

Inflation and Structural Reforms in Different Societies (Game Theory Approach)

2023-04-05

WP 2023/05

Central Bank of Armenia
Working Paper 2023/02

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March 2023

Abstract

The combination of structural reforms and inflation differs across countries. There are many evidences which claim about a trade-off between reforms and inflation. While reforms have their effects in the long run and are costly for government, the latter can get benefits from inflation financing in the short run. Our aim is to find the main driving forces of policies based on which various governments choose different proportions of structural reforms and inflation. We extend Barro and Gordon (1983) framework by introducing reforms into the model and design a non-cooperative game between public and government. The paper shows that the forward lookingness of public could be considered a key driving force of making reforms. Less forward looking public, which appears mostly in developing countries, cannot see the long run benefits of reforms and enjoys short run inflationary results. More forward looking public, contrarily, requires government to make reforms and avoid creating inflation.

The paper also simulates a dynamic game, tracing a policy path which enhances the amount of reforms over periods. Conducted reforms, in turn, increase forward lookingness resulting in a loop of amplifying reforms.

Thus it is important for developing countries to primarily conduct a policy which involves at least negligible amount of reforms.

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