Solving economic problems with MATLAB

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- Many economic problems are VERY complicated
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- Often, even if we can describe some QUALITATIVE features, we need numerical methods for QUANTITATIVE results
- Mostly: solving non-linear equations and optimisation problems

Optimization Toolbox: basics

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- linear programming

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- systems of nonlinear equations
- multiobjective optimization

Optimization Toolbox: basics (cont.)

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All the functions are **function functions**: they take other functions as inputs. In particular:

- the objective function is a **function** file
- nonlinear constraints must be set in a **function** file

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- nonlinear constraints must be set in a **function** file

Options: set with `optimset`

REMINDER: what is a function?

```
function z = olscoefficient(X,Y)
  z = inv(X'*X)*(X'*Y);
end
```

Nonlinear equations in one variable

Use the function `fzero`: finds roots of continuous functions
Syntax:

```
[x, fval] = fzero('objfun',x0);
```

`x`: optimum
`fval`: value of the objective function calculated in the optimum
`objfun`: function file where we have stored the objective function
`x0`: initial condition from which `fzero` looks for a solution

Nonlinear equations in more than one variable

If you have n nonlinear equations $F_i(x) = 0$, with $x \in R^n$, use `fsolve`.
Syntax:

```
[x, fval] = fsolve('objfun',x0);
```

`x`: optimum

`fval`: value of the objective function calculated in the optimum

`objfun`: function file where we have stored the objective function

`x0`: initial condition from which `fsolve` looks for a solution

Example 1

Solve the following system of equations:

$$c_1^{-\sigma} = \beta(1+r)c_2^{-\sigma}$$
$$c_1 + \frac{c_2}{1+r} = y_1 + \frac{y_2}{1+r}$$

where $r = 0.05$, $\sigma = 2$, $\beta = .99$, and $y_1 = y_2 = 1$.

Example 2

Same as before, but with an initial amount of savings s_0:

$$c_1^{-\sigma} = \beta(1+r)c_2^{-\sigma}$$
$$c_1 + \frac{c_2}{1+r} = y_1 + \frac{y_2}{1+r} + s_0$$

where $r = 0.05$, $\sigma = 2$, $\beta = .99$, and $y_1 = y_2 = 1$.
Solve for the optimal allocation for different values of the initial savings.

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3. **Linear Equality Constraints**: $Aeq \cdot x = beq$, same dimensionality of linear inequality constraints
4. **Nonlinear Constraints**: $c(x) \leq 0$ and $ceq(x) = 0$. Both c and ceq are scalars or vectors representing several constraints

Setting options

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```
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```

IMPORTANT: some parameter values are strings, therefore you have to enter them between ' '. Example:

```
options  = optimset('Display','iter');
```

Unconstrained Minimization

No constraints

$$\min_{x} f(x)$$

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Use `fminunc`:

```
[x, fval] = fminunc('objfun',x0)
```

Constrained Minimization

$$\begin{aligned} \min_{x} \quad & f(x) \\ s.t. \quad & x \geq LB, \quad x \leq UB \\ & A \cdot x \leq B, \quad Aeq \cdot x = Beq \\ & c(x) \leq 0, \quad ceq(x) = 0 \end{aligned}$$

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Use `fmincon`:

```
[x, fval] = fmincon('objfun',x0,A,B,Aeq,Beq,...
    LB,UB,nonlcon);
```

When one or more constraints absent: use []

Writing a nonlinear constraint function

Writing a nonlinear constraint function

It must have a particular structure

```
function [c, ceq] = nonlinconst(input1,input2,...)

c(1) = ...
c(2) = ...
...
ceq(1) = ...
ceq(2) = ...
...
```

Writing a nonlinear constraint function

It must have a particular structure

```
function [c, ceq] = nonlinconst(input1,input2,...)

c(1) = ...
c(2) = ...
...
ceq(1) = ...
ceq(2) = ...
...
```

If no constraints of one type: use `ceq = [];`

Example 1

Use fmincon to maximize the utility function $u(c) = \frac{c^{1-\sigma}}{1-\sigma}$ under the constraints:

$$c \geq 0$$
$$c \leq y$$

where $\sigma = 2$ and $y = 1$.

Example 2

Take again a two-periods economy with an initial amount of savings s_0. Your problem is

$$\max_{c_1, c_2} \frac{c_1^{1-\sigma}}{1-\sigma} + \beta \frac{c_2^{1-\sigma}}{1-\sigma}$$
$$s.t. \quad c_1 + \frac{c_2}{1+r} \leq y_1 + \frac{y_2}{1+r} + s_0$$

where $r = 0.05$, $\sigma = 2$, $\beta = .99$, and $y_1 = y_2 = 1$. Solve for the optimal allocation for different values of the initial savings. (Hint: vectorizing the procedure is not possible here, therefore you need to use a `for` loop).

Example 3

Maximize the utility function $u(c_1, ..., c_{10}) = \sum_{i=1}^{10} \frac{c_i^{1-\sigma}}{1-\sigma}$ under the constraints:

$$c_i \geq 0 \text{ for all } i$$
$$\sum_{i=1}^{10} c_i \leq y$$
$$2c_3 + c1 = 12$$
$$0.5(c_5 - c_4)^2 = 4$$

where $\sigma = 2$ and $y = 100$.