

Contents

Acknowledgements xix

Preface to the third edition xx

Part I: The imperialism of recursive methods

1. Overview 3

1.1. Warning. 1.2. A common ancestor. 1.3. The savings problem. 1.3.1. Linear quadratic permanent income theory. 1.3.2. Precautionary saving. 1.3.3. Complete markets, insurance, and the distribution of wealth. 1.3.4. Bewley models. 1.3.5. History dependence in standard consumption models. 1.3.6. Growth theory. 1.3.7. Limiting results from dynamic optimal taxation. 1.3.8. Asset pricing. 1.3.9. Multiple assets. 1.4. Recursive methods. 1.4.1. Methodology: dynamic programming issues a challenge. 1.4.2. Dynamic programming challenged. 1.4.3. Imperialistic response of dynamic programming. 1.4.4. History dependence and “dynamic programming squared”. 1.4.5. Dynamic principal-agent problems. 1.4.6. More applications.

Part II: Tools

2. Time Series 29

2.1. Two workhorses. 2.2. Markov chains. 2.2.1. Stationary distributions. 2.2.2. Asymptotic stationarity. 2.2.3. Forecasting the state. 2.2.4. Forecasting functions of the state. 2.2.5. Forecasting functions. 2.2.6. Enough one-step-ahead forecasts determine P . 2.2.7. Invariant functions and ergodicity. 2.2.8. Simulating a Markov chain. 2.2.9. The likelihood function. 2.3. Continuous-state Markov chain. 2.4. Stochastic linear difference equations. 2.4.1. First and second moments. 2.4.2. Summary of moment formulas. 2.4.3. Impulse response function. 2.4.4. Prediction and discounting. 2.4.5. Geometric sums of quadratic forms. 2.5. Population regression. 2.5.1. Multiple regressors. 2.6. Estimation of model parameters. 2.7. The Kalman filter. 2.7.1. Estimation again. 2.8. Vector autoregressions and the Kalman filter. 2.8.1. Conditioning on the semi-infinite past of y . 2.8.2. A time-invariant VAR. 2.8.3. Interpreting VARs. 2.9. Applications of the Kalman filter. 2.9.1. Muth's reverse engineering exercise. 2.9.2. Jovanovic's application. 2.10. The spectrum. 2.10.1. Examples. 2.11. Example: the LQ permanent income model. 2.11.1. Another representation. 2.11.2. Debt dynamics. 2.11.3. Two classic examples. 2.11.4. Spreading consumption cross section. 2.11.5. Invariant subspace approach. 2.12. Concluding remarks. A. Linear difference equations 2.A.1. A first-order difference equation. 2.A.2. A second-order difference equation. B. MCMC approximation of Bayesian posterior 2.15. Exercises.

3. Dynamic Programming 103

3.1. Sequential problems. 3.1.1. Three computational methods. 3.1.2. Cobb-Douglas transition, logarithmic preferences. 3.1.3. Euler equations. 3.1.4. A sample Euler equation. 3.2. Stochastic control problems. 3.3. Concluding remarks. 3.4. Exercise.

4. Practical Dynamic Programming 113

4.1. The curse of dimensionality. 4.2. Discrete-state dynamic programming. 4.3. Bookkeeping. 4.4. Application of Howard improvement algorithm. 4.5. Numerical implementation. 4.5.1. Modified policy iteration. 4.6. Sample Bellman equations. 4.6.1. Example 1: calculating expected utility. 4.6.2. Example 2: risk-sensitive preferences. 4.6.3. Example 3: costs of business cycles. 4.7. Polynomial approximations. 4.7.1. Recommended computational strategy. 4.7.2. Chebyshev polynomials. 4.7.3. Algorithm: summary. 4.7.4. Shape-preserving splines. 4.8. Concluding remarks.

5. Linear Quadratic Dynamic Programming 127

5.1. Introduction. 5.2. The optimal linear regulator problem. 5.2.1. Value function iteration. 5.2.2. Discounted linear regulator problem. 5.2.3. Policy improvement algorithm. 5.3. The stochastic optimal linear regulator problem. 5.3.1. Discussion of certainty equivalence. 5.4. Shadow prices in the linear regulator. 5.4.1. Stability. 5.5. A Lagrangian formulation. 5.6. The Kalman filter again. 5.7. Concluding remarks. A. Matrix formulas B. Linear quadratic approximations 5.B.1. An example: the stochastic growth model. 5.B.2. Kydland and Prescott's method. 5.B.3. Determination of \bar{z} . 5.B.4. Log linear approximation. 5.B.5. Trend removal. 5.10. Exercises.

6. Search, Matching, and Unemployment 159

6.1. Introduction. 6.2. Preliminaries. 6.2.1. Nonnegative random variables. 6.2.2. Mean-preserving spreads. 6.3. McCall's model of intertemporal job search. 6.3.1. Characterizing reservation wage. 6.3.2. Effects of mean-preserving spreads. 6.3.3. Allowing quits. 6.3.4. Waiting times. 6.3.5. Firing. 6.4. A lake model. 6.5. A model of career choice. 6.6. Offer distribution unknown. 6.7. An equilibrium price distribution. 6.7.1. A Burdett-Judd setup. 6.7.2. Consumer problem with noisy search. 6.7.3. Firms. 6.7.4. Equilibrium. 6.7.5. Special cases. 6.8. Jovanovic's matching model. 6.8.1. Recursive formulation and solution. 6.8.2. Endogenous statistics. 6.9. A longer horizon version of Jovanovic's model. 6.9.1. The Bellman equations. 6.10. Concluding remarks. A. More numerical dynamic programming 6.A.1. Example 4: search. 6.A.2. Example 5: a Jovanovic model. 6.12. Exercises.

Part III: Competitive equilibria and applications

7. Recursive (Partial) Equilibrium 227

7.1. An equilibrium concept. 7.2. Example: adjustment costs. 7.2.1. A planning problem. 7.3. Recursive competitive equilibrium. 7.4. Equilibrium human capital accumulation. 7.4.1. Planning problem. 7.4.2. Decentralization. 7.5. Equilibrium occupational choice. 7.5.1. A planning problem. 7.5.2. Decentralization. 7.6. Markov perfect equilibrium. 7.6.1. Computation. 7.7. Linear Markov perfect equilibria. 7.7.1. An example. 7.8. Concluding remarks. 7.9. Exercises.

8. Equilibrium with Complete Markets 251

8.1. Time 0 versus sequential trading. 8.2. The physical setting: preferences and endowments. 8.3. Alternative trading arrangements. 8.3.1. History dependence. 8.4. Pareto problem. 8.4.1. Time invariance of Pareto weights. 8.5. Time 0 trading: Arrow-Debreu securities. 8.5.1. Equilibrium pricing function. 8.5.2. Optimality of equilibrium allocation. 8.5.3. Interpretation of trading arrangement. 8.5.4. Equilibrium computation. 8.6. Simpler computational algorithm. 8.6.1. Example 1: risk sharing. 8.6.2. Implications for equilibrium computation. 8.6.3. Example 2: no aggregate uncertainty. 8.6.4. Example 3: periodic endowment processes. 8.6.5. Example 4. 8.7. Primer on asset pricing. 8.7.1. Pricing redundant assets. 8.7.2. Riskless consol. 8.7.3. Riskless strips. 8.7.4. Tail assets. 8.7.5. One-period returns. 8.8. Sequential trading: Arrow securities. 8.8.1. Arrow securities. 8.8.2. Financial wealth as an endogenous state variable. 8.8.3. Financial and non-financial wealth. 8.8.4. Reopening markets. 8.8.5. Debt limits. 8.8.6. Sequential trading. 8.8.7. Equivalence of allocations. 8.9. Recursive competitive equilibrium. 8.9.1. Endowments governed by a Markov process. 8.9.2. Equilibrium outcomes inherit the Markov property. 8.9.3. Recursive formulation of optimization and equilibrium. 8.9.4. Computing an equilibrium with sequential trading of Arrow-securities. 8.10. j -step pricing kernel. 8.10.1. Arbitrage-free pricing. 8.11. Recursive version of Pareto problem. 8.12. Concluding remarks. A. Gaussian asset-pricing model B. The permanent income model revisited 8.B.1. Reinterpreting the single-agent model. 8.B.2. Decentralization and scaled prices. 8.B.3. Matching equilibrium and planning allocations. 8.B.4. Interpretation. 8.15. Exercises.

9. Overlapping Generations Models 315

9.1. Endowments and preferences. 9.2. Time 0 trading. 9.2.1. Example equilibria. 9.2.2. Relation to welfare theorems. 9.2.3. Nonstationary equilibria. 9.2.4. Computing equilibria. 9.3. Sequential trading. 9.4. Money. 9.4.1. Computing more equilibria with valued fiat currency. 9.4.2. Equivalence of equilibria. 9.5. Deficit finance. 9.5.1. Steady states and the Laffer curve. 9.6. Equivalent setups. 9.6.1. The economy. 9.6.2. Growth. 9.7. Optimality and the existence of monetary equilibria. 9.7.1. Balasko-Shell criterion for optimality. 9.8. Within-generation heterogeneity. 9.8.1. Nonmonetary equilibrium. 9.8.2. Monetary equilibrium. 9.8.3. Nonstationary equilibria. 9.8.4. The real bills doctrine. 9.9. Gift-giving equilibrium. 9.10. Concluding remarks. 9.11. Exercises.

10. Ricardian Equivalence 363

10.1. Borrowing limits and Ricardian equivalence. 10.2. Infinitely lived agent economy. 10.2.1. Optimal consumption/savings decision when $b_{t+1} \geq 0$. 10.2.2. Optimal consumption/savings decision when $b_{t+1} \geq \bar{b}_{t+1}$. 10.3. Government. 10.3.1. Effect on household. 10.4. Linked generations interpretation. 10.5. Concluding remarks.

11. Fiscal Policies in a Growth Model 375

11.1. Introduction. 11.2. Economy. 11.2.1. Preferences, technology, information. 11.2.2. Components of a competitive equilibrium. 11.3. The term structure of interest rates. 11.4. Digression: sequential version of government budget constraint. 11.4.1. Irrelevance of maturity structure of government debt. 11.5. Competitive equilibria with distorting taxes. 11.5.1. The household: no-arbitrage and asset-pricing formulas. 11.5.2. User cost of capital formula. 11.5.3. Household first-order conditions. 11.5.4. A theory of the term structure of interest rates. 11.5.5. Firm. 11.6. Computing equilibria. 11.6.1. Inelastic labor supply. 11.6.2. The equilibrium steady state. 11.6.3. Computing the equilibrium path with the shooting algorithm. 11.6.4. Other equilibrium quantities. 11.6.5. Steady-state \bar{R} . 11.6.6. Lump-sum taxes available. 11.6.7. No lump-sum taxes available. 11.7. A digression on back-solving. 11.8. Effects of taxes on equilibrium allocations and prices. 11.9. Transition experiments with inelastic labor supply. 11.10. Linear approximation. 11.10.1. Relationship between the λ_i 's. 11.10.2. Conditions for existence and uniqueness. 11.10.3. Once-and-for-all jumps. 11.10.4. Simplification of formulas. 11.10.5. A one-time pulse. 11.10.6. Convergence rates and anticipation rates. 11.10.7. A remark about accuracy: Euler equation

errors. 11.11. Growth. 11.12. Elastic labor supply. 11.12.1. Steady-state calculations. 11.12.2. Some experiments. 11.13. A two-country model. 11.13.1. Initial conditions. 11.13.2. Equilibrium steady state values. 11.13.3. Initial equilibrium values. 11.13.4. Shooting algorithm. 11.13.5. Transition exercises. 11.14. Concluding remarks. A. Log linear approximations 11.16. Exercises.

12. Recursive Competitive Equilibria

455

12.1. Endogenous aggregate state variable. 12.2. The stochastic growth model. 12.3. Lagrangian formulation of the planning problem. 12.4. Time 0 trading: Arrow-Debreu securities. 12.4.1. Household. 12.4.2. Firm of type I. 12.4.3. Firm of type II. 12.4.4. Equilibrium prices and quantities. 12.4.5. Implied wealth dynamics. 12.5. Sequential trading: Arrow securities. 12.5.1. Household. 12.5.2. Firm of type I. 12.5.3. Firm of type II. 12.5.4. Equilibrium prices and quantities. 12.5.5. Financing a type II firm. 12.6. Recursive formulation. 12.6.1. Technology is governed by a Markov process. 12.6.2. Aggregate state of the economy. 12.7. Recursive formulation of the planning problem. 12.8. Recursive formulation of sequential trading. 12.8.1. A “Big K , little k ” trick. 12.8.2. Price system. 12.8.3. Household problem. 12.8.4. Firm of type I. 12.8.5. Firm of type II. 12.9. Recursive competitive equilibrium. 12.9.1. Equilibrium restrictions across decision rules. 12.9.2. Using the planning problem. 12.10. Concluding remarks.

13. Asset Pricing Theory

481

13.1. Introduction. 13.2. Asset Euler equations. 13.3. Martingale theories of consumption and stock prices. 13.4. Equivalent martingale measure. 13.5. Equilibrium asset pricing. 13.6. Stock prices without bubbles. 13.7. Computing asset prices. 13.7.1. Example 1: logarithmic preferences. 13.7.2. Example 2: a finite-state version. 13.7.3. Example 3: asset pricing with growth. 13.8. The term structure of interest rates. 13.9. State-contingent prices. 13.9.1. Insurance premium. 13.9.2. Man-made uncertainty. 13.9.3. The Modigliani-Miller theorem. 13.10. Government debt. 13.10.1. The Ricardian proposition. 13.10.2. No Ponzi schemes.

14. Asset Pricing Empirics

515

14.1. Introduction. 14.2. Interpretation of risk-aversion parameter. 14.3. The equity premium puzzle. 14.4. Market price of risk. 14.5.

Hansen-Jagannathan bounds. 14.5.1. Law of one price implies that $EmR = 1$. 14.5.2. Inner product representation of the pricing kernel. 14.5.3. Classes of stochastic discount factors. 14.5.4. A Hansen-Jagannathan bound. 14.6. Failure of CRRA to attain HJ bounds. 14.7. Non-expected utility. 14.7.1. Another representation of the utility recursion. 14.7.2. Stochastic discount factor. 14.8. Reinterpretation of the utility recursion. 14.8.1. Risk aversion or model misspecification aversion. 14.8.2. Recursive representation of probability distortions. 14.8.3. Entropy. 14.8.4. Expressing ambiguity. 14.8.5. Ambiguity averse preferences. 14.8.6. Market price of model uncertainty. 14.8.7. Measuring model uncertainty. 14.9. Costs of aggregate fluctuations. 14.10. Reverse engineered consumption heterogeneity. 14.11. Exponential affine stochastic discount factors. 14.11.1. General application. 14.11.2. Term structure application. 14.12. Concluding remarks. A. Riesz representation theorem B. A log normal bond pricing model 14.B.1. Slope of yield curve depends on serial correlation of $\log m_{t+1}$. 14.B.2. Backus and Zin's stochastic discount factor. 14.B.3. Reverse engineering a stochastic discount factor. 14.15. Exercises.

15. Economic Growth

583

15.1. Introduction. 15.2. The economy. 15.2.1. Balanced growth path. 15.3. Exogenous growth. 15.4. Externality from spillovers. 15.5. All factors reproducible. 15.5.1. One-sector model. 15.5.2. Two-sector model. 15.6. Research and monopolistic competition. 15.6.1. Monopolistic competition outcome. 15.6.2. Planner solution. 15.7. Growth in spite of nonreproducible factors. 15.7.1. "Core" of capital goods produced without nonreproducible inputs. 15.7.2. Research labor enjoying an externality. 15.8. Concluding remarks. 15.9. Exercises.

16. Optimal Taxation with Commitment

613

16.1. Introduction. 16.2. A nonstochastic economy. 16.2.1. Government. 16.2.2. Household. 16.2.3. Firms. 16.3. The Ramsey problem. 16.4. Zero capital tax. 16.5. Limits to redistribution. 16.6. Primal approach to the Ramsey problem. 16.6.1. Constructing the Ramsey plan. 16.6.2. Revisiting a zero capital tax. 16.7. Taxation of initial capital. 16.8. Nonzero capital tax due to incomplete taxation. 16.9. A stochastic economy. 16.9.1. Government. 16.9.2. Households. 16.9.3. Firms. 16.10. Indeterminacy of state-contingent debt and capital taxes. 16.11. The Ramsey plan under uncertainty. 16.12. Ex ante capital tax varies around zero. 16.12.1. Sketch of the proof of Proposition 2.

16.13. Examples of labor tax smoothing. 16.13.1. Example 1: $g_t = g$ for all $t \geq 0$. 16.13.2. Example 2: $g_t = 0$ for $t \neq T$ and nonstochastic $g_T > 0$. 16.13.3. Example 3: $g_t = 0$ for $t \neq T$, and g_T is stochastic. 16.14. Lessons for optimal debt policy. 16.15. Taxation without state-contingent debt. 16.15.1. Future values of $\{g_t\}$ become deterministic. 16.15.2. Stochastic $\{g_t\}$ but special preferences. 16.15.3. Example 3 revisited: $g_t = 0$ for $t \neq T$, and g_T is stochastic. 16.16. Nominal debt as state-contingent real debt. 16.16.1. Setup and main ideas. 16.16.2. Optimal taxation in a nonmonetary economy. 16.16.3. Optimal policy in a corresponding monetary economy. 16.17. Relation to fiscal theories of the price level. 16.17.1. Budget constraint versus asset pricing equation. 16.17.2. Disappearance of quantity theory? 16.17.3. Price level indeterminacy under interest rate peg. 16.17.4. Monetary or fiscal theory of the price level? 16.18. Zero tax on human capital. 16.19. Should all taxes be zero? 16.20. Concluding remarks. 16.21. Exercises.

Part IV: The savings problem and Bewley models

17. Self-Insurance

699

17.1. Introduction. 17.2. The consumer's environment. 17.3. Non-stochastic endowment. 17.3.1. An ad hoc borrowing constraint: non-negative assets. 17.3.2. Example: periodic endowment process. 17.4. Quadratic preferences. 17.5. Stochastic endowment process: i.i.d. case. 17.6. Stochastic endowment process: general case. 17.7. Intuition. 17.8. Endogenous labor supply. 17.9. Concluding remarks. A. Supermartingale convergence theorem 17.11. Exercises.

18. Incomplete Markets Models

725

18.1. Introduction. 18.2. A savings problem. 18.2.1. Wealth-employment distributions. 18.2.2. Reinterpretation of the distribution λ . 18.2.3. Example 1: a pure credit model. 18.2.4. Equilibrium computation. 18.2.5. Example 2: a model with capital. 18.2.6. Computation of equilibrium. 18.3. Unification and further analysis. 18.4. The nonstochastic savings problem when $\beta(1+r) < 1$. 18.5. Borrowing limits: natural and ad hoc. 18.5.1. A candidate for a single state variable. 18.5.2. Supermartingale convergence again. 18.6. Average assets as a function of r . 18.7. Computed examples. 18.8. Several Bewley models. 18.8.1. Optimal stationary allocation. 18.9. A model with capital and private

IOUs. 18.10. Private IOUs only. 18.10.1. Limitation of what credit can achieve. 18.10.2. Proximity of r to ρ . 18.10.3. Inside money or free banking interpretation. 18.10.4. Bewley's basic model of fiat money. 18.11. A model of seigniorage. 18.12. Exchange rate indeterminacy. 18.13. Interest on currency. 18.13.1. Explicit interest. 18.13.2. The upper bound on $\frac{M}{p}$. 18.13.3. A very special case. 18.13.4. Implicit interest through deflation. 18.14. Precautionary savings. 18.15. Models with fluctuating aggregate variables. 18.15.1. Aiyagari's model again. 18.15.2. Krusell and Smith's extension. 18.16. Concluding remarks. 18.17. Exercises.

Part V: Recursive contracts

19. Dynamic Stackelberg Problems

775

19.1. History dependence. 19.2. The Stackelberg problem. 19.3. Solving the Stackelberg problem. 19.3.1. Step 1: solve an optimal linear regulator. 19.3.2. Step 2: use the stabilizing properties of shadow price Py_t . 19.3.3. Stabilizing solution. 19.3.4. Step 3: convert implementation multipliers into state variables. 19.3.5. Step 4: solve for x_0 and μ_{x0} . 19.3.6. Summary. 19.3.7. History-dependent representation of decision rule. 19.3.8. Digression on determinacy of equilibrium. 19.4. A large firm with a competitive fringe. 19.4.1. The competitive fringe. 19.4.2. The monopolist's problem. 19.4.3. Equilibrium representation. 19.4.4. Numerical example. 19.5. Concluding remarks. A. The stabilizing $\mu_t = Py_t$ B. Matrix linear difference equations C. Forecasting formulas 19.9. Exercises.

20. Insurance Versus Incentives

797

20.1. Insurance with recursive contracts. 20.2. Basic environment. 20.3. One-sided no commitment. 20.3.1. Self-enforcing contract. 20.3.2. Recursive formulation and solution. 20.3.3. Recursive computation of contract. 20.3.4. Profits. 20.3.5. $P(v)$ is strictly concave and continuously differentiable. 20.3.6. Many households. 20.3.7. An example. 20.4. A Lagrangian method. 20.5. Insurance with asymmetric information. 20.5.1. Efficiency implies $b_{s-1} \geq b_s, w_{s-1} \leq w_s$. 20.5.2. Local upward and downward constraints are enough. 20.5.3. Concavity of P . 20.5.4. Local downward constraints always bind. 20.5.5. Coinsurance. 20.5.6. $P'(v)$ is a martingale. 20.5.7. Comparison to model with

commitment problem. 20.5.8. Spreading continuation values. 20.5.9. Martingale convergence and poverty. 20.5.10. Extension to general equilibrium. 20.5.11. Comparison with self-insurance. 20.6. Insurance with unobservable storage. 20.6.1. Feasibility. 20.6.2. Incentive compatibility. 20.6.3. Efficient allocation. 20.6.4. The case of two periods ($T = 2$). 20.6.5. Role of the planner. 20.6.6. Decentralization in a closed economy. 20.7. Concluding remarks. A. Historical development 20.A.1. Spear and Srivastava. 20.A.2. Timing. 20.A.3. Use of lotteries. 20.9. Exercises.

21. Equilibrium without Commitment

859

21.1. Two-sided lack of commitment. 21.2. A closed system. 21.3. Recursive formulation. 21.4. Equilibrium consumption. 21.4.1. Consumption dynamics. 21.4.2. Consumption intervals cannot contain each other. 21.4.3. Endowments are contained in the consumption intervals. 21.4.4. All consumption intervals are nondegenerate (unless autarky is the only sustainable allocation). 21.5. Pareto frontier and ex ante division of the gains. 21.6. Consumption distribution. 21.6.1. Asymptotic distribution. 21.6.2. Temporary imperfect risk sharing. 21.6.3. Permanent imperfect risk sharing. 21.7. Alternative recursive formulation. 21.8. Pareto frontier revisited. 21.8.1. Values are continuous in implicit consumption. 21.8.2. Differentiability of the Pareto frontier. 21.9. Continuation values à la Kocherlakota. 21.9.1. Asymptotic distribution is nondegenerate for imperfect risk sharing (except when $S = 2$). 21.9.2. Continuation values do not always respond to binding participation constraints. 21.10. A two-state example: amnesia overwhelms memory. 21.10.1. Pareto frontier. 21.10.2. Interpretation. 21.11. A three-state example. 21.11.1. Perturbation of parameter values. 21.11.2. Pareto frontier. 21.12. Empirical motivation. 21.13. Generalization. 21.14. Decentralization. 21.15. Endogenous borrowing constraints. 21.16. Concluding remarks. 21.17. Exercises.

22. Optimal Unemployment Insurance

913

22.1. History-dependent unemployment insurance. 22.2. A one-spell model. 22.2.1. The autarky problem. 22.2.2. Unemployment insurance with full information. 22.2.3. The incentive problem. 22.2.4. Unemployment insurance with asymmetric information. 22.2.5. Computed example. 22.2.6. Computational details. 22.2.7. Interpretations. 22.2.8. Extension: an on-the-job tax. 22.2.9. Extension: intermittent unemployment spells. 22.3. A multiple-spell model with lifetime contracts.

22.3.1. The setup. 22.3.2. A recursive lifetime contract. 22.3.3. Compensation dynamics when unemployed. 22.3.4. Compensation dynamics while employed. 22.3.5. Summary. 22.4. Concluding remarks. 22.5. Exercises.

23. Credible Government Policies, I

937

23.1. Introduction. 23.1.1. Diverse sources of history dependence. 23.2. The one-period economy. 23.2.1. Competitive equilibrium. 23.2.2. The Ramsey problem. 23.2.3. Nash equilibrium. 23.3. Nash and Ramsey outcomes. 23.3.1. Taxation example. 23.3.2. Black-box example with discrete choice sets. 23.4. Reputational mechanisms: general idea. 23.4.1. Dynamic programming squared. 23.5. The infinitely repeated economy. 23.5.1. A strategy profile implies a history and a value. 23.5.2. Recursive formulation. 23.6. Subgame perfect equilibrium (SPE). 23.7. Examples of SPE. 23.7.1. Infinite repetition of one-period Nash equilibrium. 23.7.2. Supporting better outcomes with trigger strategies. 23.7.3. When reversion to Nash is not bad enough. 23.8. Values of all SPEs. 23.8.1. The basic idea of dynamic programming squared. 23.9. The APS machinery. 23.10. Self-enforcing SPE. 23.10.1. The quest for something worse than repetition of Nash outcome. 23.11. Recursive strategies. 23.12. Examples of SPE with recursive strategies. 23.12.1. Infinite repetition of Nash outcome. 23.12.2. Infinite repetition of a better-than-Nash outcome. 23.12.3. Something worse: a stick-and-carrot strategy. 23.13. The best and the worst SPE values. 23.13.1. When v_1 is outside the candidate set. 23.14. Examples: alternative ways to achieve the worst. 23.14.1. Attaining the worst, method 1. 23.14.2. Attaining the worst, method 2. 23.14.3. Attaining the worst, method 3. 23.14.4. Numerical example. 23.15. Interpretations. 23.16. Extensions. 23.17. Exercises.

24. Credible Government Policies, II

985

24.1. Sources of history-dependent government policies. 24.2. The setting. 24.2.1. The household's problem. 24.2.2. Government. 24.2.3. Solution of household's problem. 24.2.4. Competitive equilibrium. 24.3. Inventory of key objects. 24.4. Formal analysis. 24.4.1. Some useful notation. 24.4.2. Another convenient operator. 24.5. Sustainable plans.

25. Two Topics in International Trade 1005

25.1. Two dynamic contracting problems. 25.2. Lending with moral hazard and difficult enforcement. 25.2.1. Autarky. 25.2.2. Investment with full insurance. 25.2.3. Limited commitment and unobserved investment. 25.2.4. Optimal capital outflows under distress. 25.3. Gradualism in trade policy. 25.3.1. Closed-economy model. 25.3.2. A Ricardian model of two countries under free trade. 25.3.3. Trade with a tariff. 25.3.4. Welfare and Nash tariff. 25.3.5. Trade concessions. 25.3.6. A repeated tariff game. 25.3.7. Time-invariant transfers. 25.3.8. Gradualism: time-varying trade policies. 25.3.9. Baseline policies. 25.3.10. Multiplicity of payoffs and continuation values. 25.4. Another model. 25.5. Concluding remarks. A. Computations for Atkeson's model 25.7. Exercises.

Part VI: Classical monetary and labor economics

26. Fiscal-Monetary Theories of Inflation 1045

26.1. The issues. 26.2. A shopping time monetary economy. 26.2.1. Households. 26.2.2. Government. 26.2.3. Equilibrium. 26.2.4. "Short run" versus "long run". 26.2.5. Stationary equilibrium. 26.2.6. Initial date (time 0). 26.2.7. Equilibrium determination. 26.3. Ten monetary doctrines. 26.3.1. Quantity theory of money. 26.3.2. Sustained deficits cause inflation. 26.3.3. Fiscal prerequisites of zero inflation policy. 26.3.4. Unpleasant monetarist arithmetic. 26.3.5. An "open market" operation delivering neutrality. 26.3.6. The "optimum quantity" of money. 26.3.7. Legal restrictions to boost demand for currency. 26.3.8. One big open market operation. 26.3.9. A fiscal theory of the price level. 26.3.10. Exchange rate indeterminacy. 26.3.11. Determinacy of the exchange rate retrieved. 26.4. An example of exchange rate (in)determinacy. 26.4.1. Trading before sunspot realization. 26.4.2. Fiscal theory of the price level. 26.4.3. A game theoretic view of the fiscal theory of the price level. 26.5. Optimal inflation tax: the Friedman rule. 26.5.1. Economic environment. 26.5.2. Household's optimization problem. 26.5.3. Ramsey plan. 26.6. Time consistency of monetary policy. 26.6.1. Model with monopolistically competitive wage setting. 26.6.2. Perfect foresight equilibrium. 26.6.3. Ramsey plan. 26.6.4. Credibility of the Friedman rule. 26.7. Concluding remarks. 26.8. Exercises.

27. Credit and Currency 1093

27.1. Credit and currency with long-lived agents. 27.2. Preferences and endowments. 27.3. Complete markets. 27.3.1. A Pareto problem. 27.3.2. A complete markets equilibrium. 27.3.3. Ricardian proposition. 27.3.4. Loan market interpretation. 27.4. A monetary economy. 27.5. Townsend's "turnpike" interpretation. 27.6. The Friedman rule. 27.6.1. Welfare. 27.7. Inflationary finance. 27.8. Legal restrictions. 27.9. A two-money model. 27.10. A model of commodity money. 27.10.1. Equilibrium. 27.10.2. Virtue of fiat money. 27.11. Concluding remarks. 27.12. Exercises.

28. Equilibrium Search and Matching 1129

28.1. Introduction. 28.2. An island model. 28.2.1. A single market (island). 28.2.2. The aggregate economy. 28.3. A matching model. 28.3.1. A steady state. 28.3.2. Welfare analysis. 28.3.3. Size of the match surplus. 28.4. Matching model with heterogeneous jobs. 28.4.1. A steady state. 28.4.2. Welfare analysis. 28.4.3. The allocating role of wages I: separate markets. 28.4.4. The allocating role of wages II: wage announcements. 28.5. Matching model with overlapping generations. 28.5.1. A steady state. 28.5.2. Reservation productivity is increasing in age. 28.5.3. Wage rate is decreasing in age. 28.5.4. Welfare analysis. 28.5.5. The optimal policy. 28.6. Model of employment lotteries. 28.7. Lotteries for households versus lotteries for firms. 28.7.1. An aggregate production function. 28.7.2. Time-varying capacity utilization. 28.8. Employment effects of layoff taxes. 28.8.1. A model of employment lotteries with layoff taxes. 28.8.2. An island model with layoff taxes. 28.8.3. A matching model with layoff taxes. 28.9. Kiyotaki-Wright search model of money. 28.9.1. Monetary equilibria. 28.9.2. Welfare. 28.10. Concluding remarks. 28.11. Exercises.

29. Foundations of Aggregate Labor Supply 1203

29.1. Introduction. 29.2. Equivalent allocations. 29.2.1. Choosing career length. 29.2.2. Employment lotteries. 29.3. Taxation and social security. 29.3.1. Taxation. 29.3.2. Social security. 29.4. Earnings-experience profiles. 29.4.1. Time averaging. 29.4.2. Employment lotteries. 29.4.3. Prescott tax and transfer scheme. 29.4.4. No discounting now matters. 29.5. Intensive margin. 29.5.1. Employment lotteries. 29.5.2. Time averaging. 29.5.3. Prescott taxation. 29.6. Ben-Porath human capital. 29.6.1. Time averaging. 29.6.2. Employment lotteries. 29.6.3. Prescott taxation. 29.7. Earnings shocks. 29.7.1. Interpretation

of wealth and substitution effects. 29.8. Time averaging in a Bewley model. 29.8.1. Incomplete markets. 29.8.2. Complete markets. 29.8.3. Simulations of Prescott taxation. 29.9. L and S equivalence meets C and K's agents. 29.9.1. Guess the value function. 29.9.2. Verify optimality of time averaging. 29.9.3. Equivalence of time averaging and lotteries. 29.10. Concluding remarks.

Part VII: Technical appendices

A. Functional Analysis	1257
A.1. Metric spaces and operators. A.2. Discounted dynamic programming. A.2.1. Policy improvement algorithm. A.2.2. A search problem.	
B. Linear projections and hidden Markov models	1269
B.1. Linear projections. B.2. Hidden Markov models. B.3. Nonlinear filtering.	
1. References	1275
2. Subject Index	1309
3. Author Index	1315
4. Matlab Index	1321