A generic continuous time, infinite horizon, deterministic sequential problem (**SP**) can be written:

given

where is the state vector, the control vector, the return function, the discount rate, the optimal value, the transition function, and the initial condition.

The corresponding functional equation (**HJB**) can be written:

The FOC: gives the policy function in terms of the unknown value function.

The user should make sure the appropriate SOCs hold.

Combining the HJB with the FOC we get a **DE**:

In general, DE has multiple solutions, and only one of them is the optimal value function in SP. The goal of this note is to try to understand how to restrict DE to ensure the solution is the optimal value function.

The examples in this note can also be solved by solving the Euler-Lagrange (**EL**) equation (the continuous time analog to the Euler Equation), which in generic differentiable problems with 1 state & 1 control variable can be written:

Note that the corresponding recursive costate variable is and TS.

Following Sethi 2022, the standard terminal condition (TC) for this subset of control problems is

.

**Proposition 1**: **DE** has a unique viscosity solution, which is also the solution to **SP**.

This allows for weak solutions (value functions with non-differentiable kinks).

Reference: Crandall & Lions 1983 etc.

**Proposition 2**: DE can be solved with an FD scheme that converges to the unique viscosity solution under 3 conditions monotonicity/consistency/stability.

Reference: Barles & Souganidis 1991, [Tourin 2013](https://www.fields.utoronto.ca/programs/scientific/09-10/finance/courses/tourin.pdf) etc.

Q: what theorem tells us that if a candidate solution to DE satisfies an appropriate state boundary inequality, then it must be the unique viscosity solution?

In general, for each example there will be at least 4 ways to rule out the non-viscosity solution to DE.

0: for LQR problems (examples 1 & 2) the optimal solution is the Stabilizing solution of the continuous time Algebraic Riccati Equation (ARE).

1: for these examples, each solution to DE, will give a time-series (TS) solution. Only the optimal value function gives .

{Q: what is the analog to this for stochastic problems? Stochastic maximum principle?}

2: for theses examples, each solution to DE, will give a TS solution. We can plug the TS solution into the return function and compute the implied value function. Then we can check if the implied value function is the same as the solution to DE.

Q: where is it proven that this only holds for the viscosity solution?

3. if you can prove a solution to DE is either not a viscosity supersolution or subsolution, then it cannot be a solution to DE. In general, this can be hard to verify.

4. the solution to DE, which also solves, must satisfy the state constraint boundary inequality (BI), the other solutions do not. In general, this is much easier to verify.

IMPORTANT: I don’t fully understand the BI .

It makes perfect sense for problems where know that, then if.

What about for problems (such as consumption saving) where for some parameters?

TOC of examples:

|  |  |
| --- | --- |
| 1: LQ from  Viscosity solutions for Dummies | DE has two quadratic solutions.  The viscosity sol: Satisfies TC, , satisfies BI |
| 2: LQ, Non-Hayashi investment | DE has two quadratic solutions. {One is affine.}  The viscosity sol: Satisfies TC, , satisfies BI |
| 3: Hayashi investment  No SS. | .  DE has two linear solutions.  The viscosity sol: Satisfies TC, , satisfies BI |
| 4: Consumption saving | DE has a concave & an affine solution. {Possibly others too.}  The viscosity sol: Satisfies TC, , satisfies BI |
| 5: NGM to do |  |

In the first two examples:

The TS implies by the viscosity solution will converge to the SS. The TS implies by the non-viscosity solutions will diverge.

This is not true in general.

In the consumption savings model (and Hayashi firm investment problem), for certain parameters the TS implied by the viscosity solution also diverges!

Example 1 (LQ example from “Viscosity solutions for Dummies”):

|  |  |
| --- | --- |
| SP | , given. Here.  Note: the return function is bounded in .  Note: the return function is bounded in . |
| HJB, FOC  DE  LQR | DE  LQR: Exactly 2 quadratic solutions to DE: |
| BI | Q: how do you know to set?  BI: |
| EL | {EL & LOM & IC}  {unique steady state}  {Combine EL & LOM}      Note: {TS costate variable} |

Compare the 2 quadratic solutions to DE:

|  |  |
| --- | --- |
| Solution 1 (quadratic concave): | Solution 2 (quadratic convex): |
| Recursive Solution:  {value}  {policy}  {transition}  {always}    {concave} | Recursive Solution:  {value}  {policy}  {transition}  {never}    {convex} |
| TS Solution implied by the recursive solution:  {IVP-ODE}        Same as the solution to EL when. | TS Solution implied by the recursive solution:  {IVP-ODE}        Same as the solution to EL when. |
| 0: Stabilizing solution of the continuous time ARE. | 0: Anti-Stabilizing solution of the continuous time ARE. |
| 1: | 1: |
| Plug TS into return fcn:  Plugin SP:  2: TS implied is the same as the solution to DE! | Plug TS into return fcn:  Plugin SP:  2: If |
| 3: is a viscosity solution of DE. | 3: is not a viscosity supersolution.  Let for. |
| 4: BI:  How do you know to set??? | 4: BI:  Not satisfy BI for . |

Example 2 (LQ, Non-Hayashi Firm Investment) Summary:

|  |  |
| --- | --- |
| SP | , given.  Parameters:. Let.  Note: the return function is bounded in.  Note: the return function is unbounded in |
| HJB, FOC  DE  LQR | DE  LQR: 2 quadratic solutions to DE: |
| BI | Q: how do you know to set?  BI: |
| EL | {EL & LOM & IC}  {unique steady state}  {Combine EL & LOM}      Note: {TS costate variable} |

Compare the 2 quadratic solutions to DE:

|  |  |
| --- | --- |
| Solution 1 (quadratic concave): | Solution 2 (quadratic convex): |
| Recursive Solution:  {value}  {policy}  {transition}  {always}    {weakly concave} | Recursive Solution:  {value}  {policy}  {transition}  {never}    {convex} |
| TS Solution implied by the recursive solution:  {IVP-ODE}        Same as the solution to EL when. | TS Solution implied by the recursive solution:  {IVP-ODE}        Same as the solution to EL when. |
| 0: Stabilizing solution of the continuous time ARE. | 0: Not Anti-Stabilizing solution of the continuous time ARE.  Does not satisfy LQ sufficient conditions… |
| 1: | 1: |
| Plug TS into return fcn:  Plugin SP:  2: TS implied is the same as the solution to DE! | Plug TS into return fcn:  Plugin SP:  2: TS implied is **not** the same as the solution to DE! |
| 3: is a viscosity solution of DE. | 3: is not a viscosity solution. |
| 4: BI:  How do you know to set??? | 4: BI:  BI not satisfied for . |

Example 3 (Firm Investment Hayashi) Summary:

|  |  |
| --- | --- |
| SP | , given.  Parameters:  Note: the return is bounded in  Note: the return is unbounded in |
| HJB, FOC  DE | DE |
| BI | BI: |
| EL | EL: Nasty quadratic ODE, no SS.  Note: {TS costate variable} |

Compare the 2 linear solutions to DE:

|  |  |
| --- | --- |
| Solution 1: | Solution 2: |
| Recursive Solution:  {value}  {policy}  {transition}  {}    {weakly concave} | Recursive Solution:  {value}  {policy}  {transition}  {Never}    {weakly concave} |
| TS Solution implied by the recursive solution:  {IVP-ODE} | TS Solution implied by the recursive solution: |
| 1: {Always} | 1: {always} |
| Plug TS into return fcn:  Plugin SP:  2: TS implied is the same as the solution to DE! | Plug TS into return fcn:  Plugin SP:  2: TS implied is **not** the same as the solution  to DE! |
| 3: is a viscosity solution of DE. | 3: is not a viscosity solution. |
| 4: BI: | 4: BI |

Example 4 (Consumption Savings) Summary:

|  |  |
| --- | --- |
| SP | , given, or  Let: let and note  Note: the return function is unbounded. Need . |
| HJB, FOC  DE  LQR | DE  Sol 1:  Sol 2: if and and |
| BI | Q: how do you know to set?  BI:  BI: |
| EL | {EL & LOM & IC}  {unique steady state}  {Combine EL & LOM}      Note: {TS costate variable} |

Compare the 2 solutions to DE:

|  |  |
| --- | --- |
| Solution 1 (concave): | Solution 2 (weakly concave): |
| Recursive Solution:  {value}  {policy}  {transition}  {if}    {weakly concave} | Recursive Solution:  {value}  {policy}  {transition}  {never}    {weakly concave} |
| TS Solution implied by the recursive solution:  {IVP-ODE}        Same as the solution to EL when. | TS Solution implied by the recursive solution:  {IVP-ODE} |
| 1: | 1: |
| Plug TS into return fcn:    2: TS implied is the same as the solution to DE! | Plug TS into return fcn:    2: TS implied is **not** the same as the solution to DE! |
| 3: is a viscosity solution of DE. | 3: is not a viscosity solution. |
| 4: BI: | 4: BI: contradicts |