

Online Appendix:

Fiscal Rules and Discretion under Persistent Shocks

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This Online Appendix provides proofs for our results in the extension to a continuum of types in Appendix B and describes the algorithm that we use to compute the equilibria in Subsection 5.3 of the paper.

A Proofs for Appendix B

A.1 Proofs of Proposition 7 and Corollary 2

In order to prove these results, consider the program isomorphic to (16)–(17) under a continuum of shocks. Define a function $f(\theta_t) = \theta_t/\tilde{\theta}_t$ for $\tilde{\theta}_t$ which depends on θ_t as defined in (4). Let $\omega_t = f(\theta_t) \in \Omega \equiv [\underline{\omega}, \bar{\omega}]$, where it is clear that from Assumption 3, there is a one to one mapping from θ_t to ω_t . Let $h(\omega_t|\omega_{t-1})$ correspond to the value of $\tilde{\theta}_t p(\theta_t|\theta_{t-1}) (f'(\theta_t))^{-1} / \mathbb{E}[\tilde{\theta}_t p(\theta_t|\theta_{t-1})|\theta_{t-1}]$, so that $h(\omega_t|\omega_{t-1}) > 0$,

$$h(\omega_t|\omega_{t-1})d\omega_t = \tilde{\theta}_t p(\theta_t|\theta_{t-1})/\mathbb{E}[\tilde{\theta}_t p(\theta_t|\theta_{t-1})|\theta_{t-1}]d\theta_t,$$

and $\int_{\underline{\omega}}^{\bar{\omega}} h(\omega_t|\omega_{t-1})d\omega_t = 1$, where we have used the fact that $d\omega_t = f'(\theta_t)d\theta_t$. Therefore, $h(\omega_t|\omega_{t-1})$ is effectively a density function. Define $H(\omega_t|\omega_{t-1})$ as the associated c.d.f.

Using this formulation, (16)–(17) can be rewritten as

$$\max_{\{s_t(\omega_t)\}_{\omega_t \in \Omega}} \int_{\underline{\omega}}^{\bar{\omega}} h(\omega_t|\omega_{t-1}) (\omega_t U(1 - s_t(\omega_t)) + U(s_t(\omega_t))) d\omega_t \quad (\text{A.1})$$

s.t.

$$\omega_t U(1 - s_t(\omega_t)) + \beta U(s_t(\omega_t)) \geq \omega_t U(1 - s_t(\hat{\omega}_t)) + \beta U(s_t(\hat{\omega}_t)) \quad \forall \omega_t \text{ and } \forall \hat{\omega}_t \neq \omega_t. \quad (\text{A.2})$$

(A.1)–(A.2) is identical to (16)–(17), where we have used the one to one mapping from θ_t to ω_t to write the program as one of choosing a savings rate conditional on the report $\hat{\omega}_t$.

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Now consider a relaxed version of (A.1)–(A.2) which allows (1) to be an inequality:

$$\max_{\{u_t(\omega_t), y_t(\omega_t)\}_{\omega_t \in \Omega}} \int_{\underline{\omega}}^{\bar{\omega}} h(\omega_t | \omega_{t-1}) (\omega_t u_t(\omega_t) + y_t(\omega_t)) d\omega_t \quad (\text{A.3})$$

s.t.

$$U^{-1}(u_t(\omega_t)) + U^{-1}(y_t(\omega_t)) \leq 1 \quad \forall \omega_t \quad (\text{A.4})$$

$$\omega_t u_t(\omega_t) + \beta y_t(\omega_t) \geq \omega_t u_t(\hat{\omega}_t) + \beta y_t(\hat{\omega}_t) \quad \forall \omega_t \text{ and } \forall \hat{\omega}_t \neq \omega_t. \quad (\text{A.5})$$

(A.3)–(A.5) is identical to (A.1)–(A.2) if the solution admits (A.4) holding with equality $\forall \omega_t$. (A.3)–(A.5) corresponds to the problem analyzed in Section 3.2 of Amador, Werning, and Angeletos (2006) so that their analysis applies here as well.

The envelope condition which characterizes (A.5) implies that

$$\frac{\omega_t}{\beta} u(\omega_t) + y(\omega_t) = \int_{\underline{\omega}}^{\omega_t} \frac{1}{\beta} u(\omega') d\omega' + \frac{\omega}{\beta} u(\underline{\omega}) + y(\underline{\omega}). \quad (\text{A.6})$$

Standard arguments also require $u(\omega_t)$ to be a non-decreasing function of ω_t . Thus, (A.6) and monotonicity are necessary for incentive compatibility. Substituting (A.6) into the objective function and the resource constraint and integrating by parts allows us to rewrite the problem as:

$$\max_{\{u_t(\omega_t), y(\underline{\omega})\}} \left\{ \frac{\omega}{\beta} u(\underline{\omega}) + y(\underline{\omega}) + \frac{1}{\beta} \int_{\underline{\omega}}^{\bar{\omega}} (1 - G(\omega_t | \omega_{t-1})) u(\omega_t) d\omega_t \right\} \quad (\text{A.7})$$

s.t.

$$U(1 - U^{-1}(u_t(\omega_t))) + \frac{\omega_t}{\beta} u(\omega_t) - \frac{\omega}{\beta} u(\underline{\omega}) - y(\underline{\omega}) - \frac{1}{\beta} \int_{\underline{\omega}}^{\omega_t} u(\omega') d\omega' \geq 0 \quad (\text{A.8})$$

$$\text{and } u_t(\omega_t) \text{ non-decreasing} \quad (\text{A.9})$$

for

$$G(\omega_t | \omega_{t-1}) = H(\omega_t | \omega_{t-1}) + \omega_t(1 - \beta)h(\omega_t | \omega_{t-1}).$$

The above program can be solved using Lagrangian methods. Following Amador, Werning, and Angeletos (2006), define $\omega_p(\omega_{t-1}) = \max\{\underline{\omega}, \omega'\}$ where ω' is the lowest $\omega \in \Omega$ such that $\forall \omega'' \geq \omega$,

$$\int_{\omega''}^{\bar{\omega}} (1 - G(\omega''' | \omega_{t-1})) d\omega''' \leq 0. \quad (\text{A.10})$$

Consider the following condition.

Condition 2. $\forall \omega_{t-1}$ and $\forall \omega_t \leq \omega_p(\omega_{t-1})$, $G(\omega_t | \omega_{t-1})$ is non-decreasing in ω_t .

Proposition 2 in Amador, Werning, and Angeletos (2006) states that the solution to (A.7)–(A.9) admits $s_t(\omega_t) = s_t(\omega_p(\omega_{t-1}))$ if $\omega_t \geq \omega_p(\omega_{t-1})$. Moreover, Proposition 3 in that paper states that if Condition 2 holds, then the solution to (A.7)–(A.9) admits (A.8) holding with equality, so that (A.4) also holds with equality. Furthermore, $s_t(\omega_t) = s^f(\omega_t)$ if $\omega_t < \omega_p(\omega_{t-1})$, where with some abuse of notation, $s^f(\omega_t)$ is defined as the flexible optimum given by

$$\omega_t U'(1 - s^f(\omega_t)) = \beta U'(s^f(\omega_t)).$$

Let $\underline{s}(\omega_{t-1})$ be defined by $\underline{s}(\omega_{t-1}) = s^f(\omega_p(\omega_{t-1}))$ if $\omega_p(\omega_{t-1}) > \underline{\omega}$, and

$$\int_{\underline{\omega}}^{\bar{\omega}} h(\omega_t|\omega_{t-1})(\omega_t U'(1 - \underline{s}(\omega_{t-1})) - U'(\underline{s}(\omega_{t-1})))d\omega_t = 0$$

otherwise. $\forall \omega^t$, it follows then that the sequential optimum features

$$s_t(\omega^t) = \max\{s^f(\omega_t), \underline{s}(\omega_{t-1})\}.$$

This therefore means that the sequentially optimal rule at any date t can be implemented with a debt limit, which depends only on ω_{t-1} and the current level of debt.

In order to complete the argument, we must verify that $\theta_p(\theta_{t-1}) = f^{-1}(\omega_p(f(\theta_{t-1})))$ and that Assumption 4 is identical to Condition 2. To show that $\theta_p(\theta_{t-1}) = f^{-1}(\omega_p(f(\theta_{t-1})))$, note that (A.10) can be rewritten as

$$[1 - H(\omega''|\omega_{t-1})]\omega'' \left(\frac{1}{\beta} - \frac{\left(\int_{\omega''}^{\bar{\omega}} \omega''' h(\omega'''|\omega_{t-1})d\omega''' \right) / \left(\int_{\omega''}^{\bar{\omega}} h(\omega'''|\omega_{t-1})d\omega''' \right)}{\omega''} \right) \geq 0.$$

Letting $\theta'' = f^{-1}(\omega'')$ and $\theta''' = f^{-1}(\omega''')$ with associated values $\tilde{\theta}''$ and $\tilde{\theta}'''$, the above condition becomes

$$\left(\frac{1}{\beta} - \frac{\left(\int_{\theta''}^{\bar{\theta}} \theta''' p(\theta'''|\theta_{t-1})d\theta''' \right) / \left(\int_{\theta''}^{\bar{\theta}} \tilde{\theta}''' p(\theta'''|\theta_{t-1})d\theta''' \right)}{\theta''/\tilde{\theta}''} \right) \geq 0,$$

which becomes (B.1). This establishes that $\theta_p(\theta_{t-1}) = f^{-1}(\omega_p(f(\theta_{t-1})))$.

To show that Assumption 4 is identical to Condition 2, note that $G(\omega_t|\omega_{t-1})$ is continuously differentiable in ω_t and first order conditions imply that Condition 2 reduces to

$$\frac{d \log h(\omega_t|\omega_{t-1})}{d \log \omega_t} \geq -\frac{2 - \beta}{1 - \beta}. \quad (\text{A.11})$$

We can show that (B.2) implies (A.11). Given the definition of $h(\cdot)$, note that the left hand side of (A.11) can be expanded so that (A.11) becomes

$$\frac{\frac{d \log \tilde{\theta}_t}{d \log \theta_t} + \frac{d \log p(\theta_t|\theta_{t-1})}{d \log \theta_t} - \frac{d \log \left(\frac{d \tilde{\theta}_t}{d \theta_t} \right)}{d \log \theta_t}}{1 - \frac{d \log \tilde{\theta}_t}{d \log \theta_t}} \geq -\frac{2 - \beta}{1 - \beta},$$

which is equivalent to (B.2). ■

A.2 Proof of Proposition 8

Consider the case of i.i.d. shocks, and with some abuse of notation, let $W_t(\cdot)$ correspond to the continuous type analogue of the continuation value defined in (9) divided by $\delta \mathbb{E}[\theta_t]$, where we have taken into account that shocks are i.i.d. Let the range $[\underline{W}, \bar{W}]$ correspond to the feasible

range of such continuation values. To write the period zero problem, we pursue an analogous strategy as in the proof of Proposition 7 by considering the relaxed problem which allows the resource constraint to hold as an inequality:

$$\max_{\{u_t(\omega_t), y_t(\omega_t)\}_{\omega_t \in \Omega}} \int_{\underline{\omega}}^{\bar{\omega}} h(\omega_t | \omega_{t-1}) (\omega_t u_t(\omega_t) + y_t(\omega_t) + W_t(\omega_t)) d\omega_t \quad (\text{A.12})$$

s.t.

$$U^{-1}(u_t(\omega_t)) + U^{-1}(y_t(\omega_t)) \leq 1 \quad \forall \omega_t, \quad (\text{A.13})$$

$$\omega_t u_t(\omega_t) + \beta y_t(\omega_t) + \beta W_t(\omega_t) \geq \omega_t u_t(\hat{\omega}_t) + \beta y_t(\hat{\omega}_t) + \beta W_t(\hat{\omega}_t) \quad \forall \omega_t \text{ and } \forall \hat{\omega}_t \neq \omega_t, \quad (\text{A.14})$$

$$\text{and } \underline{W} \leq W_t(\omega_t) \leq \bar{W} \quad \forall \omega_t. \quad (\text{A.15})$$

The same envelope condition in (A.6) applies. Together with the monotonicity of $u_t(\omega_t)$, it implies incentive compatibility. Substituting (A.6) into (A.12), (A.13), and (A.15), the program can be rewritten as

$$\max_{\{u_t(\omega_t), y(\underline{\omega}), \underline{W} \leq W(\underline{\omega}) \leq \bar{W}\}} \left\{ \frac{\omega}{\beta} u(\underline{\omega}) + y(\underline{\omega}) + W(\underline{\omega}) + \frac{1}{\beta} \int_{\underline{\omega}}^{\bar{\omega}} (1 - G(\omega_t | \omega_{t-1})) u(\omega_t) d\omega_t \right\} \quad (\text{A.16})$$

s.t.

$$U(1 - U^{-1}(u_t(\omega_t))) + \bar{W} + \frac{\omega_t}{\beta} u(\omega_t) - \frac{\omega}{\beta} u(\underline{\omega}) - y(\underline{\omega}) - W(\underline{\omega}) - \frac{1}{\beta} \int_{\underline{\omega}}^{\omega} u(\theta') d\theta' \geq 0 \quad (\text{A.17})$$

$$\text{and } u_t(\omega_t) \text{ non-decreasing.} \quad (\text{A.18})$$

(A.16)–(A.18) is identical to (A.7)–(A.9) since the term $y(\underline{\omega})$ in (A.7)–(A.9) is replaced with $y(\underline{\omega}) + W(\underline{\omega})$ in (A.16)–(A.18) and the term $U(1 - U^{-1}(u_t(\omega_t)))$ is replaced with $U(1 - U^{-1}(u_t(\omega_t))) + \bar{W}$. Therefore, the same arguments as those of Amador, Werning, and Angeletos (2006) imply that the solution to (A.16)–(A.18) admits (A.17) holding with equality, which then means that (A.13) holds with equality and $W(\omega_t) = \bar{W}$. It thus follows that the solution admits a static mechanism, and therefore the optimal mechanism is characterized as in Proposition 7. ■

A.3 Proof of Proposition 9

Proof of part (i). Suppose by contradiction that the ex-ante optimum coincides with the sequential optimum, so the solution is characterized by Proposition 7. With some abuse of notation, let $V^{\theta_0}(\hat{\theta}_0)$ correspond to the expected date-1 welfare in the sequential optimum to a type θ_0 who lies and claims to be a type $\hat{\theta}_0$. By lying, this type receives a mechanism associated with $\hat{\theta}_0$, evaluated using probabilities $p(\theta_1 | \theta_0)$. Given the description of the solution in Proposition 7, it is straightforward to show that $V^{\theta_0}(\hat{\theta}_0)$ is continuously differentiable in $\hat{\theta}_0$ with $V^{\theta_0'}(\hat{\theta}_0) = 0$ for $\hat{\theta}_0 = \theta_0$.

We now consider a perturbation that affects types $\theta_0 < \theta_p(\theta_{-1})$. To facilitate the construction of the perturbation, note first that one implementation of the sequentially optimal mechanism is as follows. The government can choose any savings rate above $s^f(\theta_p(\theta_{-1}))$. If the chosen savings rate is $s_0 > s^f(\theta_p(\theta_{-1}))$, then the mechanism at date 1 corresponds to the sequentially optimal mechanism for type $s^{f^{-1}}(s_0)$, where $s^{f^{-1}}(\cdot)$ is a function that uses (C.1)

to derive the type from the chosen flexible savings rate. If instead the chosen savings rate is $s_0 = s^f(\theta_p(\theta_{-1}))$, then the government reports its type $\widehat{\theta}_0$, and the mechanism at date 1 corresponds to the sequentially optimal mechanism for type $\widehat{\theta}_0$.

Given this implementation, consider the following perturbation. If the chosen savings rate is $s_0 = s^f(\theta_p(\theta_{-1}))$, the mechanism is unchanged. If instead the chosen savings rate is $s_0 > s^f(\theta_p(\theta_{-1}))$, the mechanism at date 1 corresponds to the sequentially optimal mechanism for type $s^{f^{-1}}(s_0) + \varepsilon\mu(s^{f^{-1}}(s_0))$, for $\varepsilon > 0$ arbitrarily small and for some continuously differentiable function $\mu(\cdot)$ satisfying $\mu(\cdot) > 0$, $\mu'(\cdot) > -1$, and $\lim_{\theta_0 \rightarrow \theta_p(\theta_{-1})} \mu(\theta_0) = 0$. Note that if $\varepsilon = 0$, the original sequentially optimal mechanism is in place. If instead $\varepsilon > 0$, arbitrarily small, then all types $\theta_0 \geq \theta_p(\theta_{-1})$ do not change their behavior, but the chosen savings rate $s_0^\varepsilon(\theta_{-1}, \theta_0)$ for types $\theta_0 < \theta_p(\theta_{-1})$ must satisfy the following first order condition:

$$\begin{aligned} & -\theta_0 U'(1 - s_0^\varepsilon(\theta_{-1}, \theta_0)) + \beta \widetilde{\theta}_0 U'(s_0^\varepsilon(\theta_{-1}, \theta_0)) \\ & = -\beta \delta V^{\theta_0'}(s^{f^{-1}}(s_0^\varepsilon(\theta_{-1}, \theta_0)) + \varepsilon\mu(s^{f^{-1}}(s_0^\varepsilon(\theta_{-1}, \theta_0)))) \frac{d[s^{f^{-1}}(s_0^\varepsilon(\theta_{-1}, \theta_0)) + \varepsilon\mu(s^{f^{-1}}(s_0^\varepsilon(\theta_{-1}, \theta_0)))]}{ds_0^\varepsilon(\theta_{-1}, \theta_0)}. \end{aligned} \quad (\text{A.19})$$

As ε approaches 0, $s_0^\varepsilon(\theta_{-1}, \theta_0)$ approaches $s_0^f(\theta_0)$. We can show that it must approach it from above; that is, for sufficiently small $\varepsilon > 0$, it must be that $s_0^\varepsilon(\theta_{-1}, \theta_0) \geq s_0^f(\theta_0)$. If instead $s_0^\varepsilon(\theta_{-1}, \theta_0) < s_0^f(\theta_0)$, then type θ_0 could make itself strictly better off by increasing its savings rate to $s_0^f(\theta_0)$, as this maximizes its immediate welfare and raises its continuation utility.

Suppose that Condition 1 holds for θ_{-1} and some θ_0 . Together with (A.19), this implies that $s_0^\varepsilon(\theta_{-1}, \theta_0) > s_0^f(\theta_0)$ for a positive measure of types θ_0 . Using (A.19), the change in welfare as ε approaches 0 for any such θ_0 has the same sign as

$$[-\theta_0 U'(1 - s_0^f(\theta_0)) + \widetilde{\theta}_0 U'(s_0^f(\theta_0))] \frac{ds_0^\varepsilon(\theta_{-1}, \theta_0)}{d\varepsilon} \Big|_{\varepsilon=0} + \delta V^{\theta_0'}(\theta_0) \frac{1}{s^{f'}(\theta_0)} \frac{ds_0^\varepsilon(\theta_{-1}, \theta_0)}{d\varepsilon} \Big|_{\varepsilon=0} > 0,$$

where we have used (C.1) and the fact that $V^{\theta_0'}(\theta_0) = 0$. Therefore, the perturbation strictly increases welfare. Note that if Condition 1 does not hold for θ_{-1} , then it necessarily holds at some θ_{t-1} , and the same perturbation can be performed at that date while continuing to satisfy all incentive compatibility constraints at $t - k$ for $k > 1$.

Proof of part (ii). Suppose by contradiction that the mechanism does not exhibit history dependence. Let $V^\theta(\widehat{\theta})$ correspond to the continuation value to a type θ who reports $\widehat{\theta}$ under this history-independent mechanism, where by assumption, $V^\theta(\widehat{\theta})$ is piecewise continuously differentiable. Given that the continuation mechanism is independent of the date, and given that the ex-ante optimal mechanism is chosen at date 0, it follows that $\forall \theta_{-1}$, the continuation value at date 0 is $V^\theta(\theta)$ if $\theta = \theta_{-1}$, and by optimality, $V^{\theta'}(\theta) = 0$. Thus, the first order conditions which guarantee truth-telling whenever the mechanism is differentiable imply that

$$[-\theta_t U'(1 - s_t(\theta_{t-1}, \theta_t)) + \beta \widetilde{\theta}_t U'(s_t(\theta_{t-1}, \theta_t))] \frac{ds_t(\theta_{t-1}, \theta_t)}{d\theta_t} = 0. \quad (\text{A.20})$$

This requires that either $s_t(\theta_{t-1}, \theta_t) = s^f(\theta_t)$ or $ds_t(\theta_{t-1}, \theta_t)/d\theta_t = 0$. Therefore, (A.20) effectively corresponds to the first order condition to static incentive compatibility constraints. As such, the optimal mechanism is not dynamic. The solution to the program subject to a sequence of static incentive compatibility constraints coincides with the solution to the

sequential optimum described in Proposition 7. However, part (i) shows that this mechanism is suboptimal. ■

B Algorithm

This section describes the algorithm that we use to compute the equilibria in Subsection 5.3. We work from the first order conditions to the program in (28). Let ϕ be the Lagrange multiplier on the relevant incentive constraint (26). Define

$$\Gamma = \frac{p(\theta^L|\theta^i) + \lambda p(\theta^L|\theta^{-i})}{1 + \lambda}$$

and the following functions:

$$\begin{aligned} s^{L*}(\Gamma, \phi) &= \left[\frac{\theta^L}{\tilde{\theta}^L} \left(\frac{\Gamma + \phi}{\Gamma + \delta\phi} \right) + 1 \right]^{-1}, \\ s^{H*}(\Gamma, \phi) &= \left[\frac{\theta^H}{\tilde{\theta}^H} \left(\frac{1 - \Gamma - \phi\theta^L/\theta^H}{1 - \Gamma - \delta\phi\tilde{\theta}^L/\tilde{\theta}^H} \right) + 1 \right]^{-1}, \\ \Gamma'^*(\Gamma, \phi) &= \frac{(1 - \Gamma)(1 - \alpha) - \delta\phi\alpha}{(1 - \Gamma) - \delta\phi}, \end{aligned}$$

where $\alpha \equiv p(\theta^i|\theta^i)$. These equations correspond to the first order conditions to (28), where $\Gamma'^*(\Gamma, \phi)$ is the value of Γ in the next period given a particular Γ in the current period. We guess some initial functions $V_0^L(\Gamma)$ and $V_0^H(\Gamma)$ defined for $\Gamma \in [0, \alpha]$. Then the next steps allow us to define $V_t^L(\Gamma)$ and $V_t^H(\Gamma)$ iteratively, where t denotes the number of the iteration:

1. Define $F_t(\Gamma, \phi)$ for a given $V_t^L(\Gamma)$ and $V_t^H(\Gamma)$:

$$\begin{aligned} F_t(\Gamma, \phi) &= \theta^L U(1 - s^{L*}(\Gamma, \phi)) + \delta\tilde{\theta}^L U(s^{L*}(\Gamma, \phi)) + \delta\beta V_t^L(\alpha) \\ &\quad - \theta^L U(1 - s^{H*}(\Gamma, \phi)) - \delta\tilde{\theta}^L U(s^{H*}(\Gamma, \phi)) - \delta\beta V_t^L(\Gamma'^*(\Gamma, \phi)). \end{aligned}$$

Note that $F_t(\Gamma, \phi)$ captures the incentive constraint in (26).

2. For each Γ , choose the value of ϕ that minimizes the absolute value of $F_t(\Gamma, \phi)$, effectively letting (26) hold with equality. Denote this value by $\phi_t^*(\Gamma)$.

3. Given $\phi_t^*(\Gamma)$, define the following functions:

$$V_{t+1}^L(\Gamma) = \left\{ \begin{array}{l} \alpha \left[\theta^L U(1 - s^{L*}(\Gamma, \phi_t^*(\Gamma))) + \tilde{\theta}^L U(s^{L*}(\Gamma, \phi_t^*(\Gamma))) \right] \\ + (1 - \alpha) \left[\theta^H U(1 - s^{H*}(\Gamma, \phi_t^*(\Gamma))) + \tilde{\theta}^H U(s^{H*}(\Gamma, \phi_t^*(\Gamma))) \right] \\ + \alpha \beta V_t^L(\alpha) + (1 - \alpha) \beta V_t^H(\Gamma'^*(\Gamma, \phi_t^*(\Gamma))) \end{array} \right\},$$

$$V_{t+1}^H(\Gamma) = \left\{ \begin{array}{l} (1 - \alpha) \left[\theta^L U(1 - s^{L*}(\Gamma, \phi_t^*(\Gamma))) + \tilde{\theta}^L U(s^{L*}(\Gamma, \phi_t^*(\Gamma))) \right] \\ + \alpha \left[\theta^H U(1 - s^{H*}(\Gamma, \phi_t^*(\Gamma))) + \tilde{\theta}^H U(s^{H*}(\Gamma, \phi_t^*(\Gamma))) \right] \\ + (1 - \alpha) \beta V_t^L(\alpha) + \alpha \beta V_t^H(\Gamma'^*(\Gamma, \phi_t^*(\Gamma))) \end{array} \right\}.$$

$V_{t+1}^i(\Gamma)$ is the continuation welfare given last period's shock θ^i and given the weight Γ assigned to the low type. Our construction takes into account the resetting property, so $V_t^L(\alpha)$ is the continuation value with weight α if the low shock was realized in the previous period.¹

4. Given $V_{t+1}^L(\Gamma)$ and $V_{t+1}^H(\Gamma)$, repeat steps 1-3 until $V_{t+1}^L(\Gamma)$ and $V_{t+1}^H(\Gamma)$ converge.

Using the values of $V^L(\Gamma)$ and $V^H(\Gamma)$ that emerge from this iteration, we can define the policy functions $s^{L*}(\Gamma, \phi^*(\Gamma))$, $s^{H*}(\Gamma, \phi^*(\Gamma))$, and $\Gamma'^*(\Gamma, \phi^*(\Gamma))$. These policy functions can then be used to simulate a path of shocks and calculate the value of \bar{s} .

References

AMADOR, M., I. WERNING, AND G.-M. ANGELETOS (2006): "Commitment Vs. Flexibility," *Econometrica*, 74, 365–96.

¹When the equilibrium resets, $\lambda = 0$ because the threat-keeping constraint is slack, and thus $\Gamma = \alpha$.