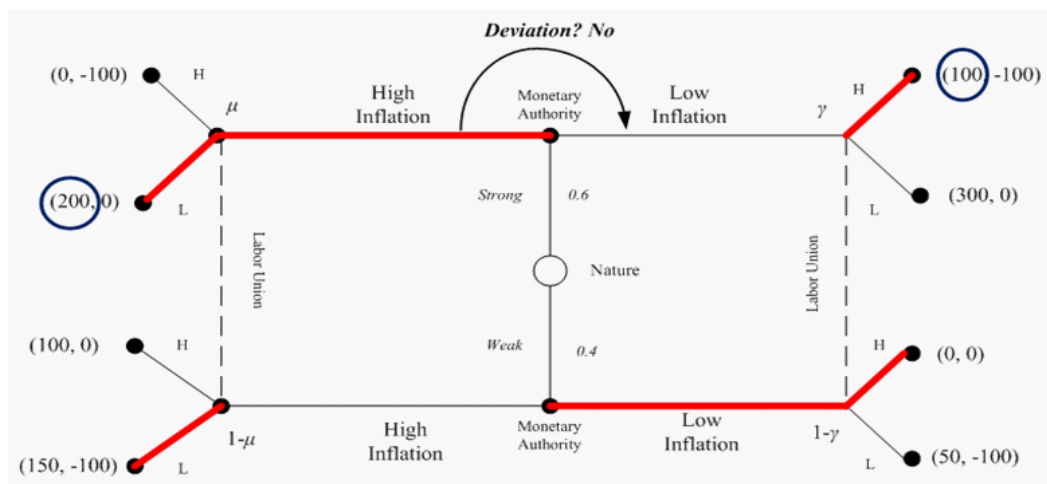
in the lower right-hand corner of the figure (see box).

Separating equilibrium with (High,Low)

- Summarizing the optimal responses we just found:
 - L after high inflation, but H after high inflation.

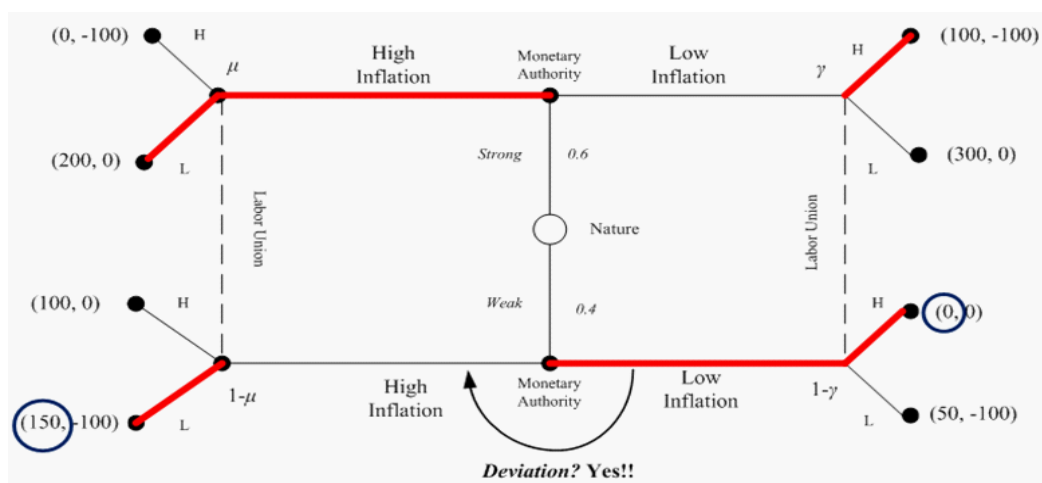


Separating equilibrium with (High,Low)



- **Step #4:** Optimal messages of the informed player
 - (a) When the monetary authority is Strong, if it chooses High (as prescribed), its payoff is \$200,
 - while if it deviates, its payoff decreases to \$100.
 - (No incentives to deviate).

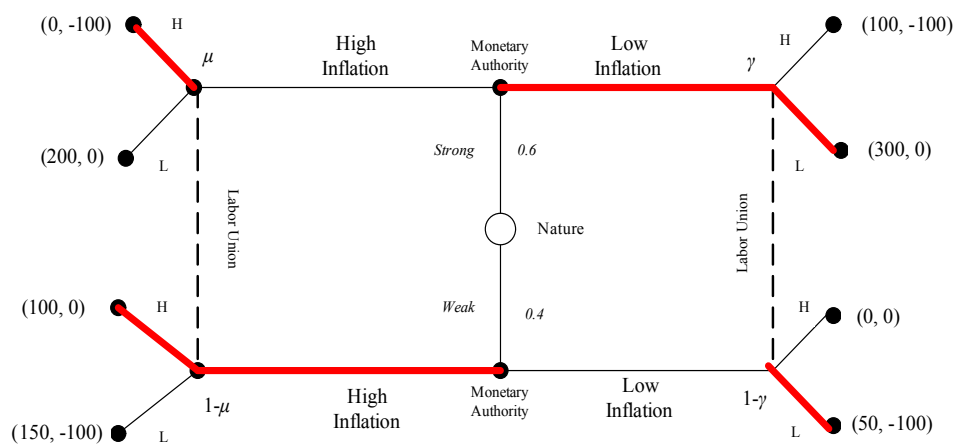
Separating equilibrium with (High,Low)



• Step #4: Optimal messages

- (b) When the monetary authority is Weak, if it chooses Low (as prescribed), its payoff is \$0,
- while if it deviates, its payoff **increases** to \$150.
- (Incentives to deviate!!).

Separating equilibrium with (High,Low)



- Since we found one type of privately informed player (the Weak monetary authority) who has incentives to deviate...
 - The separating strategy profile $High^S Low^W$ **cannot** be sustained as a PBE.