

# Game Theory with Economic and Finance Applications

Magistère BFA 2 - Fall 2024

Jérôme MATHIS

[www.jeromemathis.fr/BFA2](http://www.jeromemathis.fr/BFA2)

LEDa - Univ. Paris-Dauphine

Chap.2 Sequential games

## Introduction

- Up till now we have seen games where players play simultaneously
- In most situations, players do not move simultaneously
- We now move to games where they play in turn and can observe what happened before
- Called sequential games.
- One player usually moves first and the other can observe the move

## Sequential games

### Outline

- 1 Introduction
- 2 Simultaneous vs sequential move
- 3 Solution concept
- 4 Order of moves
- 5 Announcing his strategy
- 6 Bargaining
- 7 War and Peace
- 8 Complexity
- 9 Promises and threats
- 10 Burning bridges behind

## Introduction

### To lead or not to lead

- Widespread strategy: « follow the leader ».
  - ▶ Why ?
  - ▶ If the leader's position is due to his ability then... he is the person others want to follow.
- Counter-example: Vendée Globe (round-the-world single-handed yacht race)

## Introduction

To lead or not to lead



## Introduction

To lead or not to lead



## Introduction

To lead or not to lead

- Counter-example: Vendée Globe 1st imitates 2nd!
  - ▶ The leader imitates the follower even when the follower is clearly pursuing a poor strategy. Because in sailboat racing close doesn't count: only winning matters.

## Introduction

To lead or not to lead: Stock-market analysts and economic forecasters

- Leading forecasters have an incentive to follow the pack and produce predictions similar to everyone else's.
  - ▶ This way people are unlikely to change their perception of these forecasters' abilities.
- Newcomers take the risky strategies:
  - ▶ They tend to predict boom or doom.
  - ▶ Usually they are wrong and are never heard of again.
  - ▶ But once they are proven to be correct they move to the ranks of the famous.
- Example: Ranking on the stock pickers sell-side analysts
  - ▶ Best on the Street Survey (Wall Street Journal);
  - ▶ StarMine (Thomson Reuters); and
  - ▶ The All-America Research Team (Institutional Investor).

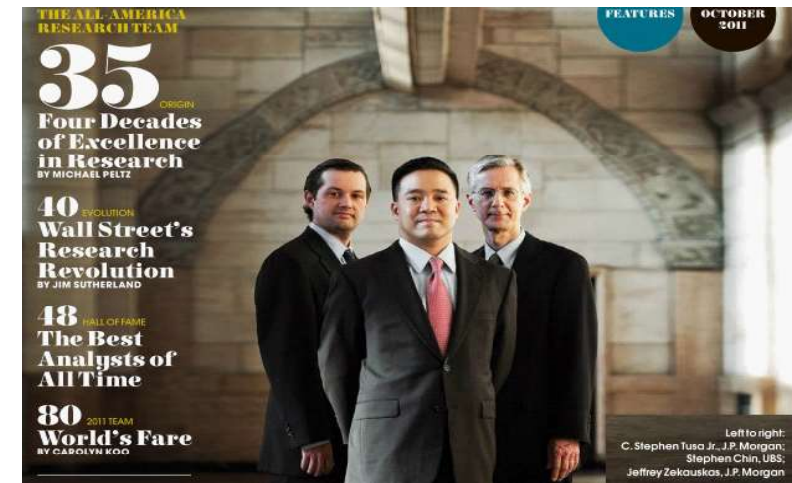
## Introduction

To lead or not to lead: Stock-market analysts and economic forecasters



## Introduction

To lead or not to lead: Stock-market analysts and economic forecasters



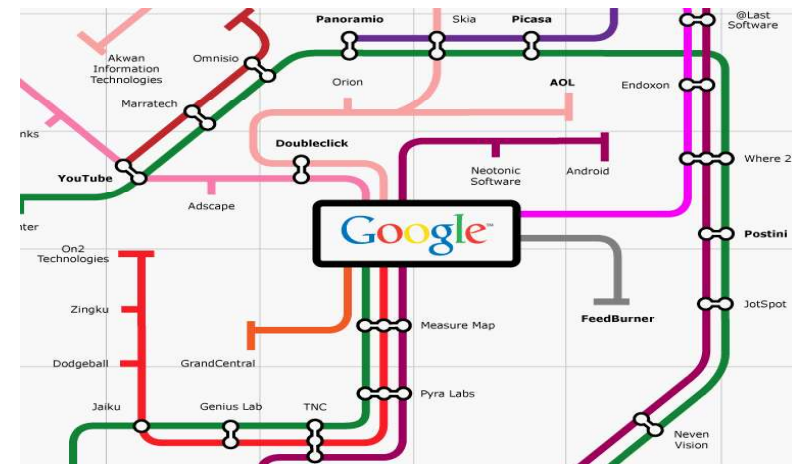
## Introduction

To lead or not to lead: Industrial and technological competition

- IBM vs Apple.
  - ▶ In 1990's IBM was less known for its innovation than for its ability to bring standardized technology to the mass market.
  - ▶ More new ideas had come from Apple and Sun.
- Start-up companies have to take risky innovations to gain market share.
- In Silicon Valley, big firms as Microsoft, Apple, or Google usually:
  - ▶ observe start-up companies activity;
  - ▶ after a period of natural selection, they choose which survival to acquire.

## Introduction

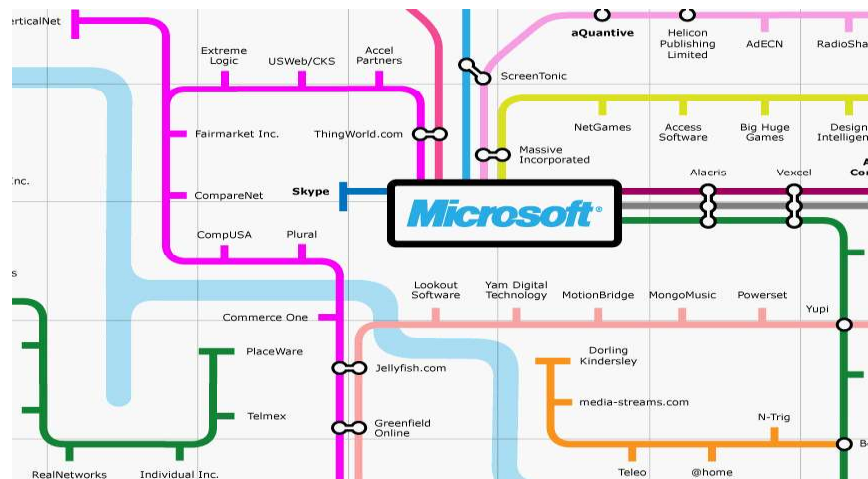
To lead or not to lead: Industrial and technological competition



Google acquisitions and investments

## Introduction

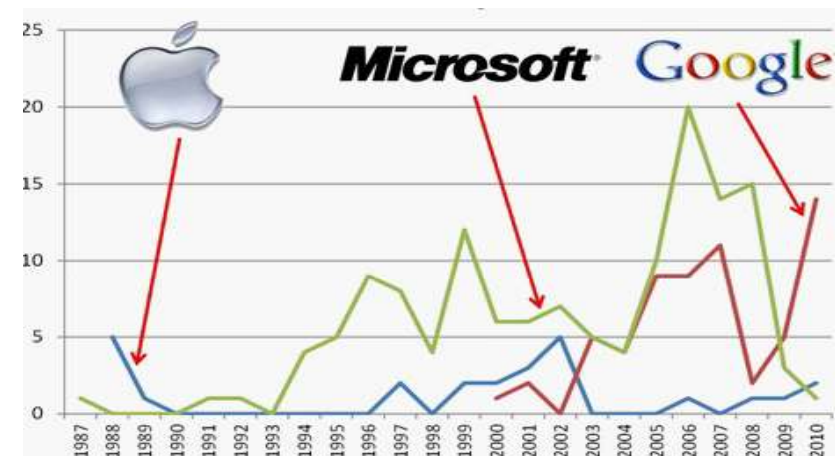
To lead or not to lead: Industrial and technological competition



Microsoft acquisitions and investments

## Introduction

To lead or not to lead: Industrial and technological competition



Number of acquisitions per year

## Introduction

To lead or not to lead: Industrial and technological competition

### Google vs Facebook

- One firm may have the leadership in one field and be a follower in another.
- Two firms may compete by... imitating each other leadership activity.
- Google Buzz is a social networking and messaging tool created by Google to compete with Facebook.
- Facebook now integrates Bing as an internet search engine, so members don't have to leave anymore the site to conduct additional research.

## Introduction

To lead or not to lead: Sport vs Business

- There are two ways to move second:
  - ▶ imitate as soon as the other has revealed his approach (as in sailboat racing); or
  - ▶ wait longer until the success or the failure of the approach is known (as in computer).
- The second strategy is more advantageous in business because, unlike sports, . . . the competition is usually not winner-take-all.

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# Simultaneous vs sequential move

## Back to fashion

- How does the fashion game change?

		<b>RL</b>	
		Sale	No sale
<b>Armani</b>	Sale	40 , 40	50 , 30
	No sale	30 , 70	60 , 60

# Simultaneous vs sequential move

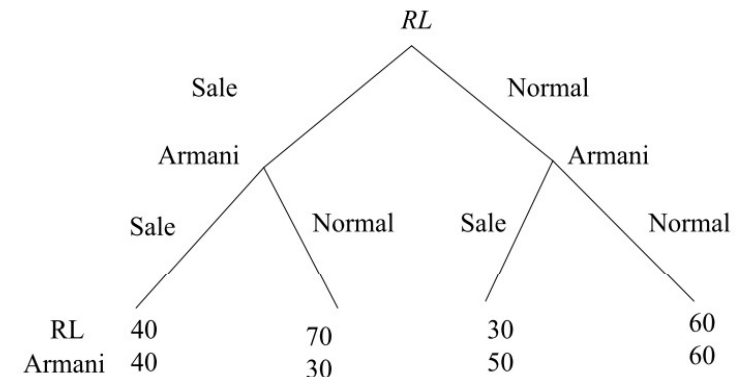
## Back to fashion

# Simultaneous vs sequential move

## Back to fashion

- Situation represented by a tree
- At each node of the tree, one player makes a decision
- Each branch of the tree represents a different decision

## Sequential Moves: RL Goes First



## Sequential games

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## Solution concept

- Need to be more careful in definition of strategies!!!
- A strategy is a full contingent plan: states what you will do at every node in the game where you play
- Define what you do even at points of the game unlikely to be reached.
- In the previous case:
  - ▶ Strategy for RL is sale or normal
  - ▶ Strategy for Armani is more complicated: it states what Armani plays
    - ★ If RL plays Sale
    - ★ If RL plays Normal

## Solution concept

- Nash equilibria defined as it was before:

### Definition (Informal)

A **Nash equilibrium** is a strategy profile where each player's strategy is the best response to that of the other.

- In this case the following are Nash equilibria:
  - ▶ RL plays Sale / Armani plays Sale if RL plays Sale and plays Sale if RL plays Normal
  - ▶ RL plays Normal / Armani plays Sale if RL plays Sale and plays Normal if RL plays Normal

## Solution concept

- First equilibrium based on a non credible threat.
  - ▶ RL does not play Normal because of the threat that if he does, Armani will play Sale: but threat not credible
- Need equilibrium concept that is stronger.

## Solution concept

### Definition

A **Subgame Perfect Nash Equilibrium** is a combination of strategies, one for each player, that generates a Nash Equilibrium in every subgame.

- Subgame: any game starting at some node of the tree
- To find subgame perfect nash equilibrium, use **backwards induction**:
  - ▶ Start from the end of the game
  - ▶ Determine optimal choice of the player playing last
  - ▶ Pull back up the payoffs corresponding to the actions he chose

## Sequential games

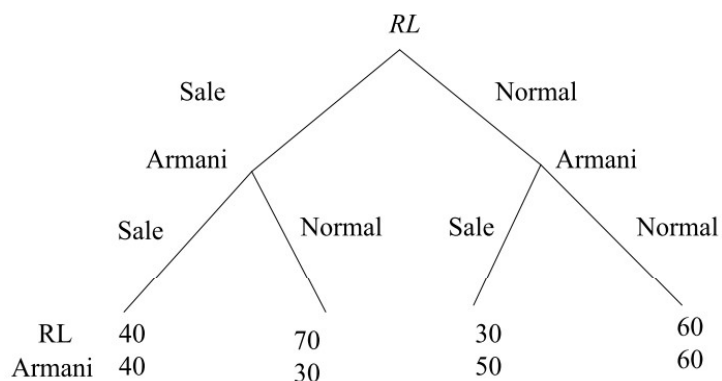
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## Order of moves

### Back to fashion

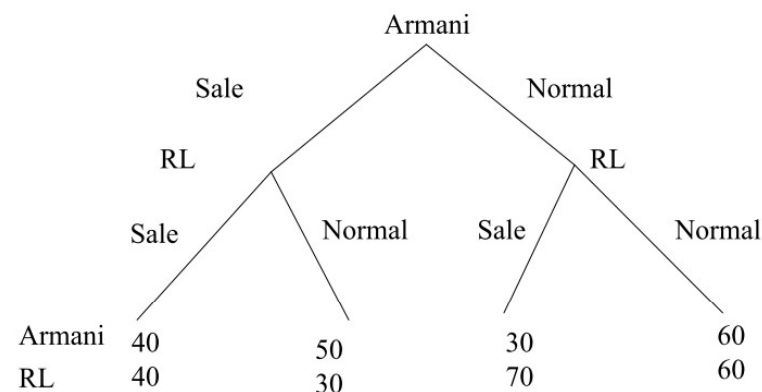
## Sequential Moves: RL Goes First



## Order of moves

### Back to fashion

## What if Armani goes first



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# Announcing his strategy

Competition for 3D innovation between U.S. and Japan.

		Japanese R&D effort	
		Low	High
U.S. R&D effort	Low		
	High		

Assume that for a similar quality product, U.S. obtains a higher market share. But Japan has lower costs.

# Announcing his strategy

Both sides regard a high-effort race as the worst scenario.

		Japanese R&D effort	
		Low	High
U.S. R&D effort	Low	(.,.)	(.,.)
	High	(.,.)	(1,1)

# Announcing his strategy

Each side's second worst outcome is to offer a lower quality product than its competitor does.

		Japanese R&D effort	
		Low	High
U.S. R&D effort	Low	(.,.)	(2,.)
	High	(.,2)	(1,1)



## Announcing his strategy

The Japanese like best the situation in which they pursue high effort and U.S. follows low effort.

		Japanese R&D effort	
		Low	High
U.S. R&D effort	Low	(.,.)	(2,4)
	High	(.,2)	(1,1)

## Announcing his strategy

The second best outcome for Japan is competition of similar low quality products.

		Japanese R&D effort	
		Low	High
U.S. R&D effort	Low	(.,3)	(2,4)
	High	(.,2)	(1,1)

## Announcing his strategy

This last situation is the U.S.'s first-best because they would obtain the higher market share...

		Japanese R&D effort	
		Low	High
U.S. R&D effort	Low	(4,3)	(2,4)
	High	(.,2)	(1,1)

## Announcing his strategy

... while offering a better quality product would give them a just higher market share, but at high costs of effort.

		Japanese R&D effort	
		Low	High
U.S. R&D effort	Low	(4,3)	(2,4)
	High	(3,2)	(1,1)

## Announcing his strategy

U.S. has a dominant strategy:

---

		Japanese R&D effort	
		Low	High
U.S. R&D effort	Low	(4,3)	(2,4)
	High	(3,2)	(1,1)

## Announcing his strategy

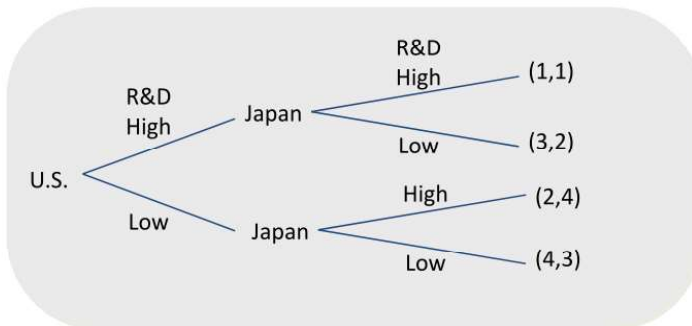
So Japan will choose:

-----

		Japanese R&D effort	
		Low	High
U.S. R&D effort	Low	(4,3)	(2,4)
	High	(3,2)	(1,1)

## Announcing his strategy

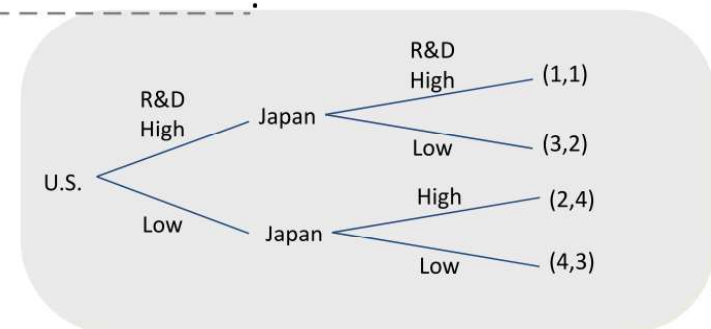
Suppose now the U.S. -----.



## Announcing his strategy

The solution is given by

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It consists in for U.S. to announce « Low », and for Japan to respond « Low ».

## Announcing his strategy

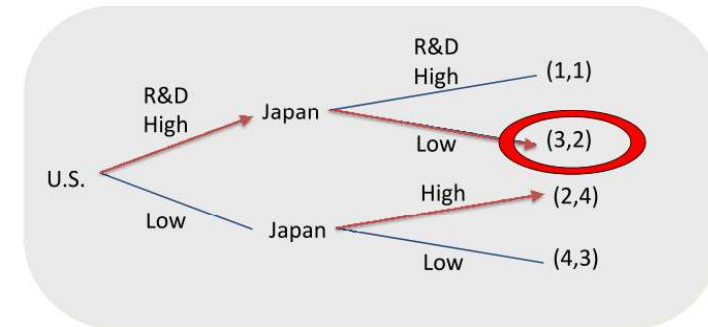
Comparing with the simultaneous move...

		Japanese R&D effort	
		Low	High
U.S. R&D effort	Low	(4,3)	(2,4)
	High	(3,2)	(1,1)

## Announcing his strategy

... U.S. increase their payoffs.

So they have an advantage to \_\_\_\_\_!



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## Bargaining

- The solution of any bargaining depends on:
  - 1 Who gets to make an offer to whom?
  - 2 What happens if the parties fail to reach an agreement?

## Bargaining

- By posting a price in retail stores, the sellers make a «take-it-or-leave-it» offer.
- In the case of wage bargaining, a labor union makes a claim and then the company decides whether to accede. If it does not, it may a counteroffer, or wait for the union to adjust its demand.
- An essential feature of negotiations is that « time is money ».
- When negotiation becomes protracted, the pie begins to shrink.
- If failure to reach a wage agreement leads to a labor strike, the firm loses profits and workers lose their wages.

## Bargaining

- Charles Dickens's Bleack House (1852) novel illustrates the extreme case.
- At the novel's core is long-running litigation in England's Court of Chancery which has far-reaching consequences for all involved.
- The case revolves around a testator who apparently made several wills.
- The litigation was so prolonged that the entire estate was swallowed up by lawyers' fees.

## Bargaining

- Consider the following game:
  - ▶ 2 players have to split a pie.
  - ▶ Player 1 makes an offer. If player 2 refuses, the pie shrinks to zero.
- What is player 1's optimal strategy?
  - ▶

## Bargaining

- Suppose there is a second round of negotiation:
  - ▶ If 2 refuses 1's offer, then the pie shrinks to  $\frac{1}{2}$  and 2 can make an counteroffer.
  - ▶ If 1 refuses 2's counteroffer then the pie shrinks to zero.
- What are players' optimal strategies?
  - ▶ Let us proceed by backward induction: looking ahead and reasoning back

## Bargaining

- At the 2nd round, 2 offers the splitting
  - ▶
- Considering what will happen during the 2nd round, if 1 wants to incentivize 2 to accept his 1st round offer, he has to offer to 2:
  - ▶
- Hence, 1 offers the splitting  $\frac{2}{3}$  and 2 agrees.
  - ▶

## Bargaining

- Let us add a 3rd round:
  - ▶ at each step, the pie loses  $\frac{1}{3}$ .
- At the 3rd round, 1 offers the splitting:
  - ▶
- At the 2nd round, 2 offers at least:
  - ▶
- At the 1st round, 1 offers the splitting :  $\frac{1}{3}$ 
  - ▶

## Bargaining

- What about the 50:50 splitting?
  - ▶ It is the outcome when the number of rounds is even. I.e., when 2 makes the final offer.
- For  $n$  steps, we obtain the following splitting:
  - ▶
  - ▶

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## War and Peace

Some years ago, Sudan was ...



## War and Peace

... a prey to Libya.



## War and Peace

But Libya did not want to draw back troops away from its eastern border with Egypt!



## War and Peace

Three enemies created stability.



1967: Six-Day War.



1978: Camp David Accords. Carter bring together Begin and El-Saddate. Peace Nobel prize 1978.



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## Complexity

### Theorem

*Every sequential game with a finite number of actions possess a best response strategy.*

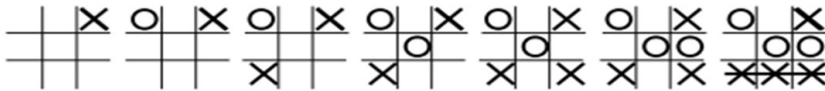
### Problem

*The number of leaves (or terminal nodes) may be very high!*

## Complexity

### Tick-tack-toe

- For instance, even for a game as simple as tick-tack-toe:



- Winning the game requires at least 5 moves. (So there are at least 3 crux)

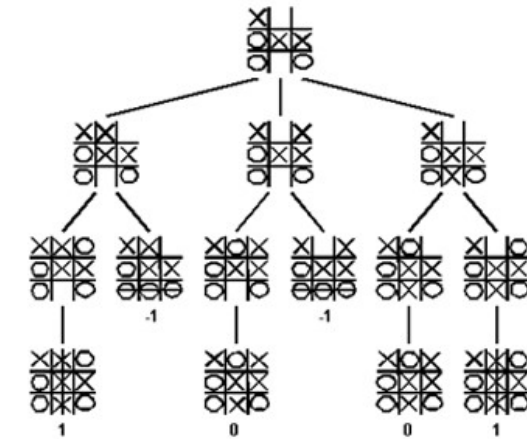
## Complexity

### Tick-tack-toe

- We can use a symmetric argument.
- There are 9 possibilities for the first move.
- By symmetry, we can reduce it to 3: corner, edge, or middle. And, so on...
- Using backward reasoning enables us to compute an algorithm that beat the Backgammon world champion, almost every chess players, ...

## Complexity

### Tick-tack-toe



- The corresponding game tree has a minimum of  $9 \times 8 \times 7 \times 6 \times 5 = 15\,120$  terminal nodes!

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## Promises and threats

Republicans vs Democrats.

A Republican government would like to make Congress votes a budget cut for the sake of a smaller deficit.

The Democrats disapprove because they prefer a Keynesian economic stimulus plan.

Each party has two choices.

## Promises and threats

Democrats has to choose between:

- « supporting » the budget proposal, by voting « yes » to some law propositions; and
- « attacking », by voting « no » to all propositions.

		Republicans	
		support	attack
Democrats	support		
	attack		

## Promises and threats

Republicans has to choose between :

- « completely supporting » the budget proposal, by voting « yes » to all law propositions; and
- « compromising », by voting « yes » to some, but not all law propositions.

		Republicans	
		support completely	compromise
Democrats	support		
	attack		

## Promises and threats

In the case where both parties confront one another by Republicans voting «yes» and Democrats voting «no» to all propositions, the budget cut is blocked.

Opinion polls indicate that people would be infuriated by status quo outcome, and they would criticize Democrats.

		Republicans	
		support completely	compromise
Democrats	support		
	attack		Status quo

## Promises and threats

Democrats would like Republicans to compromise.

		Republicans	
		support completely	compromise
Democrats	support	(2,.)	(3,.)
	attack	(1,.)	(4,.)

## Promises and threats

Republicans would like Democrats to support.

		Republicans	
		support completely	compromise
Democrats	support	(.,4)	(.,3)
	attack	(.,2)	(.,1)

## Promises and threats

Republicans have a dominant strategy :

-----

		Republicans	
		support completely	compromise
Democrats	support	(2,4)	(3,3)
	attack	(1,2)	(4,1)

## Promises and threats

Democrats' best response is:

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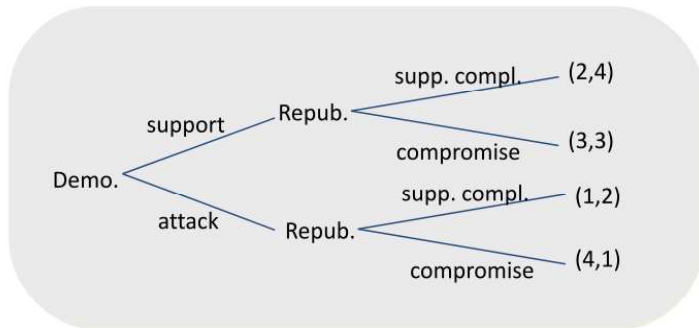
		Republicans	
		support completely	compromise
Democrats	support	(2,4)	(3,3)
	attack	(1,2)	(4,1)

## Promises and threats

Would Democrats benefit from announcing their strategy?

Republicans -----.

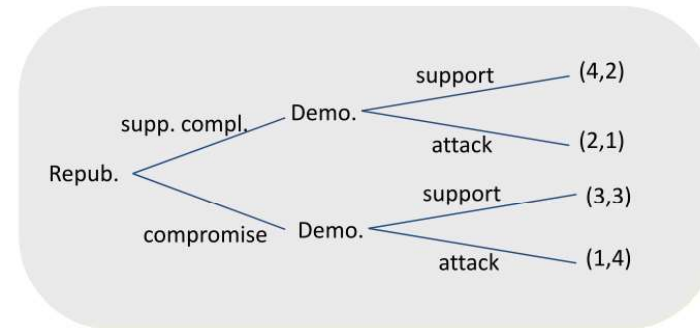
So playing at first -----



## Promises and threats

Would Democrats benefit from letting Republicans to play at first, then best-responding?

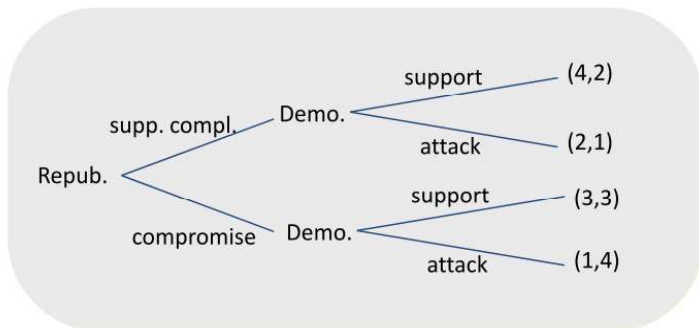
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## Promises and threats

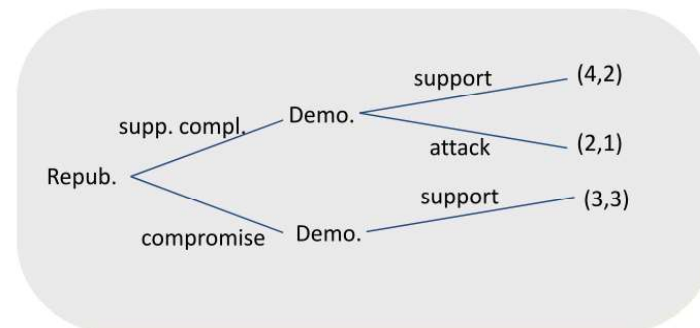
An other solution would consist in Democrats:

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## Promises and threats

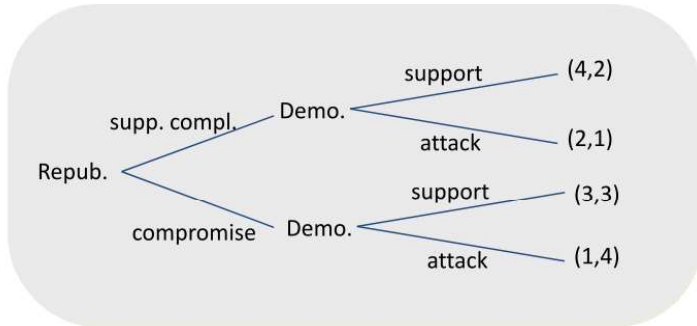
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## Promises and threats

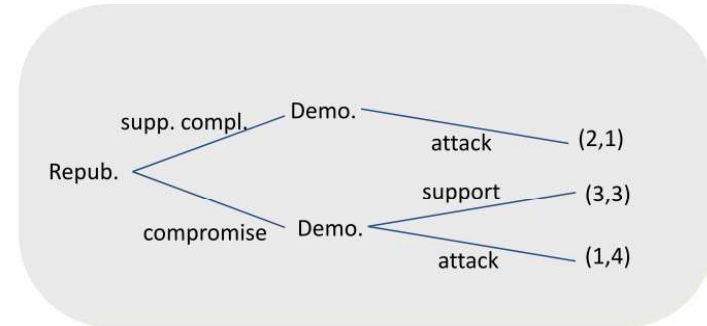
An other solution would consist in Democrats to

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## Promises and threats

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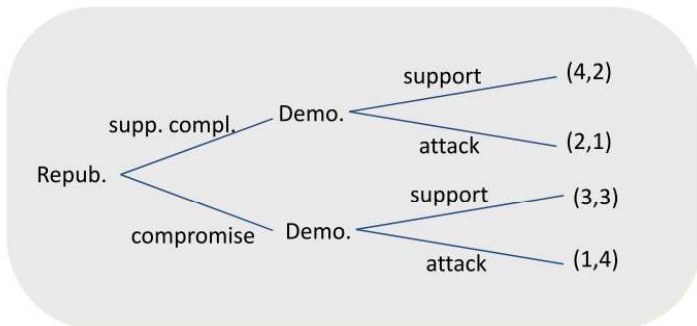
## Promises and threats

The solution is Democrats:

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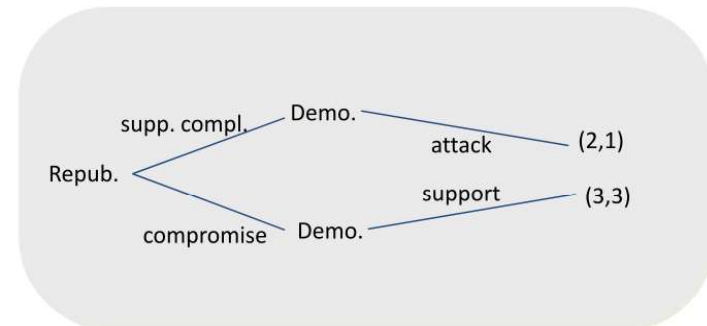
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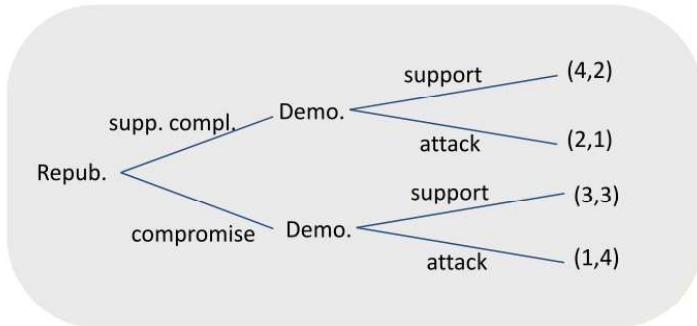
## Promises and threats

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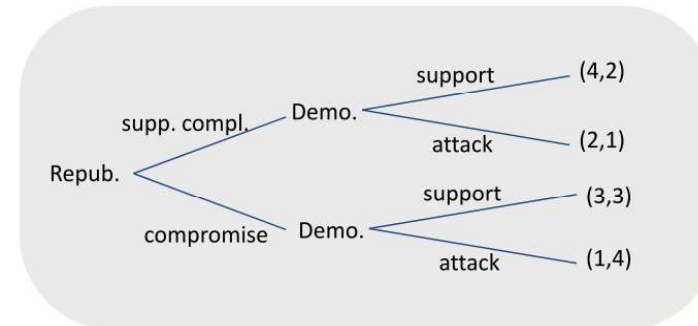
## Promises and threats

Such a strategy requires Democrats to be credible.  
 Because once Republicans have « compromised » ...  
 ... they have ----- !



## Promises and threats

If Republicans anticipate such a deviation,  
 -----



## Promises and threats

Interacting repeatedly may confer credibility to  
 -----

If the interaction occurs only once,  
 -----  
 -----

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## Burning bridges behind

- In sequential games we saw that the order of moves is essential
- Players can then take actions prior to the game, that will change the outcome
- These actions can:
  - ▶ Make threats credible
  - ▶ Change directly the payoffs of the game

## Burning bridges behind

« Quemar las naves ! »

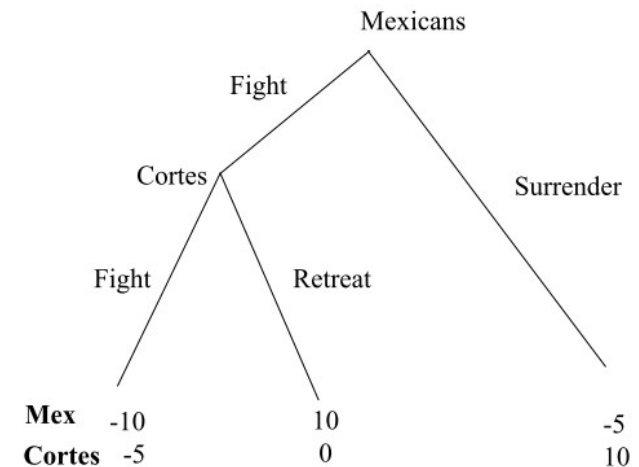


Hernán Cortés  
1485 - 1547

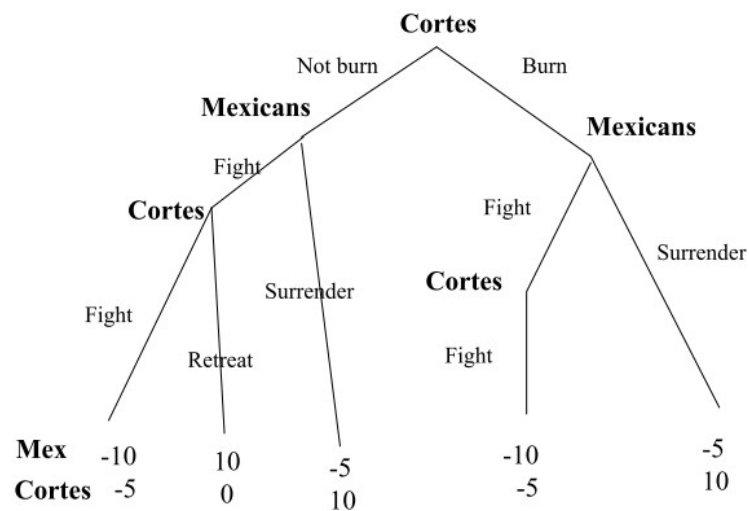
## Burning bridges behind

- Most classical examples of these types of moves can be found throughout history
- Famous example is Cortes' conquest of Mexico
- Upon arrival in Cempoalla he gave orders to burn down all ships
- What did this change?

## Burning bridges behind



## Burning bridges behind



## Burning bridges behind

### Politics

- Such examples abound in history of warfare
  - ▶ Involve burning down ships, bridges (ways to retreat)
- Not limited to warfare
- Campaign promises: are they credible?
  - ▶ Credibility is linked to the cost of going back on the promise
  - ▶ How can the cost be changed?
  - ▶ Delegating policy to independent agencies
  - ▶ In particular monetary policy
    - ★ Limiting *stop-and-go* policy
  - ▶ Goal is to create *credibility*