Credibility Dynamics and Disinflation Plans

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Motivation

- Macro models: expectations of future policy determine current outcomes
- Policy is typically set assuming commitment or discretion

- Governments actively attempt to influence beliefs about future policy
  - Forward guidance, inflation targets, fiscal rules

- This paper: rational-expectations theory of government credibility
  - Insights from reputation models ▸ Kreps-Wilson
- Application in a (modern) Barro-Gordon setup

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    - Insights from reputation models Kreps-Wilson
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Outline

- What is reputation?
  - Private sector *posterior belief* that the government is committed to a *particular* plan
- Given a plan — [Continuation equilibrium]
  - Larger departures are **easier** to detect
    - Crucial feature: noise partially masks government's current choice
  - 'More time-inconsistent' plans have a more negative average drift of reputation
- Planner anticipates credibility dynamics of plans — [Equilibrium]

Main result

Planner chooses a back-loaded plan

- In application, gradual disinflation
- No real inertia, but good for incentives

- Consider the limit when initial reputation **vanishes** to zero

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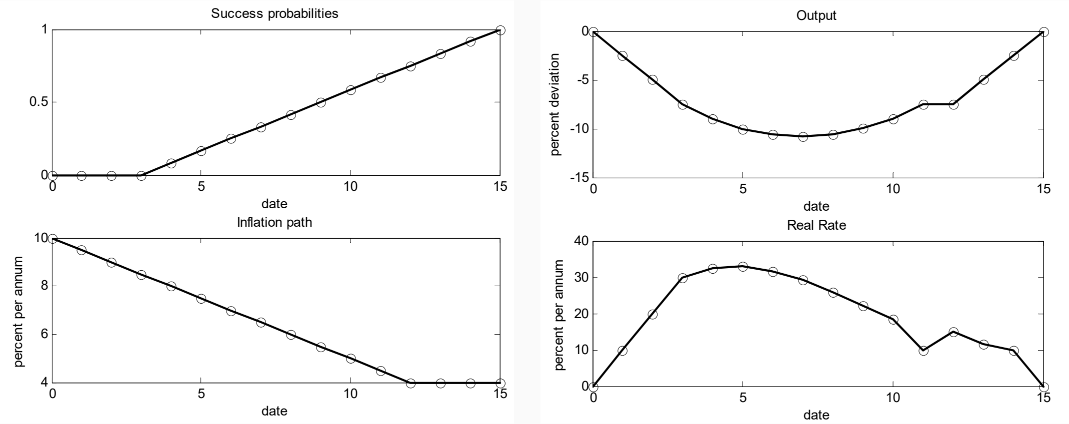
OUR *WANT* OPERATOR

- Goodfriend and King (2005) describe the Volcker disinflation



Literature

- **Sustainable plans** – anything goes
  from Kydland and Prescott (1977), Chari and Kehoe (1990), Phelan and Stacchetti (2001)

- **Reputation without noise** – zero inflation at onset
  Milgrom and Roberts (1982), Kreps and Wilson (1982), Barro (1986), Backus and Driffill (1985), Barro and Gordon (1986), Sleet and Yeltekin (2007)

- **Preference uncertainty with noise** – announcements irrelevant
  Cukierman and Meltzer (1986), Faust and Svensson (2001), Phelan (2006), etc

- **Reputation with noise**
  Commitment: Lu (2013), Lu, King, and Pastén (2008, 2016)
  Static plans: Faingold and Sannikov (2011)

Roadmap

- Model
- Continuation equilibria conditional on a plan
- Plans
- Conclusion

Model

Framework

- A government dislikes inflation and output away from a target $y^\star > 0$

$$L_t = \mathbb{E}_t\left[\sum_{s=0}^{\infty} \beta^s \left((y^\star - y_{t+s})^2 + \gamma \pi_{t+s}^2\right)\right]$$

- A Phillips curve relates output to current and expected future inflation

$$\pi_t = \kappa y_t + \beta \mathbb{E}_t\left[\pi_{t+1}\right]$$

- The government controls inflation only imperfectly (through g_t)

$$\pi_t = g_t + \epsilon_t$$

with $\epsilon_t \overset{iid}{\sim} F_\epsilon$

Reputation

- The government can be **rational** or one of many 'behavioral' types
    - Behavioral types $c \in \mathcal{C}$
    - Type c is committed to an inflation plan $\{a_t\}_{t=0}^{\infty}$
    - For simplicity let all plans have $a_{t+1} = \phi_c(a_t)$ [Finding the state is an art]
- Behavioral types have (total) probability z
    - Conditional on behavioral, probability ν over $\mathcal{C}$
- Private sector knows z and ν
    - Does **inference** over the government's type
    - Uses announcement and inflation choices

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Behavioral types

- What is the set $\mathcal{C}$?
  - $\cdots$ and associated possible ϕ_c functions
- Consider $\{a_t\}_t$ paths characterized by
  - Starting point a_0
  - Decay rate ω
  - Asymptote χ

$$a_t = \chi + (a_0 - \chi)e^{-\omega t}$$
$$\phi(a) = \chi + e^{-\omega}(a - \chi)$$

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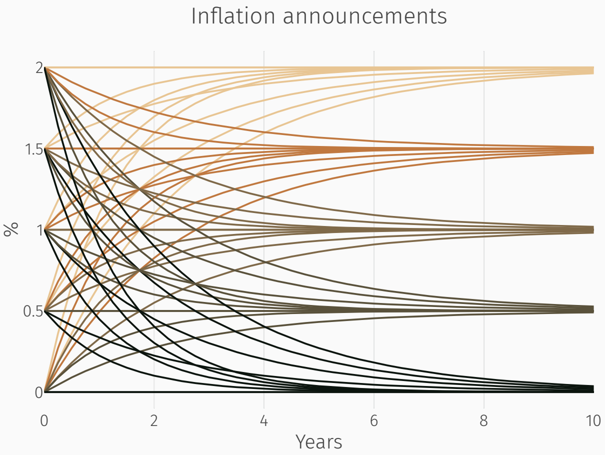
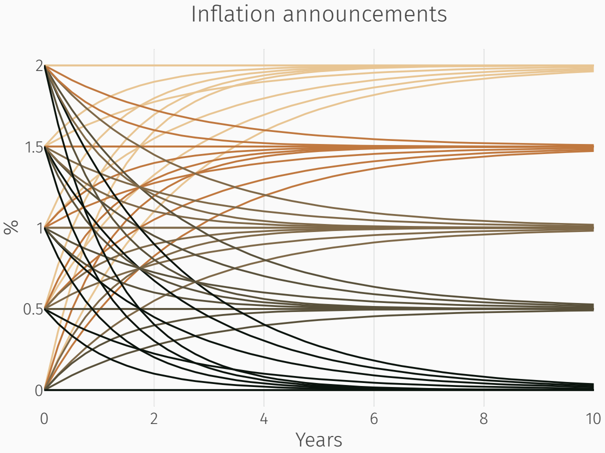


Gameplay

- At $t = 0$, inflation targets are announced
  - Type $c \in \mathcal{C}$ says c
  - Rational type **strategizes** announces r possibly $\in \mathcal{C}$
- At time $t \geq 0$, the government sets inflation
  - Behavioral type $c \in \mathcal{C}$ implements $g_t = a_t^c$
  - Rational type acts **strategically** chooses $g_t \lesseqgtr a_t^c$



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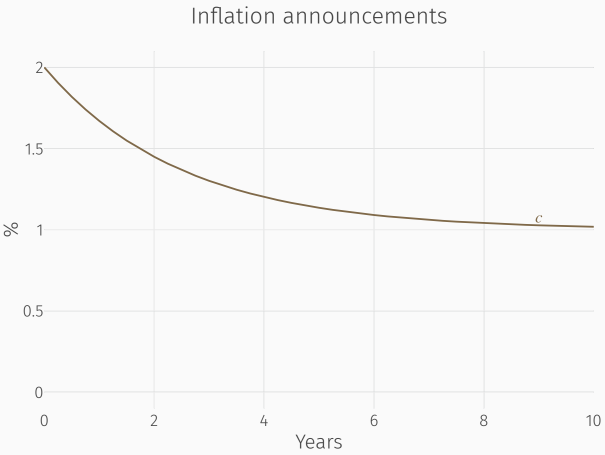

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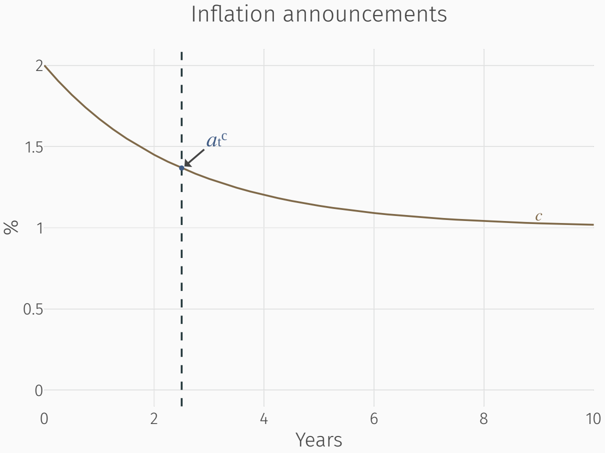

Continuation equilibria conditional on a plan

- Output is determined by **beliefs** $\mathbb{E}_t[\pi_{t+1}]$ and **actual inflation** $\pi_t = g_t + \epsilon_t$

$$\pi_t = \kappa y_t + \beta\mathbb{E}_t[\pi_{t+1}] = \kappa y_t + \beta\mathbb{E}_t\left[\mathbb{1}_c a^c_{t+1} + (1-\mathbb{1}_c)g^\star_{t+1}\right]$$

- Private sector solves a signal extraction problem to update beliefs

$$\mathbb{P}(c \mid \pi_t, \mathcal{F}_{t-1}) = \frac{\mathbb{P}(c \mid \mathcal{F}_{t-1}) \cdot f_\epsilon(\epsilon_t|c)}{\mathbb{P}(c \mid \mathcal{F}_{t-1}) \cdot f_\epsilon(\epsilon_t|c) + (1-\mathbb{P}(c \mid \mathcal{F}_{t-1})) \cdot f_\epsilon(\epsilon_t|r)}$$

Reputation and Outcomes

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Rational type's problem

Given an announcement c,

- The problem of the rational type is, given expectations $g_c^\star$

$$\mathcal{L}^c(p,a) = \min_g \mathbb{E}\left[(y^\star - y)^2 + \gamma\pi^2 + \beta\mathcal{L}^c(p', \phi_c(a))\right]$$

$$\text{subject to } \pi = g + \epsilon$$

$$\pi = \kappa y + \beta\left[p'\phi_c(a) + (1-p')g_c^\star(p', \phi_c(a))\right]$$

$$p' = p + p(1-p)\frac{f_\epsilon(a-\pi) - f_\epsilon(g_c^\star(p,a) - \pi)}{pf_\epsilon(a-\pi) + (1-p)f_\epsilon(g_c^\star(p,a)-\pi)}$$

- Rational expectations requires $g_c^\star$ to be the policy associated with $\mathcal{L}^c$

Definition

Given an announcement c, a *continuation equilibrium* is a pair $(\mathcal{L}^c, g_c^\star)$ such that

- $\mathcal{L}^c$ is the rational type's value function at expectations $g_c^\star$
- $g_c^\star$ is the policy function associated with $\mathcal{L}^c$

Observation

- Plans $c \in \mathcal{C}$ are

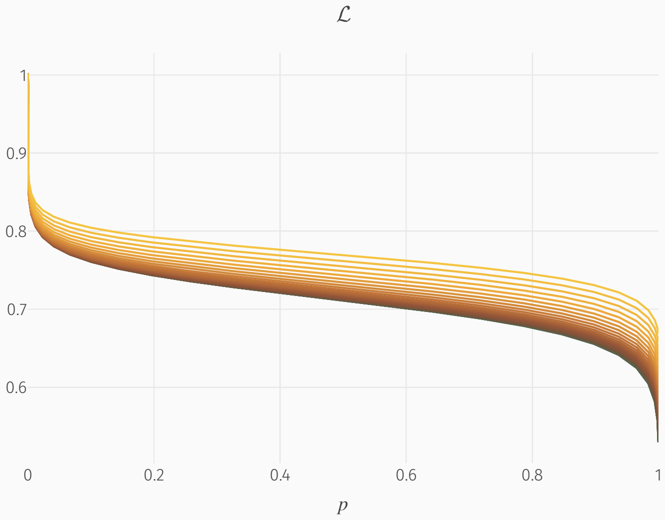
$$c = (a_0, \chi, \omega)$$

- For $a, b \in \mathbb{R}$

$(\mathcal{L}, g^\star)$ is a continuation equilibrium for (a, χ, ω) $\iff$ $(\mathcal{L}, g^\star)$ is a continuation equilibrium for (b, χ, ω)

- Means $a \mapsto \mathcal{L}^c(p, a)$ compares the same plan at **different** times and **different** plans

Results



- $\mathcal{L}$ decreasing in p
- $\mathcal{L}$ convex-concave in p
- $\mathcal{L}$ increasing in a for large p only

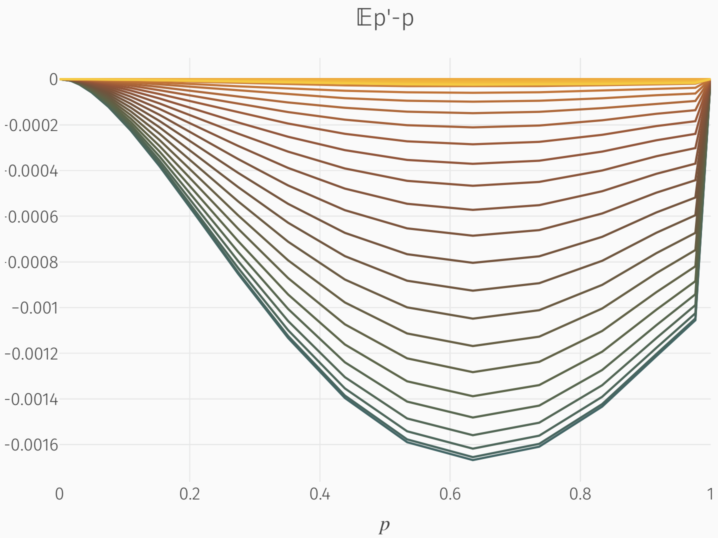
Lemma 1 ▸ Idea

In any continuation equilibrium,

$$\mathbb{E}_t\left[p_{t+1} \mid \text{rational}\right] \leq p_t$$

So $\{p_t\}_t$ is a supermartingale

Results



𝔼p'-p
0
-0.0002
-0.0004
-0.0006
-0.0008
−0.001
−0.0012
−0.0014
−0.0016
0
0.2
0.4
0.6
0.8
1
p

From the Phillips curve

$$\frac{\partial y}{\partial \pi} = \frac{1}{\kappa}\left[1 - \beta\frac{\partial p'}{\partial \pi}\left(\phi_c(a) - g^\star(p', \phi_c(a)) + (1-p')\frac{\partial g^\star(p', \phi_c(a))}{\partial p'}\right)\right]$$

- More inflation
  1. Increases output by $\frac{1}{\kappa}$
  2. Shifts inflation expectations from $\phi_c(a)$ towards $g^\star(p', \phi_c(a))$

     ... p' decreases with higher π when $g^\star(p, a) > a$
  3. Shifts expectations of the rational type's future choice

Incentives

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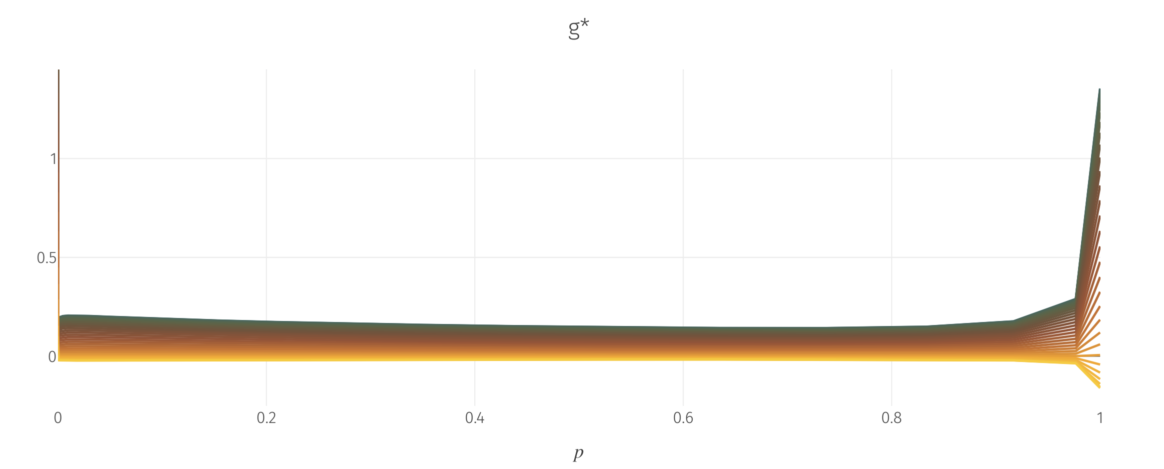
g*
1
0.5
0
0
0.2
0.4
0.6
0.8
1
p

Conjecture

- Let π^N be the Nash equilibrium inflation of the stage game. Then

$$\forall c \in \mathcal{C} : \qquad g_c^\star(p, a) \leq \pi^N$$

- This makes us define the *remaining credibility* of a plan as

$$C(p, a; c) = \mathbb{E}\left[(1-\beta)\frac{\pi^N - \pi_t}{\pi^N - a} + \beta C(p_c'(p, a), \phi_c(a))\right]$$

Plans

Plans

- For each $c \in \mathcal{C}$, find $\mathcal{L}^c(p, a), g^\star_c(p, a)$.
- Generates big matrix $\mathcal{L}(p, a; \omega, \chi)$
- First pass: preferred plan at each p

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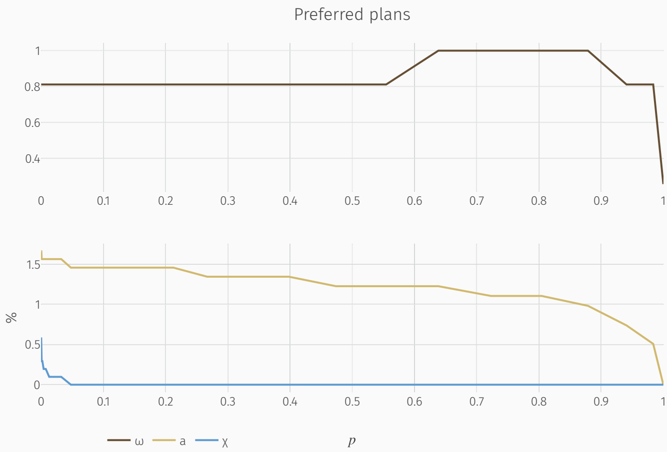

What plan to choose?

- Back to the initial announcement
- Ideally, if in equilibrium gov't announces type c with density $\mu(c)$,

$$p_0(c; z, \mu) = \frac{z\nu(c)}{z\nu(c) + (1 - z)\mu(c)}$$

- So study

$$\lim_{z \to 0} \min_{\mu} \int \mathcal{L}(p_0(a_0, \omega, \chi; z, \mu), a_0, \omega, \chi) d\mu$$

What plan to choose?

- Back to the initial announcement
- Today, Kambe (1999): gov't announces type c and 'becomes' committed to c with exogenous p_0 probability
  - Tractable: p_0 independent of c
- So the limit we consider is

$$\lim_{p_0 \to 0} \min_{a_0, \omega, \chi} \mathcal{L}(p_0, a_0, \omega, \chi)$$

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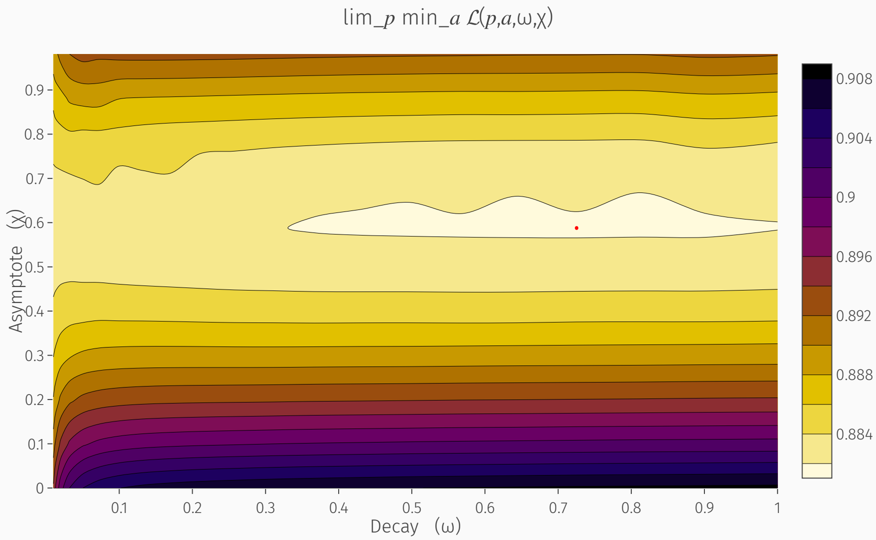
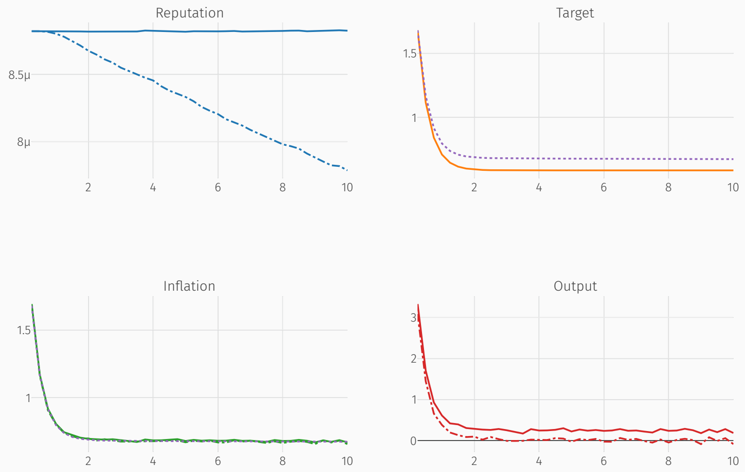
- Not entirely arbitrary
  - For given p_0, plans that minimize $\mathcal{L}$ should be played often

Results

▸ Associated a_O



Simulations



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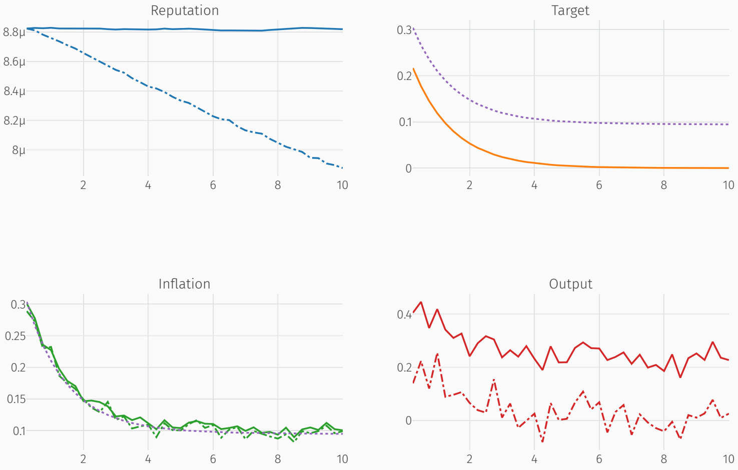


Conclusion

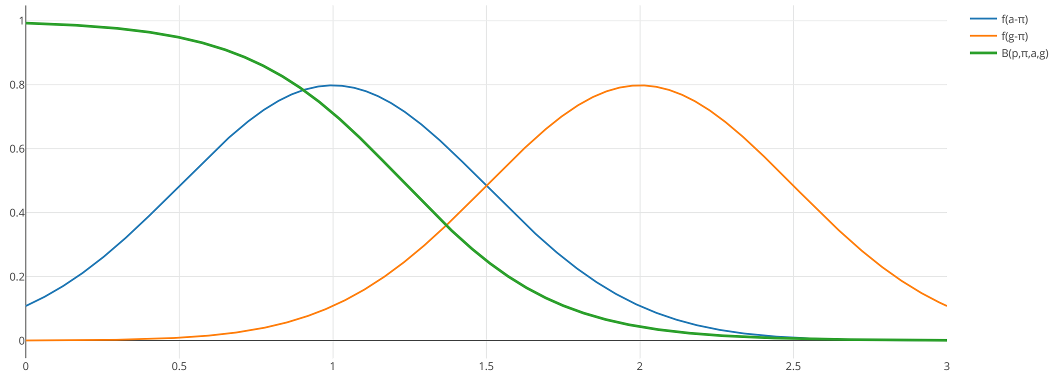
Concluding Remarks

- Model of reputational dynamics and policy
  - Simple environment
  - Focus on low reputation limit
- Credibility-dynamics concerns influence choice of policy
  - Tradeoff between literal **promises** and **incentives**
  - Gradual plans boost reputation-building incentives for future decision-makers
- To do:
  - Solve for complete distribution of mimicked types + take limit
  - Thousand extensions

Bayes' Law

Back

$$\mathcal{B}(p,\pi,a,g) = p + p(1-p)\frac{f_\epsilon(\pi-a) - f_\epsilon(\pi-g)}{pf_\epsilon(\pi-a) + (1-p)f_\epsilon(\pi-g)}$$



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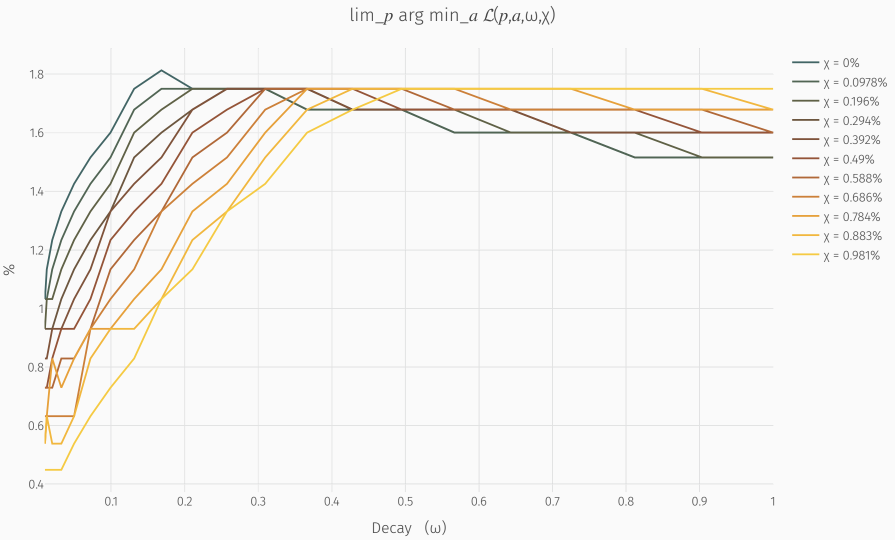

Reputation (Kreps and Wilson, 1982; Milgrom and Roberts, 1982)

Back

Imagine an incumbent facing a sequence of potential entrants

- Each period, entrant decides entry, incumbents **fights** or **accomodates**
  - Incumbent prefers entrant to stay out but prefers to accomodate if entry
- Fighting the first entrant doesn't affect the decision of following entrants

- Reputation as incomplete information
  - What if the incumbent could be behavioral and always produce q upon entry?
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