Debt, Inflation, And Government Reputation

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Motivation Mexico LATAM

- For a broader set of emerging economies, the correlation between inflation and public real debt has declined.

$$\pi_t^c = \beta_0 + \beta_1 b_t^c + \lambda_t + \mu_c + \epsilon_t^c,$$

	1970-2000	2000-2023	Last 5 Years
Corr. Debt and Inflation	0.87 (0.18)	0.14 (0.04)	0.38 (0.05)

- In addition, both debt and inflation became more persistent.
- Previous literature: implementation of reforms such as Central Bank independence and inflation targeting.

Motivation

FINANCIAL TIMES

"Central banks warn over surge in global sovereign debt levels"

THE WALL STREET JOURNAL.

Rising Government Debt Threatens Financial Stability, Inflation, BIS Says

OXFORD ECONOMICS

How Inflation eroded governments' debts and why it matters |

IMF BLOG

The Fiscal and Financial Risks of a High-Debt, Slow-Growth World

My Proposal

- I propose a theory that highlights the role of government reputation to determine inflation-debt dynamics.

- Game between private agents and a **consolidated government**, which makes decisions on both inflation and debt.
  - I add fiscal considerations to Barro and Gordon (1983)'s monetary game.
  - Debt becomes a state variable that influences the game.

- Agents are uncertain about the type of government they face:
  1. Prudent: generates low inflation with low debt levels.
  2. Imprudent: generates high inflation with high debt levels.

- **Government Reputation: probability agents assign to be facing a government that is committed to low inflation.**

My Proposal

- Reputation is an endogenous outcome, based on the observed history of government actions.
- Two state variables: debt and government reputation.
  - The government must decide whether to use inflation to dilute debt or increase its reputation.
  - Whenever reputation is low and debt is high: the government will favor inflation to dilute debt, even at a reputational cost.
  - Whenever reputation is high and debt is high: the government favors low inflation to mantain its reputation, even at the cost of higher debt.
- **My theory explains why the correlation between debt and inflation vary over time, as a function of an endogenous variable: government reputation.**
  - No need of regime/type changes as in previous literature.

Model

- Two players:
  1. Continuum of monopolistically competitive wage setters, who aim to have a constant real wage over time.
  2. A government who has output, inflation, and debt targets.
- Time is discrete $t = 1, 2, 3, \ldots$
- In each period, both players choose their actions simultaneously:
  1. Wage setter $i \in [0, 1]$ choose w_t^i.
  2. The government chooses inflation (π_t) and deficit (d_t).
- The choice of these variables determines the aggregate wage w_t, price level p_t, output y_t, and the evolution of debt in the economy b_t.

Model

- The government has its desired inflation and deficit levels, however, the economy may be influenced by exogenous factors that affect these variables.
- Hence, the realized inflation and deficits levels are given by:

$$\tilde{\pi} = \pi + \epsilon_{\pi}, \quad \tilde{d} = d + \epsilon_{d},$$

  where ϵ_x are i.i.d. random variables with mean zero and variance $\sigma_x^2 \geq 0$.

- Whenever $\sigma_x^2 = 0$, I say that the government is in perfect control over variable $x \in \{\pi, d\}$.

Model: Government Reputation

- Wage setters do not know the type of government they are facing.
- The government may be of two types:
  1. Type P (Prudent): a government that cares about having both low inflation and low debt levels.
  2. Type I (Imprudent): a government that cares less about maniging debt and inflation.
- Let $\rho_0 \in [0, 1]$ be the prior probability that the government is of type P.
- Upon observing the history of policies implemented by the government, wage setters update their beliefs on the type of government they are facing.
  - Let ρ_t be the posterior belief that the government is of type P.
  - I will refer to this posterior as the current **government reputation**.

Model: Benchmark

- Complete information framework: no reputational concerns.
- Perfect control over inflation and deficit: $\sigma_\pi^2 = \sigma_d^2 = 0$.
- Dynamic game, since debt is a state variable.
- In every period, both players observe the entire history of policies implemented by the government as well as the wage setters' behavior up until that period.

Model: One Period Payoffs Role γ

- Wage setter $i \in [0,1]$ chooses w_t^i to maximize:

$$UW_t^i = -\left(\frac{w_t^i - p_t}{p_{t-1}}\right)^2 = -(\pi_t^{e,i} - \pi_t)^2,$$

where $\pi_t = (p_t - p_{t-1})/p_{t-1}$, $\pi_t^{e,i} = (w_t - p_{t-1})/p_{t-1}$. WS Problem

- Government chooses π_t, d_t: G Problem

$$UG_t = -(y_t - k\bar{y})^2 - s(\pi_t - \bar{\pi})^2 - \gamma b_t^2,$$

where:

$$y_t = \bar{y} + \theta\left(\frac{p_t - w_t}{p_{t-1}}\right) + d_t = \bar{y} + \theta(\pi_t - \pi_t^e) + d_t,$$

$$b_t = d_t + \frac{(1+r)(1+\pi_t^e)b_{t-1}}{1+\pi_t} - \bar{m}\pi_t.$$

Model: Intertemporal Incentives

- Since there is a continuum of wage setters and the government only observes aggregate behavior, they choose their wage myopically.
- The government chooses inflation and debt taking into account future implications of its decisions.
  - The government discounts the future with factor $\delta \in [0, 1)$.

Equilibrium Definition Benchmark Game Existence

- I restrict attention to Markov strategies, which are functions of the current state of the economy.

Definition Non-Markovian Equilibria

A Markov perfect equilibrium of this game are functions (π^e, π, d) such that:

1. (π^e, π, d) are Markov strategies.
2. Given (π, d), wage setters choose π^e to maximize their payoffs. WS Problem
3. Given π^e, the government chooses (π, d) to maximize its payoffs. G Problem

Model: Government's Problem

- Given the current debt b and a conjecture on wage setters' behavior $\hat{\pi}^e$, the government's best reply is the solution of the following problem:

$$V(b) = \max_{\pi, d, b'} \quad (1-\delta)\left[-(y-k\bar{y})^2 - s(\pi-\pi^\star)^2 - \gamma(b')^2\right] + \delta V(b')$$

$$y = \bar{y} + \theta\left(\pi - \hat{\pi}^e(b)\right) + d,$$

$$b' = d + \frac{(1+r)(1+\hat{\pi}^e(b))b}{1+\pi} - \bar{m}\pi,$$

$$0 \leq b' \leq \bar{b}.$$

- This creates a mapping $\hat{\pi}^e(\cdot) \to \pi(\cdot)$, in which an equilibrium is a fixed point.

Equilibrium Characterization Benchmark Game

Proposition

In every Markov perfect equilibrium of this dynamic game:

1. $\pi^\star(\cdot)$ is an increasing function of b.
2. $d^\star(\cdot)$ is a decreasing function of b.
3. No surprise inflation: $\pi^{e\star}(b) = \pi^\star(b)$ for all b, which implies:

$$y = \bar{y} + \theta\left(\pi^\star(b) - \pi^e(b)\right) + d^\star(b) = \bar{y} + d^\star(b),$$

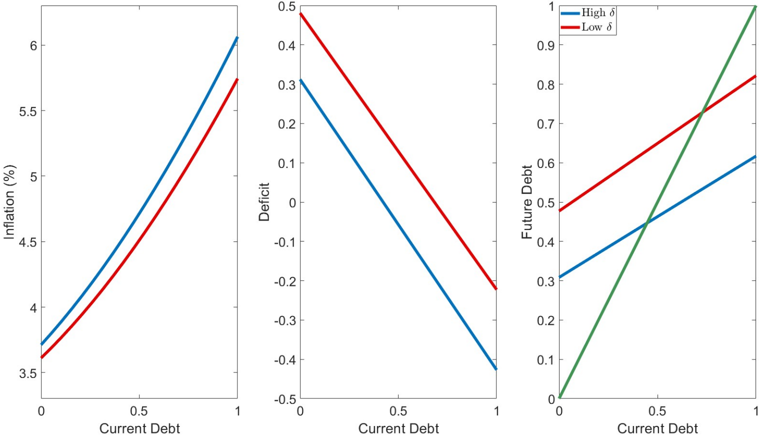
$$b' = d^\star(b) + \frac{(1+r)(1+\pi^e(b))b}{1+\pi^\star(b)} - \bar{m}\pi^\star(b) = d^\star(b) + (1+r)b - \bar{m}\pi^\star(b)$$

Two Important Parameters

- Now, I highlight the role of two parameters in the model: δ and s.
- The discount factor heavily influences debt dynamics.
- The disutility for inflation parameter s determines inflation dynamics.
- I use variation in both parameters to motivate the types of governments I consider in my reputation framework.

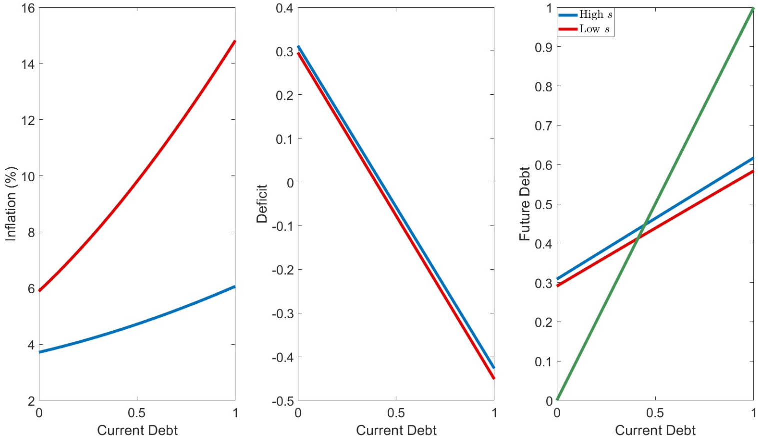
The Role of δ Details

$\delta = 0.1 < \delta = 0.9.$



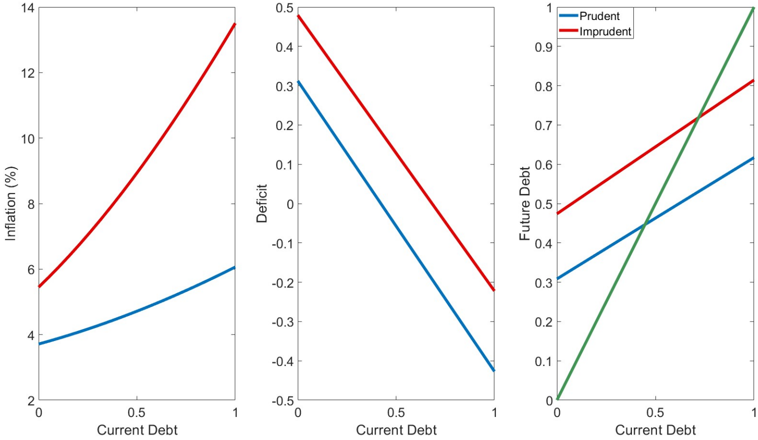
The Role of s Details

$s = 1 < s = 10.$



Prudent vs Imprudent Governments Details

$\delta = 0.1, s = 1 < \delta = 0.9, s = 10.$



Takeaways of Benchmark Game

- A government with higher δ generates a lower debt policy function and a lower long-run debt level.
- A government with higher s generates a lower inflation policy function and a lower long-run inflation level.
- This model can explain, by varying δ and s, how a government can generate high inflation with high debt levels, or low inflation with low debt levels.
- The model has problems in explaining why a government would generate low inflation with high debt levels as well as slow transition between regimes.
- Solution: introduce reputational concerns.

Reputation Framework

- Wage setters now interact with a government that may be of two types:
  1. Type P (Prudent): a government that has a discount factor $\delta_P \in (0, 1)$ and a disutility for inflation parameter s_P.
  2. Type I (Imprudent): a government that has a discount factor $\delta_I = 0 < \delta_P$ and $s_I < s_P$.

Reputation Framework: Perfect Control

- Perfect control: $\sigma_\pi^2 = \sigma_d^2 = 0$.
- Since in equilibrium wage setters know the action chosen by each type of government, then one of two things can happen:
  1. The two governments choose different policies, which allows wage setters to perfectly identify the type of government they are facing.
  2. The two government always choose the same policy, which makes it impossible for wage setters to identify the type of government they are facing.
- Hence, in order to have non-trivial reputation dynamics, I need to assume that there is an imperfect control over inflation and deficit.

Reputation Framework: Markov Strategies

- Once again, I restrict attention to analyze pure Markov strategies.
- In this dynamic game, there are two state variables:
  1. The current debt level b.
  2. Government reputation ρ, i.e., the belief of wage setters that the government is of type P given the observed history of play up until that point.

Reputation Framework: Type I's Problem

- Taking as given (b, ρ) and a conjecture on wage setters $\hat{\pi}^e$, the government of type I's best reply is characterized by the following problem:

$$V^I(b,\rho) = \max_{\pi, d, b'} \quad \mathbb{E}_{\epsilon_\pi, \epsilon_d}\left[-(\tilde{y} - k\bar{y})^2 - s_I(\tilde{\pi} - \bar{\pi})^2 - \gamma(\tilde{b}')^2\right],$$

$$\tilde{y} = \bar{y} + \theta\left(\tilde{\pi} - \hat{\pi}^e(b,\rho)\right) + \tilde{d},$$

$$\tilde{b}' = d + \frac{(1+r)(1+\hat{\pi}^e(b,\rho))b}{1+\tilde{\pi}} - \bar{m}\tilde{\pi},$$

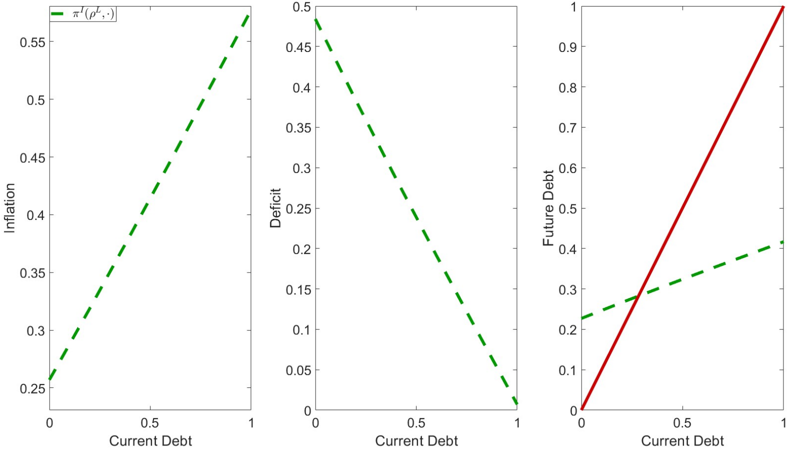
$$\tilde{\pi} = \pi + \epsilon_\pi,$$

$$\tilde{d} = d + \epsilon_d.$$

$$0 \leq \tilde{b}' \leq \bar{b}.$$

Reputation Framework: Type I's Behavior

- The imprudent government is myopic, but it is not a behavioral type, it's behavior is endogenous.



Reputation Framework: Type P's Problem

- Taking as given (b, ρ) and a conjecture on wage setters $\hat{\pi}^e$ as well as the behavior of the government of type I, the government of type P's best reply is characterized by the following problem:

$$V^P(b,\rho) =$$

$$\max_{\pi, d, b'} \quad \mathbb{E}_{\epsilon_\pi, \epsilon_d}\left[(1-\delta)\left[-(\tilde{y}-k\bar{y})^2 - s_P(\tilde{\pi}-\bar{\pi})^2 - \gamma(\tilde{b}')^2\right] + \delta V^P(b', \rho')\right],$$

$$\tilde{y} = \bar{y} + \theta\left(\tilde{\pi} - \hat{\pi}^e(b,\rho)\right) + \tilde{d},$$

$$\tilde{b}' = d + \frac{(1+r)(1+\hat{\pi}^e(b,\rho))b}{1+\tilde{\pi}} - \bar{m}\tilde{\pi},$$

$$\tilde{\pi} = \pi + \epsilon_\pi,$$

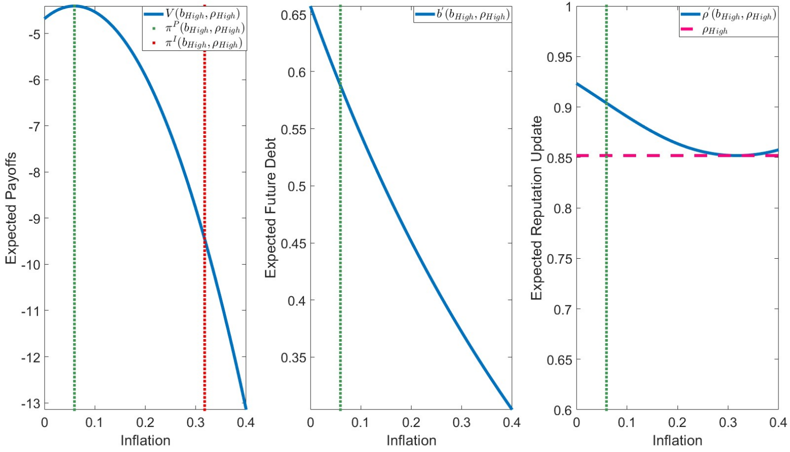
$$\tilde{d} = d + \epsilon_d,$$

$$0 \le \tilde{b}' \le \bar{b},$$

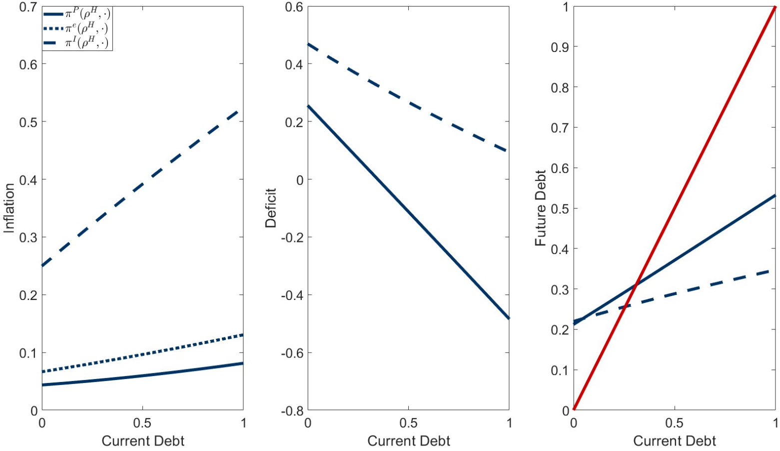
$$\rho' = \frac{\rho g_\pi(\tilde{\pi}-\pi)\, g_d\left(\tilde{d}-d\right)}{\rho g_\pi(\tilde{\pi}-\pi)\, g_d\left(\tilde{d}-d\right) + (1-\rho) g_\pi(\tilde{\pi}-\hat{\pi}^I)\, g_d\left(\tilde{d}-\hat{d}^I\right)}.$$

Reputation Framework: Equilibrium

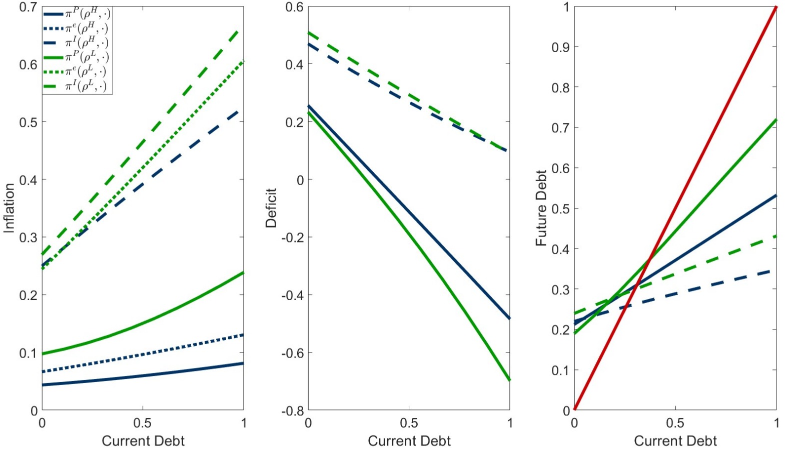
- The prudent government faces a trade-off of either increasing reputation or decreasing future debt.



Equilibrium: High Reputation



Equilibrium: High vs Low Reputation



Equilibrium: High vs Low Reputation

Low Reputation

- Why does a prudent government choose high inflation and deficit levels when it has low reputation?
- In equilibrium, whenever ρ is low, inflation expectations are close to $\pi^I(b,\rho)$.
- If the prudent government were to choose an inflation level that is considerably lower than $\pi^I(b,\rho)$, it would generate both a lower output and a higher debt:

$$y = \bar{y} + \theta\left(\pi^P(b,\rho) - \pi^e(b,\rho)\right) + d^P,$$

$$b' = d^P(b,\rho) + \frac{(1+r)(1+\pi^e(b,\rho))b_t}{1+\pi^P(b,\rho)} - \bar{m}\pi^P(b,\rho).$$

Reputation Framework: Equilibrium

Theorem Proof

In every Markov perfect equilibrium of this game:

1. For all (b, ρ):
$$\pi^e(b, \rho) = \rho\pi^P(b, \rho) + (1 - \rho)\pi^I(b, \rho).$$
2. The behavior of the prudent government has the following characteristics for all (b, ρ):
$$\frac{\partial \pi^P}{\partial b}(b, \rho) > 0, \quad \frac{\partial \pi^P}{\partial \rho}(b, \rho) < 0, \quad \frac{\partial^2 \pi^P}{\partial b \partial \rho}(b, \rho) < 0,$$
$$\frac{\partial d^P}{\partial b}(b, \rho) < 0 \text{ and } \frac{\partial d^P}{\partial \rho}(b, \rho) < 0.$$
3. Similar inflation and deficit dynamics for the imprudent government, as well as inflation dynamics for wage setters' equilibrium behavior.
4. For all (b, ρ) the actions chosen by each type of government are different.

Model Predictions and Mexican Data

- I analyze the time series data for Mexico through the lens of the model.
- I consider data on inflation and total public debt between 1970-2022.
- I present the model's predicted time series for government reputation, inflation expectations, output, and fiscal deficit.
- I calibrated the model choosing the parameter values that minimize the distance between the model's inflation expectations time series and the observed inflation time series.
- Then, I compare the model's predictions for deficit, output and expectations with the available data.

Model Predictions and Mexican Data

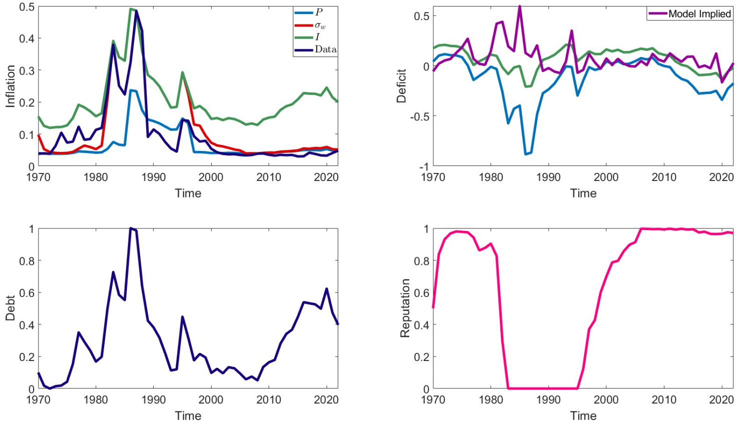
- Time series data $(\pi_t^{data}, b_t^{data})$ for Mexico between 1970-2022.
- For each period, I consider (b_t^{data}, ρ_t) to be the state and compute inflation expectations, inflation, and deficit choices for each government type.
- Hence, I construct the time series for $(\pi_t^P, \pi_t^I, d_t^P, d_t^I, \pi_t^e, \rho_{t+1})$ according to the model.
- For the fiscal deficit "data", I compute the fiscal deficit that is consistent with the model:

$$d_t = b_t^{data} + \bar{m}\pi_t^{data} - \frac{(1+r)\left(1+\pi_t^e(b_t^{data}, \rho_t)\right) b_{t-1}^{data}}{1+\pi_t^{data}}.$$

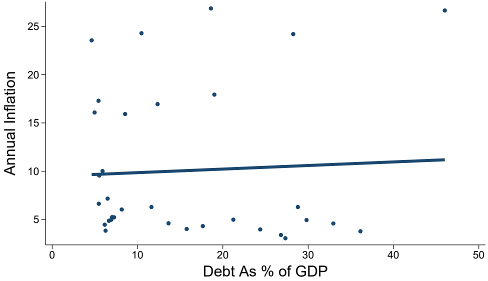
- For the reputation update, I considered the likelihood of receiving shocks of size $\pi_t^{data} - \pi_t^P(b_t^{data}, \rho_t)$, $d_t - d_t^P(b_t^{data}, \rho_t)$ vs $\pi_t^{data} - \pi_t^I(b_t^{data}, \rho_t)$, $d_t - d_t^I(b_t^{data}, \rho_t)$.

Model Predictions and Mexican Data

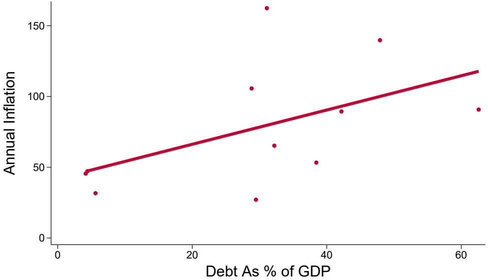
Parameter Values



Debt, Inflation, And Government Reputation in Mexico



High Reputation



Low Reputation

Key Takeaways of Reputation Model

- As reputation increases, we should expect a disconnection between inflation and debt.
- The value of reputation is crucial to determine government behavior.
  - Even a prudent government finds it optimal to choose high inflation and deficits when it has low reputation.
  - Importance of not only having high reputation, but also to mantain it.
- The transition during the 90s from elevated correlation between debt and inflation towards a lower relationship is more consistent with a regime change.
- However, the recent increase in this correlation is more consistent with a decrease in government reputation.

Debt, Inflation, And Government Reputation

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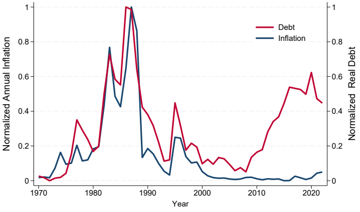
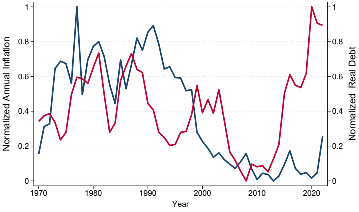
European Economic Association Congress, August 2025

Debt and Inflation in Latin America

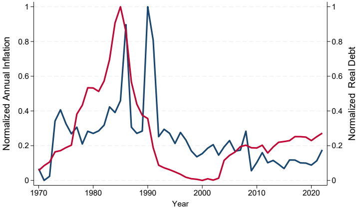
Back



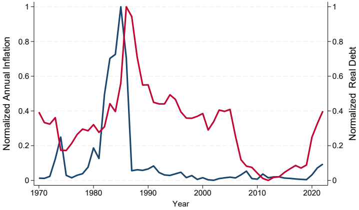
(a) Mexico.



(b) Colombia.



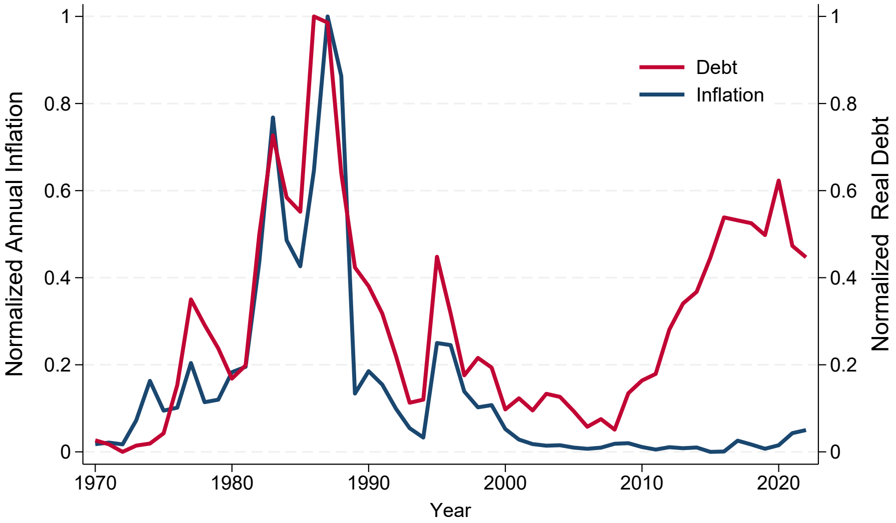
(c) Guatemala.



(d) Bolivia.

Debt and Inflation in Mexico

Back



Model: Wage Setters

- I model the labor market as a monopolistic competition market, in which there is a continuum of wage setters, indexed by $i \in [0, 1]$.
- Wage setter i chooses w_t^i having as an objective a constant real wage over time:

$$UW_t^i = -\left(\frac{w_t^i - p_t}{p_{t-1}}\right)^2.$$

- Each i knows their wage decision does not affect p_t, and hence their expected utility maximizing wage choice is i´s expected price level, $w_t^i = p_t^{e,i}$.
- Since, by assumption, every wage setter has the same information when deciding w_t, then $w_t = p_t^{e,i} = p_t^e$ for all i.

Model: Wage Setters Back

- If we define inflation as $\pi_t = (p_t - p_{t-1})/p_{t-1}$, and $\pi_t^{e,i} = (p_t^{e,i} - p_{t-1})/p_{t-1}$ then we can re-write the wage setters payoffs as:

$$UW_t^i = -\left(\frac{w_t^i - p_t}{p_{t-1}}\right)^2 = -\left(\frac{p_t^{e,i} - p_{t-1} + p_{t-1} - p_t}{p_{t-1}}\right)^2 = -(\pi_t^{e,i} - \pi_t)^2.$$

- From now on, I consider $\pi_t^{e,i}$ to be the relevant variable for wage setters, which is pin downed by their wage decision.

Model: Government Back

- The government makes decisions on both the fiscal and monetary aspects of the economy.
- Each period, the government inherits a debt level b_{t-1}, and must decide on the deficit level d_t (government expenditures minus income) and growth rate of money g_t.
- The government is interested in pegging output, inflation, and debt to a target level:

$$UG_t = -(y_t - k\bar{y})^2 - s(\pi_t - \bar{\pi})^2 - \gamma b_t^2,$$

where $k > 1, s > 0, \gamma > 0$, $\bar{y}$ is the natural output level, and $\bar{\pi}$ is the inflation target of the government.

Model: Output

Back

- Following the Neo-Keynesian tradition, output varies around a natural level $\bar{y}$.
- These fluctuations are driven by the labor market.
  - In an economy with sticky wages, higher prices attract more firms and workers to the market, increasing output.
- Hence, output is given by:

$$y_t = \bar{y} + \theta(p_t - w_t) + d_t = \bar{y} + \theta(\pi_t - \pi_t^e) + d_t,$$

where $\theta > 0$ measures the effect of the labor market on output.

Model: Evolution of Debt Back

- The evolution of government debt will be determined by:
  1. Real (primary) deficit d_t: the difference between government expenditures and income.
  2. Real service of debt: the amount of previous debt that the government must pay.
  3. Seigniorage: the revenue that the government gets from printing money.

- Importantly, according to the Fisher equation, the interest rate that the government faces is:

$$1 + i_t = (1 + r)(1 + \pi_t^e),$$

where $r > -1$ is the natural interest rate.

Model: Evolution of Debt Back

- The evolution of debt in real terms is given by:

$$b_t = d_t + \frac{(1+i_t)b_{t-1}}{1+\pi_t} - S_t = d_t + \frac{(1+r)(1+\pi_t^e)b_{t-1}}{1+\pi_t} - S_t.$$

- Then, higher inflation (as a result of higher money growth) generates a lower real interest rate and hence a higher seigniorage, which in turn will reduces the real value of debt.

Model: Restrictions on Debt Back

- I restrict debt to be non-negative, i.e., $b_t \geq 0$.
- Also, I assume that the government has a bound on the amount of debt it can issue $\bar{b}$. Restrictions
- I focus on the case $\bar{b}$ is large and not-binding, although future work where $\bar{b}$ is binding could be interesting.
- Let $\mathcal{D} = [0, \bar{b}]$ be the set of feasible debt levels.

Model: Real Balances Demand and Money Growth Back

- To close up the model, I need to specify how prices are determined.
- Again, following the Neo-Keynesian tradition, I assume that prices and money are related through a money demand function.
- To keep the model simple, I assume that the government faces the following money demand function:

$$\frac{m_t}{p_t} = \bar{m},$$

which has two implications:

1. $g_t - \pi_t = 0$, i.e., by choosing g_t the government is pinning down inflation.
2. Seigniorage is then given by $S_t = \bar{m}\pi_t$.

Model: Markov Strategies

Back

- I make a restriction to stationary Markov pure strategies.
  - Wage setters choose a strategy $\pi^e : \mathbb{R} \to \mathbb{R}$, where $\pi^e(b)$ represents inflation expectations upon observing a previous debt level b.
  - The government chooses $\sigma_g : \mathbb{R} \to \mathbb{R}^3$, where

    $$(\pi(b), d(b), b'(b))$$

    represent the inflation, deficit, and debt decisions upon observing b and given the strategy σ_w of wage setters.
- I restrict the strategy of wage setters to be a concave and twice differentiable function with uniformly bounded first derivatives.

Dynamic Game: Wage Setters' Problem Back

- Given the current debt b and a conjecture on government inflation behavior $\hat{\pi}$, the wage setters best reply is such that:

$$\pi^e(b) = \underset{\pi^e}{\operatorname{argmax}} \quad -(\pi^e - \hat{\pi}(b))^2.$$

Dynamic Game: Government's Problem Back

- Given the current debt b and a conjecture on wage setters' behavior $\hat{\pi}^e$, the government's best reply is the solution of the following problem:

$$V(b) = \max_{\pi, d, b'} \quad (1-\delta)\left[-(y - k\bar{y})^2 - s(\pi - \pi^\star)^2 - \gamma(b')^2\right] + \delta V(b')$$

$$y = \bar{y} + \theta\left(\pi - \hat{\pi}^e(b)\right) + d,$$

$$b' = d + \frac{(1+r)(1+\hat{\pi}^e(b))b}{1+\pi} - \bar{m}\pi,$$

$$0 \leq b' \leq \bar{b}.$$

Equilibrium Characterization Back

Proposition

In a Markov Perfect Equilibrium of this dynamic game:

1. No surprise inflation: $\pi^{e\star}(b) = \pi^{\star}(b)$ for all $b \in [0, \bar{b}]$.
2. $V^{\star}$ is a strictly concave and decreasing function of current debt $b \in [0, \bar{b}]$.
3. $\pi^{e\star}$ is an increasing function of $b \in [0, \bar{b}]$.
4. $\pi^{\star}(b)$ is an increasing and differentiable function of $b \in [0, \bar{b}]$.
5. $d^{\star}(b)$ is a decreasing and differentiable function of $b \in [0, \bar{b}]$.
6. Let $s > s'$. Then, $\pi^{\star}(b|s) \leq \pi^{\star}(b|s')$ for all $b \in [0, \bar{b}]$.
7. Let $k > k'$. Then, $\pi^{\star}(b|k) \geq \pi^{\star}(b|k')$ for all $b \in [0, \bar{b}]$.

Dynamic Game: Equilibrium Back

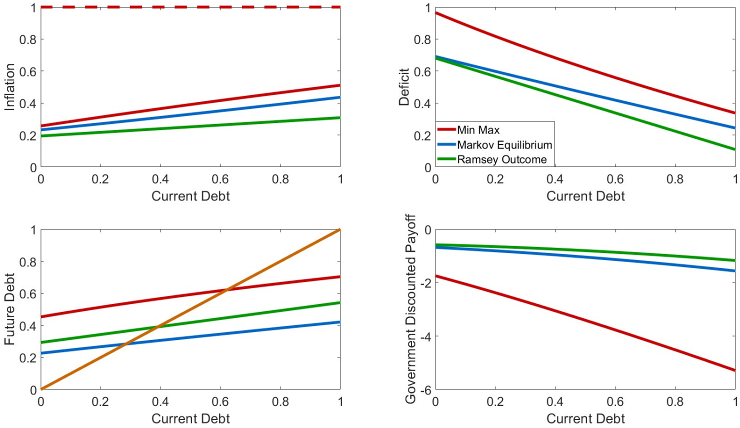
- Given σ_w, the government's (inflation) best reply is π.
- Under convexity and differentiability assumptions on σ_w, the government's best reply is unique.
- Therefore, the government's problem creates a best-reply mapping $\sigma_w \to \pi$.
- Given the utility of wage wetters $-(\pi - \pi^e)^2$, an equilibrium of this game is a fixed point of such mapping.
- Existence of such fixed point is guaranteed by the Schauder Fixed-Point Theorem.
- Equilibrium characterization can be done using the Implicit Function Theorem, the Envelope Theorem, and the Benveniste-Scheinkman Theorem.

Dynamic Game: Markov Equilibria Back

- Why focus on analyzing Markov equilibria?
- In dynamic games, strategies are more complicated objects than in repeated games, and they live in a "very large" space.
- Non-Markovian "easy" strategies in repeated games, like Grim Trigger, become more complicated to handle, since now strategy has to guarantee that the player does not want to deviate to influence the state transition.
- Also, they do not require agents to coordinate on beliefs about future play, which is a feature of some Non-Markovian strategies as pointed out by Green and Porter (1984).

Markov Equilibria In My Model Back

- In the game analyzed in my paper, the Markov equilibrium yields payoffs that are close to the “first-best”, which would be achieved if the government could commit to a policy rule.



Parameter Restrictions Back

- For the restriction $b' \leq \bar{b}$ to be not binding, I need to impose some parameter restrictions.

Assumption

Let $\bar{y} = 1$. Then, for $b' \leq \bar{b}$ in the stage game for all possible values of $b \in \mathcal{D}$, the parameters must satisfy:

$$r\bar{b} \leq \frac{\bar{b}\gamma(r(s-1)-s)+\gamma k}{\gamma(1+s+\theta)+s}.$$

- All the examples presented in this presentation satisfy this restriction.

The Role of γ Back

- Recall that the flow payoffs for the government are:

$$UG_t = -(y_t - k\bar{y})^2 - s(\pi_t - \bar{\pi})^2 - \gamma b_t^2.$$

- The parameter γ captures the government's aversion to debt.
- Some have suggested to consider $\gamma = 0$ in order to simplify the analysis.
- However, this leads to an uninteresting equilibrium where the government chooses a constant inflation rate.

The Role of γ Back

Proposition

Suppose $\gamma = 0$ and $\bar{y}(1 + \bar{\pi} - k) \leq r\bar{b}$. Then, in the unique Markov equilibrium of the dynamic game $\pi(b) = \bar{\pi}$, $d(b) = (k-1)\bar{y}$, and $V(b) = 0$ for all $b \in \mathcal{D}$.

The Role of γ Back

Proof

- Since $\pi^e(b) = \bar{\pi}$, then $y = \bar{y} + \theta(\pi - \bar{\pi}) + d$.
- Then, since the government's flow payoffs are $-(y - k\bar{y})^2 - s(\pi - \bar{\pi})^2$, the government will choose $\pi = \bar{\pi}$ and $d = (k-1)\bar{y}$.
- This gives the government a flow payoff of zero, which is the highest achievable flow payoff.
- In order for the Bellman equation to hold, the value function must be zero.
- Notice that in this case $b' = (k-1)\bar{y} + (1+r)b - \bar{y}\bar{\pi}$, which converges to $b = \max\{0, \frac{\bar{y}(1+\bar{\pi}-k)}{r}\} \leq \bar{b}$ as long as $\bar{y}(1+\bar{\pi}-k) \leq r\bar{b}$.

- Hence, the term $-\gamma b_t^2$ creates a trade-off between inflation and deficit, which is also impacted by the current debt level.

Reputation Framework: Wage Setters Problem Back

- Taking as given (b, ρ) and a conjecture on government behavior $\hat{\pi}^P, \hat{\pi}^I$, wage setters' best reply is characterized by the following problem:

$$\pi^e(b,\rho) = \underset{\pi^e}{\text{argmax}} \;\; \mathbb{E}\left[-\rho(\pi^e - \tilde{\pi}^P(b,\rho))^2 - (1-\rho)(\pi^e - \tilde{\pi}^I(b,\rho))^2\right],$$

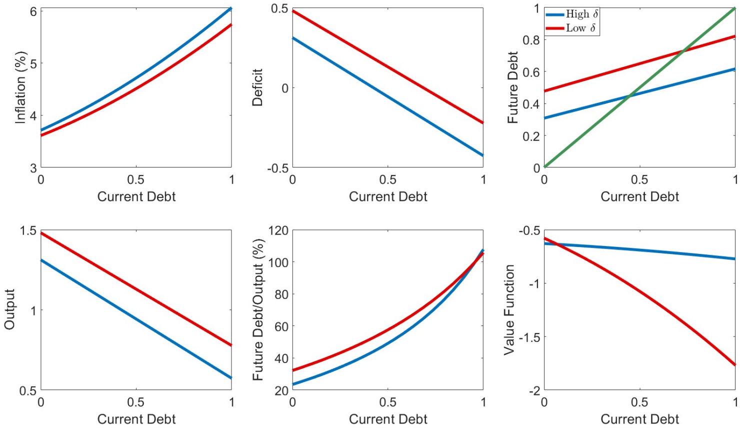
where $\tilde{\pi}^P(b,\rho) = \hat{\pi}^P(b,\rho) + \epsilon_\pi^P$ and $\tilde{\pi}^I(b,\rho) = \hat{\pi}^I(b,\rho) + \epsilon_\pi^I$.

- Then, the best reply of wage setters is given by:

$$\pi^e(b,\rho) = \rho\hat{\pi}^P(b,\rho) + (1-\rho)\hat{\pi}^I(b,\rho).$$

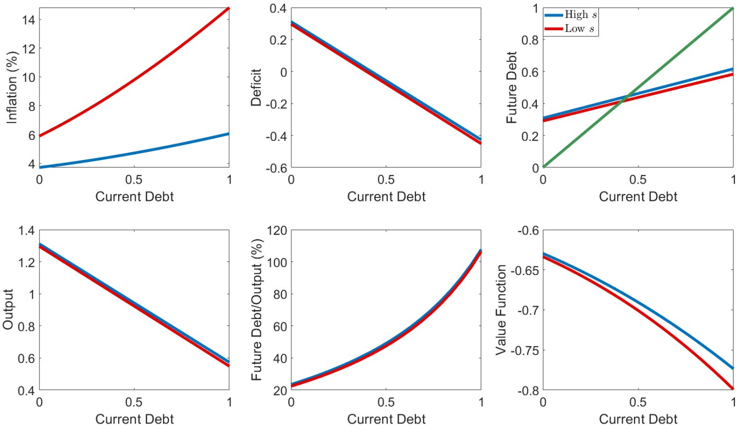
Equilibrium Example: The Role of δ Back

$$V(b) = \max_{\pi, d, b'} \; (1-\delta)\left[-(y-k\bar{y})^2 - s(\pi-\bar{\pi})^2 - \gamma(b')^2\right] + \delta V(b').$$



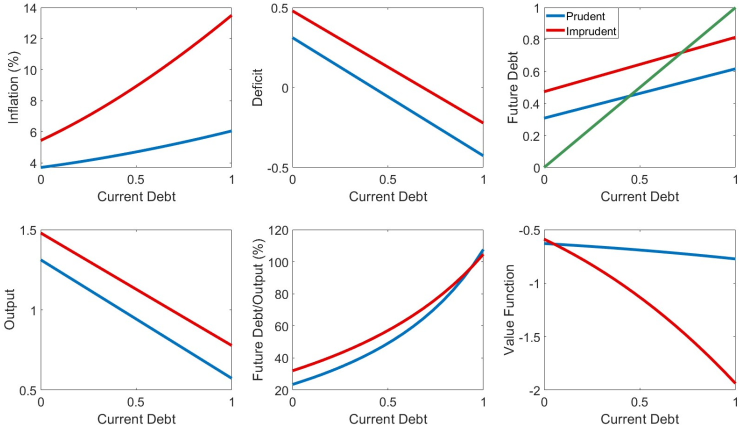
Equilibrium Example: The Role of s Back

$$V(b) = \max_{\pi, d, b'} \; (1-\delta)\left[-(y - k\bar{y})^2 - s(\pi - \bar{\pi})^2 - \gamma(b')^2\right] + \delta V(b').$$



Example: Prudent vs Imprudent Governments Back

$$V(b) = \max_{\pi, d, b'} \; (1-\delta)\left[-(y-k\bar{y})^2 - s(\pi-\bar{\pi})^2 - \gamma(b')^2\right] + \delta V(b').$$



Reputation Framework: Type P's Problem Back

- Taking as given (b, ρ) and a conjecture on wage setters $\hat{\pi}^e$ as well as the behavior of the government of type I, the government of type P's best reply is characterized by the following problem:

$$V^P(b,\rho) =$$

$$\max_{\pi, d, b'} \quad \mathbb{E}_{\epsilon_\pi, \epsilon_d}\left[(1-\delta)\left[-(\tilde{y}-k\bar{y})^2 - s_P(\tilde{\pi}-\bar{\pi})^2 - \gamma(\tilde{b}')^2\right] + \delta V^P(b', \rho')\right],$$

$$\tilde{y} = \bar{y} + \theta\left(\tilde{\pi} - \hat{\pi}^e(b,\rho)\right) + \tilde{d},$$

$$\tilde{b}' = d + \frac{(1+r)(1+\hat{\pi}^e(b,\rho))b}{1+\tilde{\pi}} - \bar{m}\tilde{\pi},$$

$$\tilde{\pi} = \pi + \epsilon_\pi,$$

$$\tilde{d} = d + \epsilon_d,$$

$$0 \leq \tilde{b}' \leq \bar{b}.$$

$$\rho' = \frac{\rho g_\pi\left(\tilde{\pi}-\pi\right) g_d\left(\tilde{d}-d\right)}{\rho g_\pi\left(\tilde{\pi}-\pi\right) g_d\left(\tilde{d}-d\right) + (1-\rho) g_\pi\left(\tilde{\pi}-\hat{\pi}^I\right) g_d\left(\tilde{d}-\hat{d}^I\right)}.$$

Reputation Framework: Type I's Problem Back

- Taking as given (b, ρ) and a conjecture on wage setters $\hat{\pi}^e$, the government of type I's best reply is characterized by the following problem:

$$V^I(b,\rho) = \max_{\pi, d, b'} \quad \mathbb{E}_{\epsilon_\pi, \epsilon_d}\left[-(\tilde{y} - k\bar{y})^2 - s_I(\tilde{\pi} - \bar{\pi})^2 - \gamma(\tilde{b}')^2\right],$$

$$\tilde{y} = \bar{y} + \theta\left(\tilde{\pi} - \hat{\pi}^e(b,\rho)\right) + \tilde{d},$$

$$\tilde{b}' = d + \frac{(1+r)(1+\hat{\pi}^e(b,\rho))b}{1+\tilde{\pi}} - \bar{m}\tilde{\pi},$$

$$\tilde{\pi} = \pi + \epsilon_\pi,$$

$$\tilde{d} = d + \epsilon_d.$$

$$0 \leq \tilde{b}' \leq \bar{b}.$$

Reputation Framework: Updating Rule Back

- Upon observing $(\tilde{\pi}, \tilde{d})$, wage setters will update their beliefs according to Bayes' Rule:

$$\rho'(b, \rho) =$$

$$\frac{\rho g_{\pi}\left(\tilde{\pi} - \pi^{P}(b, \rho)\right) g_{d}\left(\tilde{d} - d^{P}(b, \rho)\right)}{\rho g_{\pi}\left(\tilde{\pi} - \pi^{P}(b, \rho)\right) g_{d}\left(\tilde{d} - d^{P}(b, \rho)\right) + (1 - \rho) g_{\pi}\left(\tilde{\pi} - \pi^{I}(b, \rho)\right) g_{d}\left(\tilde{d} - d^{I}(b, \rho)\right)},$$

Reputation Framework: Equilibrium Proof Back

Proof Theorem

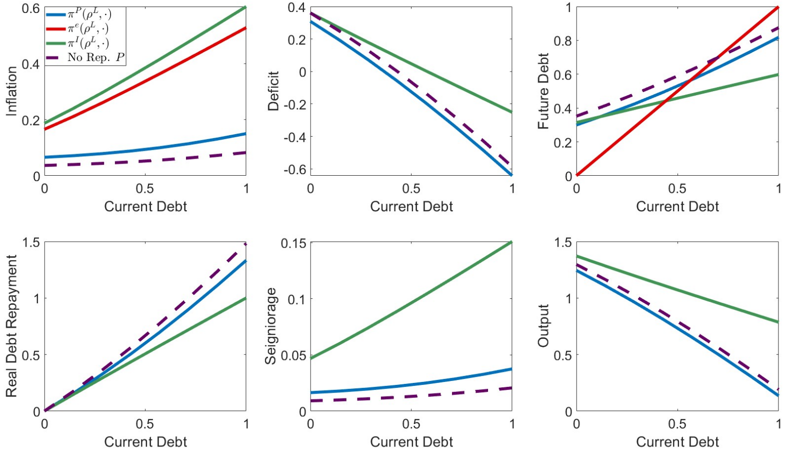
- Let Σ be the set of all functions $\sigma_w : [0, \bar{b}] \times [0, 1] \to \mathbb{R}$ that are strictly convex, uniformly bounded, and have uniformly bounded first derivatives.
- I show that an equilibrium exists by proving that the mapping $\tilde{\pi} : \Sigma_w \to \Omega$ defined by:

$$\tilde{\pi}(\sigma_w)(b, \rho) = \rho \pi^P(b, \rho | \sigma_w) + (1 - \rho)\pi^I(b, \rho | \sigma_w),$$

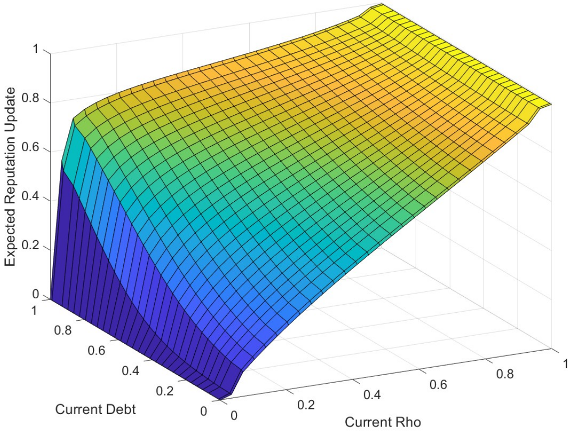
  has a fixed point.
- I consider the Schauder Fixed Point Theorem, and hence I need to show:
  1. Σ_W is a non-empty, convex, and compact subset of a Banach space.
  2. $\tilde{\pi}$ is a continuous mapping with $\Omega \subseteq \Sigma_w$.

Equilibrium: Low Reputation Back

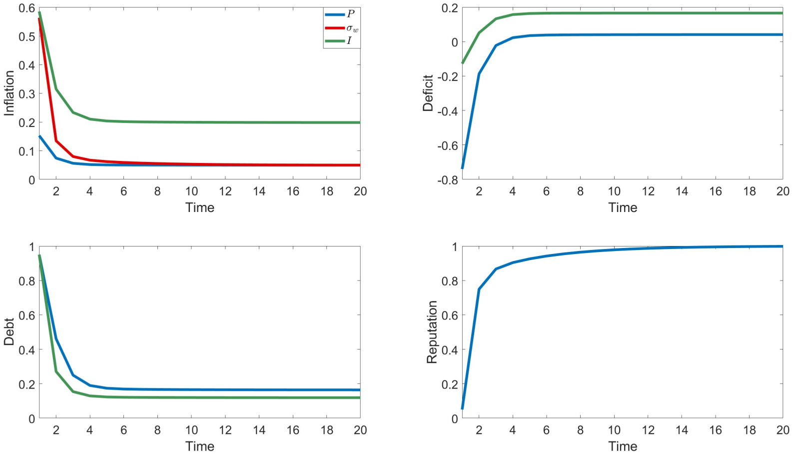
- If the prudent government had no reputation concerns, it would choose lower inflation, which would lead to higher debt, higher real interest rates, and lower seigniorage.



Updating Rule Dynamics Back

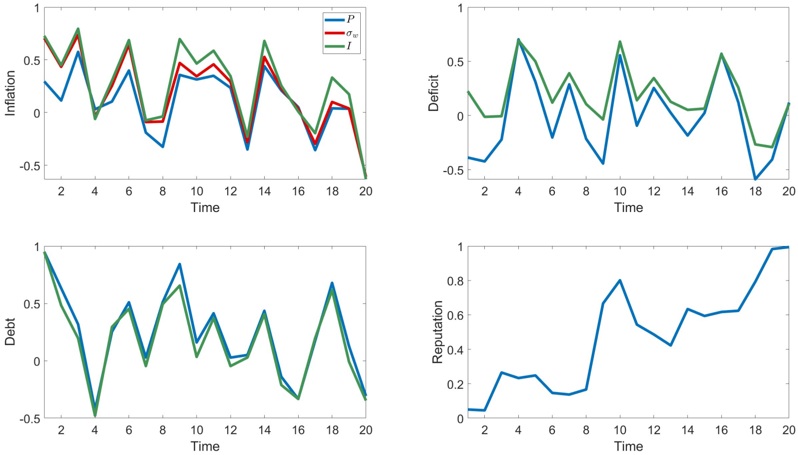


Equilibrium: Long-Run Learning Back



Equilibrium: Long-Run Learning

Back



Parameter Values for Mexico 1970-2022 Back

Parameter	Interpretation	Value
s_P	Inflation Target Weight Prudent Government	80
s_I	Inflation Target Weight Imprudent Government	5
δ_P	Discount Factor Prudent Government	0.45
δ_I	Discount Factor Imprudent Government	0
ϵ_π	Standard Deviation Inflation Shock	0.15
ϵ_d	Standard Deviation Deficit Shock	0.20
θ	Sensitivity of Output to Inflation	0.50
k	Time Inconsistency Parameter	2
γ	Debt Weight	2
$\bar{y}$	Natural Level of Output	1
$\bar{\pi}$	Inflation Target	3%
r	Interest Rate	5%