



Solving a Ramsey Model

numecon

Jeppe Druedahl

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Plan

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Introduction

Introduction

- **Subject:** Solve a Ramsey model numerically (using Python)
- **NumEcon module**
 1. **Source files:** GitHub.com
 2. **Interactive version:** MyBinder.org
- **Today:**
 1. **Notebook:** macro\Ramsey.ipynb
 2. **Code:** numecon\macro\Ramsey.py

Model



- **Households** (of measure 1):
Own capital, supply labor and consume.
- **Firms:** Rent capital and hire labor to produce.
- **Variables:**
 1. Capital: K_t
 2. Labor supply: L_t
 3. Output: Y_t
 4. Consumption: C_t
- **Per worker:** $k_t \equiv K_t/L_t$, $y_t \equiv Y_t/L_t$ and $c_t \equiv C_t/L_t$
- **Prices** are taken as given by households and firms
 1. r_t , rental rate on capital
 2. w_t , wage rate
- **Net return factor on capital:** $R_t \equiv 1 + r_t - \delta$
where $\delta > 0$ is the depreciation rate

Households I

- Inelastically supply labour, $L_t = 1$
- Maximize the discounted sum of utility from consumption

$$\max_{\{c_t\}_{t=0}^{\infty}} \sum_{t=0}^{\infty} \beta^t u(c_t), \quad u' > 0, u'' < 0$$

under the constraints

$$k_{t+1} = R_t k_t + w_t - c_t$$

$$\lim_{t \rightarrow \infty} \mathcal{R}_t^{-1} k_t \geq 0$$

$$\mathcal{R}_t = \prod_{j=0}^t R_j$$

$$k_0 \text{ given}$$

and given time paths for $\{R_t\}_{t=0}^{\infty}$ and $\{w_t\}_{t=0}^{\infty}$

- **Optimal behavior** imply the Euler-equation $\frac{u'(c_t)}{u'(c_{t+1})} = \beta R_{t+1}$
- **CRRA utility:** $u(c_t) = \frac{c_t^{1-\sigma}}{1-\sigma}, \sigma > 0$

1. **Euler-equation**

$$c_{t+1} = (\beta R_{t+1})^{1/\sigma} c_t$$

2. **Consumption function**

$$\begin{aligned} c_0 &= \frac{1}{\theta} [R_0 k_0 + h_0] \\ h_0 &\equiv \sum_{t=0}^{\infty} \mathcal{R}_t^{-1} w_t \\ \theta &\equiv \sum_{t=0}^{\infty} (\beta^t \mathcal{R}_t)^{1/\sigma} \mathcal{R}_t^{-1} \end{aligned}$$

- **Production function:** $Y_t = F(K_t, L_t) = f(k_t)L_t$
where F is neoclassical
- **Maximize profits**

$$\max_{K_t, L_t} f(k_t)L_t - r_t K_t - w_t L_t =$$

- The **first order conditions** imply

$$\begin{aligned} f'(k_t) &= r_t \\ f(k_t) - f'(k_t)k_t &= w_t \end{aligned}$$

- The **law-of-motion**, $(k_{t+1}, c_{t+1}) = \Gamma(k_t, c_t)$, is given by the solution to the equation system

$$k_{t+1} = k_t(1 - \delta) + f(k_t) - c_t$$

$$\frac{u'(c_t)}{u'(c_{t+1})} = \beta(1 + f'(k_{t+1}) - \delta)$$

- **Curves (loci)** where k or c is constant
 1. k : $\{(k, c) \mid c = f(k) - \delta k\}$
 2. c : $\{(k, c) \mid 1 = \beta(1 + f'(k) - \delta)\}$

Solution algorithm

Find steady state

- In **steady state**:

1. capital, k^* , solves

$$\beta(1 + f'(k^*) - \delta) = 1$$

2. consumption, c^* , then equals

$$c^* = f(k^*) - \delta k^*$$

- **Cobb-Douglas**:

$$k^* = \left(\frac{\frac{1}{\beta} - 1 + \delta}{\alpha} \right)^{\frac{1}{\alpha-1}}$$

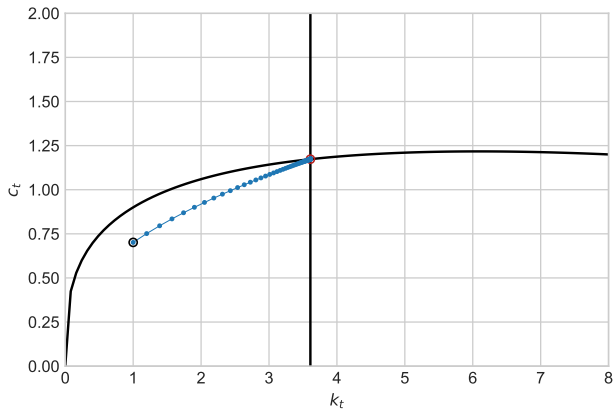
Find initial consumption, c_0

1. Choose **initial capital** $k_0 > 0$ and **tolerance level** $\tau > 0$
2. Set **initial bounds** as $(\underline{c}_0, \bar{c}_0) =$
$$\begin{cases} (0, f(k_0) - \delta k_0) & \text{if } k_0 < k^* \\ (f(k_0) - \delta k_0, f(k_0) + k_0 - \delta k_0) & \text{if } k_0 \geq k^* \end{cases}$$
3. Set $c_0 = (\underline{c}_0 + \bar{c}_0)/2$ and $c = c_0$ and $k = k_0$
4. **Update** using the law-of-motion: $(k, c) = \Gamma(k, c)$
 - a. If $\sqrt{(c^* - c)^2 + (k^* - k)^2} < \tau$ **stop**
 - b. If $k_0 \leq k^*$ then
 - If $c \leq c^* \wedge k \leq k^*$ go to step 4
 - If $k > k^*$ set $\underline{c}_0 = c_0$ and go to step 3
 - If $c > c^*$ set $\bar{c}_0 = c_0$ and go to step 3
 - c. If $k_0 > k^*$ then
 - If $c \geq c^* \wedge k \geq k^*$ go to step 4
 - If $k < k^*$ set $\bar{c}_0 = c_0$ and go to step 3
 - If $c < c^*$ set $\underline{c}_0 = c_0$ and go to step 3

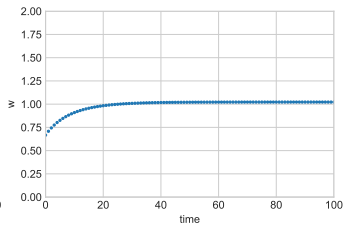
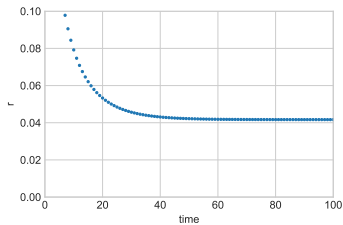
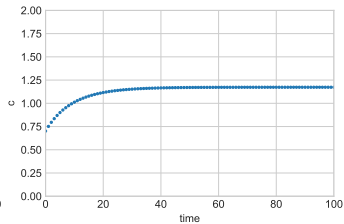
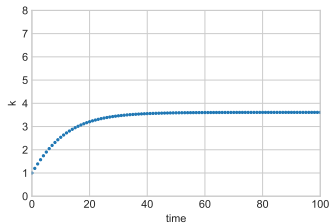
Example

1. $f(k_t) = k_t^\alpha$ (Cobb-Douglas)
2. $\beta = 0.96$
3. $\sigma = 2$
4. $\alpha = 1/3$
5. $\delta = 0.10$
6. $k_0 = 1$
7. $\tau = 10^{-6}$

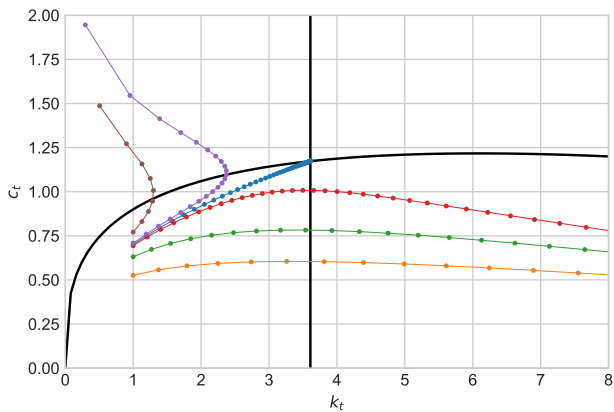
Phase diagram



Time profiles



Diverging paths



Extensions

Potential extensions

1. **Government** (taxes and spending)
2. **Temporary shock(s)**
3. **Announced shock(s)**
4. **Endogenous labor supply**