

# Seminar 9. Incomplete information in Static Games

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## 1 Problem 1 - Bayesian normal form and NE

Consider the following two normal form games. Assume that **only player 1 knows** which game is being played, while player 2 thinks that the two games are **equally likely**.

Game 1

	$L$	$R$
$U$	0,0	4,2
$D$	2,6	0,8

Game 2

	$L$	$R$
$U'$	0,2	0,0
$D'$	2,0	2,2

### (a) Bayesian normal form

Model this situation in an *ex ante* perspective by specifying the Bayesian normal form.

Who has contingent strategies?

- Player 1 has private information (Game 1 or Game 2 is played), therefore has  $2 \times 2 = 4$  types of contingent strategies,
- Player 2 doesn't know either which game is played (incomplete) or how player 1 moves (static), thus can only choose  $L$  or  $R$ .

	$L$	$R$
$UU'$	0,1	2,1
$UD'$	1,0	3,2
$DU'$	1,4	0,4
$DD'$	2,3	1,5

We calculate the payoff according to player 2's belief. For example, the payoff for  $(UU', L)$  is  $(0, 1)$ :

$$U^1 = 0.5 \times 0 + 0.5 \times 0 = 0$$

$$U^2 = 0.5 \times 0 + 0.5 \times 2 = 1$$

Note: the question is slightly different from those in Watson textbook.

In the textbook, it often says the nature moves with probability  $(Pr_1, Pr_2)$ , i.e. both of the two players have expected payoff. Here only player 2 has to guess, while player 1 doesn't need to.

Although the question can be solved in the same way, you may wonder if it's reasonable to calculate player 1's "expected payoff" according to player 2's belief.

**The payoff in the Bayesian normal form is actually player 2's imagination.**

- Player 2 believes player 1 has the expected payoff  $U^1 = 0.5 \times \dots + 0.5 \times \dots$ , and player 1 knows what player 2 believes.
- In the view of player 1, there is actually no expected payoff, since the which game to play is determined for him/her.

We calculate player 1's "expected payoff" according to player 2's belief for 2 reasons:

- Player 2 believes player 1 has this payoff, and acts according to it. This will in return affect player 1's behavior.
- Even though player 1's "expected payoff" is calculated by  $U^1 = 0.5 \times \dots + 0.5 \times \dots$ , what it reflects is actually his/her preference given which game is played. For example:
  - We know if Game 1 is played and player 2 chooses L, then  $D \succsim U$  for player 1.
  - In the Bayesian normal form, this preference is reflected by: if player 2 chooses L,  $DU' \succsim UU'$ ,  $DD' \succsim UD'$ , i.e. no matter  $U'$  or  $D'$  is chosen in Game 2, once Game 1 is played and player 2 chooses L,  $D \succsim U$ .

(Actually player 1's preference can be preserved by any belief  $(0 < Pr < 1)$  of player 2.)

Anyway, the method is the same, simply calculate the expected payoff according to the belief for both of the two players.

## (b) NE

For the Bayesian normal form found in part (a), determine a NE. Is there more than one NE?  $(UD', R)$  is the unique NE.

$DU'$  is dominated by  $DD' \Rightarrow L$  is dominated by  $R \Rightarrow UD'$  dominates the rest 2 strategies. Dominated strategies can't be BR and should be assigned with probability 0.

## 2 Problem 2 - Bayesian normal form

Consider the following two variants of a battle-of-the-sexes game. The game at the top – variant (i) – is of the usual kind where both players wish to meet each other, while the one at the bottom – variant (ii) – has the unusual feature that 1 wishes to avoid 2.

		Variant (i)	
		$P_2$ $q$ $O$ $1-q$ $M$	
$P_1$	$p$ $O$	3, 1	0, 0
	$1-p$ $M$	0, 0	1, 3

		Variant (ii)	
		$P_2$ $q$ $O$ $1-q$ $M$	
$P_1$	$p$ $O'$	0, 1	3, 0
	$1-p$ $M'$	1, 0	0, 3

## (a) NE - static & complete information

For each of these games, determine the set of (pure) rationalizable strategies for each player, and the set of pure-strategy and/or mixed-strategy NE.

All strategies are rationalizable.

Recall: Rationalizable strategies (Watson pp.70): The set of strategies that survive iterated dominance is therefore called the rationalizable strategies. Here all strategies can be BR (= UD for 2-player games).

**Variant (i)** has 2 pure NE  $(O, O)$ ,  $(M, M)$ , and a mixed NE  $((\frac{3}{4}, \frac{1}{4}), (\frac{1}{4}, \frac{3}{4}))$ .

To derive the mixed-strategy NE, let  $p$  be the probability of  $P_1$  choosing  $O$  and  $q$  be the probability of  $P_2$  choosing  $O$ .

$$U_O^1 = 3q$$

$$U_M^1 = 1 - q$$

$$U_O^1 = U_M^1 \Rightarrow 3q = 1 - q \Rightarrow q = \frac{1}{4}$$

$$U_O^2 = p$$

$$U_M^2 = 3(1 - p)$$

$$U_O^2 = U_M^2 \Rightarrow p = 3(1 - p) \Rightarrow p = \frac{3}{4}$$

**Variant (ii)** has no pure NE but a mixed NE  $((\frac{3}{4}, \frac{1}{4}), (\frac{3}{4}, \frac{1}{4}))$ .

To derive the mixed-strategy NE in variant (ii), let  $p$  the probability of 1 choosing  $O'$  and  $q$  being the probability of 2 choosing  $O$ .

$$U_O^1 = 3(1 - q)$$

$$U_M^1 = q$$

$$U_O^1 = U_M^1 \Rightarrow 3(1 - q) = q \Rightarrow q = \frac{3}{4}$$

$$U_O^2 = p$$

$$U_M^2 = 3(1 - p)$$

$$U_O^2 = U_M^2 \Rightarrow p = 3(1 - p) \Rightarrow p = \frac{3}{4}$$

Recall: why players are indifferent between O and M in a Mixed strategy?

## (b) Bayesian normal form

Assume next that only player 1 knows which game is being played, while player 2 thinks that the two games are equally likely. Model this situation in an *ex ante* perspective by specifying the Bayesian normal form.

Think: Who has private information and therefore contingent strategies?

Payoff is calculated similarly to Question 1. For example, for  $(OO', O)$  is  $(\frac{3}{2}, 1)$ :

$$U^1 = 0.5 \times 3 + 0.5 \times 0 = \frac{3}{2}$$

$$U^2 = 0.5 \times 1 + 0.5 \times 1 = 1$$

	$O$	$M$
$OO'$	$\frac{3}{2}, 1$	$\frac{3}{2}, 0$
$OM'$	$2, \frac{1}{2}$	$0, \frac{3}{2}$
$MO'$	$0, \frac{1}{2}$	$2, \frac{3}{2}$
$MM'$	$\frac{1}{2}, 0$	$\frac{1}{2}, 3$

### (c) Rationalizable strategies and NE

For the Bayesian normal form found in part (b), determine the set of (pure) rationalizable strategies for each player, and the set of pure-strategy and/or mixed-strategy NE.

$MM'$  is dominated by  $OO'$ . All the other strategies are rationalizable.

**NE:**  $(MO', M)$ ,  $((\frac{1}{2}, \frac{1}{2}, 0, 0), (\frac{3}{4}, \frac{1}{4}))$ , and  $((\frac{1}{2}, 0, \frac{1}{2}, 0), (\frac{1}{4}, \frac{3}{4}))$ .

For mixed strategy,  $P_1$  chooses strategies among (note  $MM'$  is dominated and can't be chosen):

$$\begin{cases} OO' \\ OM' \\ MO' \end{cases}$$

There are 4 possible combinations:

$$(1) \begin{cases} OO' \\ OM' \end{cases} \quad (2) \begin{cases} OM' \\ MO' \end{cases} \quad (3) \begin{cases} OO' \\ MO' \end{cases} \quad (4) \begin{cases} OO' \\ OM' \\ MO' \end{cases}$$

Let  $q$  being the probability of  $P_2$  choosing  $O$ .

$$\begin{aligned} U_{OO'}^1 &= \frac{3}{2}q + \frac{3}{2}(1-q) = \frac{3}{2} \\ U_{OM'}^1 &= 2q + 0 \times (1-q) = 2q \\ U_{MO'}^1 &= 0 \times q + 2(1-q) = 2(1-q) \end{aligned}$$

(1) If  $P_1$  mixes  $OO'$  and  $OM'$  with probability  $(p, 1-p)$

For  $P_1$ :

$$U_{OO'}^1 = U_{OM'}^1 \Rightarrow \frac{3}{2} = 2q \Rightarrow q = \frac{3}{4}$$

For  $P_2$ :

$$\begin{aligned} U_O^2 &= p + \frac{1}{2}(1-p) \\ U_M^2 &= 0 \times p + \frac{3}{2}(1-p) = \frac{3}{2}(1-p) \\ U_O^2 = U_M^2 &\Rightarrow p + \frac{1}{2}(1-p) = \frac{3}{2}(1-p) \Rightarrow p = \frac{1}{2} \end{aligned}$$

The NE is  $[(\frac{1}{2}, \frac{1}{2}, 0, 0), (\frac{3}{4}, \frac{1}{4})]$

Note how we assign 0 probability to the strategies  $P_1$  doesn't choose.

(2) If  $P_1$  mixes  $OM'$  and  $MO'$  with probability  $(p, 1 - p)$

For  $P_2$ , facing with  $P_1$ 's mixed strategy,  $M$  dominates  $O$  (therefore  $q = 1$ ). The mixed strategy brokes down.

(3) If  $P_1$  mixes  $OO'$  and  $MO'$  with probability  $(p, 1 - p)$

For  $P_1$ :

$$U_{OO'}^1 = U_{MO'}^1 \Rightarrow \frac{3}{2} = 2(1 - q) \Rightarrow q = \frac{1}{4}$$

For  $P_2$ :

$$U_O^2 = p + \frac{1}{2}(1 - p)$$

$$U_M^2 = 0 \times p + \frac{3}{2}(1 - p) = \frac{3}{2}(1 - p)$$

$$U_O^2 = U_M^2 \Rightarrow p + \frac{1}{2}(1 - p) = \frac{3}{2}(1 - p) \Rightarrow p = \frac{1}{2}$$

The NE is :  $[(\frac{1}{2}, 0, \frac{1}{2}, 0), (\frac{1}{4}, \frac{3}{4})]$

(4) If  $P_1$  mixes  $OO'$ ,  $OM'$  and  $MO'$  with probability  $(m, n, 1 - m - n)$

There must be  $U_{OO'}^1 = U_{OM'}^1 = U_{MO'}^1$ .

From (1) and (3) we already know  $P_1$ 's belief (i.e.  $P_2$  chooses  $O$  with  $Pr = q$  and  $M$  with  $Pr = 1 - q$ ) supporting  $U_{OO'}^1 = U_{OM'}^1$  is different from his/her belief supporting  $U_{OO'}^1 = U_{MO'}^1$ . Therefore there is no such a brief that supports  $U_{OO'}^1 = U_{OM'}^1 = U_{MO'}^1$ .

### 3 Problem 3 - Rationalizability in incomplete information games

(Watson Exercise 26.3, solution is on pp. 469-470)

Suppose that nature selects A with probability  $1/2$  and B with probability  $1/2$ . If nature selects A, then players 1 and 2 interact according to matrix "A." If nature selects B, then the players interact according to matrix "B." These matrices are pictured here. Suppose that, before the players select their actions, player 1 observes nature's choice. That is, **player 1 knows from which matrix the payoffs are drawn**, and player 1 can condition his or her decision on this knowledge. Player 2 does not know which matrix is being played when he or she selects between L and R.

		2	
		L	R
1	U	2, 2	0, 0
	D	0, 0	4, 4

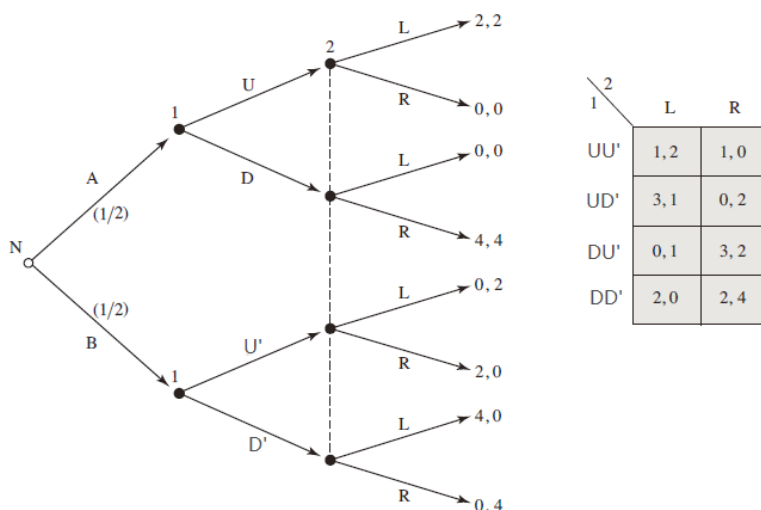
**A**

		2	
		L	R
1	U'	0, 2	2, 0
	D'	4, 0	0, 4

**B**

#### (a) Representation, rationalizability and NE

(1) Draw the extensive-form and Bayesian normal form.



Note, the dashed line passes through all the four nodes, meaning player 2 doesn't know either which game is played (incomplete) or how player 1 moves (static), thus can only choose  $L$  or  $R$ .

## (2) Compute the set of rationalizable strategies and NE

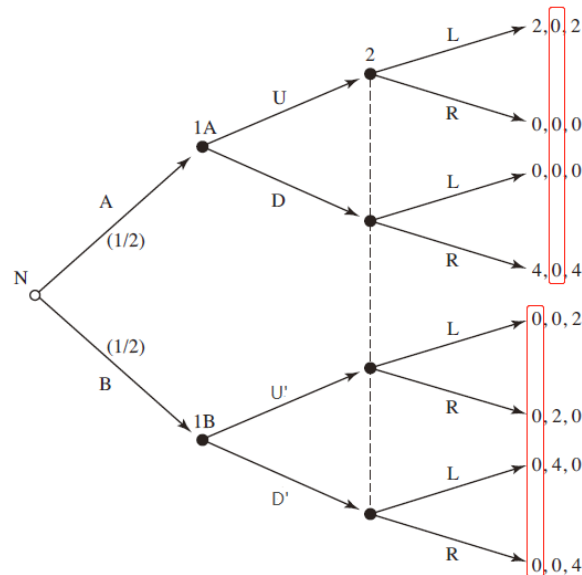
$UU'$  is dominated by  $DD'$ , then  $L$  is dominated by  $R$ . In the end, only  $(DU', R)$  survives iterated dominance method.

Therefore the set of rationalizable strategies is  $\{(DU', R)\}$ . The only NE is  $(DU', R)$

## (b) A three-player interpretation

Consider a three-player interpretation of this strategic setting in which each of player 1's types is modeled as a separate player. That is, the game is played by players 1A, 1B, and 2. Assume that player 1A's payoff is zero whenever nature chooses B; likewise, player 1B's payoff is zero whenever nature selects A. Depict this version of the game in the **extensive form** (remember that payoff vectors consist of three numbers) and in the **normal form**. Compute the set of **rationalizable strategies** and find the NE.

Extensive form:



Player 2 doesn't know who he/she is playing with.

Note also when Player 1A (1B) is reached, the payoff for 1B (1A) is 0 (in red frame).



Normal form:

		1B	
		U'	D'
1A	U	1, 0, 2	1, 2, 1
	D	0, 0, 1	0, 2, 0

		1B	
		U'	D'
1A	U	0, 1, 0	0, 0, 2
	D	2, 1, 2	2, 0, 4

### Rationalizable strategies

When player 2 choose L, the BR for player 1B is  $D'$  (dominates  $U'$ ), and the BR for player 1A is  $U$  (dominates  $D$ ).

When player 2 choose R, the BR for player 1A is  $D$  (dominates  $U$ ), and the BR for player 1B is  $U'$  (dominates  $D'$ ).

As a result, all find the NE

Although there are 3 players, player 2 still doesn't know who he/she is playing with. As a result, the payoff is in player 2's imagination, and player 1A,1B know how player 2 thinks clearly (an *ex ante* perspective).

You can also draw the normal form the way on Geir's slides (lecture part 5, pp.5), i.e. draw the matrix for player 1B and player 2, and player 1A joins as another player.

- We use the textbook's way because it makes the next question more clearly,
- Note also the difference between the textbook and Geir's slides:
  - The textbook calculates expected payoff for all the 3 players, It's more intuitive and can get the correct Bayesian NE.
  - The slides pp.5 is an *ex post* perspective, and the payoff for player 1A and 1B is not expected payoff but what they can really get. The result should be the same.
  - More about *ex post* and *ex ante* perspective can be found [here](#).

(c)

Explain why the predictions of parts (a) and (b) are the same in regard to equilibrium but different in regard to rationalizability. (Hint: The answer has to do with the scope of the players' beliefs.)

n the Bayesian normal form (which is analyzed in (a)),  $Dd$  strictly dominates  $Uu$ . That means that  $Dd$  is better than  $Uu$  independently of what beliefs player 1 has about the choice of player 2. Note that the two types of player 1 have the same belief of what player 2 will do.

In the 3-player version in (b),

type A of player 1 prefers  $U$  to  $D$  if he believes player 2 will choose  $L$ , and type B of player 1 prefers  $u$  to  $d$  if he believes player 2 will choose  $R$ . So they may end up making  $U$  and  $u$  as rational choices, since they may believe that player 2 does different things.

This does not matter for equilibrium since the two types of player 1 always believes in equilibrium that player 2 will choose his equilibrium strategy.

In the "3-player view", player 1A and 1B game with each other as separate individuals. Without thinking about player 1, player 1A and 1B

## 4 Problem 4 - Differentiated duopoly

(Watson Exercise 26.5, solution is on pp. 470.)

Consider a differentiated duopoly market in which firms compete by selecting prices and produce to fill orders. Let  $p_1$  be the price chosen by firm 1 and let  $p_2$  be the price of firm 2. Let  $q_1$  and  $q_2$  denote the quantities demanded (and produced) by the two firms. Suppose that the demand for firm 1 is given by  $q_1 = 222p_1 + p_2$ , and the demand for firm 2 is given by  $q_2 = 222p_2 + p_1$ . Firm 1 produces at a constant marginal cost of 10 and no fixed cost. Firm 2 produces at a constant marginal cost of  $c$  and no fixed cost. The payoffs are the firms' individual profits.

### (a) payoff functions

The firms' strategies are their prices. Represent the normal form by writing the firms' payoff functions.

$$\begin{aligned} U^1 &= p_1 q_1 - 10 q_1 \\ &= p_1 (222p_1 + p_2) - 10(222p_1 + p_2) \\ &= 222p_1^2 - 2p_1^2 + p_1 p_2 - 2220 + 20p_1 - 10p_2 \\ &= -2p_1^2 + p_1 p_2 + 42p_1 - 10p_2 - 220 \end{aligned}$$

$$\begin{aligned} U^2 &= p_2 q_2 - c q_2 \\ &= p_2 (222p_2 + p_1) - c(222p_2 + p_1) \\ &= 222p_2^2 - 2p_2^2 + p_1 p_2 - 222c + 2c p_2 - c p_1 \\ &= -2p_2^2 + p_1 p_2 - c p_1 + (22 + 2c)p_2 - 22c \end{aligned}$$

### (b) Calculate the firms' best-response functions.

FOC:

$$\frac{\partial U^1}{\partial p_1} = 0 \Rightarrow -4p_1^* + 42 + p_2 = 0 \Rightarrow p_1^* = \frac{42 + p_2}{4}$$

SOC:

$$\frac{\partial^2 U^1}{\partial p_1^2} = -4 < 0$$

FOC:

$$\frac{\partial U^2}{\partial p_2} = 0 \Rightarrow -4p_2^* + 22 + 2c + p_1 = 0 \Rightarrow p_2^* = \frac{22 + 2c + p_1}{4}$$

SOC:

$$\frac{\partial^2 U^2}{\partial p_2^2} = -4 < 0$$

For payoff functions, we use FOC & SOC to find the BR functions. Be clear about what is variable and what is parameter. See also seminar 7 problem 3.

### (c) Complete information

Suppose that  $c = 10$  so the firms are identical (the game is symmetric). Calculate the NE prices.

When  $c = 10$ , we have:

$$p_1^* = \frac{42 + p_2}{4}$$
$$p_2^* = \frac{42 + p_1}{4}$$

NE is a price s.t. both of the two firms are applying BR and there is no incentive to deviate. That is,  $p_1^* = \frac{42 + p_2^*}{4} = \frac{42 + \frac{42 + p_1^*}{4}}{4}$  (or  $p_2^* = \frac{42 + p_1^*}{4}$ ). Therefore  $p_1^* = p_2^* = 14$ .

### (d) Incomplete information

Now suppose that firm 1 does not know firm 2's marginal cost  $c$ . With probability 1/2 nature picks  $c = 14$ , and with probability 1/2 nature picks  $c = 6$ . **Firm 2 knows** its own cost (that is, it observes nature's move), but firm 1 only knows that firm 2's marginal cost is either 6 or 14 (with equal probabilities). Calculate the best-response functions of player 1 and the two types ( $c = 6$  and  $c = 14$ ) of player 2 and calculate the Bayesian NE quantities.

With different MC, firm 2 can set different (contingent) price. Denote the price when  $MC_2 = 14$  as  $p_2^H$ , and the price when  $MC_2 = 6$  as  $p_2^L$ .

While firm 1 can only set one price according to its expected payoff function.

(Compare this with the extensive form games in this seminar. Always be clear about who has contingent strategies!)

For player 2:

(1) When  $c = c^H = 14$

(I omitted the superscript <sup>H</sup> of  $p_2$  and  $c$  for simplicity.)

$$\begin{aligned} U^{2H} &= -2p_2^2 + p_1 p_2 - c p_1 + (22 + 2c)p_2 - 22c \quad (\text{the result from question a.}) \\ &= -2p_2^2 + p_1 p_2 - 14p_1 + 50p_2 - 22 \times 14 \end{aligned}$$

FOC:

$$\frac{\partial U^{2H}}{\partial p_2} = 0 \Rightarrow -4p_2^{H*} + 50 + p_1 = 0 \Rightarrow p_2^{H*} = \frac{50 + p_1}{4}$$

SOC:

$$\frac{\partial^2 U^{2H}}{\partial p_1^2} = -4 < 0$$

(2) When  $c = c^L = 6$

(I omitted the superscript <sup>L</sup> of  $p_2$  and  $c$  for simplicity.)

$$\begin{aligned} U^{2L} &= -2p_2^2 + p_1 p_2 - c p_1 + (22 + 2c)p_2 - 22c \quad (\text{the result from question a.}) \\ &= -2p_2^2 + p_1 p_2 - 6p_1 + 34p_2 - 22 \times 6 \end{aligned}$$

FOC:

$$\frac{\partial U^{2L}}{\partial p_2} = 0 \Rightarrow -4p_2^{L*} + 34 + p_1 = 0 \Rightarrow p_2^{L*} = \frac{34 + p_1}{4}$$

SOC:

$$\frac{\partial^2 U^{2L}}{\partial p_1^2} = -4 < 0$$

$$\begin{aligned} E(U^1) &= 0.5U^1(p_1, p_2^H) + 0.5U^1(p_1, p_2^L) \\ &= 0.5(-2p_1^2 + p_1 p_2^H + 42p_1 - 10p_2^H - 220) + 0.5(-2p_1^2 + p_1 p_2^L + 42p_1 - 10p_2^L - 220) \\ &= -2p_1^2 + 42p_1 + (p_1 - 10)(0.5p_2^H + 0.5p_2^L) - 220 \end{aligned}$$