

# Lecture IV: Differentiation, IFT, Unconstrained Optimization

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## 1. Differentiation

**Definition 1.** Let  $I \subseteq \mathbb{R}$  be an open interval; a function  $f : I \rightarrow \mathbb{R}$  is **differentiable** at  $a \in I$  if

$$\lim_{x \rightarrow a} \frac{f(x) - f(a)}{x - a} = L$$

for some  $L$  (that is, the limit exists). We write  $f'(a) = L$  or  $\frac{df}{dx}(a) = L$ . If  $f$  is differentiable  $\forall a \in I$  then we say  $f$  is differentiable in  $I$ .

Intuitively, differentiation yields the slope of a function at a point:

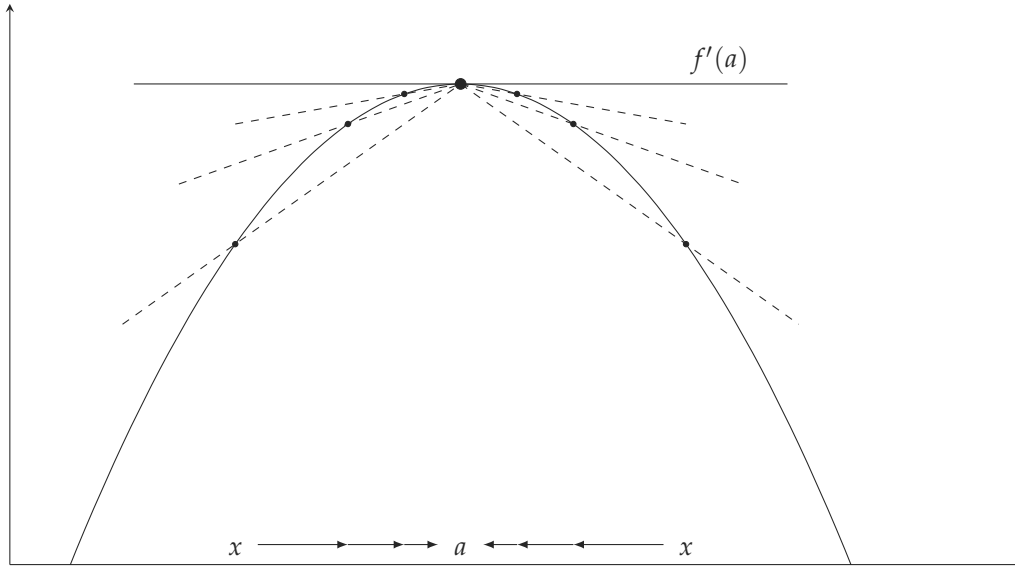


Figure 1: Graphical representation of a derivative

**Theorem 1.** If  $f : I \rightarrow \mathbb{R}$  is differentiable at  $a \in I$  then  $f$  is also continuous at  $a$ .

*Proof.* We want to show that  $\forall \varepsilon > 0 \exists \delta > 0$  s.t.

$$|x - a| < \delta \implies |f(x) - f(a)| < \varepsilon$$

Since  $f$  is differentiable, we know that for any such  $\varepsilon$ , we can find some  $\tilde{\delta} > 0$  s.t.

$$\frac{|f(x) - f(a)|}{\tilde{\delta}} < \frac{|f(x) - f(a)|}{|x - a|} = \left| \frac{f(x) - f(a)}{x - a} - L + L \right| \leq \left| \frac{f(x) - f(a)}{x - a} - L \right| + |L| < \varepsilon + |L|$$

for some  $L$ . That is, we know the derivative exists and it is equal to some  $L$ , so by the definition of a limit, we can find  $\tilde{\delta} > 0$  s.t.

$$|x - a| < \tilde{\delta} \implies \left| \frac{f(x) - f(a)}{x - a} - L \right| < \varepsilon$$

Hence whenever  $|x - a| < \tilde{\delta}$  we get

$$|f(x) - f(a)| < (\varepsilon + |L|) \tilde{\delta}$$

If we can find  $\delta \leq \tilde{\delta}$  s.t.  $(\varepsilon + |L|) \delta < \varepsilon$  then we'd be done. If  $\tilde{\delta} < 1$ , then take  $\delta = \tilde{\delta} \cdot \frac{\varepsilon}{\varepsilon + |L|} \leq \tilde{\delta}$  (since  $|L| \geq 0$ , we multiply  $\tilde{\delta}$  by something  $< 1$ ). Then we have

$$|x - a| < \delta \leq \tilde{\delta} \implies |f(x) - f(a)| < (\varepsilon + |L|) \frac{\varepsilon}{\varepsilon + |L|} \tilde{\delta} = \varepsilon \tilde{\delta} < \varepsilon$$

where the last inequality holds if  $\tilde{\delta} < 1$ . If  $\tilde{\delta} \geq 1$ , then set  $\delta = \frac{\varepsilon}{\varepsilon + |L|} \leq 1 \leq \tilde{\delta}$  and we get

$$|x - a| < \delta \leq \tilde{\delta} \implies |f(x) - f(a)| < (\varepsilon + |L|) \frac{\varepsilon}{\varepsilon + |L|} = \varepsilon$$

□

**Theorem 2.** Let  $f : I \rightarrow \mathbb{R}$  and  $g : I \rightarrow \mathbb{R}$  be differentiable.

- $\frac{d}{dx}[cf(x)] = cf'(x)$ .
- $\frac{d}{dx}[f(x) + g(x)] = f'(x) + g'(x)$ .
- **Product rule:**  $\frac{d}{dx}f(x)g(x) = f'(x)g(x) + f(x)g'(x)$ .
- **Power rule:**  $\frac{d}{dx}x^k = kx^{k-1}$ .
- **Chain rule:**  $(f \circ g)(x) = f(g(x)) = f'(g(x))g'(x)$ .
- **Quotient rule:**  $\frac{f(x)}{g(x)} = \frac{f'(x)g(x) - f(x)g'(x)}{g(x)^2}$ .

Some useful special results:

$$\begin{aligned}\frac{d}{dx}e^x &= e^x \\ \frac{d}{dx}\log(x) &= \frac{1}{x} \\ \frac{d}{dx}\sin(x) &= \cos(x) \\ \frac{d}{dx}\cos(x) &= -\sin(x)\end{aligned}$$

**Definition 2.** A function  $f : I \rightarrow \mathbb{R}$  is **continuously differentiable** if  $f'$  is continuous.

**Example 1.**  $f(x) = x^2$  is continuously differentiable since  $f'(x) = 2x$  is continuous. However,

$$f(x) = \begin{cases} x^2 \sin(1/x) & x \neq 0 \\ 0 & x = 0 \end{cases}$$

is *not* continuously differentiable. In particular, for  $x \neq 0$ ,

$$f'(x) = 2x \cos(1/x) - x^2 \frac{1}{x^2} \cos(1/x) = 2x \cos(1/x) - \cos(1/x)$$

and for  $x = 0$  the derivative is 0:

$$\lim_{x \rightarrow 0} \frac{f(x) - f(0)}{x - 0} = \lim_{x \rightarrow 0} \frac{x^2 \sin(1/x)}{x} = \lim_{x \rightarrow 0} x \sin(1/x)$$

With  $\sin(1/x)$  bounded,  $x \rightarrow 0 \implies x \sin(1/x) \rightarrow 0$ . However, the derivative itself is not continuous at 0. Note that while  $2x \cos(1/x) \xrightarrow{x \rightarrow 0} 0$ ,  $-\cos(1/x)$  does not have a limit, so the derivative does not have a limit as  $x \rightarrow 0$  either, meaning it cannot be continuous.  $\square$

**Theorem 3** (L'Hôpital's rule.). Take  $f, g : [a, b] \rightarrow \mathbb{R}$  be continuous functions on  $[a, b]$  and differentiable on  $(a, b)$  with  $f(x), g(x) \neq 0$  for all  $x \in (a, b)$ . Further, let

$$\lim_{x \rightarrow b} \frac{f'(x)}{g'(x)} = L$$

and  $g(b) = f(b) = 0$  or  $\lim_{x \rightarrow b} g(b) = \lim_{x \rightarrow b} f(b) = 0$ . Then

$$\lim_{x \rightarrow b} \frac{f(x)}{g(x)} = L$$

**Theorem 4** (Taylor's theorem). Let  $n \in \mathbb{N}$  and  $f : [a, b] \rightarrow \mathbb{R}$  be continuously differentiable  $n + 1$  times on  $(a, b)$ . Then for all  $\tilde{x}, x \in (a, b)$  there is some  $c \in (\tilde{x}, x)$  s.t.

$$f(x) = \sum_{k=0}^n \frac{f^{(k)}(\tilde{x})}{k!} (x - \tilde{x})^k + \frac{f^{(n+1)}(c)}{(n+1)!} (x - \tilde{x})^{n+1}$$

The first term is called the  **$n$ th order Taylor expansion** of  $f$  around  $\tilde{x}$ .

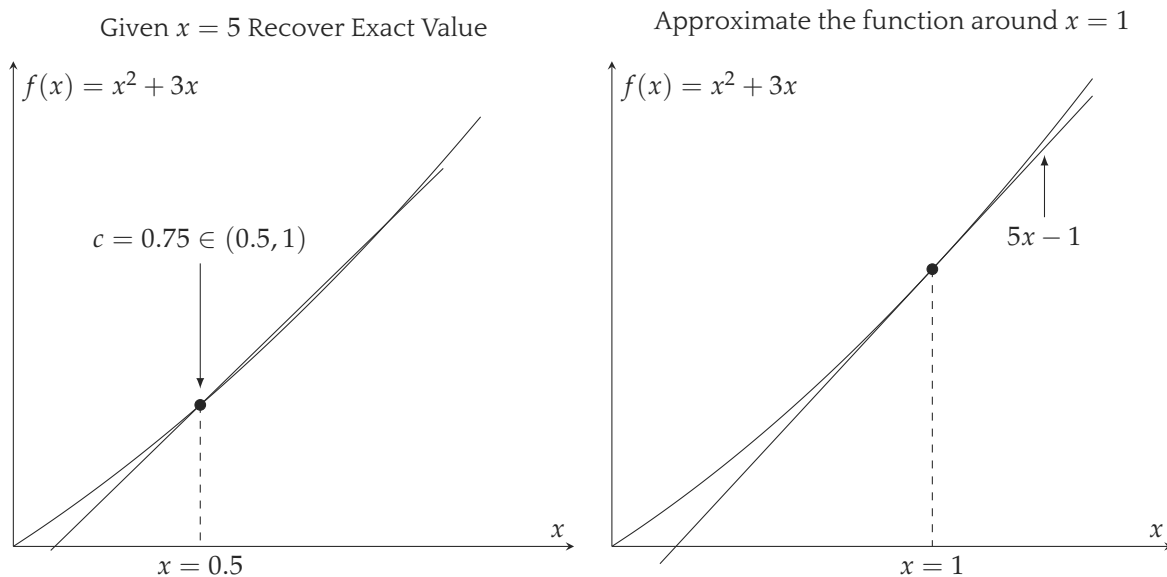
**Example 2.** • The Taylor expansion of any polynomial is the polynomial itself. Consider

$$f(x) = x^2 + 3x$$

$$\begin{aligned} f(x) &= \frac{f(1)}{0!} (x-1)^0 + \frac{f'(1)}{1!} (x-1)^1 + \frac{f''(c)}{2!} (x-1)^2 \\ &= 4 + 5(x-1) + \frac{2}{2} (x-1)^2 \\ &= 4 + 5x - 5 + x^2 - 2x + 1 = x^2 + 3x \end{aligned}$$

However, for lower-order Taylor expansions the theorem still applies. Visually:

Figure 2: Visualizing Taylor's Theorem



The left and right figures correspond to:

$$\begin{aligned} f(x) &= \frac{f(1)}{0!} (x-1)^0 + \frac{f'(c)}{1!} (x-1)^1 \\ &= 4 + (2c + 3)(x-1) \\ f(x) &\approx \frac{f(1)}{0!} (x-1)^0 + \frac{f'(1)}{1!} (x-1)^1 \end{aligned}$$

$$= 4 + 5(x - 1)$$

We can see on the left that there is indeed some number  $c$  s.t. Taylor's theorem holds. For our sample value of  $x = 0.5$  we find  $c = 0.75 \in (0.5, 1)$ . On the right figure, on the other hand, we plot the *approximation*. In this case, the function and the approximation are exactly equal at 1, since the approximation at that point simplifies to  $f(1)$ . We can also see that around  $x = 1$  the approximation is fairly good! However, farther away the error increases, as we would expect.

- One common Taylor approximation is for the logarithm. In particular, the first order Taylor expansion around 1:

$$\log(x) \approx \log(1) + \frac{1}{1}(x - 1) = x - 1$$

Another version of this approximation is for  $\log(1 + x)$  around 0:

$$\log(1 + x) \approx \log(1) + \frac{1}{1+0}(x - 0) = x$$

Take the relation:

$$\log Y = \alpha \log K + (1 - \alpha) \log L$$

Using the approximation above, we can say that if  $K$  increases by 10%, then  $Y$  increases by  $\alpha \log(1.1) \approx \alpha \cdot 0.1$ , that is,  $10\alpha\%$ .

This second approximation is often used when dealing with percentage changes. You will hear the term **log-linearization** thrown around, and this is what that's in reference to: Logarithms can be approximated as a percentage for small values.  $\square$

### 1.1. Partial Derivatives.

**Definition 3.** Let  $f : S \subseteq \mathbb{R}^N \rightarrow \mathbb{R}^M$ ,  $e = (e_1, \dots, e_N)$  a standard basis of  $\mathbb{R}^N$ ,  $u = (u_1, \dots, u_M)$  a standard basis for  $\mathbb{R}^M$ .  $\forall x \in S$ ,  $f(x) \in \mathbb{R}^M$ ,  $f(x)$  is a linear combination of  $u$  and some set of functions  $\{f_1, \dots, f_M\}$  s.t.  $f_i : S \rightarrow \mathbb{R}$  with

$$f(x) = \sum_{i=1}^M f_i(x) u_i$$

**Definition 4.** The **partial derivative** of a function  $f : S \subseteq \mathbb{R}^N \rightarrow \mathbb{R}^M$  at  $x \in S$  is

$$\frac{\partial}{\partial x_j} f_i(x) = \lim_{t \rightarrow 0} \frac{f_i(x + t \cdot e_j) - f_i(x)}{t}$$

for  $i = 1, \dots, M$  and  $j = 1, \dots, N$ .

Note that partial derivatives needn't imply anything about the behavior of the function overall. Take, for instance,  $f : \mathbb{R}^2 \rightarrow \mathbb{R}$  with

$$f(x, y) = \begin{cases} \frac{xy^2}{x^2 + y^4} & (x, y) \neq (0, 0) \\ 0 & (x, y) = (0, 0) \end{cases}$$

The partial derivatives at 0 are all 0 (crucially, we take the limits one dimension at a time, so it's not that  $(x, y) \rightarrow (0, 0)$ , but rather  $x \rightarrow 0$  and then  $y \rightarrow 0$ . Now take any  $y_m \rightarrow 0$  and  $x_m = y_m^2$  s.t.  $y_m \neq 0$  for all  $n$ .

$$\lim_{n \rightarrow \infty} f(x_m, y_m) = \frac{1}{2} \neq 0$$

which means the function is not even continuous at 0.

**Theorem 5** (Schwarz's Theorem). Let  $f : S \subseteq \mathbb{R}^N \rightarrow \mathbb{R}$ ; then

$$\frac{\partial}{\partial x_i} \frac{\partial}{\partial x_j} f(x) = \frac{\partial}{\partial x_j} \frac{\partial}{\partial x_i} f(x)$$

if all the partial derivatives exist. That is, mixed partial derivatives are symmetric (if they exist).

**Definition 5.** Let  $f : S \subseteq \mathbb{R}^N \rightarrow \mathbb{R}^M$  and  $x \in S$ ;  $(Df)(x)$  is a  $N \times M$  matrix with  $i, j$  entry equal to  $\frac{\partial}{\partial x_i} f_j(x)$ .

**Definition 6.** The **gradient** of  $f : S \subseteq \mathbb{R}^N \rightarrow \mathbb{R}$  at  $x \in S$  is

$$(\nabla f)(x) = \begin{bmatrix} \frac{\partial}{\partial x_1} f(x) \\ \vdots \\ \frac{\partial}{\partial x_N} f(x) \end{bmatrix}$$

The gradient can also be denoted as  $(Df)(x)$ .

**Definition 7.** The **Hessian** of  $f : S \subseteq \mathbb{R}^N \rightarrow \mathbb{R}$  at  $x \in S$  is

$$(D^2 f)(x) = \begin{bmatrix} \frac{\partial^2}{\partial x_1^2} f(x) & \cdots & \frac{\partial^2}{\partial x_N \partial x_1} f(x) \\ \vdots & \ddots & \vdots \\ \frac{\partial}{\partial x_1 \partial x_N} f(x) & \cdots & \frac{\partial^2}{\partial x_N^2} f(x) \end{bmatrix}$$

Where  $D^2$  denotes the application of the  $D$  operator twice.

## 1.2. Mean Value Theorem (MVT).

**Theorem 6** (Mean Value Theorem (MVT)). Let  $f : [a, b] \rightarrow \mathbb{R}$  be a continuous function on the closed interval  $[a, b]$  and differentiable on the open interval  $(a, b)$ . Then  $\exists c \in (a, b)$  s.t.

$$f'(c) = \frac{f(b) - f(a)}{b - a}$$

We will prove an equivalent, albeit perhaps conceptually easier, version of this:

**Theorem 7** (Rolle's Theorem). Let  $g : [a, b] \rightarrow \mathbb{R}$  be continuous on  $[a, b]$  and differentiable on  $(a, b)$  with  $g(a) = g(b)$ . Then  $\exists c \in (a, b)$  s.t.

$$f'(c) = 0$$

**Claim 1.** *Rolle's Theorem* iff *Mean Value Theorem (MVT)*.

*Proof.* The mean value theorem implies Rolle's theorem by definition. Simply note that by the MVT there is some  $c$  s.t.

$$f'(c) = \frac{g(b) - g(a)}{b - a} = 0$$

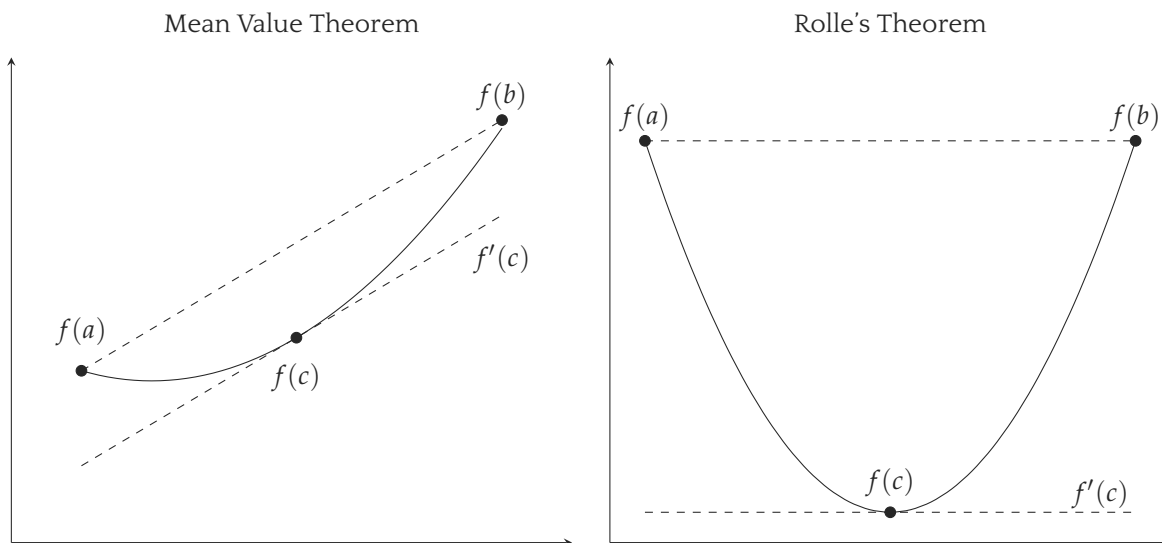


Figure 3: Graphical depiction of MVT

Now to show Rolle's theorem implies MVT, we only need a simple transformation:

$$g(x) = (f(x) - f(a)) - \frac{f(b) - f(a)}{b - a}(x - a)$$

Note that  $g(a) = g(b) = 0$ . Hence  $\exists c$  s.t.

$$g'(c) = 0$$

But we can see that

$$g'(c) = f'(c) - \frac{f(b) - f(a)}{b - a} = 0 \implies f'(c) = \frac{f(b) - f(a)}{b - a}$$

□

Now we show [Rolle's Theorem](#).

*Proof.* For Rolle's theorem we will use the extreme value theorem, and we know that  $f$  is bounded and attains its sup and its inf in  $[a, b]$ . If the sup and the inf are both at  $\{a, b\}$ , then because by assumption  $f(a) = f(b) = 0$ ,  $f(x) = 0$  everywhere on  $[a, b]$ . Take any  $c \in (a, b)$ , and

$$f'(c) = \lim_{y \rightarrow c} \frac{f(y) - f(c)}{y - c} = \lim_{y \rightarrow c} \frac{0}{y - c} = \lim_{y \rightarrow c} 0 = 0$$

Suppose then that either the sup or the inf occur at an interior point  $c \in (a, b)$ . Take the sup (the case for the inf will be analogous). By assumption  $f$  is differentiable, so  $f'(c)$  exists. That is, we know that

$$f'(c) = \lim_{y \rightarrow c} \frac{f(y) - f(c)}{y - c} = L$$

Consider  $y \rightarrow c^-$ , that is  $y$  approaching  $c$  from the left. Since the sup is attained at  $c$ ,  $f(c) \geq f(y)$  for all  $c > y$ , which in turn gives

$$\frac{f(y) - f(c)}{y - c} \geq 0 \quad \forall c > y$$

Now take  $y \rightarrow c^+$ , that is  $y$  approaching  $c$  from the right. Again, since the sup is attained at  $c$ ,  $f(c) \geq f(y)$  for all  $c < y$ , which in turn gives

$$\frac{f(y) - f(c)}{y - c} \leq 0 \quad \forall c < y$$

Which means that

$$L_- = \lim_{y \rightarrow c^-} \frac{f(y) - f(c)}{y - c} \geq 0$$

Suppose not, then  $L_- < 0$ . But for every  $\varepsilon > 0$  there is some  $\delta$  s.t.

$$c^- - \delta < y < c^- < c^- + \delta \implies L_- - \varepsilon < \frac{f(y) - f(c)}{y - c} < L_- + \varepsilon$$

Take  $\varepsilon$  s.t.  $L_- < -\varepsilon < 0$ . Then for some  $\delta > 0$ , we get

$$c^- - \delta < y < c^- < c^- + \delta \implies L_- - \varepsilon < \frac{f(y) - f(c)}{y - c} < L_- + \varepsilon < 0$$

But we have established that  $y < c$  gives  $\frac{f(y) - f(c)}{y - c} \geq 0$ , a contradiction. By that same logic, we can write

$$L_+ = \lim_{y \rightarrow c^+} \frac{f(y) - f(c)}{y - c} \leq 0$$

Since  $f'(c)$  exists, it must be the case that

$$f'(c) = \lim_{y \rightarrow c^+} \frac{f(y) - f(c)}{y - c} = L_+ = \lim_{y \rightarrow c^-} \frac{f(y) - f(c)}{y - c} = L_- = L$$

Now we can see that  $L_+ \leq 0$ ,  $L_- \geq 0$ , and  $L_+ = L_- = L$  gives that  $L = 0$ . The proof for the case when the inf is interior is completely analogous.  $\square$

**Corollary 1.** If  $f$  is continuous on  $[a, b]$  and differentiable on  $(a, b)$  and obtains a local minimum or maximum at  $c$ , then  $f'(c) = 0$ .

**Corollary 2.** If  $f$  is continuous on  $[a, b]$  and differentiable on  $(a, b)$  and  $f'(x) > 0$  for every  $x \in (a, b)$  then  $f$  is increasing on  $(a, b)$ . Conversely, if  $f'(x) < 0$  for every  $x \in (a, b)$  then  $f$  is decreasing on  $(a, b)$ .

**Theorem 8** (Generalized MVT). Let  $f, g : [a, b] \rightarrow \mathbb{R}$  be continuous functions on  $[a, b]$  and differentiable on  $(a, b)$ . Then  $\exists c \in (a, b)$  s.t.

$$g'(c) (f(b) - f(a)) = f'(c) (g(b) - g(a))$$

The MVT is a case where  $g(x) = x$ , the identity function.

## 2. Implicit Function Theorem (IFT)

**2.1. Motivation.** Consider a function  $f(x, y) = 0$ . How do we characterize a function relating  $x$  to  $y$ ? We can write that for  $f : \mathbb{R}^2 \rightarrow \mathbb{R}$  continuously differentiable on an open set  $O$  with  $f(x, y) = 0$ , there exists some function  $h$  s.t.

$$f(x, h(x)) = 0 \text{ and } \frac{dy}{dx} = -\frac{\partial f / \partial x}{\partial f / \partial y}$$



One classic example is how to characterize the slope of a tangent line at a point  $(x, y)$  of some circle of radius  $r$  centered at  $(0, 0)$ . That is,  $x^2 + y^2 = r^2$ . We can write

$$f(x, y) = x^2 + y^2 - r^2 = 0$$

So we know that for some  $h(x)$ ,  $f(x, h(x)) = 0$ . Furthermore,

$$\frac{\partial f}{\partial x} = 2x \quad \frac{\partial f}{\partial y} = 2y \implies \frac{dy}{dx} = -\frac{x}{y}$$

We will look at the general version of the theorem. We often work with a parameter space and a variable space, and we want to express the variables in terms of the parameters (or with exogenous and endogenous variables, and we want to express the endogenous variables in terms of the exogenous variables). Take

$$(\theta_1, \dots, \theta_N) = \theta \in \mathbb{R}^N$$

to be the parameters (or exogenous) and

$$(x_1, \dots, x_M) = x \in \mathbb{R}^M$$

to be the variables (or endogenous). It's typically not common to have an explicit expression for the latter in terms of the former, but often we will encounter an implicit relation of the form

$$f(\theta, x) = 0$$

For example, some system of equations

$$f_1(\theta, x) = 0$$

$$\vdots$$

$$f_M(\theta, x) = 0$$

The IFT gives a result we can apply to these types of problems.

## 2.2. The IFT.

**Theorem 9** (Implicit Function Theorem (IFT)). *Take a function  $f : \mathbb{R}^N \times \mathbb{R}^M \rightarrow \mathbb{R}^M$  that is continuously differentiable and fix a point  $(\tilde{\theta}, \tilde{x}) \in \mathbb{R}^N \times \mathbb{R}^M$  s.t.  $f(\tilde{\theta}, \tilde{x}) = 0$ . If  $D_x f(\tilde{\theta}, \tilde{x})$  is non-singular (i.e. full-rank, or has a non-0 determinant) then for some open sets  $A, B$  s.t.  $\tilde{\theta} \in A$ ,  $\tilde{x} \in B$ , there exist a unique function  $h : A \rightarrow B$  that is continuously differentiable in  $A$  s.t.*

$$f(\theta, h(\theta)) = 0$$

for all  $\theta \in A$ , and  $h(\tilde{\theta}) = \tilde{x}$ . Taking derivatives with respect to  $\theta$ , we further have

$$\begin{aligned} D_\theta f(\theta, h(\theta)) + D_x f(\theta, h(\theta)) D_\theta h(\theta) &= 0 \\ D_\theta h(\theta) &= -[D_x f(\theta, h(\theta))]^{-1} D_\theta f(\theta, h(\theta)) \end{aligned}$$

**2.3. Example.** Take a simplified version of the IS-LM model

$$Y = C + I + G$$

$$C = C(Y - T)$$

$$I = I(r)$$

$$M^S = M^D(Y, r)$$

with

$$0 < C'(x) < 1 \quad I'(r) < 0 \quad \frac{\partial M^D}{\partial Y} > 0 \quad \frac{\partial M^D}{\partial r} < 0$$

National income must equal consumption plus investment (savings) plus government spending: consumption is some function of income minus taxes, the level of investment is determined by the interest rate, and money supply must equal money demand. We have that

$$\begin{aligned} Y - C(Y - T) - I(r) - G &= 0 \\ M^S - M^D(Y, r) &= 0 \end{aligned}$$

which is the exact type of problem the IFT can help us solve. We have endogenous variables  $x = (Y, r)$ , national income and the interest rate, and exogenous variables  $\theta = (M^S, G, T)$ , money supply, government spending, and taxes. Hence

$$(1) \quad f(\theta, x) = \begin{bmatrix} f_1(\theta, x) \\ f_2(\theta, x) \end{bmatrix} = \begin{bmatrix} Y - C(Y - T) - I(r) - G \\ M^S - M^D(Y, r) \end{bmatrix} = 0$$

Hence for some  $h$ , we can write

$$\begin{aligned} h(\theta) &= \begin{bmatrix} Y(M^S, G, T) \\ r(M^S, G, T) \end{bmatrix} \\ D_\theta f(\theta, h(\theta)) + D_x f(\theta, h(\theta)) D_\theta h(\theta) &= 0 \end{aligned}$$

We have that

$$\begin{aligned} D_\theta f(\theta, h(\theta)) &= \begin{bmatrix} 0 & -1 & C'(Y(\cdot) - T) \\ 1 & 0 & 0 \end{bmatrix} \\ D_x f(\theta, h(\theta)) &= \begin{bmatrix} \frac{\partial f_1}{\partial Y} = 1 - C'(Y(\cdot) - T) & \frac{\partial f_1}{\partial r} = -I'(r(\cdot)) \\ \frac{\partial f_2}{\partial Y} = -\frac{\partial M^D}{\partial Y} & \frac{\partial f_2}{\partial r} = -\frac{\partial M^D}{\partial r} \end{bmatrix} \\ [D_x f(\theta, h(\theta))]^{-1} &= \frac{1}{D} \begin{bmatrix} -\frac{\partial M^D}{\partial r} & I'(r(\cdot)) \\ \frac{\partial M^D}{\partial Y} & 1 - C'(Y(\cdot) - T) \end{bmatrix} \\ D &= -\underbrace{\frac{\partial M^D}{\partial r}}_{<0} \underbrace{\left(1 - C'(Y(\cdot) - T)\right)}_{>0} - \underbrace{I'(r(\cdot))}_{<0} \underbrace{\frac{\partial M^D}{\partial Y}}_{>0} \implies D > 0 \end{aligned}$$

A non-zero determinant implies that the inverse exists. Hence we find that

$$\begin{aligned}
 D_{\theta}h(\theta) &= \begin{bmatrix} \frac{\partial Y}{\partial M^S} & \frac{\partial Y}{\partial G} & \frac{\partial Y}{\partial T} \\ \frac{\partial r}{\partial M^S} & \frac{\partial r}{\partial G} & \frac{\partial r}{\partial T} \end{bmatrix} = -\frac{1}{D} \begin{bmatrix} I'(r(\cdot)) & \frac{\partial M^D}{\partial r} & -\frac{\partial M^D}{\partial r} C'(Y(\cdot) - T) \\ 1 - C'(Y(\cdot) - T) & -\frac{\partial M^D}{\partial Y} & \frac{\partial M^D}{\partial Y} C'(Y(\cdot) - T) \end{bmatrix} \\
 &= -\frac{1}{D} \begin{bmatrix} < 0 & < 0 & > 0 \\ > 0 & < 0 & > 0 \end{bmatrix} = \frac{1}{D} \begin{bmatrix} > 0 & > 0 & < 0 \\ < 0 & > 0 & < 0 \end{bmatrix}
 \end{aligned}$$

Which means that for some  $x = (Y, r), \theta = (M^S, G, T)$  that satisfies [Equation \(1\)](#) there is some local neighborhood around  $\theta$  where we can characterize the behavior of  $(Y, r)$  with respect to each of the variables in  $\theta$ . In particular, income reacts positively to increases money supply or government spending but negatively to taxes, while the interest rate goes down with increases in the money supply or taxes but goes up with increases in government spending.

### 3. Unconstrained Optimization

**Definition 8.** Let  $f : A \rightarrow B$

1.  $x \in A$  is a **local maximum** of  $f$  if  $\exists \varepsilon > 0$  s.t.

$$y \in B_{\varepsilon}(x) \cap A \implies f(x) \geq f(y)$$

The local maximum is **strict** if the inequality is strict. (Note the intersection: For example,  $f(x) = x$  has no local maximum on  $\mathbb{R}$ , but every point is a local maximum if we define the function over  $x \in \mathbb{N}$ .)

2. The **local minimum** definition is analogous.
3.  $x \in A$  is a **global maximum** of  $f$  if  $\forall y \in A, f(x) \geq f(y)$ . It is a strict global maximum if whenever  $x \neq y$  we have  $f(x) > f(y)$ .
4. The **global minimum** definition is analogous.

**Definition 9.** The argmax of a function  $f$  is the set

$$\operatorname{argmax}_{x \in A} f(x) = \{x \in A : f(x) \geq f(y) \ \forall y \in A\}$$

The argmin is analogously defined.

#### 3.1. Linear Algebra Review.

**Definition 10.** A square  $N \times N$  matrix  $S$  with elements in  $\mathbb{R}$  is **positive semidefinite** (PSD) if  $\forall p \in \mathbb{R}^N$  we have

$$p^T S p \geq 0$$

and **positive definite** (PD) if the inequality is strict.

**Definition 11.** A square  $N \times N$  matrix  $S$  with elements in  $\mathbb{R}$  is **negative semidefinite** (NSD) if  $\forall p \in \mathbb{R}^N$  we have

$$p^T S p \leq 0$$

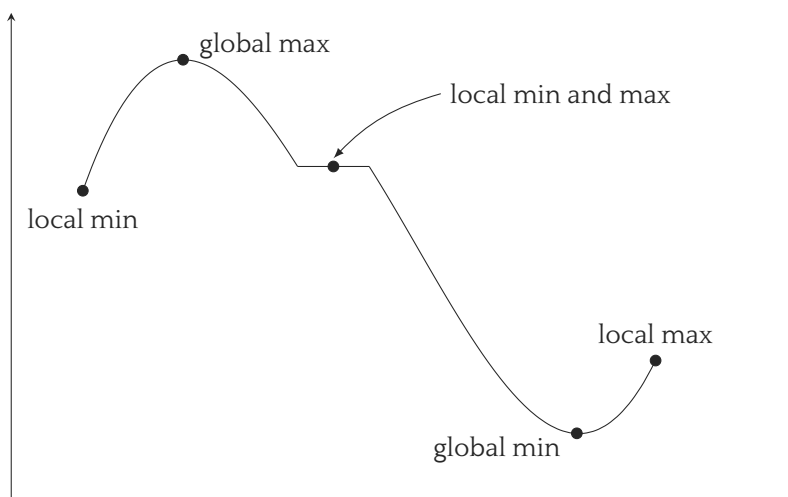


Figure 4: Examples of local and global maxima and minima

and **negative definite** (ND) if the inequality is strict.

**Definition 12.** Let  $S$  be a  $N \times N$  matrix with elements in  $\mathbb{R}$ . If  $\exists p_1, p_2 \in \mathbb{R}^N$  s.t.

$$p_1^T S p_1 > 0 \quad \text{and} \quad p_2^T S p_2 < 0$$

then we say  $S$  is **indefinite**.

**Definition 13.** Let  $S$  be a  $N \times N$  matrix with elements in  $\mathbb{R}$ . The  $k$ th order **principal minor** is a submatrix of  $S$  obtained by removing  $N - k$  rows and the corresponding columns of  $S$ .

It's easiest to talk about the principal minors using examples: Take

$$S = \begin{bmatrix} 1 & 2 & 3 \\ 4 & 5 & 6 \\ 7 & 8 & 9 \end{bmatrix}$$

The 1st order principal minors are

$$[1] \quad [5] \quad [9]$$

The 2nd order principal minors are

$$\begin{bmatrix} 1 & 2 \\ 4 & 5 \end{bmatrix} \quad \begin{bmatrix} 1 & 3 \\ 7 & 9 \end{bmatrix} \quad \begin{bmatrix} 5 & 6 \\ 8 & 9 \end{bmatrix}$$

Finally, the 3rd order principal minor is just the matrix  $S$  itself.

**Definition 14.** Let  $S$  be a  $N \times N$  matrix with elements in  $\mathbb{R}$ . The  $k$ th **leading principal minor** is the principal minors obtained by removing the “last”  $N - k$  columns and rows of  $S$ .

In our example above, these are the matrix  $S$  itself (3rd leading principal minor), and

$$\text{2nd} \rightarrow [1] \quad \text{1st} \rightarrow \begin{bmatrix} 1 & 2 \\ 4 & 5 \end{bmatrix}$$

**Definition 15.** A matrix  $S$  is **symmetric** if  $S = S^T$ ; that is, so  $S$  with entries  $s(i, j)$  we have

$$s(i, j) = s(j, i)$$

**Theorem 10.** Let  $S$  be a  $N \times N$  symmetric matrix.

1. If the determinant of all the leading principal minors is strictly positive, then  $S$  is positive definite.
2. If for every  $k \leq N$  the determinant of the  $k$ th order leading principal minor has sign  $(-1)^k$  (that is, positive for  $k$  even and negative for  $k$  odd), then  $S$  is negative definite.
3. If the determinant of the  $k$ th order leading principal minor is non-zero and does not fit either pattern above for some  $k$ , then  $S$  is indefinite.
4. If the determinant of all principal minors of  $S$  are weakly positive ( $\geq 0$ ) then  $S$  is positive semidefinite.
5. If for every  $k \leq N$  the determinant of all  $k$ th order principal minors are  $\leq 0$  when  $k$  is odd and  $\geq 0$  when  $k$  is even, then  $S$  is negative semidefinite.

### 3.2. First Order Conditions (FOC).

**Theorem 11.** Let  $f : A \rightarrow \mathbb{R}$  be a continuously differentiable function on an open set  $A \subseteq \mathbb{R}^N$ . If  $x^* \in A$  is a local minimum or maximum, then

$$Df(x^*) = 0$$

that is, the first-order partials evaluated at  $x^*$  equal 0.

**Remark 1.** In general the converse need not be true. For instance  $f(x) = x^3$ . We have  $f'(x) = 3x^2 = 0$  if  $x = 0$ . However the function does not have a local minimum or maximum at 0. Hence  $Df(x) = 0$  is a necessary but not sufficient condition.  $\square$

Some examples

1. Take  $f(x) = 2x^3 - 3x^2$ . We have

$$Df(x) = 6x^2 - 6x$$

$Df(x) = 0$  at  $x = 0, 1$ , so if  $f$  has local maxima or minima they must occur at those points, but we don't yet know how to check whether they are local maxima or minima.

2.  $f(x, y) = x^3 - y^3 + 9xy$ , so  $f : \mathbb{R}^2 \rightarrow \mathbb{R}$ . We have

$$Df(x, y) = \begin{bmatrix} 3x^2 + 9y \\ -3y^2 + 9x \end{bmatrix}$$

$Df(x, y) = 0$  at  $(0, 0)$  and  $(3, -3)$ . Note

$$0 = 3x^2 + 9y$$

$$\begin{aligned}
0 &= -3y^2 + 9x \\
3y^2 &= 9x \\
x^2 &= -3y \\
x^4 &= 9y^2 = 3(3y^2) = 3(9x)
\end{aligned}$$

So

$$\begin{aligned}
x^4 &= 27x \implies x = 3 \\
27 + 9y &= 0 \implies y = -3
\end{aligned}$$

### 3.3. Second Order Conditions (SOC).

**Theorem 12.** Let  $f : A \rightarrow \mathbb{R}$  be a twice continuously differentiable function on an open set  $A \subseteq \mathbb{R}^N$  with

$$Df(x^*) = 0$$

for some  $x^* \in A$ . If  $D^2f(x^*)$  the Hessian at  $x^*$  is negative definite then  $x^*$  is a local maximum, and if it is positive definite then it is a local minimum.

**Remark 2.** The converse need not hold. For instance, take  $f(x) = x^4$ ,  $Df(x) = 4x^3$ ,  $D^2f(x) = 12x^2$ . At  $x^* = 0$ , we have  $Df(0) = 0$ , but  $D^2f(0) = 0$  is neither positive nor negative definite. Hence a strictly definite Hessian is a sufficient condition for a local maximum or minimum, but it is not necessary.  $\square$

**Theorem 13.** Let  $f : A \rightarrow \mathbb{R}$  be a twice continuously differentiable function on an open set  $A \subseteq \mathbb{R}^N$ . If  $x^* \in A$  is a local maximum, then

$$Df(x^*) = 0$$

and  $D^2f(x^*)$  is negative semidefinite. If  $x^* \in A$  is a local minimum, then  $Df(x^*) = 0$  and  $D^2f(x^*)$  is positive semidefinite.

**Remark 3.** Again, the converse need not be true. In our previous example,  $x^* = 0$  is actually a local minimum, and we can check that  $Df(x^*) = 4(0^3) = 0$  and  $D^2f(x^*) = 12(0^2) = 0 \geq 0$  (positive semidefinite). However,  $D^2f(x^*) \leq 0$  means that it is negative semidefinite as well, but that does not imply a local maximum. Hence the condition is necessary but not sufficient.  $\square$

Let us take  $f(x) = 2x^3 - 3x^2$ , the function from our previous example. We saw that  $Df(x) = 6x^2 - 6x = 0$  at  $x = 0, 1$ . Now we have

$$\begin{aligned}
D^2f(x) &= 12x - 6 \\
D^2f(0) &= -6 < 0 \implies \text{local max} \\
D^2f(1) &= 6 > 0 \implies \text{local min}
\end{aligned}$$

What about  $f(x, y) = x^2 - y^2 + 9xy$ ? Recall

$$Df(x, y) = \begin{bmatrix} 3x^2 + 9y \\ -3y^2 + 9x \end{bmatrix} = 0 \iff (x, y) = (0, 0) \text{ or } (3, -3)$$

We find that

$$D^2f(x, y) = \begin{bmatrix} 6x & 9 \\ 9 & -6y \end{bmatrix}$$

The second order principal minor is just the Hessian itself. The 1st order principal minor is  $6x$ . Note the determinant is

$$|D^2f(x, y)| = -36xy - 81$$

1. For  $(0, 0)$ , we have  $6(0) = 0$  and  $-36(0)(0) - 81 = -81 < 0$ . The determinant of the 2nd leading principal minor is negative, so the Hessian at that point cannot be positive definite. Further,  $(-1)^2$  is positive, so it cannot be negative definite either. Hence the Hessian at  $(0, 0)$  is indefinite.
2. For  $(3, -3)$ , we have  $6(3) = 18 > 0$  and  $-36(3)(-3) - 81 = 324 - 81 = 243 > 0$ . The determinant of the 1st and 2nd leading principal minors are both positive, which means the Hessian at that point is positive definite and  $(3, -3)$  is a local minimum.

### 3.4. Concavity and Convexity.

**Definition 16.** A function  $f : A \rightarrow \mathbb{R}$  is **concave** if for any  $\alpha \in [0, 1]$  and  $x, y \in A$

$$\alpha f(x) + (1 - \alpha)f(y) \leq f(\alpha x + (1 - \alpha)y)$$

It is **strictly concave** if the above holds strictly for  $\alpha \in (0, 1)$ .

**Definition 17.** A function  $f : A \rightarrow \mathbb{R}$  is **convex** if for any  $\alpha \in [0, 1]$  and  $x, y \in A$

$$\alpha f(x) + (1 - \alpha)f(y) \geq f(\alpha x + (1 - \alpha)y)$$

It is **strictly convex** if the above holds strictly for  $\alpha \in (0, 1)$ .

**Theorem 14.** Let  $f : A \rightarrow \mathbb{R}$  be a twice continuously differentiable function on an open set  $A \subseteq \mathbb{R}^N$ .

1.  $f(x)$  is concave  $\iff D^2f(x)$  is negative semidefinite. (Strictly concave iff negative definite.)
2.  $f(x)$  is convex  $\iff D^2f(x)$  is positive semidefinite. (Strictly convex iff positive definite.)

**Theorem 15.** Let  $f : A \rightarrow \mathbb{R}$  be a twice continuously differentiable function on an open set  $A \subseteq \mathbb{R}^N$ .

1. If  $f$  is concave and  $x^*$  is s.t.  $Df(x^*) = 0$  then  $x^*$  is a global maximum. (If  $f$  is strictly concave the global maximum is unique.)
2. If  $f$  is convex and  $x^*$  is s.t.  $Df(x^*) = 0$  then  $x^*$  is a global minimum. (If  $f$  is strictly convex the global minimum is unique.)

Some examples:

1. Take the function  $f(x, y) = x^2 + y^2$ . We have

$$Df(x, y) = \begin{bmatrix} 2x \\ 2y \end{bmatrix} \quad D^2f(x, y) = \begin{bmatrix} 2 & 0 \\ 0 & 2 \end{bmatrix}$$

Note that  $Df(0,0) = (0,0)$ . Further, the determinant of the 1st leading principal minor of the Hessian is  $2 > 0$ ; for the 2nd leading principal minor we have  $2(2) - 0(0) = 4 > 0$ . Thus  $D^2f(x)$  is positive definite; this means  $f$  is convex and  $(0,0)$  is a global minimum.

2. What about  $f(x) = x^4$ ? In this case

$$Df(x) = 4x^3 \quad D^2f(x, y) = 12x^2$$

$Df(0) = 0$  and  $D^2f(0) = 0$ . However,  $12x^2 \geq 0$  for all  $x$ , so the function is convex, which means that 0 is a global minimum.

3.  $f(x, y) = x^2y^2$

$$Df(x, y) = \begin{bmatrix} 2xy^2 \\ 2x^2y \end{bmatrix} \quad D^2f(x, y) = \begin{bmatrix} 2y^2 & 4xy \\ 4xy & 2x^2 \end{bmatrix}$$

Generally,  $Df(x, 0) = Df(0, y) = (0, 0)$ , but the determinant of the  $k$ th order principal minors are all 0 at  $(x, 0)$  or  $(0, y)$ . More generally we have that while determinant of the 1st principal minors are  $2y^2 \geq 0$  and  $2x^2 \geq 0$ , the determinant of the 2nd principal minor is

$$4x^2y^2 - 16x^2y^2 \leq 0$$

Hence we cannot even say whether it is positive or negative semidefinite.



# Keywords

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argmin, 11  
 $n$ th order taylor expansion, 4

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