Introduction to Dynamic Programming

Part III: FE for identifying the optimal policy

PPE Phil(e)¹

¹material @ https://github.com/PPEphile

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Table of Contents

Identifying the optimal policy

- Theorem 4 (necessary condition)
- Theorem 5 (sufficient condition)
- Example

Stokey, N.L., Lucas, R.E. and Prescott, E.C. (1989) *Recursive Methods in Economic Dynamics*. Cambridge, Harvard University Press.

Intro

• We want to solve:

$$\max_{0 \le x_{t+1} \le f(x_t)} \sum_{t=0}^{\infty} \beta^t F(x_t, x_{t+1})$$
 (SP)

- Last time we identified $v^*(x)$, the solution to the (SP)
- But is that really what we were after?

Corn-growing with linear utility

Consider the classical corn growing example with utility U(c)=c, f(k)=2k and $\beta=\frac{1}{3}$ and some $k_0\geq 0$.

A necessary condition

This gives us an intuitive necessary condition:

Theorem 4

If the path \underline{x}^* is optimal, then

$$v^*(x_t^*) = F(x_t^*, x_{t+1}^*) + \beta v^*(x_{t+1}^*) = \max_{y \in \Gamma(x)} \{F(x, y) + \beta v^*(y)\}$$

for all t.

A sufficient condition

Theorem 5

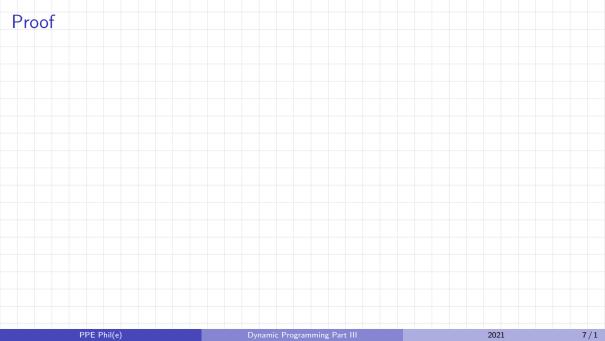
If the candidate path \hat{x} is feasible and satisfies

$$v^*(\hat{x}_t) = F(\hat{x}_t, \hat{x}_{t+1}) + \beta v^*(\hat{x}_{t+1})$$

for all t and

$$\limsup_{t\to\infty}\beta^t v^*(\hat{x}_t)\leq 0$$

then \hat{x} is optimal.



Example

Corn-growing with linear utility

Consider the classical corn growing example with utility U(c) = c, f(k) = 3k and $\beta = \frac{1}{3}$ and some $k_0 \ge 0$.