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# **Quantitative Economics with Python using JAX**

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This website presents a set of lectures on quantitative economic modeling using GPUs and [Google JAX](#).

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## **Part I**

# **Introduction**



## ABOUT

Perhaps the single most notable feature of scientific computing in the past two decades is the rise and rise of parallel computation.

For example, the advanced artificial intelligence applications now shaking the worlds of business and academia require massive computer power to train, and the great majority of that computer power is supplied by GPUs.

For us economists, with our ever-growing need for more compute cycles, parallel computing provides both opportunities and new difficulties.

The main difficulty we face vis-a-vis parallel computation is accessibility.

Even for those with time to invest in careful parallelization of their programs, exploiting the full power of parallel hardware is challenging for non-experts.

Moreover, that hardware changes from year to year, so any human capital associated with mastering intricacies of a particular GPU has a very high depreciation rate.

For these reasons, we find [Google JAX](#) compelling.

In short, JAX makes high performance and parallel computing accessible (and fun!).

It provides a familiar array programming interface based on NumPy, and, as long as some simple conventions are adhered to, this code compiles to extremely efficient and well-parallelized machine code.

One of the most agreeable features of JAX is that the same code set and be run on either CPUs or GPUs, which allows users to test and develop locally, before deploying to a more powerful machine for heavier computations.

JAX is relatively easy to learn and highly portable, allowing us programmers to focus on the algorithms we want to implement, rather than particular features of our hardware.

This lecture series provides an introduction to using Google JAX for quantitative economics.

The rest of this page provides some background information on JAX, notes on how to run the lectures, and credits for our colleagues and RAs.

## 1.1 What is JAX?

JAX is an open source Python library developed by Google Research to support in-house artificial intelligence and machine learning.

JAX provides data types, functions and a compiler for fast linear algebra operations and automatic differentiation.

Loosely speaking, JAX is like [NumPy](#) with the addition of

- automatic differentiation
- automated GPU/TPU support

- a just-in-time compiler

In short, JAX delivers

1. high execution speeds on CPUs due to efficient parallelization and JIT compilation,
2. a powerful and convenient environment for GPU programming, and
3. the ability to efficiently differentiate smooth functions for optimization and estimation.

These features make JAX ideal for almost all quantitative economic modeling problems that require heavy-duty computing.

## 1.2 How to run these lectures

The easiest way to run these lectures is via [Google Colab](#).

JAX is pre-installed with GPU support on Colab and Colab provides GPU access even on the free tier.

Each lecture has a “play” button on the top right that you can use to launch the lecture on Colab.

You might also like to try using JAX locally.

If you do not own a GPU, you can still install JAX for the CPU by following the relevant [install instructions](#).

(We recommend that you install [Anaconda Python](#) first.)

If you do have a GPU, you can try installing JAX for the GPU by following the [install instructions for GPUs](#).

(This is not always trivial but is starting to get easier.)

## 1.3 Credits

In building this lecture series, we had invaluable assistance from research assistants at QuantEcon and our QuantEcon colleagues.

In particular, we thank and credit

- [Shu Hu](#)
- [Smit Lunagariya](#)
- [Matthew McKay](#)
- [Humphrey Yang](#)
- [Hengcheng Zhang](#)
- [Frank Wu](#)

## 1.4 Prerequisites

We assume that readers have covered most of the QuantEcon lecture series on [Python programming](#).



## AN INTRODUCTION TO JAX

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### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

This lecture provides a short introduction to [Google JAX](#).

As mentioned above, the lecture was built using a GPU:

```
!nvidia-smi
```

```
Thu May 2 02:25:54 2024
+-----+
| NVIDIA-SMI 470.182.03   Driver Version: 470.182.03   CUDA Version: 12.3   |
+-----+-----+-----+-----+-----+
| GPU  Name                Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp   Perf   Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                           |              |                  MIG M. |
+=====+-----+-----+-----+=====+

```

```
|  0  Tesla V100-SXM2...  Off  | 00000000:00:1E.0 Off |                    0 |
| N/A   27C    P0     38W / 300W |      0MiB / 16160MiB |      2%      Default |
|                                           |              |                  N/A |
+-----+-----+-----+-----+-----+

```

```
+-----+
| Processes:
| GPU  GI   CI           PID   Type   Process name                      GPU Memory
|     ID   ID                                   |              Usage
+=====+
| No running processes found
+-----+

```

## 2.1 JAX as a NumPy Replacement

One way to use JAX is as a plug-in NumPy replacement. Let's look at the similarities and differences.

### 2.1.1 Similarities

The following import is standard, replacing `import numpy as np`:

```
import jax
import jax.numpy as jnp
```

Now we can use `jnp` in place of `np` for the usual array operations:

```
a = jnp.asarray((1.0, 3.2, -1.5))
```

```
print(a)
```

```
[ 1.   3.2 -1.5]
```

```
print(jnp.sum(a))
```

```
2.6999998
```

```
print(jnp.mean(a))
```

```
0.9
```

```
print(jnp.dot(a, a))
```

```
13.490001
```

However, the array object `a` is not a NumPy array:

```
a
```

```
Array([ 1. ,  3.2, -1.5], dtype=float32)
```

```
type(a)
```

```
jaxlib.xla_extension.ArrayImpl
```

Even scalar-valued maps on arrays return JAX arrays.

```
jnp.sum(a)
```



```
Array(2.6999998, dtype=float32)
```

JAX arrays are also called “device arrays,” where term “device” refers to a hardware accelerator (GPU or TPU).

(In the terminology of GPUs, the “host” is the machine that launches GPU operations, while the “device” is the GPU itself.)

Operations on higher dimensional arrays are also similar to NumPy:

```
A = jnp.ones((2, 2))
B = jnp.identity(2)
A @ B
```

```
Array([[1., 1.],
       [1., 1.]], dtype=float32)
```

```
from jax.numpy import linalg
```

```
linalg.inv(B) # Inverse of identity is identity
```

```
Array([[1., 0.],
       [0., 1.]], dtype=float32)
```

```
linalg.eigh(B) # Computes eigenvalues and eigenvectors
```

```
EighResult(eigenvalues=Array([0.99999994, 0.99999994], dtype=float32),
           eigenvectors=Array([[1., 0.],
                               [0., 1.]], dtype=float32))
```

## 2.1.2 Differences

One difference between NumPy and JAX is that JAX currently uses 32 bit floats by default.

This is standard for GPU computing and can lead to significant speed gains with small loss of precision.

However, for some calculations precision matters. In these cases 64 bit floats can be enforced via the command

```
jax.config.update("jax_enable_x64", True)
```

Let’s check this works:

```
jnp.ones(3)
```

```
Array([1., 1., 1.], dtype=float64)
```

As a NumPy replacement, a more significant difference is that arrays are treated as **immutable**.

For example, with NumPy we can write

```
import numpy as np
a = np.linspace(0, 1, 3)
a
```

```
array([0. , 0.5, 1. ])
```

and then mutate the data in memory:

```
a[0] = 1
a
```

```
array([1. , 0.5, 1. ])
```

In JAX this fails:

```
a = jnp.linspace(0, 1, 3)
a
```

```
Array([0. , 0.5, 1. ], dtype=float64)
```

```
a[0] = 1
```

```
-----
TypeError                                Traceback (most recent call last)
Cell In[20], line 1
----> 1 a[0] = 1

File /opt/conda/envs/quantecon/lib/python3.11/site-packages/jax/_src/numpy/array_
methods.py:278, in _unimplemented_setitem(self, i, x)
    273 def _unimplemented_setitem(self, i, x):
    274     msg = ("'{}' object does not support item assignment. JAX arrays are "
    275           "immutable. Instead of ``x[idx] = y``, use ``x = x.at[idx].
↳set(y)`` "
    276           "or another .at[] method: "
    277           "https://jax.readthedocs.io/en/latest/_autosummary/jax.numpy.
↳ndarray.at.html")
--> 278     raise TypeError(msg.format(type(self)))

TypeError: '<class 'jaxlib.xla_extension.ArrayImpl'>' object does not support item_
↳assignment. JAX arrays are immutable. Instead of ``x[idx] = y``, use ``x = x.
↳at[idx].set(y)`` or another .at[] method: https://jax.readthedocs.io/en/latest/_
↳autosummary/jax.numpy.ndarray.at.html
```

In line with immutability, JAX does not support inplace operations:

```
a = np.array((2, 1))
a.sort()
a
```

```
array([1, 2])
```

```
a = jnp.array((2, 1))
a_new = a.sort()
a, a_new
```

```
(Array([2, 1], dtype=int64), Array([1, 2], dtype=int64))
```

The designers of JAX chose to make arrays immutable because JAX uses a functional programming style. More on this below.

Note that, while mutation is discouraged, it is in fact possible with `at`, as in

```
a = jnp.linspace(0, 1, 3)
id(a)
```

```
110813136
```

```
a
```

```
Array([0. , 0.5, 1. ], dtype=float64)
```

```
a.at[0].set(1)
```

```
Array([1. , 0.5, 1. ], dtype=float64)
```

We can check that the array is mutated by verifying its identity is unchanged:

```
id(a)
```

```
110813136
```

## 2.2 Random Numbers

Random numbers are also a bit different in JAX, relative to NumPy. Typically, in JAX, the state of the random number generator needs to be controlled explicitly.

```
import jax.random as random
```

First we produce a key, which seeds the random number generator.

```
key = random.PRNGKey(1)
```

```
type(key)
```

```
jaxlib.xla_extension.ArrayImpl
```

```
print(key)
```

```
[0 1]
```

Now we can use the key to generate some random numbers:

```
x = random.normal(key, (3, 3))
x
```

```
Array([[ -1.35247421, -0.2712502 , -0.02920518],
       [ 0.34706456,  0.5464053 , -1.52325812],
       [ 0.41677264, -0.59710138, -0.5678208 ]], dtype=float64)
```

If we use the same key again, we initialize at the same seed, so the random numbers are the same:

```
random.normal(key, (3, 3))
```

```
Array([[ -1.35247421, -0.2712502 , -0.02920518],
       [ 0.34706456,  0.5464053 , -1.52325812],
       [ 0.41677264, -0.59710138, -0.5678208 ]], dtype=float64)
```

To produce a (quasi-) independent draw, best practice is to “split” the existing key:

```
key, subkey = random.split(key)
```

```
random.normal(key, (3, 3))
```

```
Array([[ 1.85374374, -0.37683949, -0.61276867],
       [-1.91829718,  0.27219409,  0.54922246],
       [ 0.40451442, -0.58726839, -0.63967753]], dtype=float64)
```

```
random.normal(subkey, (3, 3))
```

```
Array([[ -0.4300635 ,  0.22778552,  0.57241269],
       [-0.15969178,  0.46719192,  0.21165091],
       [ 0.84118631,  1.18671326, -0.16607783]], dtype=float64)
```

The function below produces  $k$  (quasi-) independent random  $n \times n$  matrices using this procedure.

```
def gen_random_matrices(key, n, k):
    matrices = []
    for _ in range(k):
        key, subkey = random.split(key)
        matrices.append(random.uniform(subkey, (n, n)))
    return matrices
```

```
matrices = gen_random_matrices(key, 2, 2)
for A in matrices:
    print(A)
```

```
[[0.97440813 0.3838544 ]
 [0.9790686  0.99981046]]
[[0.3473302  0.17157842]
 [0.89346686 0.01403153]]
```

One point to remember is that JAX expects tuples to describe array shapes, even for flat arrays. Hence, to get a one-dimensional array of normal random draws we use `(len, )` for the shape, as in

```
random.normal(key, (5, ))
```

```
Array([-0.64377279,  0.76961857, -0.29809604,  0.47858776, -2.00591299],
      dtype=float64)
```

## 2.3 JIT compilation

The JAX just-in-time (JIT) compiler accelerates logic within functions by fusing linear algebra operations into a single optimized kernel that the host can launch on the GPU / TPU (or CPU if no accelerator is detected).

### 2.3.1 A first example

To see the JIT compiler in action, consider the following function.

```
def f(x):
    a = 3*x + jnp.sin(x) + jnp.cos(x**2) - jnp.cos(2*x) - x**2 * 0.4 * x**1.5
    return jnp.sum(a)
```

Let's build an array to call the function on.

```
n = 50_000_000
x = jnp.ones(n)
```

How long does the function take to execute?

```
%time f(x).block_until_ready()
```

```
CPU times: user 278 ms, sys: 7.1 ms, total: 285 ms
Wall time: 486 ms
```

```
Array(2.19896006e+08, dtype=float64)
```

**Note:** Here, in order to measure actual speed, we use the `block_until_ready()` method to hold the interpreter until the results of the computation are returned from the device. This is necessary because JAX uses asynchronous dispatch, which allows the Python interpreter to run ahead of GPU computations.

The code doesn't run as fast as we might hope, given that it's running on a GPU.

But if we run it a second time it becomes much faster:

```
%time f(x).block_until_ready()
```

```
CPU times: user 5.72 ms, sys: 652 µs, total: 6.37 ms  
Wall time: 25.6 ms
```

```
Array(2.19896006e+08, dtype=float64)
```

This is because the built in functions like `jnp.cos` are JIT compiled and the first run includes compile time.

Why would JAX want to JIT-compile built in functions like `jnp.cos` instead of just providing pre-compiled versions, like NumPy?

The reason is that the JIT compiler can specialize on the *size* of the array being used, which is helpful for parallelization.

For example, in running the code above, the JIT compiler produced a version of `jnp.cos` that is specialized to floating point arrays of size `n = 50_000_000`.

We can check this by calling `f` with a new array of different size.

```
m = 50_000_001  
y = jnp.ones(m)
```

```
%time f(y).block_until_ready()
```

```
CPU times: user 281 ms, sys: 10.2 ms, total: 291 ms  
Wall time: 498 ms
```

```
Array(2.19896011e+08, dtype=float64)
```

Notice that the execution time increases, because now new versions of the built-ins like `jnp.cos` are being compiled, specialized to the new array size.

If we run again, the code is dispatched to the correct compiled version and we get faster execution.

```
%time f(y).block_until_ready()
```

```
CPU times: user 5.18 ms, sys: 364 µs, total: 5.54 ms  
Wall time: 18.7 ms
```

```
Array(2.19896011e+08, dtype=float64)
```

The compiled versions for the previous array size are still available in memory too, and the following call is dispatched to the correct compiled code.

```
%time f(x).block_until_ready()
```

```
CPU times: user 4.23 ms, sys: 1.77 ms, total: 6.01 ms  
Wall time: 25.5 ms
```

```
Array(2.19896006e+08, dtype=float64)
```

### 2.3.2 Compiling the outer function

We can do even better if we manually JIT-compile the outer function.

```
f_jit = jax.jit(f)  # target for JIT compilation
```

Let's run once to compile it:

```
f_jit(x)
```

```
Array(2.19896006e+08, dtype=float64)
```

And now let's time it.

```
%time f_jit(x).block_until_ready()
```

```
CPU times: user 825 µs, sys: 322 µs, total: 1.15 ms
Wall time: 114 ms
```

```
Array(2.19896006e+08, dtype=float64)
```

Note the speed gain.

This is because the array operations are fused and no intermediate arrays are created.

Incidentally, a more common syntax when targetting a function for the JIT compiler is

```
@jax.jit
def f(x):
    a = 3*x + jnp.sin(x) + jnp.cos(x**2) - jnp.cos(2*x) - x**2 * 0.4 * x**1.5
    return jnp.sum(a)
```

## 2.4 Functional Programming

From JAX's documentation:

*When walking about the countryside of Italy, the people will not hesitate to tell you that JAX has “una anima di pura programmazione funzionale”.*

In other words, JAX assumes a functional programming style.

The major implication is that JAX functions should be pure.

A pure function will always return the same result if invoked with the same inputs.

In particular, a pure function has

- no dependence on global variables and
- no side effects

JAX will not usually throw errors when compiling impure functions but execution becomes unpredictable.

Here's an illustration of this fact, using global variables:

```
a = 1 # global

@jax.jit
def f(x):
    return a + x
```

```
x = jnp.ones(2)
```

```
f(x)
```

```
Array([2., 2.], dtype=float64)
```

In the code above, the global value `a=1` is fused into the jitted function.

Even if we change `a`, the output of `f` will not be affected — as long as the same compiled version is called.

```
a = 42
```

```
f(x)
```

```
Array([2., 2.], dtype=float64)
```

Changing the dimension of the input triggers a fresh compilation of the function, at which time the change in the value of `a` takes effect:

```
x = jnp.ones(3)
```

```
f(x)
```

```
Array([43., 43., 43.], dtype=float64)
```

Moral of the story: write pure functions when using JAX!

## 2.5 Gradients

JAX can use automatic differentiation to compute gradients.

This can be extremely useful for optimization and solving nonlinear systems.

We will see significant applications later in this lecture series.

For now, here's a very simple illustration involving the function

```
def f(x):
    return (x**2) / 2
```

Let's take the derivative:

```
f_prime = jax.grad(f)
```



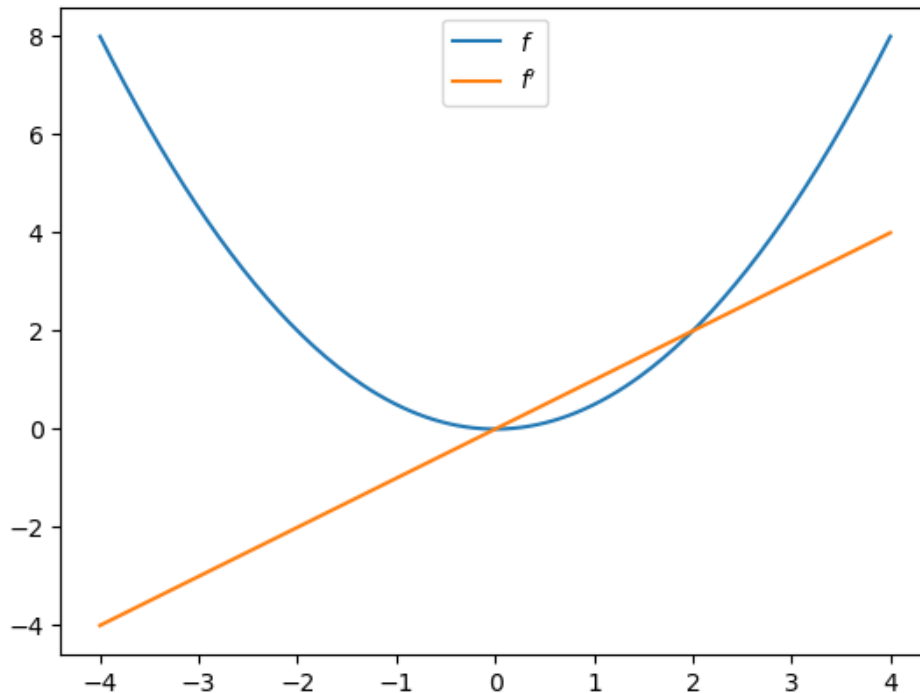
```
f_prime(10.0)
```

```
Array(10., dtype=float64, weak_type=True)
```

Let's plot the function and derivative, noting that  $f'(x) = x$ .

```
import matplotlib.pyplot as plt

fig, ax = plt.subplots()
x_grid = jnp.linspace(-4, 4, 200)
ax.plot(x_grid, f(x_grid), label="$f$")
ax.plot(x_grid, [f_prime(x) for x in x_grid], label="$f'$")
ax.legend(loc='upper center')
plt.show()
```



## 2.6 Writing vectorized code

Writing fast JAX code requires shifting repetitive tasks from loops to array processing operations, so that the JAX compiler can easily understand the whole operation and generate more efficient machine code.

This procedure is called **vectorization** or **array programming**, and will be familiar to anyone who has used NumPy or MATLAB.

In most ways, vectorization is the same in JAX as it is in NumPy.

But there are also some differences, which we highlight here.

As a running example, consider the function

$$f(x, y) = \frac{\cos(x^2 + y^2)}{1 + x^2 + y^2}$$

Suppose that we want to evaluate this function on a square grid of  $x$  and  $y$  points and then plot it.

To clarify, here is the slow `for` loop version.

```
@jax.jit
def f(x, y):
    return jnp.cos(x**2 + y**2) / (1 + x**2 + y**2)

n = 80
x = jnp.linspace(-2, 2, n)
y = x

z_loops = np.empty((n, n))
```

```
%%time
for i in range(n):
    for j in range(n):
        z_loops[i, j] = f(x[i], y[j])
```

```
CPU times: user 13.9 s, sys: 2.09 s, total: 16 s
Wall time: 7.55 s
```

Even for this very small grid, the run time is extremely slow.

(Notice that we used a NumPy array for `z_loops` because we wanted to write to it.)

OK, so how can we do the same operation in vectorized form?

If you are new to vectorization, you might guess that we can simply write

```
z_bad = f(x, y)
```

But this gives us the wrong result because JAX doesn't understand the nested `for` loop.

```
z_bad.shape
```

```
(80,)
```

Here is what we actually wanted:

```
z_loops.shape
```

```
(80, 80)
```

To get the right shape and the correct nested `for` loop calculation, we can use a `meshgrid` operation designed for this purpose:

```
x_mesh, y_mesh = jnp.meshgrid(x, y)
```

Now we get what we want and the execution time is very fast.

```
%%time
z_mesh = f(x_mesh, y_mesh)
```

```
CPU times: user 48.2 ms, sys: 0 ns, total: 48.2 ms
Wall time: 81.7 ms
```

```
%%time
z_mesh = f(x_mesh, y_mesh)
```

```
CPU times: user 898 µs, sys: 0 ns, total: 898 µs
Wall time: 425 µs
```

Let's confirm that we got the right answer.

```
jnp.allclose(z_mesh, z_loops)
```

```
Array(True, dtype=bool)
```

Now we can set up a serious grid and run the same calculation (on the larger grid) in a short amount of time.

```
n = 6000
x = jnp.linspace(-2, 2, n)
y = x
x_mesh, y_mesh = jnp.meshgrid(x, y)
```

```
%%time
z_mesh = f(x_mesh, y_mesh)
```

```
CPU times: user 50.9 ms, sys: 974 µs, total: 51.8 ms
Wall time: 87.1 ms
```

```
%%time
z_mesh = f(x_mesh, y_mesh)
```

```
CPU times: user 543 µs, sys: 216 µs, total: 759 µs
Wall time: 396 µs
```

But there is one problem here: the mesh grids use a lot of memory.

```
x_mesh.nbytes + y_mesh.nbytes
```

```
576000000
```

By comparison, the flat array `x` is just

```
x.nbytes # and y is just a pointer to x
```

```
48000
```

This extra memory usage can be a big problem in actual research calculations.

So let's try a different approach using `jax.vmap`

First we vectorize `f` in `y`.

```
f_vec_y = jax.vmap(f, in_axes=(None, 0))
```

In the line above, `(None, 0)` indicates that we are vectorizing in the second argument, which is `y`.

Next, we vectorize in the first argument, which is `x`.

```
f_vec = jax.vmap(f_vec_y, in_axes=(0, None))
```

With this construction, we can now call the function `f` on flat (low memory) arrays.

```
%%time  
z_vmap = f_vec(x, y)
```

```
CPU times: user 56.4 ms, sys: 745 µs, total: 57.1 ms  
Wall time: 94 ms
```

```
%%time  
z_vmap = f_vec(x, y)
```

```
CPU times: user 2.45 ms, sys: 0 ns, total: 2.45 ms  
Wall time: 1.76 ms
```

The execution time is essentially the same as the mesh operation but we are using much less memory.

And we produce the correct answer:

```
jnp.allclose(z_vmap, z_mesh)
```

```
Array(True, dtype=bool)
```

## 2.7 Exercises

---

### Exercise 2.7.1

In the Exercise section of a [lecture on Numba and parallelization](#), we used Monte Carlo to price a European call option.

The code was accelerated by Numba-based multithreading.

Try writing a version of this operation for JAX, using all the same parameters.

If you are running your code on a GPU, you should be able to achieve significantly faster execution.

---

### Solution to Exercise 2.7.1

---

Here is one solution:

```
M = 10_000_000

n, beta, K = 20, 0.99, 100
mu, rho, v, S0, h0 = 0.0001, 0.1, 0.001, 10, 0

@jax.jit
def compute_call_price_jax(beta=beta,
                           mu=mu,
                           S0=S0,
                           h0=h0,
                           K=K,
                           n=n,
                           rho=rho,
                           v=v,
                           M=M,
                           key=jax.random.PRNGKey(1)):

    s = jnp.full(M, np.log(S0))
    h = jnp.full(M, h0)
    for t in range(n):
        key, subkey = jax.random.split(key)
        Z = jax.random.normal(subkey, (2, M))
        s = s + mu + jnp.exp(h) * Z[0, :]
        h = rho * h + v * Z[1, :]
    expectation = jnp.mean(jnp.maximum(jnp.exp(s) - K, 0))

    return beta**n * expectation
```

Let's run it once to compile it:

```
compute_call_price_jax()
```

```
Array(180876.48840921, dtype=float64)
```

And now let's time it:

```
%%time
compute_call_price_jax().block_until_ready()
```

```
CPU times: user 1.32 ms, sys: 0 ns, total: 1.32 ms
Wall time: 122 ms
```

```
Array(180876.48840921, dtype=float64)
```



## NEWTON'S METHOD VIA JAX

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

### 3.1 Overview

One of the key features of JAX is automatic differentiation.

While other software packages also offer this feature, the JAX version is particularly powerful because it integrates so closely with other core components of JAX, such as accelerated linear algebra, JIT compilation and parallelization.

The application of automatic differentiation we consider is computing economic equilibria via Newton's method.

Newton's method is a relatively simple root and fixed point solution algorithm, which we discussed in a [more elementary QuantEcon lecture](#).

JAX is almost ideally suited to implementing Newton's method efficiently, even in high dimensions.

We use the following imports in this lecture

```
import jax
import jax.numpy as jnp
from scipy.optimize import root
import matplotlib.pyplot as plt
```

Let's check the GPU we are running

```
!nvidia-smi
```

```
/opt/conda/envs/quantecon/lib/python3.11/pty.py:89: RuntimeWarning: os.fork() was
↳called. os.fork() is incompatible with multithreaded code, and JAX is
↳multithreaded, so this will likely lead to a deadlock.
pid, fd = os.forkpty()
```

```

Thu May  2 02:27:51 2024
+-----+
| NVIDIA-SMI 470.182.03   Driver Version: 470.182.03   CUDA Version: 12.3   |
+-----+
| GPU  Name                Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp  Perf    Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                           MIG M.         |
+=====+
|   0   Tesla V100-SXM2...    Off   | 00000000:00:1E:0  Off   |             0      |
| N/A   27C    P0     38W / 300W |  0MiB / 16160MiB |    2%      Default  |
|                                           |             N/A    |
+-----+

+-----+
| Processes:                                                       |
| GPU  GI  CI           PID  Type  Process name                        GPU Memory |
|                                           Usage   |
+=====+
| No running processes found                                         |
+-----+

```

## 3.2 Newton in one dimension

As a warm up, let's implement Newton's method in JAX for a simple one-dimensional root-finding problem.

Let  $f$  be a function from  $\mathbb{R}$  to itself.

A **root** of  $f$  is an  $x \in \mathbb{R}$  such that  $f(x) = 0$ .

Recall that Newton's method for solving for the root of  $f$  involves iterating with the map  $q$  defined by

$$q(x) = x - \frac{f(x)}{f'(x)}$$

Here is a function called `newton` that takes a function  $f$  plus a scalar value  $x_0$ , iterates with  $q$  starting from  $x_0$ , and returns an approximate fixed point.

```

def newton(f, x_0, tol=1e-5):
    f_prime = jax.grad(f)
    def q(x):
        return x - f(x) / f_prime(x)

    error = tol + 1
    x = x_0
    while error > tol:
        y = q(x)
        error = abs(x - y)
        x = y

    return x

```

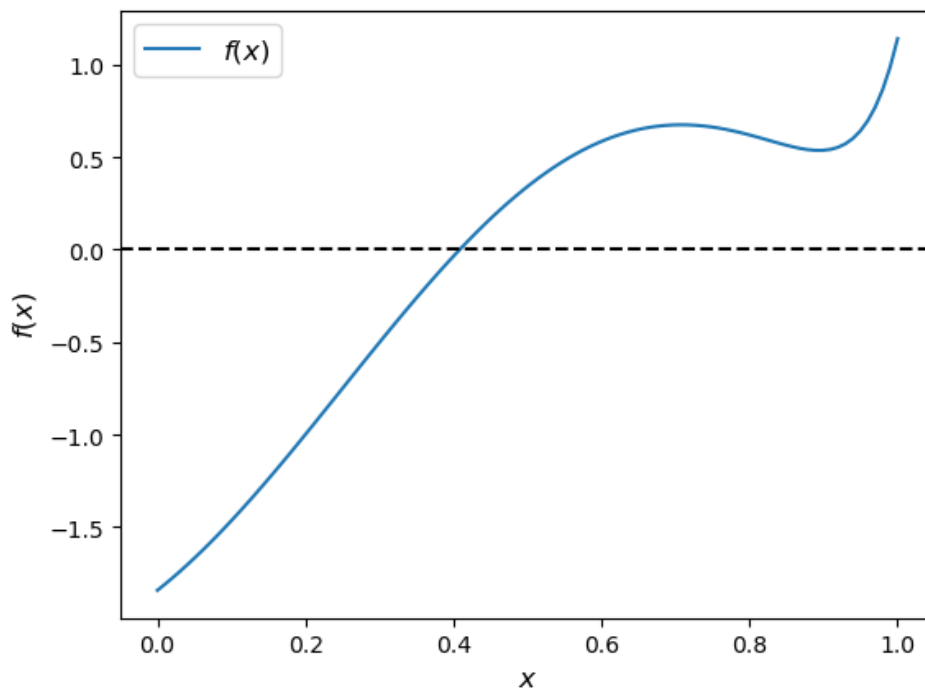
The code above uses automatic differentiation to calculate  $f'$  via the call to `jax.grad`.

Let's test our `newton` routine on the function shown below.



```
f = lambda x: jnp.sin(4 * (x - 1/4)) + x + x**20 - 1
x = jnp.linspace(0, 1, 100)
```

```
fig, ax = plt.subplots()
ax.plot(x, f(x), label='$f(x)$')
ax.axhline(ls='--', c='k')
ax.set_xlabel('$x$', fontsize=12)
ax.set_ylabel('$f(x)$', fontsize=12)
ax.legend(fontsize=12)
plt.show()
```



Here we go

```
newton(f, 0.2)
```

```
Array(0.4082935, dtype=float32, weak_type=True)
```

This number looks to be close to the root, given the figure.

### 3.3 An Equilibrium Problem

Now let's move up to higher dimensions.

First we describe a market equilibrium problem we will solve with JAX via root-finding.

The market is for  $n$  goods.

(We are extending a two-good version of the market from [an earlier lecture](#).)

The supply function for the  $i$ -th good is

$$q_i^s(p) = b_i \sqrt{p_i}$$

which we write in vector form as

$$q^s(p) = b\sqrt{p}$$

(Here  $\sqrt{p}$  is the square root of each  $p_i$  and  $b\sqrt{p}$  is the vector formed by taking the pointwise product  $b_i\sqrt{p_i}$  at each  $i$ .)

The demand function is

$$q^d(p) = \exp(-Ap) + c$$

(Here  $A$  is an  $n \times n$  matrix containing parameters,  $c$  is an  $n \times 1$  vector and the  $\exp$  function acts pointwise (element-by-element) on the vector  $-Ap$ .)

The excess demand function is

$$e(p) = \exp(-Ap) + c - b\sqrt{p}$$

An **equilibrium price** vector is an  $n$ -vector  $p$  such that  $e(p) = 0$ .

The function below calculates the excess demand for given parameters

```
def e(p, A, b, c):
    return jnp.exp(- A @ p) + c - b * jnp.sqrt(p)
```

## 3.4 Computation

In this section we describe and then implement the solution method.

### 3.4.1 Newton's Method

We use a multivariate version of Newton's method to compute the equilibrium price.

The rule for updating a guess  $p_n$  of the equilibrium price vector is

$$p_{n+1} = p_n - J_e(p_n)^{-1}e(p_n) \tag{3.1}$$

Here  $J_e(p_n)$  is the Jacobian of  $e$  evaluated at  $p_n$ .

Iteration starts from initial guess  $p_0$ .

Instead of coding the Jacobian by hand, we use automatic differentiation via `jax.jacobian()`.

```
def newton(f, x_0, tol=1e-5, max_iter=15):
    """
    A multivariate Newton root-finding routine.

    """
    x = x_0
    f_jac = jax.jacobian(f)
    @jax.jit
```

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```

def q(x):
    " Updates the current guess. "
    return x - jnp.linalg.solve(f_jac(x), f(x))
error = tol + 1
n = 0
while error > tol:
    n += 1
    if(n > max_iter):
        raise Exception('Max iteration reached without convergence')
    y = q(x)
    error = jnp.linalg.norm(x - y)
    x = y
    print(f'iteration {n}, error = {error}')
return x

```

### 3.4.2 Application

Let's now apply the method just described to investigate a large market with 5,000 goods.

We randomly generate the matrix  $A$  and set the parameter vectors  $b, c$  to 1.

```

dim = 5_000
seed = 32

# Create a random matrix A and normalize the rows to sum to one
key = jax.random.PRNGKey(seed)
A = jax.random.uniform(key, [dim, dim])
s = jnp.sum(A, axis=0)
A = A / s

# Set up b and c
b = jnp.ones(dim)
c = jnp.ones(dim)

```

Here's our initial condition  $p_0$

```
init_p = jnp.ones(dim)
```

By combining the power of Newton's method, JAX accelerated linear algebra, automatic differentiation, and a GPU, we obtain a relatively small error for this high-dimensional problem in just a few seconds:

```

%%time
p = newton(lambda p: e(p, A, b, c), init_p).block_until_ready()

```

```

iteration 1, error = 29.97745704650879
iteration 2, error = 5.092828750610352
iteration 3, error = 0.10971635580062866
iteration 4, error = 5.19721070304513e-05
iteration 5, error = 1.2384003639454022e-05

```

```
iteration 6, error = 4.883217570750276e-06
CPU times: user 4.32 s, sys: 1e+03 ms, total: 5.32 s
Wall time: 3.7 s
```

Here's the size of the error:

```
jnp.max(jnp.abs(e(p, A, b, c)))
```

```
Array(1.1920929e-07, dtype=float32)
```

With the same tolerance, SciPy's `root` function takes much longer to run, even with the Jacobian supplied.

```
%%time
solution = root(lambda p: e(p, A, b, c),
                init_p,
                jac=lambda p: jax.jacobian(e)(p, A, b, c),
                method='hybr',
                tol=1e-5)
```

```
CPU times: user 2min 26s, sys: 418 ms, total: 2min 26s
Wall time: 2min 25s
```

The result is also slightly less accurate:

```
p = solution.x
jnp.max(jnp.abs(e(p, A, b, c)))
```

```
Array(7.1525574e-07, dtype=float32)
```

## 3.5 Exercises

---

### Exercise 3.5.1

Consider a three-dimensional extension of the Solow fixed point problem with

$$A = \begin{pmatrix} 2 & 3 & 3 \\ 2 & 4 & 2 \\ 1 & 5 & 1 \end{pmatrix}, \quad s = 0.2, \quad \alpha = 0.5, \quad \delta = 0.8$$

As before the law of motion is

$$k_{t+1} = g(k_t) \quad \text{where} \quad g(k) := sAk^\alpha + (1 - \delta)k$$

However  $k_t$  is now a  $3 \times 1$  vector.

Solve for the fixed point using Newton's method with the following initial values:

$$k1_0 = (1, 1, 1)$$

$$k2_0 = (3, 5, 5)$$

$$k3_0 = (50, 50, 50)$$

**Hint:**

- The computation of the fixed point is equivalent to computing  $k^*$  such that  $f(k^*) - k^* = 0$ .
- If you are unsure about your solution, you can start with the solved example:

$$A = \begin{pmatrix} 2 & 0 & 0 \\ 0 & 2 & 0 \\ 0 & 0 & 2 \end{pmatrix}$$

with  $s = 0.3$ ,  $\alpha = 0.3$ , and  $\delta = 0.4$  and starting value:

$$k_0 = (1, 1, 1)$$

The result should converge to the [analytical solution](#).

**Solution to Exercise 3.5.1**

Let's first define the parameters for this problem

```
A = jnp.array([[2.0, 3.0, 3.0],
               [2.0, 4.0, 2.0],
               [1.0, 5.0, 1.0]])

s = 0.2
α = 0.5
δ = 0.8
initLs = [jnp.ones(3),
          jnp.array([3.0, 5.0, 5.0]),
          jnp.repeat(50.0, 3)]
```

Then we define the multivariate version of the formula for the [law of motion of capital](#)

```
def multivariate_solow(k, A=A, s=s, α=α, δ=δ):
    return s * jnp.dot(A, k**α) + (1 - δ) * k
```

Let's run through each starting value and see the output

```
attempt = 1
for init in initLs:
    print(f'Attempt {attempt}: Starting value is {init} \n')
    %time k = newton(lambda k: multivariate_solow(k) - k, \
                    init).block_until_ready()
    print('-'*64)
    attempt += 1
```

```
Attempt 1: Starting value is [1. 1. 1.]
```

```
iteration 1, error = 50.496315002441406
iteration 2, error = 41.1093864440918
iteration 3, error = 4.294127464294434
iteration 4, error = 0.3854290544986725
iteration 5, error = 0.0054382034577429295
iteration 6, error = 8.92080606718082e-07
```

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```
CPU times: user 197 ms, sys: 12.5 ms, total: 209 ms
Wall time: 243 ms
```

```
-----
Attempt 2: Starting value is [3. 5. 5.]
```

```
iteration 1, error = 2.0701100826263428
iteration 2, error = 0.12642373144626617
iteration 3, error = 0.0006017307168804109
iteration 4, error = 3.3717478231665154e-07
CPU times: user 111 ms, sys: 265  $\mu$ s, total: 111 ms
Wall time: 95.9 ms
```

```
-----
Attempt 3: Starting value is [50. 50. 50.]
```

```
iteration 1, error = 73.00942993164062
```

```
iteration 2, error = 6.493789196014404
iteration 3, error = 0.6806989312171936
iteration 4, error = 0.016202213242650032
iteration 5, error = 1.0600916539260652e-05
iteration 6, error = 9.830249609876773e-07
CPU times: user 243 ms, sys: 8.4 ms, total: 251 ms
Wall time: 225 ms
```

We find that the results are invariant to the starting values.

But the number of iterations it takes to converge is dependent on the starting values.

Let substitute the output back into the formulate to check our last result

```
multivariate_solow(k) - k
```

```
Array([ 4.7683716e-07,  0.0000000e+00, -2.3841858e-07], dtype=float32)
```

Note the error is very small.

We can also test our results on the known solution

```
A = jnp.array([[2.0, 0.0, 0.0],
               [0.0, 2.0, 0.0],
               [0.0, 0.0, 2.0]])
s = 0.3
 $\alpha$  = 0.3
 $\delta$  = 0.4
init = jnp.repeat(1.0, 3)
%time k = newton(lambda k: multivariate_solow(k, A=A, s=s,  $\alpha$ = $\alpha$ ,  $\delta$ = $\delta$ ) - k, \
                 init).block_until_ready()
```

```
iteration 1, error = 1.5745922327041626
iteration 2, error = 0.21344946324825287
iteration 3, error = 0.002045975998044014
iteration 4, error = 8.259061701210157e-07
```

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```
CPU times: user 211 ms, sys: 4.62 ms, total: 216 ms
Wall time: 221 ms
```

The result is very close to the true solution but still slightly different.

We can increase the precision of the floating point numbers and restrict the tolerance to obtain a more accurate approximation (see detailed discussion in the [lecture on JAX](#))

```
# We will use 64 bit floats with JAX in order to increase the precision.
jax.config.update("jax_enable_x64", True)
init = init.astype('float64')

%time k = newton(lambda k: multivariate_solow(k, A=A, s=s, a=a, δ=δ) - k, \
                init, \
                tol=1e-7).block_until_ready()
```

```
iteration 1, error = 1.5745916432444333
iteration 2, error = 0.21344933091258958
iteration 3, error = 0.0020465547718452695
iteration 4, error = 2.0309190076799282e-07
iteration 5, error = 1.538370149106851e-15
CPU times: user 194 ms, sys: 16.4 ms, total: 210 ms
Wall time: 267 ms
```

We can see it steps towards a more accurate solution.

---

### Exercise 3.5.2

In this exercise, let's try different initial values and check how Newton's method responds to different starting points.

Let's define a three-good problem with the following default values:

$$A = \begin{pmatrix} 0.2 & 0.1 & 0.7 \\ 0.3 & 0.2 & 0.5 \\ 0.1 & 0.8 & 0.1 \end{pmatrix}, \quad b = \begin{pmatrix} 1 \\ 1 \\ 1 \end{pmatrix} \quad \text{and} \quad c = \begin{pmatrix} 1 \\ 1 \\ 1 \end{pmatrix}$$

For this exercise, use the following extreme price vectors as initial values:

$$\begin{aligned} p1_0 &= (5, 5, 5) \\ p2_0 &= (1, 1, 1) \\ p3_0 &= (4.5, 0.1, 4) \end{aligned}$$

Set the tolerance to  $10^{-15}$  for more accurate output.

---

**Hint:** Similar to [exercise 1](#), enabling `float64` for JAX can improve the precision of our results.

---

### Solution to Exercise 3.5.2

Define parameters and initial values

```
A = jnp.array([
    [0.2, 0.1, 0.7],
    [0.3, 0.2, 0.5],
    [0.1, 0.8, 0.1]
])
b = jnp.array([1.0, 1.0, 1.0])
c = jnp.array([1.0, 1.0, 1.0])
initLs = [jnp.repeat(5.0, 3),
          jnp.array([4.5, 0.1, 4.0])]
```

Let's run through each initial guess and check the output

```
attempt = 1
for init in initLs:
    print(f'Attempt {attempt}: Starting value is {init} \n')
    init = init.astype('float64')
    %time p = newton(lambda p: e(p, A, b, c), \
                    init, \
                    tol=1e-15, max_iter=15).block_until_ready()
    print('-'*64)
    attempt +=1
```

```
Attempt 1: Starting value is [5. 5. 5.]
```

```
iteration 1, error = 9.243805733085065
iteration 2, error = nan
CPU times: user 105 ms, sys: 4.2 ms, total: 110 ms
Wall time: 131 ms
```

```
-----
Attempt 2: Starting value is [4.5 0.1 4. ]
```

```
iteration 1, error = 4.892018895185869
iteration 2, error = 1.2120550201694784
iteration 3, error = 0.6942087122866175
iteration 4, error = 0.168951089180319
iteration 5, error = 0.005209730313222213
iteration 6, error = 4.3632751705775364e-06
iteration 7, error = 3.0460818773540415e-12
iteration 8, error = 0.0
CPU times: user 97 ms, sys: 8.36 ms, total: 105 ms
Wall time: 87.4 ms
-----
```

We can find that Newton's method may fail for some starting values.

Sometimes it may take a few initial guesses to achieve convergence.

Substitute the result back to the formula to check our result

```
e(p, A, b, c)
```

```
Array([0., 0., 0.], dtype=float64)
```

We can see the result is very accurate.



# **Part II**

## **Simulation**



## INVENTORY DYNAMICS

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

## 4.1 Overview

This lecture explores the inventory dynamics of a firm using so-called s-S inventory control.

Loosely speaking, this means that the firm

- waits until inventory falls below some value  $s$
- and then restocks with a bulk order of  $S$  units (or, in some models, restocks up to level  $S$ ).

We will be interested in the distribution of the associated Markov process, which can be thought of as cross-sectional distributions of inventory levels across a large number of firms, all of which

1. evolve independently and
2. have the same dynamics.

Note that we also studied this model in a [separate lecture](#), using Numba.

Here we study the same problem using JAX.

We will use the following imports:

```
import matplotlib.pyplot as plt
import numpy as np
import jax
import jax.numpy as jnp
from jax import random, lax
from collections import namedtuple
```

Here’s a description of our GPU:

```
!nvidia-smi
```

```
/opt/conda/envs/quantecon/lib/python3.11/pty.py:89: RuntimeWarning: os.fork() was
↳called. os.fork() is incompatible with multithreaded code, and JAX is
↳multithreaded, so this will likely lead to a deadlock.
pid, fd = os.forkpty()
```

```
Thu May 2 01:59:29 2024
+-----+
| NVIDIA-SMI 470.182.03    Driver Version: 470.182.03    CUDA Version: 12.3    |
+-----+-----+-----+-----+-----+-----+
| GPU  Name                Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp  Perf  Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                           |              |                  MIG M. |
+=====+=====+=====+=====+=====+=====+
|    0   Tesla V100-SXM2...  Off      | 00000000:00:1E:0  Off |                  0    |
| N/A   28C    P0     38W / 300W |      0MiB / 16160MiB |      2%      Default |
|                                           |              |                  N/A    |
+-----+-----+-----+-----+-----+-----+
+-----+
| Processes:
| GPU  GI  CI           PID  Type  Process name                        GPU Memory
|     ID  ID                                     Usage
+=====+
| No running processes found
+-----+
```

```
+-----+
|    0   Tesla V100-SXM2...  Off      | 00000000:00:1E:0  Off |                  0    |
| N/A   28C    P0     38W / 300W |      0MiB / 16160MiB |      2%      Default |
|                                           |              |                  N/A    |
+-----+-----+-----+-----+-----+-----+
+-----+
| Processes:
| GPU  GI  CI           PID  Type  Process name                        GPU Memory
|     ID  ID                                     Usage
+=====+
| No running processes found
+-----+
```

## 4.2 Sample paths

Consider a firm with inventory  $X_t$ .

The firm waits until  $X_t \leq s$  and then restocks up to  $S$  units.

It faces stochastic demand  $\{D_t\}$ , which we assume is IID across time and firms.

With notation  $a^+ := \max\{a, 0\}$ , inventory dynamics can be written as

$$X_{t+1} = \begin{cases} (S - D_{t+1})^+ & \text{if } X_t \leq s \\ (X_t - D_{t+1})^+ & \text{if } X_t > s \end{cases}$$

In what follows, we will assume that each  $D_t$  is lognormal, so that

$$D_t = \exp(\mu + \sigma Z_t)$$

where  $\mu$  and  $\sigma$  are parameters and  $\{Z_t\}$  is IID and standard normal.

Here's a namedtuple that stores parameters.

```
Parameters = namedtuple('Parameters', ['s', 'S', 'μ', 'σ'])

# Create a default instance
params = Parameters(s=10, S=100, μ=1.0, σ=0.5)
```

## 4.3 Cross-sectional distributions

Now let's look at the marginal distribution  $\psi_T$  of  $X_T$  for some fixed  $T$ .

The probability distribution  $\psi_T$  is the time  $T$  distribution of firm inventory levels implied by the model.

We will approximate this distribution by

1. fixing  $n$  to be some large number, indicating the number of firms in the simulation,
2. fixing  $T$ , the time period we are interested in,
3. generating  $n$  independent draws from some fixed distribution  $\psi_0$  that gives the initial cross-section of inventories for the  $n$  firms, and
4. shifting this distribution forward in time  $T$  periods, updating each firm  $T$  times via the dynamics described above (independent of other firms).

We will then visualize  $\psi_T$  by histogramming the cross-section.

We will use the following code to update the cross-section of firms by one period.

```
@jax.jit
def update_cross_section(params, X_vec, D):
    """
    Update by one period a cross-section of firms with inventory levels given by
    X_vec, given the vector of demand shocks in D.

    * D[i] is the demand shock for firm i with current inventory X_vec[i]

    """
    # Unpack
    s, S = params.s, params.S
    # Restock if the inventory is below the threshold
    X_new = jnp.where(X_vec <= s,
                     jnp.maximum(S - D, 0), jnp.maximum(X_vec - D, 0))
    return X_new
```

### 4.3.1 For loop version

Now we provide code to compute the cross-sectional distribution  $\psi_T$  given some initial distribution  $\psi_0$  and a positive integer  $T$ .

In this code we use an ordinary Python `for` loop to step forward through time

While Python loops are slow, this approach is reasonable here because efficiency of outer loops has far less influence on runtime than efficiency of inner loops.

(Below we will squeeze out more speed by compiling the outer loop as well as the update rule.)

In the code below, the initial distribution  $\psi_0$  takes all firms to have initial inventory `x_init`.

```
def compute_cross_section(params, x_init, T, key, num_firms=50_000):
    # Set up initial distribution
    X_vec = jnp.full((num_firms, ), x_init)
    # Loop
    for i in range(T):
        Z = random.normal(key, shape=(num_firms, ))
```

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```
D = jnp.exp(params.μ + params.σ * Z)

X_vec = update_cross_section(params, X_vec, D)
_, key = random.split(key)

return X_vec
```

We'll use the following specification

```
x_init = 50
T = 500
# Initialize random number generator
key = random.PRNGKey(10)
```

Let's look at the timing.

```
%time X_vec = compute_cross_section(params, \
    x_init, T, key).block_until_ready()
```

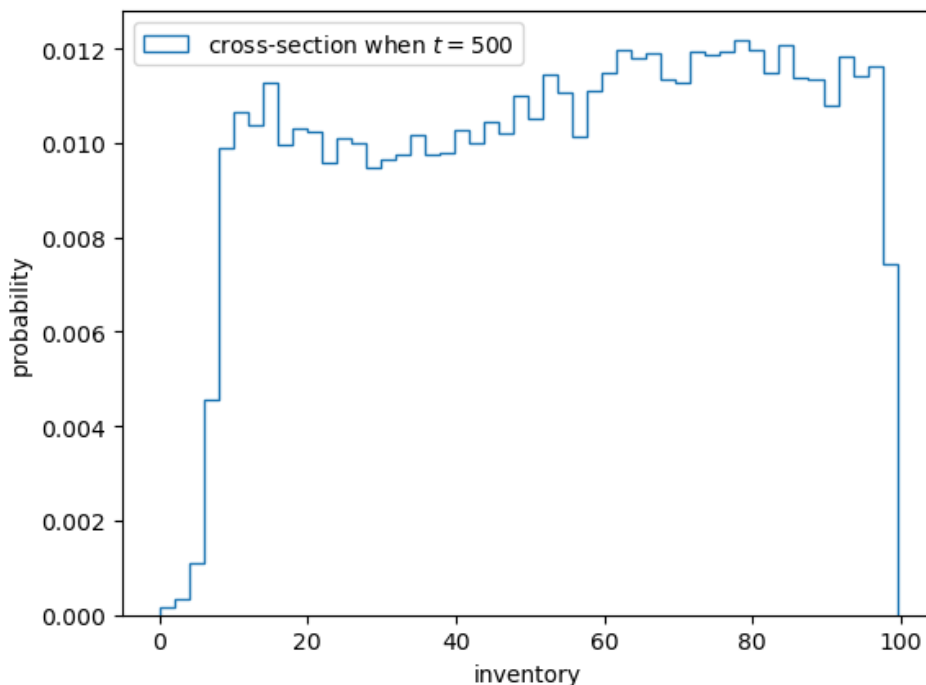
```
CPU times: user 1.37 s, sys: 416 ms, total: 1.79 s
Wall time: 949 ms
```

```
%time X_vec = compute_cross_section(params, \
    x_init, T, key).block_until_ready()
```

```
CPU times: user 1 s, sys: 368 ms, total: 1.37 s
Wall time: 546 ms
```

Here's a histogram of inventory levels at time  $T$ .

```
fig, ax = plt.subplots()
ax.hist(X_vec, bins=50,
        density=True,
        histtype='step',
        label=f'cross-section when $t = {T}$')
ax.set_xlabel('inventory')
ax.set_ylabel('probability')
ax.legend()
plt.show()
```



### 4.3.2 Compiling the outer loop

Now let's see if we can gain some speed by compiling the outer loop, which steps through the time dimension.

We will do this using `jax.jit` and a `fori_loop`, which is a compiler-ready version of a `for` loop provided by JAX.

```
def compute_cross_section_fori(params, x_init, T, key, num_firms=50_000):

    s, S, μ, σ = params.s, params.S, params.μ, params.σ
    X = jnp.full((num_firms, ), x_init)

    # Define the function for each update
    def fori_update(t, inputs):
        # Unpack
        X, key = inputs
        # Draw shocks using key
        Z = random.normal(key, shape=(num_firms,))
        D = jnp.exp(μ + σ * Z)
        # Update X
        X = jnp.where(X <= s,
                     jnp.maximum(S - D, 0),
                     jnp.maximum(X - D, 0))
        # Refresh the key
        key, subkey = random.split(key)
        return X, subkey

    # Loop t from 0 to T, applying fori_update each time.
    # The initial condition for fori_update is (X, key).
    X, key = lax.fori_loop(0, T, fori_update, (X, key))

    return X
```

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```
# Compile taking T and num_firms as static (changes trigger recompile)
compute_cross_section_for1 = jax.jit(
    compute_cross_section_for1, static_argnums=(2, 4))
```

Let's see how fast this runs with compile time.

```
%time X_vec = compute_cross_section_for1(params, \
    x_init, T, key).block_until_ready()
```

```
CPU times: user 297 ms, sys: 0 ns, total: 297 ms
Wall time: 207 ms
```

And let's see how fast it runs without compile time.

```
%time X_vec = compute_cross_section_for1(params, \
    x_init, T, key).block_until_ready()
```

```
CPU times: user 16.4 ms, sys: 0 ns, total: 16.4 ms
Wall time: 14.2 ms
```

Compared to the original version with a pure Python outer loop, we have produced a nontrivial speed gain.

This is due to the fact that we have compiled the whole operation.

### 4.3.3 Further vectorization

For relatively small problems, we can make this code run even faster by generating all random variables at once.

This improves efficiency because we are taking more operations out of the loop.

```
def compute_cross_section_for1(params, x_init, T, key, num_firms=50_000):

    s, S,  $\mu$ ,  $\sigma$  = params.s, params.S, params. $\mu$ , params. $\sigma$ 
    X = jnp.full((num_firms, ), x_init)
    Z = random.normal(key, shape=(T, num_firms))
    D = jnp.exp( $\mu$  +  $\sigma$  * Z)

    def update_cross_section(i, X):
        X = jnp.where(X <= s,
                      jnp.maximum(S - D[i, :], 0),
                      jnp.maximum(X - D[i, :], 0))
        return X

    X = lax.fori_loop(0, T, update_cross_section, X)

    return X

# Compile taking T and num_firms as static (changes trigger recompile)
compute_cross_section_for1 = jax.jit(
    compute_cross_section_for1, static_argnums=(2, 4))
```

Let's test it with compile time included.



```
%time X_vec = compute_cross_section_fori(params, \
    x_init, T, key).block_until_ready()
```

```
CPU times: user 227 ms, sys: 0 ns, total: 227 ms
Wall time: 212 ms
```

Let's run again to eliminate compile time.

```
%time X_vec = compute_cross_section_fori(params, \
    x_init, T, key).block_until_ready()
```

```
CPU times: user 5.21 ms, sys: 0 ns, total: 5.21 ms
Wall time: 4.82 ms
```

On one hand, this version is faster than the previous one, where random variables were generated inside the loop.

On the other hand, this implementation consumes far more memory, as we need to store large arrays of random draws.

The high memory consumption becomes problematic for large problems.

## 4.4 Distribution dynamics

Next let's take a look at how the distribution sequence evolves over time.

We will go back to using ordinary Python `for` loops.

Here is code that repeatedly shifts the cross-section forward while recording the cross-section at the dates in `sample_dates`.

```
def shift_forward_and_sample(x_init, params, sample_dates,
                             key, num_firms=50_000, sim_length=750):

    X = res = jnp.full((num_firms, ), x_init)

    # Use for loop to update X and collect samples
    for i in range(sim_length):
        Z = random.normal(key, shape=(num_firms, ))
        D = jnp.exp(params.μ + params.σ * Z)

        X = update_cross_section(params, X, D)
        _, key = random.split(key)

    # draw a sample at the sample dates
    if (i+1 in sample_dates):
        res = jnp.vstack((res, X))

    return res[1:]
```

Let's test it

```
x_init = 50
num_firms = 10_000
sample_dates = 10, 50, 250, 500, 750
```

(continues on next page)

(continued from previous page)

```
key = random.PRNGKey(10)

%time X = shift_forward_and_sample(x_init, params, \
                                   sample_dates, key).block_until_ready()
```

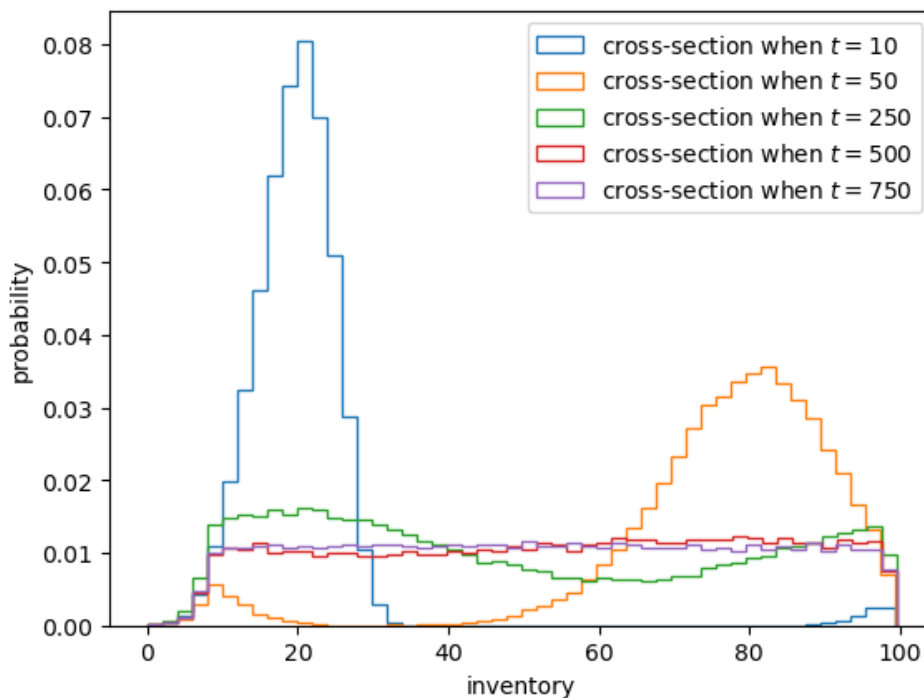
```
CPU times: user 2.23 s, sys: 0 ns, total: 2.23 s
Wall time: 1.06 s
```

Let's plot the output.

```
fig, ax = plt.subplots()

for i, date in enumerate(sample_dates):
    ax.hist(X[i, :], bins=50,
            density=True,
            histtype='step',
            label=f'cross-section when $t = {date}$')

ax.set_xlabel('inventory')
ax.set_ylabel('probability')
ax.legend()
plt.show()
```



This model for inventory dynamics is asymptotically stationary, with a unique stationary distribution.

In particular, the sequence of marginal distributions  $\{\psi_t\}$  converges to a unique limiting distribution that does not depend on initial conditions.

Although we will not prove this here, we can see it in the simulation above.

By  $t = 500$  or  $t = 750$  the distributions are barely changing.

If you test a few different initial conditions, you will see that they do not affect long-run outcomes.

## 4.5 Restock frequency

As an exercise, let's study the probability that firms need to restock over a given time period.

In the exercise, we will

- set the starting stock level to  $X_0 = 70$  and
- calculate the proportion of firms that need to order twice or more in the first 50 periods.

This proportion approximates the probability of the event when the sample size is large.

### 4.5.1 For loop version

We start with an easier `for` loop implementation

```
# Define a jitted function for each update
@jax.jit
def update_stock(n_restock, X, params, D):
    n_restock = jnp.where(X <= params.s,
                          n_restock + 1,
                          n_restock)
    X = jnp.where(X <= params.s,
                  jnp.maximum(params.S - D, 0),
                  jnp.maximum(X - D, 0))
    return n_restock, X, key

def compute_freq(params, key,
                 x_init=70,
                 sim_length=50,
                 num_firms=1_000_000):

    # Prepare initial arrays
    X = jnp.full((num_firms, ), x_init)

    # Stack the restock counter on top of the inventory
    n_restock = jnp.zeros((num_firms, ))

    # Use a for loop to perform the calculations on all states
    for i in range(sim_length):
        Z = random.normal(key, shape=(num_firms, ))
        D = jnp.exp(params.μ + params.σ * Z)
        n_restock, X, key = update_stock(
            n_restock, X, params, D)
        key = random.fold_in(key, i)

    return jnp.mean(n_restock > 1, axis=0)
```

```
key = random.PRNGKey(27)
%time freq = compute_freq(params, key).block_until_ready()
print(f"Frequency of at least two stock outs = {freq}")
```

```
CPU times: user 631 ms, sys: 0 ns, total: 631 ms
Wall time: 615 ms
Frequency of at least two stock outs = 0.4472379982471466
```

### Exercise 4.5.1

Write a `fori_loop` version of the last function. See if you can increase the speed while generating a similar answer.

---

### Solution to Exercise 4.5.1

Here is a `lax.fori_loop` version that JIT compiles the whole function

```
@jax.jit
def compute_freq(params, key,
                 x_init=70,
                 sim_length=50,
                 num_firms=1_000_000):

    s, S,  $\mu$ ,  $\sigma$  = params.s, params.S, params. $\mu$ , params. $\sigma$ 
    # Prepare initial arrays
    X = jnp.full((num_firms, ), x_init)
    Z = random.normal(key, shape=(sim_length, num_firms))
    D = jnp.exp( $\mu$  +  $\sigma$  * Z)

    # Stack the restock counter on top of the inventory
    restock_count = jnp.zeros((num_firms, ))
    Xs = (X, restock_count)

    # Define the function for each update
    def update_cross_section(i, Xs):
        # Separate the inventory and restock counter
        x, restock_count = Xs[0], Xs[1]
        restock_count = jnp.where(x <= s,
                                  restock_count + 1,
                                  restock_count)

        x = jnp.where(x <= s,
                      jnp.maximum(S - D[i], 0),
                      jnp.maximum(x - D[i], 0))

        Xs = (x, restock_count)
        return Xs

    # Use lax.fori_loop to perform the calculations on all states
    X_final = lax.fori_loop(0, sim_length, update_cross_section, Xs)

    return jnp.mean(X_final[1] > 1)
```

Note the time the routine takes to run, as well as the output

```
%time freq = compute_freq(params, key).block_until_ready()
%time freq = compute_freq(params, key).block_until_ready()

print(f"Frequency of at least two stock outs = {freq}")
```

```
CPU times: user 339 ms, sys: 0 ns, total: 339 ms
Wall time: 292 ms
CPU times: user 2.43 ms, sys: 0 ns, total: 2.43 ms
Wall time: 4.88 ms
Frequency of at least two stock outs = 0.44674399495124817
```

---



## KESTEN PROCESSES AND FIRM DYNAMICS

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

In addition to JAX and Anaconda, this lecture will need the following libraries:

```
!pip install quantecon
```

### 5.1 Overview

This lecture describes Kesten processes, which are an important class of stochastic processes, and an application of firm dynamics.

The lecture draws on [an earlier QuantEcon lecture](#), which uses Numba to accelerate the computations.

In that earlier lecture you can find a more detailed discussion of the concepts involved.

This lecture focuses on implementing the same computations in JAX.

Let’s start with some imports:

```
import matplotlib.pyplot as plt
import quantecon as qe
import jax
import jax.numpy as jnp
from jax import random
from jax import lax
```

Let’s check the GPU we are running

```
!nvidia-smi
```

```
/opt/conda/envs/quantecon/lib/python3.11/pty.py:89: RuntimeWarning: os.fork() was
↳called. os.fork() is incompatible with multithreaded code, and JAX is
↳multithreaded, so this will likely lead to a deadlock.
pid, fd = os.forkpty()
```

```
Thu May 2 02:26:41 2024
+-----+
| NVIDIA-SMI 470.182.03    Driver Version: 470.182.03    CUDA Version: 12.3    |
+-----+-----+-----+
| GPU  Name                Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp  Perf  Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                           |              |                  MIG M. |
+=====+=====+=====+
|    0   Tesla V100-SXM2...  Off      | 00000000:00:1E:0  Off |                0 |
| N/A   27C    P0     38W / 300W |      0MiB / 16160MiB |      2%      Default |
|                                           |              |                  N/A |
+-----+-----+-----+
+-----+
| Processes:
| GPU  GI  CI           PID  Type  Process name                        GPU Memory
|     ID  ID                                     Usage
+=====+
| No running processes found
+-----+
```

```
+-----+
|    0   Tesla V100-SXM2...  Off      | 00000000:00:1E:0  Off |                0 |
| N/A   27C    P0     38W / 300W |      0MiB / 16160MiB |      2%      Default |
|                                           |              |                  N/A |
+-----+-----+-----+
+-----+
| Processes:
| GPU  GI  CI           PID  Type  Process name                        GPU Memory
|     ID  ID                                     Usage
+=====+
| No running processes found
+-----+
```

## 5.2 Kesten processes

A **Kesten process** is a stochastic process of the form

$$X_{t+1} = a_{t+1}X_t + \eta_{t+1} \tag{5.1}$$

where  $\{a_t\}_{t \geq 1}$  and  $\{\eta_t\}_{t \geq 1}$  are IID sequences.

We are interested in the dynamics of  $\{X_t\}_{t \geq 0}$  when  $X_0$  is given.

We will focus on the nonnegative scalar case, where  $X_t$  takes values in  $\mathbb{R}_+$ .

In particular, we will assume that

- the initial condition  $X_0$  is nonnegative,
- $\{a_t\}_{t \geq 1}$  is a nonnegative IID stochastic process and
- $\{\eta_t\}_{t \geq 1}$  is another nonnegative IID stochastic process, independent of the first.



### 5.2.1 Application: firm dynamics

In this section we apply Kesten process theory to the study of firm dynamics.

#### Gibrat's law

It was postulated many years ago by Robert Gibrat that firm size evolves according to a simple rule whereby size next period is proportional to current size.

This is now known as [Gibrat's law of proportional growth](#).

We can express this idea by stating that a suitably defined measure  $s_t$  of firm size obeys

$$\frac{s_{t+1}}{s_t} = a_{t+1} \quad (5.2)$$

for some positive IID sequence  $\{a_t\}$ .

Subsequent empirical research has shown that this specification is not accurate, particularly for small firms.

However, we can get close to the data by modifying (5.2) to

$$s_{t+1} = a_{t+1}s_t + b_{t+1} \quad (5.3)$$

where  $\{a_t\}$  and  $\{b_t\}$  are both IID and independent of each other.

We now study the implications of this specification.

#### Heavy tails

If the conditions of the [Kesten–Goldie Theorem](#) are satisfied, then (5.3) implies that the firm size distribution will have Pareto tails.

This matches empirical findings across many data sets.

But there is another unrealistic aspect of the firm dynamics specified in (5.3) that we need to address: it ignores entry and exit.

In any given period and in any given market, we observe significant numbers of firms entering and exiting the market.

In this setting, firm dynamics can be expressed as

$$s_{t+1} = e_{t+1}\mathbb{1}\{s_t < \bar{s}\} + (a_{t+1}s_t + b_{t+1})\mathbb{1}\{s_t \geq \bar{s}\} \quad (5.4)$$

The motivation behind and interpretation of (5.4) can be found in [our earlier Kesten process lecture](#).

What can we say about dynamics?

Although (5.4) is not a Kesten process, it does update in the same way as a Kesten process when  $s_t$  is large.

So perhaps its stationary distribution still has Pareto tails?

We can investigate this question via simulation and rank-size plots.

The approach will be to

1. generate  $M$  draws of  $s_T$  when  $M$  and  $T$  are large and
2. plot the largest 1,000 of the resulting draws in a rank-size plot.

(The distribution of  $s_T$  will be close to the stationary distribution when  $T$  is large.)

In the simulation, we assume that each of  $a_t, b_t$  and  $e_t$  is lognormal.

Here's code to update a cross-section of firms according to the dynamics in (5.2.4).

```
@jax.jit
def update_s(s, s_bar, a_random, b_random, e_random):
    exp_a = jnp.exp(a_random)
    exp_b = jnp.exp(b_random)
    exp_e = jnp.exp(e_random)

    s = jnp.where(s < s_bar,
                  exp_e,
                  exp_a * s + exp_b)

    return s
```

Now we write a for loop that repeatedly calls this function, to push a cross-section of firms forward in time.

For sufficiently large  $T$ , the cross-section it returns (the cross-section at time  $T$ ) corresponds to firm size distribution in (approximate) equilibrium.

```
def generate_draws(M=1_000_000,
                  mu_a=-0.5,
                  sigma_a=0.1,
                  mu_b=0.0,
                  sigma_b=0.5,
                  mu_e=0.0,
                  sigma_e=0.5,
                  s_bar=1.0,
                  T=500,
                  s_init=1.0,
                  seed=123):

    key = random.PRNGKey(seed)

    # Initialize the array of s values with the initial value
    s = jnp.full((M, ), s_init)

    # Perform updates on s for time t
    for t in range(T):
        keys = random.split(key, 3)
        a_random = mu_a + sigma_a * random.normal(keys[0], (M, ))
        b_random = mu_b + sigma_b * random.normal(keys[1], (M, ))
        e_random = mu_e + sigma_e * random.normal(keys[2], (M, ))

        s = update_s(s, s_bar, a_random, b_random, e_random)

    # Generate new key for the next iteration
    key = random.fold_in(key, t)

    return s

%time data = generate_draws().block_until_ready()
```

```
CPU times: user 4.19 s, sys: 2.34 s, total: 6.53 s
Wall time: 3.89 s
```

Running the above function again so we can see the speed with and without compile time.

```
%time data = generate_draws().block_until_ready()
```

```
CPU times: user 4.25 s, sys: 774 ms, total: 5.03 s
Wall time: 2.25 s
```

Notice that we do not JIT-compile the `for` loops, since

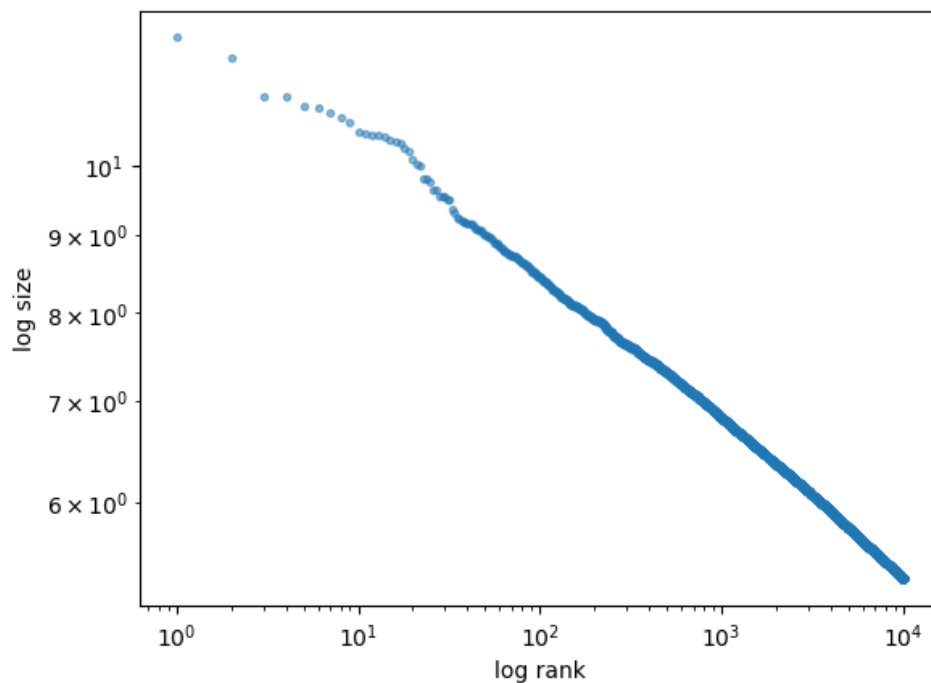
1. acceleration of the outer loop makes little difference terms of compute time and
2. compiling the outer loop is often very slow.

Let's produce the rank-size plot and check the distribution:

```
fig, ax = plt.subplots()

rank_data, size_data = qe.rank_size(data, c=0.01)
ax.loglog(rank_data, size_data, 'o', markersize=3.0, alpha=0.5)
ax.set_xlabel("log rank")
ax.set_ylabel("log size")

plt.show()
```



The plot produces a straight line, consistent with a Pareto tail.

Alternative implementation with `lax.fori_loop`

If the time horizon is not too large, we can try to further accelerate our code by replacing the `for` loop with `lax.fori_loop`.

Note, however, that

1. as mentioned above, there is not much speed gain in accelerating outer loops,
2. `lax.fori_loop` has a more complicated syntax, and, most importantly,
3. the `lax.fori_loop` implementation consumes far more memory, as we need to have to store large matrices of random draws

Hence the code below will fail due to out-of-memory errors when  $T$  and  $M$  are large.

Here is the `lax.fori_loop` version:

```
@jax.jit
def generate_draws_lax(mu_a=-0.5,
                      sigma_a=0.1,
                      mu_b=0.0,
                      sigma_b=0.5,
                      mu_e=0.0,
                      sigma_e=0.5,
                      s_bar=1.0,
                      T=500,
                      M=500_000,
                      s_init=1.0,
                      seed=123):

    key = random.PRNGKey(seed)
    keys = random.split(key, 3)

    # Generate random draws and initial values
    a_random = mu_a + sigma_a * random.normal(keys[0], (T, M))
    b_random = mu_b + sigma_b * random.normal(keys[1], (T, M))
    e_random = mu_e + sigma_e * random.normal(keys[2], (T, M))
    s = jnp.full((M, ), s_init)

    # Define the function for each update
    def update_s(i, s):
        a, b, e = a_random[i], b_random[i], e_random[i]
        s = jnp.where(s < s_bar,
                     jnp.exp(e),
                     jnp.exp(a) * s + jnp.exp(b))

        return s

    # Use lax.scan to perform the calculations on all states
    s_final = lax.fori_loop(0, T, update_s, s)
    return s_final

%time data = generate_draws_lax().block_until_ready()
```

```
CPU times: user 410 ms, sys: 0 ns, total: 410 ms
Wall time: 408 ms
```

In this case,  $M$  is small enough for the code to run and we see some speed gain over the `for` loop implementation:

```
%time data = generate_draws_lax().block_until_ready()
```

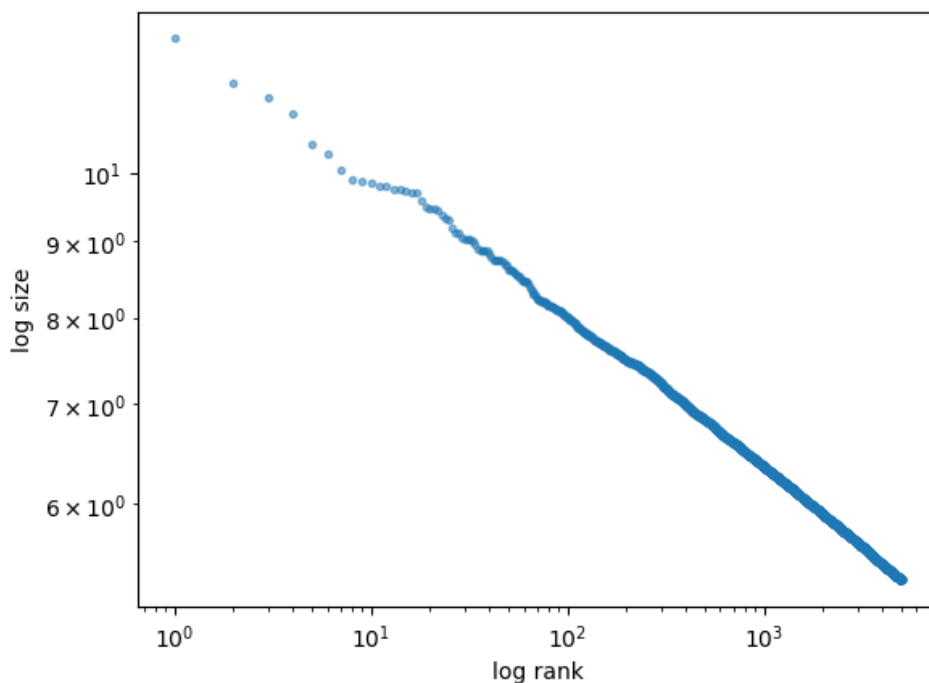
```
CPU times: user 4.01 ms, sys: 0 ns, total: 4.01 ms
Wall time: 34.7 ms
```

Here we produce the same rank-size plot:

```
fig, ax = plt.subplots()

rank_data, size_data = qe.rank_size(data, c=0.01)
ax.loglog(rank_data, size_data, 'o', markersize=3.0, alpha=0.5)
ax.set_xlabel("log rank")
ax.set_ylabel("log size")

plt.show()
```



Let's rerun the for loop version on smaller M to compare the speed

```
%time generate_draws(M=500_000).block_until_ready()
```

```
CPU times: user 4.66 s, sys: 669 ms, total: 5.33 s
Wall time: 2.53 s
```

```
Array([2.389801, 2.2558599, 3.3113828, ..., 2.7102313, 2.5520844,
       3.4196172], dtype=float32)
```

We see that the `lax.fori_loop` version is faster than the `for` loop version when memory is not an issue.



## WEALTH DISTRIBUTION DYNAMICS

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

This lecture is the extended JAX implementation of [this lecture](#).

Please refer that lecture for all background and notation.

We will use the following imports.

```
import matplotlib.pyplot as plt
import jax
import jax.numpy as jnp
from collections import namedtuple
```

Let’s check the GPU we are running

```
!nvidia-smi
```

```
/opt/conda/envs/quantecon/lib/python3.11/pty.py:89: RuntimeWarning: os.fork() was
↳called. os.fork() is incompatible with multithreaded code, and JAX is
↳multithreaded, so this will likely lead to a deadlock.
  pid, fd = os.forkpty()
```

```
Thu May  2 02:32:36 2024
+-----+
| NVIDIA-SMI 470.182.03    Driver Version: 470.182.03    CUDA Version: 12.3    |
+-----+-----+-----+
| GPU   Name               Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp  Perf    Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                           MIG M.         |
+-----+-----+-----+
|    0   Tesla V100-SXM2...    Off      | 00000000:00:1E:0 Off |                    0 |
| N/A   31C    P0     39W / 300W |      0MiB / 16160MiB |      2%      Default |
|                                           |                      | N/A         |
+-----+-----+-----+
```

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```

+-----+
| Processes:                                     |
| GPU   GI   CI           PID   Type   Process name                      GPU Memory |
|      ID   ID                                   Usage                               |
+-----+
| No running processes found                    |
+-----+

```

## 6.1 Lorenz Curves and the Gini Coefficient

Before we investigate wealth dynamics, we briefly review some measures of inequality.

### 6.1.1 Lorenz Curves

One popular graphical measure of inequality is the [Lorenz curve](#).

To illustrate, let us define a function `lorenz_curve_jax` that returns the cumulative share of people and the cumulative share of income earned.

```

@jax.jit
def lorenz_curve_jax(y):
    n = y.shape[0]
    y = jnp.sort(y)
    s = jnp.concatenate((jnp.zeros(1), jnp.cumsum(y)))
    _cum_p = jnp.arange(1, n + 1) / n
    cum_income = s / s[n]
    cum_people = jnp.concatenate((jnp.zeros(1), _cum_p))
    return cum_people, cum_income

```

Let's suppose that

```

n = 10_000                                     # Size of sample
rand_key = jax.random.PRNGKey(101)           # Set random key
w = jnp.exp(jax.random.normal(rand_key, shape=(n,))) # Lognormal draws

```

is data representing the wealth of 10,000 households.

We can compute and plot the Lorenz curve as follows:

```

%%time

f_vals, l_vals = lorenz_curve_jax(w)

```

```

CPU times: user 784 ms, sys: 14.6 ms, total: 798 ms
Wall time: 1.1 s

```

```

%%time

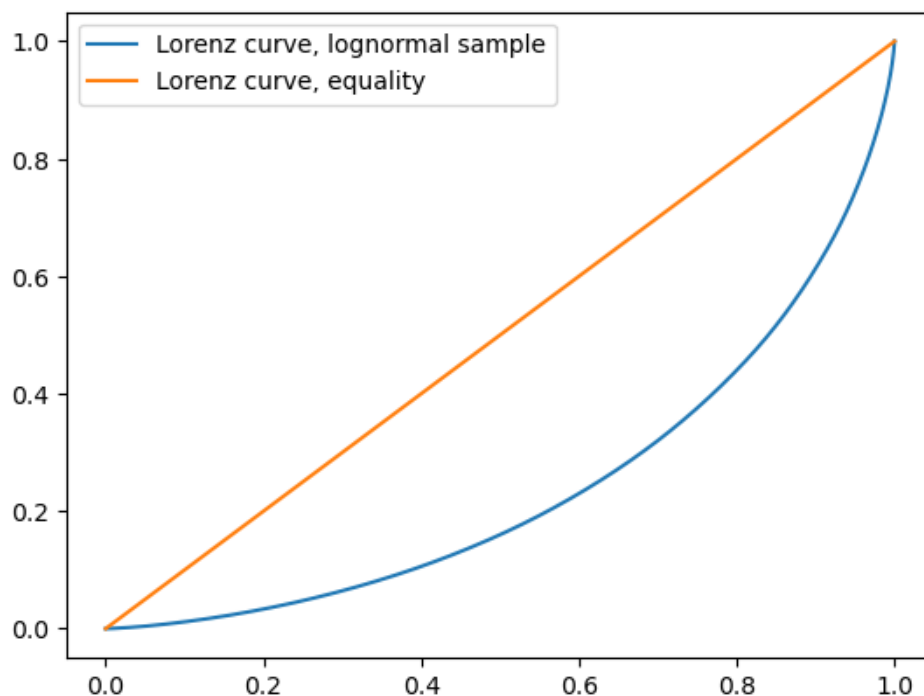
# This will be much faster as it will use the jitted function
f_vals, l_vals = lorenz_curve_jax(w)

```



```
CPU times: user 513 µs, sys: 289 µs, total: 802 µs
Wall time: 334 µs
```

```
fig, ax = plt.subplots()
ax.plot(f_vals, l_vals, label='Lorenz curve, lognormal sample')
ax.plot(f_vals, f_vals, label='Lorenz curve, equality')
ax.legend()
plt.show()
```



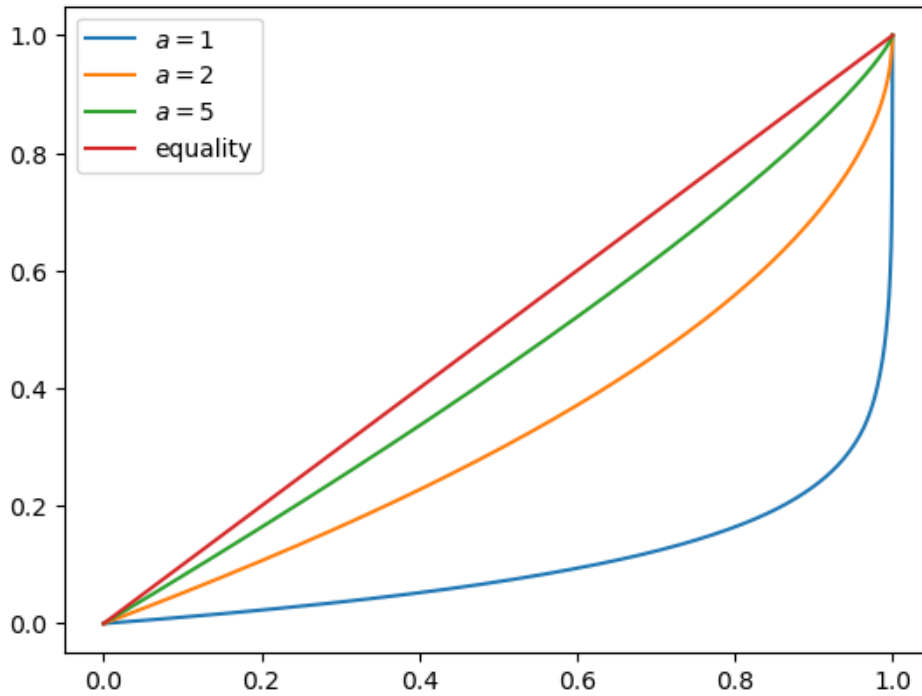
Here is another example, which shows how the Lorenz curve shifts as the underlying distribution changes.

We generate 10,000 observations using the Pareto distribution with a range of parameters, and then compute the Lorenz curve corresponding to each set of observations.

```
a_vals = (1, 2, 5)           # Pareto tail index
n = 10_000                  # size of each sample
```

```
fig, ax = plt.subplots()
for a in a_vals:
    rand_key = jax.random.PRNGKey(a*100)
    u = jax.random.uniform(rand_key, shape=(n,))
    y = u**(-1/a)           # distributed as Pareto with tail index a
    f_vals, l_vals = lorenz_curve_jax(y)
    ax.plot(f_vals, l_vals, label=f'$a = {a}$')

ax.plot(f_vals, f_vals, label='equality')
ax.legend()
plt.show()
```



You can see that, as the tail parameter of the Pareto distribution increases, inequality decreases. This is to be expected, because a higher tail index implies less weight in the tail of the Pareto distribution.

### 6.1.2 The Gini Coefficient

The definition and interpretation of the Gini coefficient can be found on the corresponding [Wikipedia page](#).

We can test it on the Weibull distribution with parameter  $a$ , where the Gini coefficient is known to be

$$G = 1 - 2^{-1/a}$$

Let's define a function to compute the Gini coefficient.

```
@jax.jit
def gini_jax(y):
    n = y.shape[0]
    g_sum = 0

    def sum_y_gini(i, g_sum):
        g_sum += jnp.sum(jnp.abs(y[i] - y))
        return g_sum

    g_sum = jax.lax.fori_loop(0, n, sum_y_gini, 0)
    return g_sum / (2 * n * jnp.sum(y))
```

Let's see if the Gini coefficient computed from a simulated sample matches this at each fixed value of  $a$ .

```
a_vals = range(1, 20)
ginis = []
ginis_theoretical = []
```

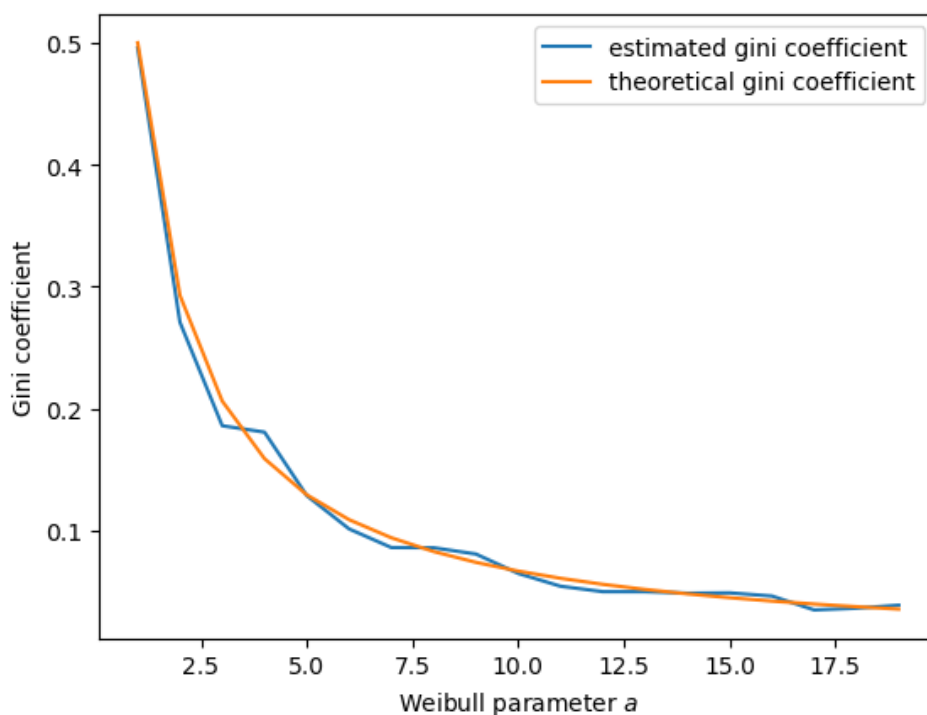
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```
n = 100

for a in a_vals:
    rand_key = jax.random.PRNGKey(a)
    y = jax.random.weibull_min(rand_key, 1, a, shape=(n,))
    ginis.append(gini_jax(y))
    ginis_theoretical.append(1 - 2**(-1/a))
```

```
fig, ax = plt.subplots()
ax.plot(a_vals, ginis, label='estimated gini coefficient')
ax.plot(a_vals, ginis_theoretical, label='theoretical gini coefficient')
ax.legend()
ax.set_xlabel("Weibull parameter $a$")
ax.set_ylabel("Gini coefficient")
plt.show()
```



The simulation shows that the fit is good.

## 6.2 A Model of Wealth Dynamics

Having discussed inequality measures, let us now turn to wealth dynamics.

The model we will study is

$$w_{t+1} = (1 + r_{t+1})s(w_t) + y_{t+1} \quad (6.1)$$

where

- $w_t$  is wealth at time  $t$  for a given household,

- $r_t$  is the rate of return of financial assets,
- $y_t$  is current non-financial (e.g., labor) income and
- $s(w_t)$  is current wealth net of consumption

## 6.3 Implementation using JAX

Let's define a model to represent the wealth dynamics.

```
# NamedTuple Model

Model = namedtuple("Model", ("w_hat", "s_0", "c_y", "mu_y",
                             "sigma_y", "c_r", "mu_r", "sigma_r", "a",
                             "b", "sigma_z", "z_mean", "z_var", "y_mean"))
```

Here's a function to create the Model with the given parameters

```
def create_wealth_model(w_hat=1.0,
                       s_0=0.75,
                       c_y=1.0,
                       mu_y=1.0,
                       sigma_y=0.2,
                       c_r=0.05,
                       mu_r=0.1,
                       sigma_r=0.5,
                       a=0.5,
                       b=0.0,
                       sigma_z=0.1):
    """
    Create a wealth model with given parameters and return
    and instance of NamedTuple Model.
    """
    z_mean = b / (1 - a)
    z_var = sigma_z**2 / (1 - a**2)
    exp_z_mean = jnp.exp(z_mean + z_var / 2)
    R_mean = c_r * exp_z_mean + jnp.exp(mu_r + sigma_r**2 / 2)
    y_mean = c_y * exp_z_mean + jnp.exp(mu_y + sigma_y**2 / 2)
    # Test a stability condition that ensures wealth does not diverge
    # to infinity.
    alpha = R_mean * s_0
    if alpha >= 1:
        raise ValueError("Stability condition failed.")
    return Model(w_hat=w_hat, s_0=s_0, c_y=c_y, mu_y=mu_y,
                 sigma_y=sigma_y, c_r=c_r, mu_r=mu_r, sigma_r=sigma_r, a=a,
                 b=b, sigma_z=sigma_z, z_mean=z_mean, z_var=z_var, y_mean=y_mean)
```

The following function updates one period with the given current wealth and persistent state.

```
def update_states_jax(arrays, wdy, size, rand_key):
    """
    Update one period, given current wealth w and persistent
    state z. They are stored in the form of tuples under the arrays argument
    """
    # Unpack w and z
```

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```

w, z = arrays

rand_key, *subkey = jax.random.split(rand_key, 3)
zp = wdy.a * z + wdy.b + wdy.σ_z * jax.random.normal(rand_key, shape=size)

# Update wealth
y = wdy.c_y * jnp.exp(zp) + jnp.exp(
    wdy.μ_y + wdy.σ_y * jax.random.normal(subkey[0], shape=size))
wp = y

R = wdy.c_r * jnp.exp(zp) + jnp.exp(
    wdy.μ_r + wdy.σ_r * jax.random.normal(subkey[1], shape=size))
wp += (w >= wdy.w_hat) * R * wdy.s_0 * w
return wp, zp

```

Here's function to simulate the time series of wealth for individual households using a for loop and JAX.

```

# Using JAX and for loop

def wealth_time_series_for_loop_jax(w_0, n, wdy, size, rand_seed=1):
    """
    Generate a single time series of length n for wealth given
    initial value w_0.

    * This implementation uses a `for` loop.

    The initial persistent state z_0 for each household is drawn from
    the stationary distribution of the AR(1) process.

    * wdy: NamedTuple Model
    * w_0: scalar/vector
    * n: int
    * size: size/shape of the w_0
    * rand_seed: int (Used to generate PRNG key)
    """
    rand_key = jax.random.PRNGKey(rand_seed)
    rand_key, *subkey = jax.random.split(rand_key, n)

    w_0 = jax.device_put(w_0).reshape(size)

    z = wdy.z_mean + jnp.sqrt(wdy.z_var) * jax.random.normal(rand_key, shape=size)
    w = [w_0]
    for t in range(n-1):
        w_, z = update_states_jax((w[t], z), wdy, size, subkey[t])
        w.append(w_)
    return jnp.array(w)

```

Let's try simulating the model at different parameter values and investigate the implications for the wealth distribution using the above function.

```

wdy = create_wealth_model() # default model
ts_length = 200
size = (1,)

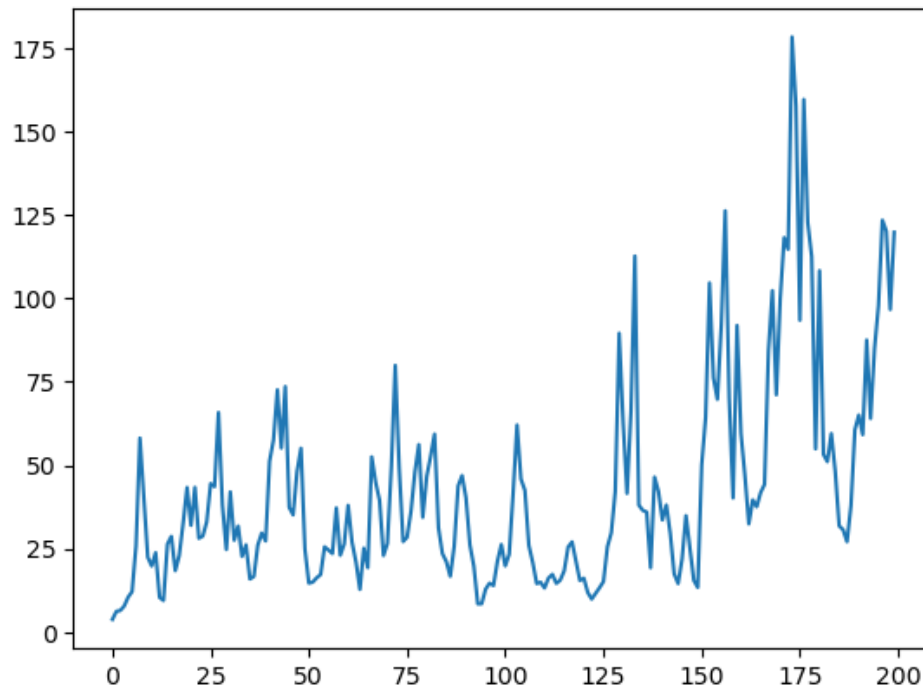
```

```
%%time

w_jax_result = wealth_time_series_for_loop_jax(wdy.y_mean,
                                              ts_length, wdy, size).block_until_
ready()
```

```
CPU times: user 2.18 s, sys: 423 ms, total: 2.61 s
Wall time: 1.75 s
```

```
fig, ax = plt.subplots()
ax.plot(w_jax_result)
plt.show()
```



We can further try to optimize and speed up the compile time of the above function by replacing `for loop` with `jax.lax.scan`.

```
def wealth_time_series_jax(w_0, n, wdy, size, rand_seed=1):
    """
    Generate a single time series of length n for wealth given
    initial value w_0.

    * This implementation uses `jax.lax.scan`.

    The initial persistent state z_0 for each household is drawn from
    the stationary distribution of the AR(1) process.

    * wdy: NamedTuple Model
    * w_0: scalar/vector
    * n: int
    * size: size/shape of the w_0
```

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```

    * rand_seed: int (Used to generate PRNG key)
    """
    rand_key = jax.random.PRNGKey(rand_seed)
    rand_key, *subkey = jax.random.split(rand_key, n)

    w_0 = jax.device_put(w_0).reshape(size)
    z_init = wdy.z_mean + jnp.sqrt(wdy.z_var) * jax.random.normal(rand_key,
↳shape=size)
    arrays = w_0, z_init
    rand_sub_keys = jnp.array(subkey)

    w_final = jnp.array([w_0])

    # Define the function for each update
    def update_w_z(arrays, rand_sub_key):
        wp, zp = update_states_jax(arrays, wdy, size, rand_sub_key)
        return (wp, zp), wp

    arrays_last, w_values = jax.lax.scan(update_w_z, arrays, rand_sub_keys)
    return jnp.concatenate((w_final, w_values))

# Create the jit function
wealth_time_series_jax = jax.jit(wealth_time_series_jax, static_argnums=(1,3,))

```

Let's try simulating the model at different parameter values and investigate the implications for the wealth distribution and also observe the difference in time between `wealth_time_series_jax` and `wealth_time_series_for_loop_jax`.

```

wdy = create_wealth_model() # default model
ts_length = 200
size = (1,)

```

```

%%time

w_jax_result = wealth_time_series_jax(wdy.y_mean, ts_length, wdy, size).block_until_
↳ready()

```

```

CPU times: user 657 ms, sys: 28 ms, total: 685 ms
Wall time: 536 ms

```

Running the above function again will be even faster because of JAX's JIT.

```

%%time

# 2nd time is expected to be very fast because of JIT
w_jax_result = wealth_time_series_jax(wdy.y_mean, ts_length, wdy, size).block_until_
↳ready()

```

```

CPU times: user 12.7 ms, sys: 0 ns, total: 12.7 ms
Wall time: 8.21 ms

```

```

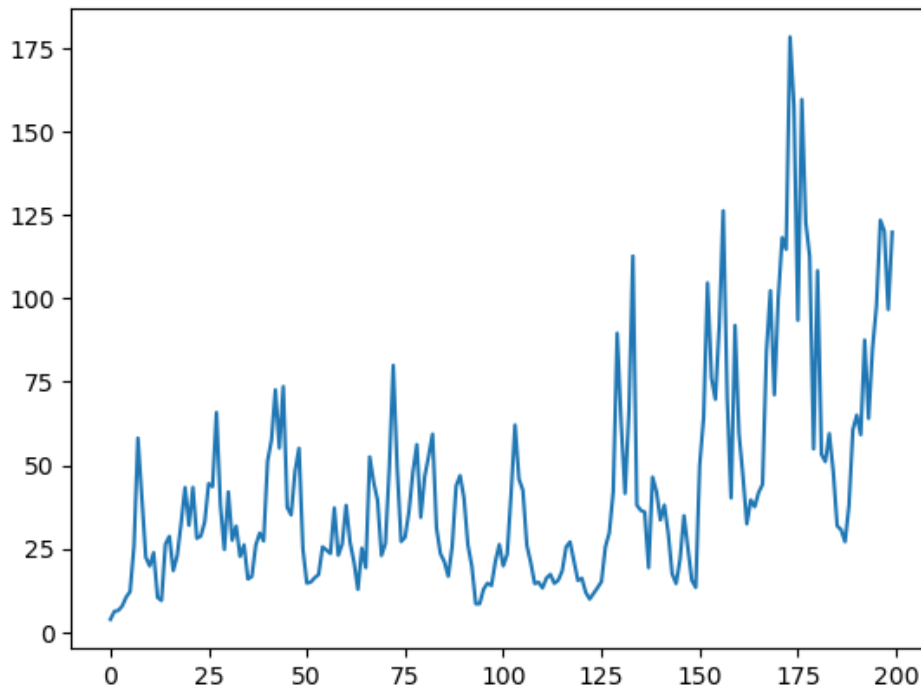
fig, ax = plt.subplots()

```

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```
ax.plot(w_jax_result)
plt.show()
```



Now here's function to simulate a cross section of households forward in time.

```
def update_cross_section_jax(w_distribution, shift_length, wdy, size, rand_seed=2):
    """
    Shifts a cross-section of household forward in time

    * wdy: NamedTuple Model
    * w_distribution: array_like, represents current cross-section

    Takes a current distribution of wealth values as w_distribution
    and updates each w_t in w_distribution to w_{t+j}, where
    j = shift_length.

    Returns the new distribution.
    """
    new_dist = wealth_time_series_jax(w_distribution, shift_length, wdy, size, rand_
    ↪seed)
    new_distribution = new_dist[-1, :]
    return new_distribution

# Create the jit function
update_cross_section_jax = jax.jit(update_cross_section_jax, static_argnums=(1,3,))
```



## 6.4 Applications

Let's try simulating the model at different parameter values and investigate the implications for the wealth distribution.

### 6.4.1 Inequality Measures

Let's look at how inequality varies with returns on financial assets.

The next function generates a cross section and then computes the Lorenz curve and Gini coefficient.

```
def generate_lorenz_and_gini_jax(wdy, num_households=100_000, T=500):
    """
    Generate the Lorenz curve data and gini coefficient corresponding to a
    WealthDynamics mode by simulating num_households forward to time T.
    """
    size = (num_households, )
     $\psi_0$  = jnp.full(size, wdy.y_mean)
     $\psi_{\text{star}}$  = update_cross_section_jax( $\psi_0$ , T, wdy, size)
    return gini_jax( $\psi_{\text{star}}$ ), lorenz_curve_jax( $\psi_{\text{star}}$ )

# Create the jit function
generate_lorenz_and_gini_jax = jax.jit(generate_lorenz_and_gini_jax,
                                       static_argnums=(1,2,))
```

Now we investigate how the Lorenz curves associated with the wealth distribution change as return to savings varies.

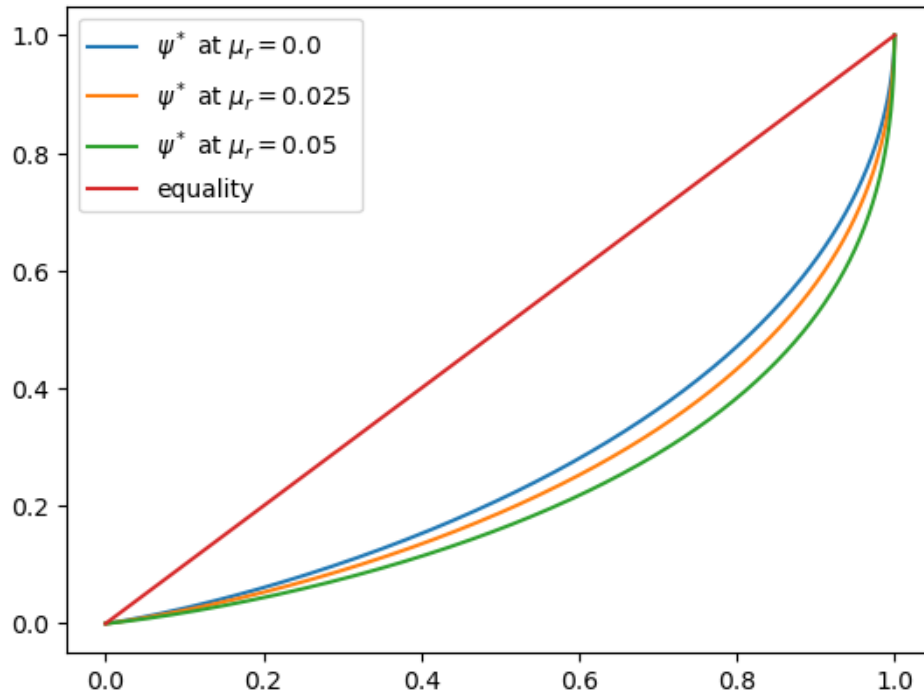
The code below plots Lorenz curves for three different values of  $\mu_r$ .

```
%%time

fig, ax = plt.subplots()
 $\mu_r$ _vals = (0.0, 0.025, 0.05)
gini_vals = []

for  $\mu_r$  in  $\mu_r$ _vals:
    wdy = create_wealth_model( $\mu_r$ = $\mu_r$ )
    gv, (f_vals, l_vals) = generate_lorenz_and_gini_jax(wdy)
    ax.plot(f_vals, l_vals, label=f' $\psi^*$  at  $\mu_r = \{\mu_r:0.2\}$ ')
    gini_vals.append(gv)

ax.plot(f_vals, f_vals, label='equality')
ax.legend(loc="upper left")
plt.show()
```

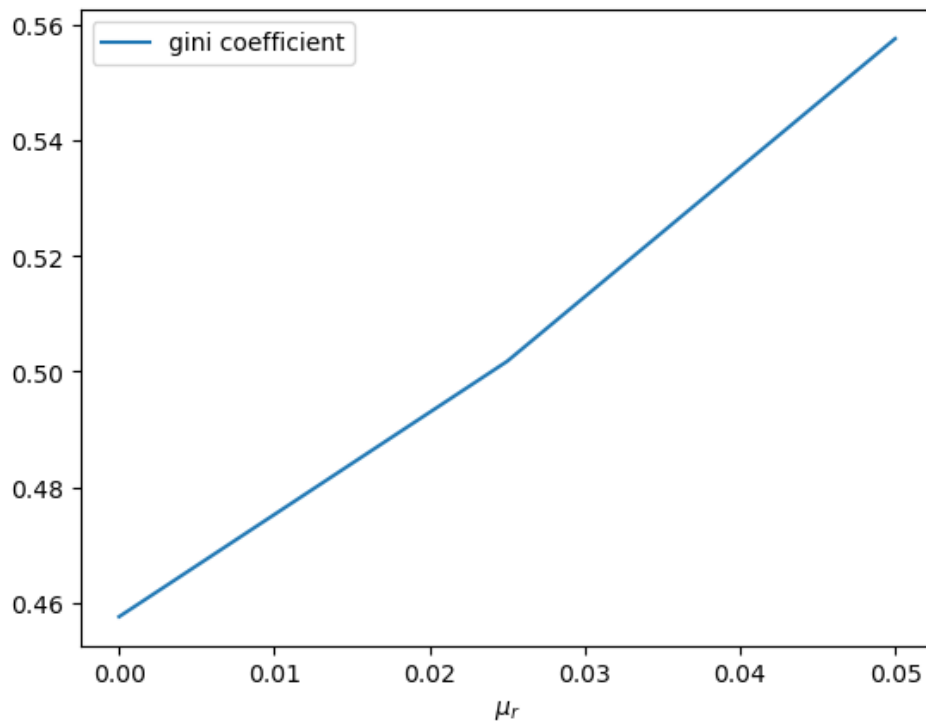


```
CPU times: user 5.48 s, sys: 0 ns, total: 5.48 s
Wall time: 5.6 s
```

The Lorenz curve shifts downwards as returns on financial income rise, indicating a rise in inequality.

Now let's check the Gini coefficient.

```
fig, ax = plt.subplots()
ax.plot(mu_r_vals, gini_vals, label='gini coefficient')
ax.set_xlabel("$\mu_r$")
ax.legend()
plt.show()
```



Once again, we see that inequality increases as returns on financial income rise.

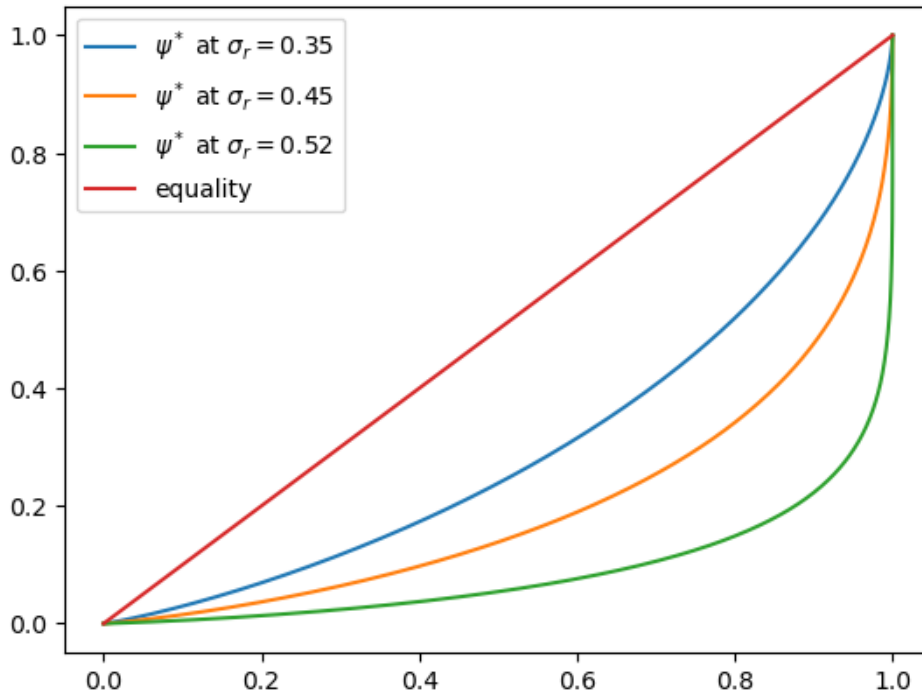
Let's finish this section by investigating what happens when we change the volatility term  $\sigma_r$  in financial returns.

```
%%time

fig, ax = plt.subplots()
sigma_r_vals = (0.35, 0.45, 0.52)
gini_vals = []

for sigma_r in sigma_r_vals:
    wdy = create_wealth_model(sigma_r=sigma_r)
    gv, (f_vals, l_vals) = generate_lorenz_and_gini_jax(wdy)
    ax.plot(f_vals, l_vals, label=f'$\psi^{*}$ at $\sigma_r = \{sigma_r:0.2\}$')
    gini_vals.append(gv)

ax.plot(f_vals, f_vals, label='equality')
ax.legend(loc="upper left")
plt.show()
```



```
CPU times: user 2.99 s, sys: 0 ns, total: 2.99 s
Wall time: 2.92 s
```

We see that greater volatility has the effect of increasing inequality in this model.

## 6.5 Exercises

### Exercise 6.5.1

For a wealth or income distribution with Pareto tail, a higher tail index suggests lower inequality.

Indeed, it is possible to prove that the Gini coefficient of the Pareto distribution with tail index  $a$  is  $1/(2a - 1)$ .

To the extent that you can, confirm this by simulation.

In particular, generate a plot of the Gini coefficient against the tail index using both the theoretical value just given and the value computed from a sample via `gini_jax`.

For the values of the tail index, use `a_vals = jnp.linspace(1, 10, 25)`.

Use sample of size 1,000 for each  $a$  and the sampling method for generating Pareto draws employed in the discussion of Lorenz curves for the Pareto distribution.

To the extent that you can, interpret the monotone relationship between the Gini index and  $a$ .

### Solution to Exercise 6.5.1

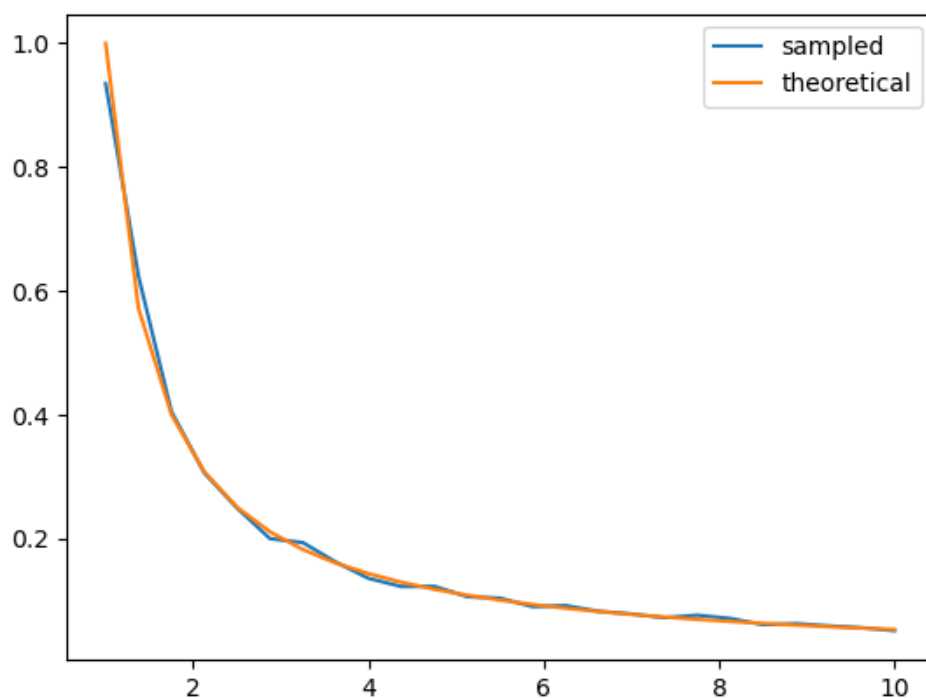
Here is one solution, which produces a good match between theory and simulation.

```

a_vals = jnp.linspace(1, 10, 25) # Pareto tail index
ginis = []

n = 1000 # size of each sample
fig, ax = plt.subplots()
for i, a in enumerate(a_vals):
    rand_key = jax.random.PRNGKey(i*10)
    u = jax.random.uniform(rand_key, shape=(n,))
    y = u**(-1/a)
    ginis.append(gini_jax(y))
ax.plot(a_vals, ginis, label='sampled')
ax.plot(a_vals, 1/(2*a_vals - 1), label='theoretical')
ax.legend()
plt.show()

```



In general, for a Pareto distribution, a higher tail index implies less weight in the right hand tail.

This means less extreme values for wealth and hence more equality.

More equality translates to a lower Gini index.

---

### Exercise 6.5.2

When savings is constant, the wealth process has the same quasi-linear structure as a Kesten process, with multiplicative and additive shocks.

The Kesten–Goldie theorem tells us that Kesten processes have Pareto tails under a range of parameterizations.

The theorem does not directly apply here, since savings is not always constant and since the multiplicative and additive terms in (6.1) are not IID.

At the same time, given the similarities, perhaps Pareto tails will arise.

To test this, run a simulation that generates a cross-section of wealth and generate a rank-size plot.

In viewing the plot, remember that Pareto tails generate a straight line. Is this what you see?

For sample size and initial conditions, use

```
num_households = 250_000
T = 500 # Shift forward T periods
ψ_0 = jnp.full((num_households, ), wdy.y_mean) # Initial distribution
```

---

### Solution to Exercise 6.5.2

First let's generate the distribution:

```
num_households = 250_000
T = 500 # how far to shift forward in time
size = (num_households, )

wdy = create_wealth_model()
ψ_0 = jnp.full(size, wdy.y_mean)
ψ_star = update_cross_section_jax(ψ_0, T, wdy, size)
```

Let's define a function to get the rank data

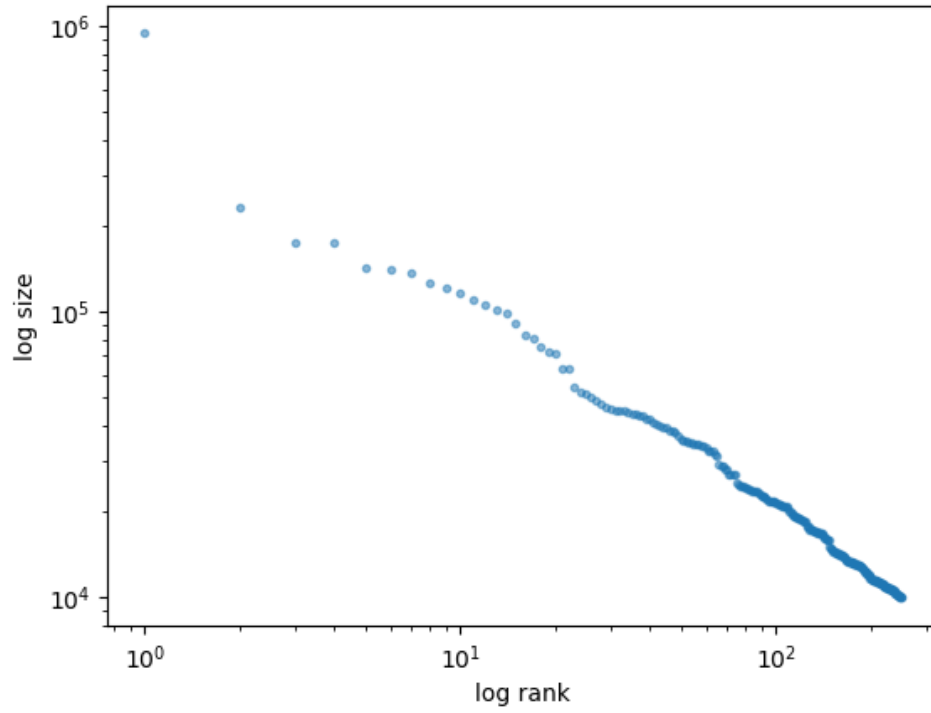
```
def rank_size(data, c=1):
    w = -jnp.sort(-data) # Reverse sort
    w = w[:int(len(w) * c)] # extract top (c * 100)%
    rank_data = jnp.arange(len(w)) + 1
    size_data = w
    return rank_data, size_data
```

Now let's see the rank-size plot:

```
fig, ax = plt.subplots()

rank_data, size_data = rank_size(ψ_star, c=0.001)
ax.loglog(rank_data, size_data, 'o', markersize=3.0, alpha=0.5)
ax.set_xlabel("log rank")
ax.set_ylabel("log size")

plt.show()
```







## **Part III**

# **Asset Pricing**



## ASSET PRICING: THE LUCAS ASSET PRICING MODEL

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

#### Contents

- *Asset Pricing: The Lucas Asset Pricing Model*
  - *Overview*
  - *The Lucas Model*
  - *Computation*
  - *Exercises*

## 7.1 Overview

An asset is a claim on a stream of prospective payments.

What is the correct price to pay for such a claim?

The asset pricing model of Lucas [[Lucas, 1978](#)] attempts to answer this question in an equilibrium setting with risk-averse agents.

Lucas’ model provides a beautiful illustration of model building in general and equilibrium pricing in competitive models in particular.

In this lecture we work through the Lucas model and show where the fundamental asset pricing equation comes from.

We’ll write code in both Numba and JAX.

Since the model is relatively small, the speed gain from using JAX is not as large as it is in some other lectures.

Nonetheless, the gain is nontrivial.

Let’s start with some imports:

```
import jax.numpy as jnp
import jax
import time
import numpy as np
import numba
from scipy.stats import lognorm
import matplotlib.pyplot as plt
```

## 7.2 The Lucas Model

Lucas studied a pure exchange economy with a representative consumer (or household), where

- *Pure exchange* means that all endowments are exogenous.
- *Representative* consumer means that either
  - there is a single consumer (sometimes also referred to as a household), or
  - all consumers have identical endowments and preferences

Either way, the assumption of a representative agent means that prices adjust to eradicate desires to trade.

This makes it very easy to compute competitive equilibrium prices.

### 7.2.1 Basic Setup

Let's review the setup.

#### Assets

There is a single “productive unit” that costlessly generates a sequence of consumption goods  $\{y_t\}_{t=0}^{\infty}$ .

Another way to view  $\{y_t\}_{t=0}^{\infty}$  is as a *consumption endowment* for this economy.

We will assume that this endowment is Markovian, following the exogenous process

$$y_{t+1} = G(y_t, \xi_{t+1})$$

Here  $\{\xi_t\}$  is an IID shock sequence with known distribution  $\phi$  and  $y_t \geq 0$ .

An asset is a claim on all or part of this endowment stream.

The consumption goods  $\{y_t\}_{t=0}^{\infty}$  are nonstorable, so holding assets is the only way to transfer wealth into the future.

For the purposes of intuition, it's common to think of the productive unit as a “tree” that produces fruit.

Based on this idea, a “Lucas tree” is a claim on the consumption endowment.

## Consumers

A representative consumer ranks consumption streams  $\{c_t\}$  according to the time separable utility functional

$$\mathbb{E} \sum_{t=0}^{\infty} \beta^t u(c_t) \quad (7.1)$$

Here

- $\beta \in (0, 1)$  is a fixed discount factor.
- $u$  is a strictly increasing, strictly concave, continuously differentiable period utility function.
- $\mathbb{E}$  is a mathematical expectation.

### 7.2.2 Pricing a Lucas Tree

What is an appropriate price for a claim on the consumption endowment?

We'll price an *ex-dividend* claim, meaning that

- the seller retains this period's dividend
- the buyer pays  $p_t$  today to purchase a claim on
  - $y_{t+1}$  and
  - the right to sell the claim tomorrow at price  $p_{t+1}$

Since this is a competitive model, the first step is to pin down consumer behavior, taking prices as given.

Next, we'll impose equilibrium constraints and try to back out prices.

In the consumer problem, the consumer's control variable is the share  $\pi_t$  of the claim held in each period.

Thus, the consumer problem is to maximize (7.1) subject to

$$c_t + \pi_{t+1}p_t \leq \pi_t y_t + \pi_t p_t$$

along with  $c_t \geq 0$  and  $0 \leq \pi_t \leq 1$  at each  $t$ .

The decision to hold share  $\pi_t$  is actually made at time  $t - 1$ .

But this value is inherited as a state variable at time  $t$ , which explains the choice of subscript.

### The Dynamic Program

We can write the consumer problem as a dynamic programming problem.

Our first observation is that prices depend on current information, and current information is really just the endowment process up until the current period.

In fact, the endowment process is Markovian, so that the only relevant information is the current state  $y \in \mathbb{R}_+$  (dropping the time subscript).

This leads us to guess an equilibrium where price is a function  $p$  of  $y$ .

Remarks on the solution method

- Since this is a competitive (read: price taking) model, the consumer will take this function  $p$  as given.
- In this way, we determine consumer behavior given  $p$  and then use equilibrium conditions to recover  $p$ .

- This is the standard way to solve competitive equilibrium models.

Using the assumption that price is a given function  $p$  of  $y$ , we write the value function and constraint as

$$v(\pi, y) = \max_{c, \pi'} \left\{ u(c) + \beta \int v(\pi', G(y, z)) \phi(dz) \right\}$$

subject to

$$c + \pi' p(y) \leq \pi y + \pi p(y) \tag{7.2}$$

We can invoke the fact that utility is increasing to claim equality in (7.2) and hence eliminate the constraint, obtaining

$$v(\pi, y) = \max_{\pi'} \left\{ u[\pi(y + p(y)) - \pi' p(y)] + \beta \int v(\pi', G(y, z)) \phi(dz) \right\} \tag{7.3}$$

The solution to this dynamic programming problem is an optimal policy expressing either  $\pi'$  or  $c$  as a function of the state  $(\pi, y)$ .

- Each one determines the other, since  $c(\pi, y) = \pi(y + p(y)) - \pi'(\pi, y)p(y)$

### Next Steps

What we need to do now is determine equilibrium prices.

It seems that to obtain these, we will have to

1. Solve this two-dimensional dynamic programming problem for the optimal policy.
2. Impose equilibrium constraints.
3. Solve out for the price function  $p(y)$  directly.

However, as Lucas showed, there is a related but more straightforward way to do this.

### Equilibrium Constraints

Since the consumption good is not storable, in equilibrium we must have  $c_t = y_t$  for all  $t$ .

In addition, since there is one representative consumer (alternatively, since all consumers are identical), there should be no trade in equilibrium.

In particular, the representative consumer owns the whole tree in every period, so  $\pi_t = 1$  for all  $t$ .

Prices must adjust to satisfy these two constraints.

### The Equilibrium Price Function

Now observe that the first-order condition for (7.3) can be written as

$$u'(c)p(y) = \beta \int v'_1(\pi', G(y, z)) \phi(dz)$$

where  $v'_1$  is the derivative of  $v$  with respect to its first argument.

To obtain  $v'_1$  we can simply differentiate the right-hand side of (7.3) with respect to  $\pi$ , yielding

$$v'_1(\pi, y) = u'(c)(y + p(y))$$

Next, we impose the equilibrium constraints while combining the last two equations to get

$$p(y) = \beta \int \frac{u'[G(y, z)]}{u'(y)} [G(y, z) + p(G(y, z))] \phi(dz) \quad (7.4)$$

In sequential rather than functional notation, we can also write this as

$$p_t = \mathbb{E}_t \left[ \beta \frac{u'(c_{t+1})}{u'(c_t)} (y_{t+1} + p_{t+1}) \right] \quad (7.5)$$

This is the famous consumption-based asset pricing equation.

Before discussing it further we want to solve out for prices.

### 7.2.3 Solving the Model

Equation (7.4) is a *functional equation* in the unknown function  $p$ .

The solution is an equilibrium price function  $p^*$ .

Let's look at how to obtain it.

#### Setting up the Problem

Instead of solving for it directly we'll follow Lucas' indirect approach, first setting

$$f(y) := u'(y)p(y) \quad (7.6)$$

so that (7.4) becomes

$$f(y) = h(y) + \beta \int f[G(y, z)] \phi(dz) \quad (7.7)$$

Here  $h(y) := \beta \int u'[G(y, z)]G(y, z)\phi(dz)$  is a function that depends only on the primitives.

Equation (7.7) is a functional equation in  $f$ .

The plan is to solve out for  $f$  and convert back to  $p$  via (7.6).

To solve (7.7) we'll use a standard method: convert it to a fixed point problem.

First, we introduce the operator  $T$  mapping  $f$  into  $Tf$  as defined by

$$(Tf)(y) = h(y) + \beta \int f[G(y, z)] \phi(dz) \quad (7.8)$$

In what follows, we refer to  $T$  as the Lucas operator.

The reason we do this is that a solution to (7.7) now corresponds to a function  $f^*$  satisfying  $(Tf^*)(y) = f^*(y)$  for all  $y$ .

In other words, a solution is a *fixed point* of  $T$ .

This means that we can use fixed point theory to obtain and compute the solution.

### A Little Fixed Point Theory

Let  $cb\mathbb{R}_+$  be the set of continuous bounded functions  $f: \mathbb{R}_+ \rightarrow \mathbb{R}_+$ .

We now show that

1.  $T$  has exactly one fixed point  $f^*$  in  $cb\mathbb{R}_+$ .
2. For any  $f \in cb\mathbb{R}_+$ , the sequence  $T^k f$  converges uniformly to  $f^*$ .

---

**Note:** If you find the mathematics heavy going you can take 1–2 as given and skip to the *next section*

---

Recall the [Banach contraction mapping theorem](#).

It tells us that the previous statements will be true if we can find an  $\alpha < 1$  such that

$$\|Tf - Tg\| \leq \alpha \|f - g\|, \quad \forall f, g \in cb\mathbb{R}_+ \tag{7.9}$$

Here  $\|h\| := \sup_{x \in \mathbb{R}_+} |h(x)|$ .

To see that (7.9) is valid, pick any  $f, g \in cb\mathbb{R}_+$  and any  $y \in \mathbb{R}_+$ .

Observe that, since integrals get larger when absolute values are moved to the inside,

$$\begin{aligned} |Tf(y) - Tg(y)| &= \left| \beta \int f[G(y, z)]\phi(dz) - \beta \int g[G(y, z)]\phi(dz) \right| \\ &\leq \beta \int |f[G(y, z)] - g[G(y, z)]| \phi(dz) \\ &\leq \beta \int \|f - g\| \phi(dz) \\ &= \beta \|f - g\| \end{aligned}$$

Since the right-hand side is an upper bound, taking the sup over all  $y$  on the left-hand side gives (7.9) with  $\alpha := \beta$ .

## 7.3 Computation

The preceding discussion tells that we can compute  $f^*$  by picking any arbitrary  $f \in cb\mathbb{R}_+$  and then iterating with  $T$ .

The equilibrium price function  $p^*$  can then be recovered by  $p^*(y) = f^*(y)/u'(y)$ .

Let's try this when  $\ln y_{t+1} = \alpha \ln y_t + \sigma \epsilon_{t+1}$  where  $\{\epsilon_t\}$  is IID and standard normal.

Utility will take the isoelastic form  $u(c) = c^{1-\gamma}/(1-\gamma)$ , where  $\gamma > 0$  is the coefficient of relative risk aversion.

We'll use Monte Carlo to compute the integral

$$\int f[G(y, z)]\phi(dz)$$

Monte Carlo is not always the fastest method for computing low-dimensional integrals, but it is extremely flexible (for example, it's straightforward to change the underlying state process).



### 7.3.1 Numba Code

Let's start with code using NumPy / Numba (and then compare it to code using JAX).

We create a function that returns tuples containing parameters and arrays needed for computation.

```
def create_lucas_tree_model( $\gamma=2$ ,          # CRR utility parameter
                            $\beta=0.95$ ,      # Discount factor
                            $\alpha=0.90$ ,     # Correlation coefficient
                            $\sigma=0.1$ ,      # Volatility coefficient
                           grid_size=500,
                           draw_size=1_000,
                           seed=11):
    # Set the grid interval to contain most of the mass of the
    # stationary distribution of the consumption endowment
     $ssd = \sigma / \text{np.sqrt}(1 - \alpha^2)$ 
    grid_min, grid_max =  $\text{np.exp}(-4 * ssd)$ ,  $\text{np.exp}(4 * ssd)$ 
    grid =  $\text{np.linspace}(grid\_min, grid\_max, grid\_size)$ 
    # Set up distribution for shocks
     $\text{np.random.seed}(seed)$ 
     $\phi = \text{lognorm}(\sigma)$ 
    draws =  $\phi.\text{rvs}(500)$ 
    # And the vector h
    h =  $\text{np.empty}(grid\_size)$ 
    for i,  $y$  in  $\text{enumerate}(grid)$ :
         $h[i] = \beta * \text{np.mean}(y^{\alpha} * draws)^{(1 - \gamma)}$ 
    # Pack and return
    params =  $\gamma, \beta, \alpha, \sigma$ 
    arrays = grid, draws, h
    return params, arrays
```

Here's a Numba-jitted version of the Lucas operator

```
@numba.jit
def T(params, arrays, f):
    """
    The Lucas pricing operator.
    """
    # Unpack
     $\gamma, \beta, \alpha, \sigma = \text{params}$ 
    grid, draws, h = arrays
    # Turn f into a function
    Af =  $\text{lambda } x: \text{np.interp}(x, grid, f)$ 
    # Compute Tf and return
    Tf =  $\text{np.empty\_like}(f)$ 
    # Apply the T operator to f using Monte Carlo integration
    for i in  $\text{range}(\text{len}(grid))$ :
         $y = grid[i]$ 
         $Tf[i] = h[i] + \beta * \text{np.mean}(Af(y^{\alpha} * draws))$ 
    return Tf
```

To solve the model, we write a function that iterates using the Lucas operator to find the fixed point.

```
def solve_model(params, arrays, tol=1e-6, max_iter=500):
    """
    Compute the equilibrium price function.
```

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```

"""
# Unpack
γ, β, α, σ = params
grid, draws, h = arrays
# Set up and loop
i = 0
f = np.ones_like(grid) # Initial guess of f
error = tol + 1
while error > tol and i < max_iter:
    Tf = T(params, arrays, f)
    error = np.max(np.abs(Tf - f))
    f = Tf
    i += 1
price = f * grid**γ # Back out price vector
return price

```

Let's solve the model and plot the resulting price function

```

params, arrays = create_lucas_tree_model()
γ, β, α, σ = params
grid, draws, h = arrays

# Solve once to compile
price_vals = solve_model(params, arrays)

# Now time execution without compile time
in_time = time.time()
price_vals = solve_model(params, arrays)
out_time = time.time()
numba_elapsed = out_time - in_time
print("Numba execution time = ", numba_elapsed)

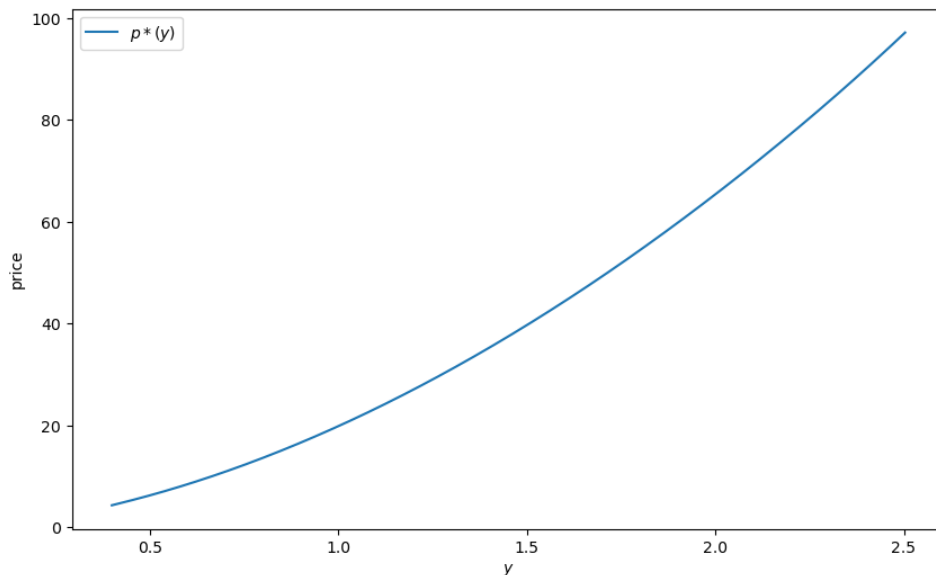
```

```
Numba execution time = 4.220258712768555
```

```

fig, ax = plt.subplots(figsize=(10, 6))
ax.plot(grid, price_vals, label='$p*(y)$')
ax.set_xlabel('$y$')
ax.set_ylabel('price')
ax.legend()
plt.show()

```



We see that the price is increasing, even if we remove all serial correlation from the endowment process.

The reason is that a larger current endowment reduces current marginal utility.

The price must therefore rise to induce the household to consume the entire endowment (and hence satisfy the resource constraint).

### 7.3.2 JAX Code

Here's a JAX version of the same problem.

```
def create_lucas_tree_model( $\gamma=2$ , # CRR utility parameter
                            $\beta=0.95$ , # Discount factor
                            $\alpha=0.90$ , # Correlation coefficient
                            $\sigma=0.1$ , # Volatility coefficient
                           grid_size=500,
                           draw_size=1_000,
                           seed=11):
    # Set the grid interval to contain most of the mass of the
    # stationary distribution of the consumption endowment
     $ssd = \sigma / \text{jnp.sqrt}(1 - \alpha^2)$ 
     $grid\_min, grid\_max = \text{jnp.exp}(-4 * ssd), \text{jnp.exp}(4 * ssd)$ 
     $grid = \text{jnp.linspace}(grid\_min, grid\_max, grid\_size)$ 

    # Set up distribution for shocks
     $key = \text{jax.random.key}(seed)$ 
     $draws = \text{jax.random.lognormal}(key, \sigma, \text{shape}=(draw\_size,))$ 
     $grid\_reshaped = grid.reshape((grid\_size, 1))$ 
     $draws\_reshaped = draws.reshape((-1, draw\_size))$ 
     $h = \beta * \text{jnp.mean}(grid\_reshaped^{\alpha} * draws\_reshaped) ** (1-\gamma), axis=1$ 
     $params = \gamma, \beta, \alpha, \sigma$ 
     $arrays = grid, draws, h$ 
    return params, arrays
```

We'll use the following function to simultaneously compute the expectation

$$\int f[G(y, z)]\phi(dz)$$

over all  $y$  in the grid, under the current specifications.

```
@jax.jit
def compute_expectation(y, a, draws, grid, f):
    return jnp.mean(jnp.interp(y**a * draws, grid, f))

# Vectorize over y
compute_expectation = jax.vmap(compute_expectation,
                               in_axes=(0, None, None, None, None))
```

Here's the Lucas operator

```
@jax.jit
def T(params, arrays, f):
    """
    The Lucas operator

    """
    grid, draws, h = arrays
    y, beta, a, sigma = params
    mci = compute_expectation(grid, a, draws, grid, f)
    return h + beta * mci
```

We'll use successive approximation to compute the fixed point.

```
def successive_approx_jax(T, # Operator (callable)
                          x_0, # Initial condition
                          tol=1e-6, # Error tolerance
                          max_iter=10_000): # Max iteration bound

    def body_fun(k_x_err):
        k, x, error = k_x_err
        x_new = T(x)
        error = jnp.max(jnp.abs(x_new - x))
        return k + 1, x_new, error

    def cond_fun(k_x_err):
        k, x, error = k_x_err
        return jnp.logical_and(error > tol, k < max_iter)

    k, x, error = jax.lax.while_loop(cond_fun, body_fun,
                                     (1, x_0, tol + 1))

    return x

successive_approx_jax = \
    jax.jit(successive_approx_jax, static_argnums=(0,))
```

Here's a function that solves the model

```
def solve_model(params, arrays, tol=1e-6, max_iter=500):
    """
    Compute the equilibrium price function.
```

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```

"""
# Simplify notation
grid, draws, h = arrays
γ, β, α, σ = params
_T = lambda f: T(params, arrays, f)
f = jnp.ones_like(grid) # Initial guess of f

f = successive_approx_jax(_T, f, tol=tol, max_iter=max_iter)

price = f * grid**γ # Back out price vector

return price

```

Now let's solve the model again and compare timing

```

params, arrays = create_lucas_tree_model()
grid, draws, h = arrays
γ, β, α, σ = params

# Solve once to compile
price_vals = solve_model(params, arrays)

# Now time execution without compile time
in_time = time.time()
price_vals = solve_model(params, arrays)
out_time = time.time()
jax_elapsed = out_time - in_time
print("JAX execution time = ", jax_elapsed)
print("Speedup factor = ", numba_elapsed / jax_elapsed)

```

```

JAX execution time = 0.42468810081481934
Speedup factor = 9.937313300446704

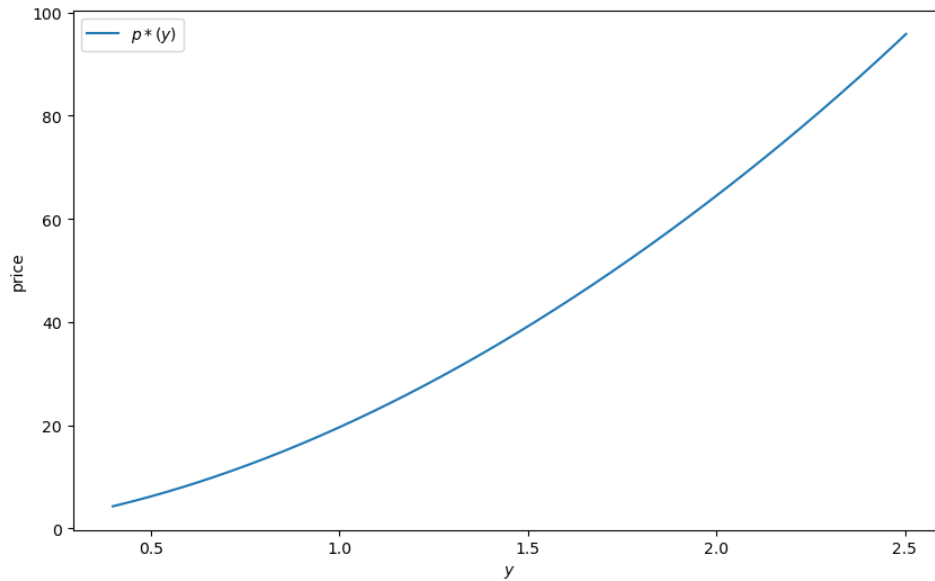
```

Let's check the solutions are similar

```

fig, ax = plt.subplots(figsize=(10, 6))
ax.plot(grid, price_vals, label='$p*(y)$')
ax.set_xlabel('$y$')
ax.set_ylabel('price')
ax.legend()
plt.show()

```



## 7.4 Exercises

### Exercise 7.4.1

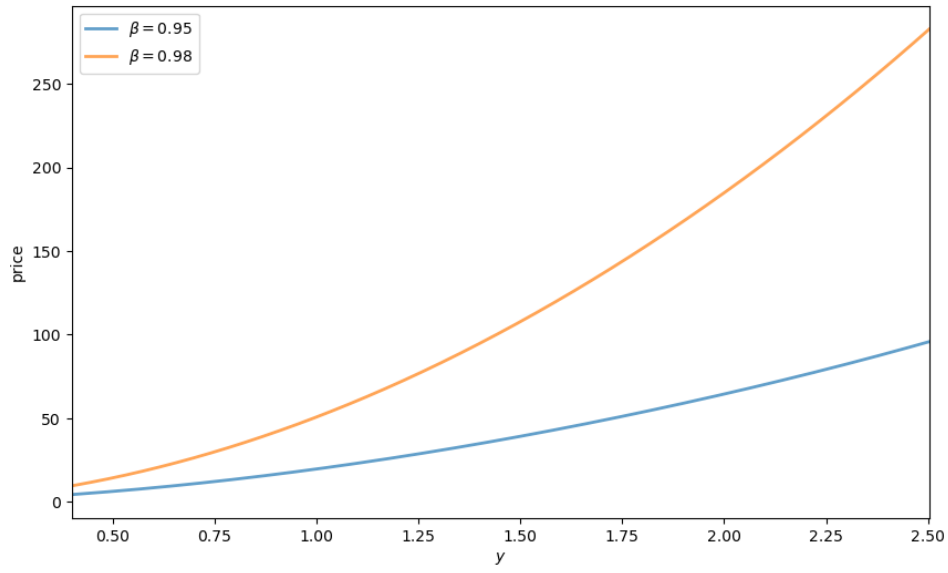
When consumers are more patient the asset becomes more valuable, and the price of the Lucas tree shifts up. Show this by plotting the price function for the Lucas tree when  $\beta = 0.95$  and  $0.98$ .

### Solution to Exercise 7.4.1

```
fig, ax = plt.subplots(figsize=(10, 6))

for beta in (.95, 0.98):
    params, arrays = create_lucas_tree_model(beta=beta)
    grid, draws, h = arrays
    y, beta, alpha, sigma = params
    price_vals = solve_model(params, arrays)
    label = rf'\beta = {beta}'
    ax.plot(grid, price_vals, lw=2, alpha=0.7, label=label)

ax.legend(loc='upper left')
ax.set(xlabel='$y$', ylabel='price', xlim=(min(grid), max(grid)))
plt.show()
```







## AN ASSET PRICING PROBLEM

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### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

### 8.1 Overview

In this lecture we consider some asset pricing problems and use them to illustrate some foundations of JAX programming.

The main difference from the lecture *Asset Pricing: The Lucas Asset Pricing Model*, which also considers asset prices, is that the state spaces will be discrete and multi-dimensional.

Most of the heavy lifting is done through routines from linear algebra.

Along the way, we will show how to solve some memory-intensive problems with large state spaces.

We do this using elegant techniques made available by JAX, involving the use of linear operators to avoid instantiating large matrices.

If you wish to skip all motivation and move straight to the first equation we plan to solve, you can jump to (8.5.5).

The code outputs below are generated by machine connected to the following GPU

```
!nvidia-smi
```

```
Thu May  2 02:27:17 2024
+-----+
| NVIDIA-SMI 470.182.03   Driver Version: 470.182.03   CUDA Version: 12.3   |
+-----+-----+-----+-----+
| GPU  Name           Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp  Perf    Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                       |                  |     MIG M.     |
+-----+-----+-----+-----+
|   0   Tesla V100-SXM2...    Off   | 00000000:00:1E:0  Off   |             0      |
| N/A   27C    P0     38W / 300W |  0MiB / 16160MiB |      2%    Default  |
|                                       |                  |             N/A   |
+-----+-----+-----+-----+
```

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```

+-----+
| Processes:                                     |
| GPU   GI   CI          PID   Type   Process name                      GPU Memory |
|      ID   ID                                   Usage                       |
+-----+
| No running processes found                    |
+-----+

```

In addition to JAX and Anaconda, this lecture will need the following libraries:

```
!pip install quantecon
```

Below we use the following imports

```

import scipy
import quantecon as qc
import matplotlib.pyplot as plt
import numpy as np
import jax
import jax.numpy as jnp
from collections import namedtuple

```

We will use 64 bit floats with JAX in order to increase precision.

```
jax.config.update("jax_enable_x64", True)
```

## 8.2 Pricing a single payoff

Suppose, at time  $t$ , we have an asset that pays a random amount  $D_{t+1}$  at time  $t + 1$  and nothing after that.

The simplest way to price this asset is to use “risk-neutral” asset pricing, which asserts that the price of the asset at time  $t$  should be

$$P_t = \beta \mathbb{E}_t D_{t+1} \quad (8.1)$$

Here  $\beta$  is a constant discount factor and  $\mathbb{E}_t D_{t+1}$  is the expectation of  $D_{t+1}$  at time  $t$ .

Roughly speaking, (8.2.1) says that the cost (i.e., price) equals expected benefit.

The discount factor is introduced because most people prefer payments now to payments in the future.

One problem with this very simple model is that it does not take into account attitudes to risk.

For example, investors often demand higher rates of return for holding risky assets.

This feature of asset prices cannot be captured by risk neutral pricing.

Hence we modify (8.2.1) to

$$P_t = \mathbb{E}_t M_{t+1} D_{t+1} \quad (8.2)$$

In this expression,  $M_{t+1}$  replaces  $\beta$  and is called the **stochastic discount factor**.

In essence, allowing discounting to become a random variable gives us the flexibility to combine temporal discounting and attitudes to risk.

We leave further discussion to [other lectures](#) because our aim is to move to the computational problem.

### 8.3 Pricing a cash flow

Now let's try to price an asset like a share, which delivers a cash flow  $D_t, D_{t+1}, \dots$

We will call these payoffs “dividends”.

If we buy the share, hold it for one period and sell it again, we receive one dividend and our payoff is  $D_{t+1} + P_{t+1}$ .

Therefore, by (8.2.2), the price should be

$$P_t = \mathbb{E}_t M_{t+1} [D_{t+1} + P_{t+1}] \quad (8.3)$$

Because prices generally grow over time, which complicates analysis, it will be easier for us to solve for the **price-dividend ratio**  $V_t := P_t/D_t$ .

Let's write down an expression that this ratio should satisfy.

We can divide both sides of (8.3) by  $D_t$  to get

$$V_t = \mathbb{E}_t \left[ M_{t+1} \frac{D_{t+1}}{D_t} (1 + V_{t+1}) \right] \quad (8.4)$$

We can also write this as

$$V_t = \mathbb{E}_t [M_{t+1} \exp(G_{t+1}^d) (1 + V_{t+1})] \quad (8.5)$$

where

$$G_{t+1}^d = \ln \frac{D_{t+1}}{D_t}$$

is the growth rate of dividends.

Our aim is to solve (8.3.3) but before that we need to specify

1. the stochastic discount factor  $M_{t+1}$  and
2. the growth rate of dividends  $G_{t+1}^d$

### 8.4 Choosing the stochastic discount factor

We will adopt the stochastic discount factor described in *Asset Pricing: The Lucas Asset Pricing Model*, which has the form

$$M_{t+1} = \beta \frac{u'(C_{t+1})}{u'(C_t)} \quad (8.6)$$

where  $u$  is a utility function and  $C_t$  is time  $t$  consumption of a representative consumer.

For utility, we'll assume the **constant relative risk aversion** (CRRA) specification

$$u(c) = \frac{c^{1-\gamma}}{1-\gamma} \quad (8.7)$$

Inserting the CRRA specification into (8.6) and letting

$$G_{t+1}^c = \ln \left( \frac{C_{t+1}}{C_t} \right)$$

the growth rate rate of consumption, we obtain

$$M_{t+1} = \beta \left( \frac{C_{t+1}}{C_t} \right)^{-\gamma} = \beta \exp(G_{t+1}^c)^{-\gamma} = \beta \exp(-\gamma G_{t+1}^c) \quad (8.8)$$

## 8.5 Solving for the price-dividend ratio

Substituting (8.4.3) into (8.5) gives the price-dividend ratio formula

$$V_t = \beta \mathbb{E}_t [\exp(G_{t+1}^d - \gamma G_{t+1}^c)(1 + V_{t+1})] \quad (8.9)$$

We assume there is a Markov chain  $\{X_t\}$ , which we call the **state process**, such that

$$\begin{aligned} G_{t+1}^c &= \mu_c + X_t + \sigma_c \epsilon_{c,t+1} \\ G_{t+1}^d &= \mu_d + X_t + \sigma_d \epsilon_{d,t+1} \end{aligned}$$

Here  $\{\epsilon_{c,t}\}$  and  $\{\epsilon_{d,t}\}$  are IID and standard normal, and independent of each other.

We can think of  $\{X_t\}$  as an aggregate shock that affects both consumption growth and firm profits (and hence dividends).

We let  $P$  be the **stochastic matrix that governs  $\{X_t\}$**  and assume  $\{X_t\}$  takes values in some finite set  $S$ .

We guess that  $V_t$  is a fixed function of this state process (and this guess turns out to be correct).

This means that  $V_t = v(X_t)$  for some unknown function  $v$ .

By (8.5.1), the unknown function  $v$  satisfies the equation

$$v(X_t) = \beta \mathbb{E}_t \left\{ \exp[a + (1 - \gamma)X_t + \sigma_d \epsilon_{d,t+1} - \gamma \sigma_c \epsilon_{c,t+1}] (1 + v(X_{t+1})) \right\} \quad (8.10)$$

where  $a := \mu_d - \gamma \mu_c$

Since the shocks  $\epsilon_{c,t+1}$  and  $\epsilon_{d,t+1}$  are independent of  $\{X_t\}$ , we can integrate them out.

We use the following property of lognormal distributions: if  $Y = \exp(c\epsilon)$  for constant  $c$  and  $\epsilon \sim N(0, 1)$ , then  $\mathbb{E}Y = \exp(c^2/2)$ .

This yields

$$v(X_t) = \beta \mathbb{E}_t \left\{ \exp \left[ a + (1 - \gamma)X_t + \frac{\sigma_d^2 + \gamma^2 \sigma_c^2}{2} \right] (1 + v(X_{t+1})) \right\} \quad (8.11)$$

Conditioning on  $X_t = x$ , we can write this as

$$v(x) = \beta \sum_{y \in S} \left\{ \exp \left[ a + (1 - \gamma)x + \frac{\sigma_d^2 + \gamma^2 \sigma_c^2}{2} \right] (1 + v(y)) \right\} P(x, y) \quad (8.12)$$

for all  $x \in S$ .

Suppose  $S = \{x_1, \dots, x_N\}$ .

Then we can think of  $v$  as an  $N$ -vector and, using square brackets for indices on arrays, write

$$v[i] = \beta \sum_{j=1}^N \left\{ \exp \left[ a + (1 - \gamma)x[i] + \frac{\sigma_d^2 + \gamma^2 \sigma_c^2}{2} \right] (1 + v[j]) \right\} P[i, j] \quad (8.13)$$

for  $i = 1, \dots, N$ .

Equivalently, we can write

$$v[i] = \sum_{j=1}^N K[i, j] (1 + v[j]) \quad (8.14)$$

where  $K$  is the matrix defined by

$$K[i, j] = \beta \left\{ \exp \left[ a + (1 - \gamma)x[i] + \frac{\sigma_d^2 + \gamma^2 \sigma_c^2}{2} \right] \right\} P[i, j] \quad (8.15)$$

Rewriting (8.5.6) in vector form yields

$$v = K(\mathbf{1} + v) \quad (8.16)$$

Notice that (8.5.8) can be written as  $(I - K)v = K\mathbf{1}$ .

The Neumann series lemma tells us that  $I - K$  is invertible and the solution is

$$v = (I - K)^{-1}K\mathbf{1} \quad (8.17)$$

whenever  $r(K)$ , the spectral radius of  $K$ , is strictly less than one.

Once we specify  $P$  and all the parameters, we can

1. obtain  $K$
2. check the spectral radius condition  $r(K) < 1$  and, assuming it holds,
3. compute the solution via (8.5.9).

## 8.6 Code

We will use the [power iteration algorithm](#) to check the spectral radius condition.

The function below computes the spectral radius of  $A$ .

```
def power_iteration_sr(A, num_iterations=15, seed=1234):
    """ Estimates the spectral radius of A via power iteration. """

    # Initialize
    key = jax.random.PRNGKey(seed)
    b_k = jax.random.normal(key, (A.shape[1],))
    sr = 0

    for _ in range(num_iterations):
        # calculate the matrix-by-vector product Ab
        b_k1 = jnp.dot(A, b_k)

        # calculate the norm
        b_k1_norm = jnp.linalg.norm(b_k1)

        # Record the current estimate of the spectral radius
        sr = jnp.sum(b_k1 * b_k) / jnp.sum(b_k * b_k)

        # re-normalize the vector and continue
        b_k = b_k1 / b_k1_norm

    return sr

power_iteration_sr = jax.jit(power_iteration_sr)
```

The next function verifies that the spectral radius of a given matrix is  $< 1$ .

```
def test_stability(Q):
    """
    Assert that the spectral radius of matrix Q is < 1.
    """
```

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```
sr = power_iteration_sr(Q)
assert sr < 1, f"Spectral radius condition failed with radius = {sr}"
```

In what follows we assume that  $\{X_t\}$ , the state process, is a discretization of the AR(1) process

$$X_{t+1} = \rho X_t + \sigma \eta_{t+1}$$

where  $\rho, \sigma$  are parameters and  $\{\eta_t\}$  is IID and standard normal.

To discretize this process we use `QuantEcon.py`'s `tauchen` function.

Below we write a function called `create_model()` that returns a namedtuple storing the relevant parameters and arrays.

```
Model = namedtuple('Model',
                  ('P', 'S', 'beta', 'gamma', 'mu_c', 'mu_d', 'sigma_c', 'sigma_d'))

def create_model(N=100,          # size of state space for Markov chain
                 rho=0.9,       # persistence parameter for Markov chain
                 sigma=0.01,    # persistence parameter for Markov chain
                 beta=0.98,     # discount factor
                 gamma=2.5,     # coefficient of risk aversion
                 mu_c=0.01,     # mean growth of consumption
                 mu_d=0.01,     # mean growth of dividends
                 sigma_c=0.02,  # consumption volatility
                 sigma_d=0.04):  # dividend volatility
    # Create the state process
    mc = ge.tauchen(N, rho, sigma)
    S = mc.state_values
    P = mc.P
    # Shift arrays to the device
    S, P = map(jax.device_put, (S, P))
    # Return the namedtuple
    return Model(P=P, S=S, beta=beta, gamma=gamma, mu_c=mu_c, mu_d=mu_d, sigma_c=sigma_c, sigma_d=sigma_d)
```

Our first step is to construct the matrix  $K$  defined in (8.5.7).

Here's a function that does this using loops.

```
def compute_K_loop(model):
    # unpack
    P, S, beta, gamma, mu_c, mu_d, sigma_c, sigma_d = model
    N = len(S)
    K = np.empty((N, N))
    a = mu_d - gamma * mu_c
    for i, x in enumerate(S):
        for j, y in enumerate(S):
            e = np.exp(a + (1 - gamma) * x + (sigma_d**2 + gamma**2 * sigma_c**2) / 2)
            K[i, j] = beta * e * P[i, j]
    return K
```

To exploit the parallelization capabilities of JAX, let's also write a vectorized (i.e., loop-free) implementation.

```
def compute_K(model):
    # unpack
    P, S, beta, gamma, mu_c, mu_d, sigma_c, sigma_d = model
```

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```

N = len(S)
# Reshape and multiply pointwise using broadcasting
x = np.reshape(S, (N, 1))
a =  $\mu_d - \gamma * \mu_c$ 
e = np.exp(a + (1 -  $\gamma$ ) * x + ( $\sigma_d^{**2} + \gamma^{**2} * \sigma_c^{**2}$ ) / 2)
K =  $\beta * e * P$ 
return K

```

These two functions produce the same output:

```

model = create_model(N=10)
K1 = compute_K(model)
K2 = compute_K_loop(model)
np.allclose(K1, K2)

```

```
True
```

Now we can compute the price-dividend ratio:

```

def price_dividend_ratio(model, test_stable=True):
    """
    Computes the price-dividend ratio of the asset.

    Parameters
    -----
    model: an instance of Model
           contains primitives

    Returns
    -----
    v : array_like
        price-dividend ratio

    """
    K = compute_K(model)
    N = len(model.S)

    if test_stable:
        test_stability(K)

    # Compute v
    I = np.identity(N)
    ones_vec = np.ones(N)
    v = np.linalg.solve(I - K, K @ ones_vec)

    return v

```

Here's a plot of  $v$  as a function of the state for several values of  $\gamma$ .

```

model = create_model()
S = model.S
ys = np.linspace(2.0, 3.0, 5)

fig, ax = plt.subplots()

```

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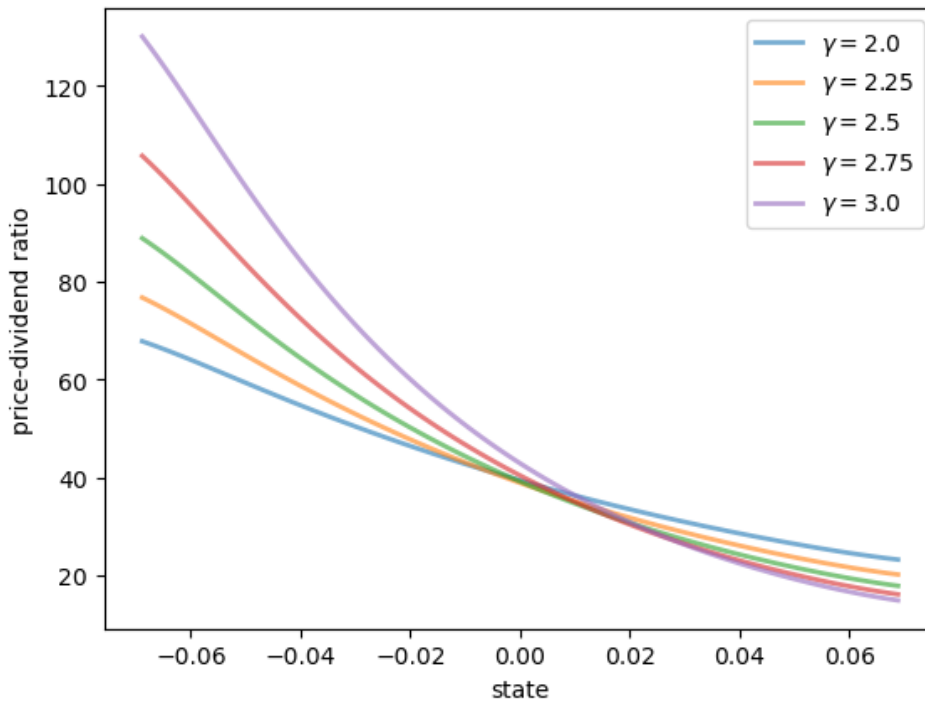
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```

for y in ys:
    model = create_model(y=y)
    v = price_dividend_ratio(model)
    ax.plot(S, v, lw=2, alpha=0.6, label=r"$\gamma = {y}$")

ax.set_ylabel("price-dividend ratio")
ax.set_xlabel("state")
ax.legend(loc='upper right')
plt.show()

```



Notice that  $v$  is decreasing in each case.

This is because, with a positively correlated state process, higher states indicate higher future consumption growth.

With the stochastic discount factor (8.8), higher growth decreases the discount factor, lowering the weight placed on future dividends.

## 8.7 An Extended Example

One problem with the last set is that volatility is constant through time (i.e.,  $\sigma_c$  and  $\sigma_d$  are constants).

In reality, financial markets and growth rates of macroeconomic variables exhibit bursts of volatility.

To accommodate this, we now develop a *stochastic volatility* model.

To begin, suppose that consumption and dividends grow as follows.

$$G_{t+1}^i = \mu_i + Z_t + \bar{\sigma} \exp(H_t^i) \epsilon_{i,t+1}, \quad i \in \{c, d\}$$

where  $\{Z_t\}$  is a finite Markov chain and  $\{H_t^c\}$  and  $\{H_t^d\}$  are volatility processes.



We assume that  $\{H_t^c\}$  and  $\{H_t^d\}$  are AR(1) processes of the form

$$H_{t+1}^i = \rho_i H_t^i + \sigma_i \eta_{i,t+1}, \quad i \in \{c, d\}$$

Here  $\{\eta_t^c\}$  and  $\{\eta_t^d\}$  are IID and standard normal.

Let  $X_t = (H_t^c, H_t^d, Z_t)$ .

We call  $\{X_t\}$  the state process and guess that  $V_t$  is a function of this state process, so that  $V_t = v(X_t)$  for some unknown function  $v$ .

Modifying (8.5.2) to accommodate the new growth specifications, we find that  $v$  satisfies

$$v(X_t) = \beta \times \mathbb{E}_t \left\{ \exp[a + (1 - \gamma)Z_t + \bar{\sigma} \exp(H_t^d)\epsilon_{d,t+1} - \gamma \bar{\sigma} \exp(H_t^c)\epsilon_{c,t+1}] (1 + v(X_{t+1})) \right\} \quad (8.18)$$

where, as before,  $a := \mu_d - \gamma\mu_c$

Conditioning on state  $x = (h_c, h_d, z)$ , this becomes

$$v(x) = \beta \mathbb{E}_t \exp[a + (1 - \gamma)z + \bar{\sigma} \exp(h_d)\epsilon_{d,t+1} - \gamma \bar{\sigma} \exp(h_c)\epsilon_{c,t+1}] (1 + v(X_{t+1})) \quad (8.19)$$

As before, we integrate out the independent shocks and use the rules for expectations of lognormals to obtain

$$v(x) = \beta \mathbb{E}_t \exp \left[ a + (1 - \gamma)z + \bar{\sigma}^2 \frac{\exp(2h_d) + \gamma^2 \exp(2h_c)}{2} \right] (1 + v(X_{t+1})) \quad (8.20)$$

Let

$$A(h_c, h_d, z, h'_c, h'_d, z') := \beta \exp \left[ a + (1 - \gamma)z + \bar{\sigma}^2 \frac{\exp(2h_d) + \gamma^2 \exp(2h_c)}{2} \right] P(h_c, h'_c) Q(h_d, h'_d) R(z, z')$$

where  $P, Q, R$  are the stochastic matrices for, respectively, discretized  $\{H_t^c\}$ , discretized  $\{H_t^d\}$  and  $\{Z_t\}$ ,

With this notation, we can write (8.7.3) more explicitly as

$$v(h_c, h_d, z) = \sum_{h'_c, h'_d, z'} (1 + v(h'_c, h'_d, z')) A(h_c, h_d, z, h'_c, h'_d, z') \quad (8.21)$$

Let's now write the state using indices, with  $(i, j, k)$  being the indices for  $(h_c, h_d, z)$ .

Then (8.21) becomes

$$v[i, j, k] = \sum_{i', j', k'} A[i, j, k, i', j', k'] (1 + v[i', j', k']) \quad (8.22)$$

One way to understand this is to reshape  $v$  into an  $N$ -vector, where  $N = I \times J \times K$ , and  $A$  into an  $N \times N$  matrix.

Then we can write (8.7.5) as

$$v = A(\mathbf{1} + v)$$

Provided that the spectral radius condition  $r(A) < 1$  holds, the solution is given by

$$v = (I - A)^{-1} A \mathbf{1}$$

## 8.8 Numpy Version

Our first implementation will be in NumPy.

Once we have a NumPy version working, we will convert it to JAX and check the difference in the run times.

The code block below provides a function called `create_sv_model()` that returns a namedtuple containing arrays and other data that form the primitives of the problem.

It assumes that  $\{Z_t\}$  is a discretization of

$$Z_{t+1} = \rho_z Z_t + \sigma_z \xi_{t+1}$$

```
SVModel = namedtuple('SVModel',
                    ('P', 'hc_grid',
                     'Q', 'hd_grid',
                     'R', 'z_grid',
                     'β', 'γ', 'bar_σ', 'μ_c', 'μ_d'))

def create_sv_model(β=0.98,          # discount factor
                   γ=2.5,           # coefficient of risk aversion
                   I=14,             # size of state space for h_c
                   ρ_c=0.9,         # persistence parameter for h_c
                   σ_c=0.01,        # volatility parameter for h_c
                   J=14,             # size of state space for h_d
                   ρ_d=0.9,         # persistence parameter for h_d
                   σ_d=0.01,        # volatility parameter for h_d
                   K=14,             # size of state space for z
                   bar_σ=0.01,      # volatility scaling parameter
                   ρ_z=0.9,         # persistence parameter for z
                   σ_z=0.01,        # persistence parameter for z
                   μ_c=0.001,       # mean growth of consumption
                   μ_d=0.005):      # mean growth of dividends

    mc = qe.tauchen(I, ρ_c, σ_c)
    hc_grid = mc.state_values
    P = mc.P
    mc = qe.tauchen(J, ρ_d, σ_d)
    hd_grid = mc.state_values
    Q = mc.P
    mc = qe.tauchen(K, ρ_z, σ_z)
    z_grid = mc.state_values
    R = mc.P

    return SVModel(P=P, hc_grid=hc_grid,
                  Q=Q, hd_grid=hd_grid,
                  R=R, z_grid=z_grid,
                  β=β, γ=γ, bar_σ=bar_σ, μ_c=μ_c, μ_d=μ_d)
```

Now we provide a function to compute the matrix  $A$ .

```
def compute_A(sv_model):
    # Set up
    P, hc_grid, Q, hd_grid, R, z_grid, β, γ, bar_σ, μ_c, μ_d = sv_model
    I, J, K = len(hc_grid), len(hd_grid), len(z_grid)
    N = I * J * K
    # Reshape and broadcast over (i, j, k, i', j', k')
```

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```

hc = np.reshape(hc_grid,      (I, 1, 1, 1, 1, 1))
hd = np.reshape(hd_grid,      (1, J, 1, 1, 1, 1))
z = np.reshape(z_grid,        (1, 1, K, 1, 1, 1))
P = np.reshape(P,             (I, 1, 1, I, 1, 1))
Q = np.reshape(Q,             (1, J, 1, 1, J, 1))
R = np.reshape(R,             (1, 1, K, 1, 1, K))
# Compute A and then reshape to create a matrix
a =  $\mu_d - \gamma * \mu_c$ 
b =  $\text{bar}_\sigma^{**2} * (\text{np.exp}(2 * \text{hd}) + \gamma^{**2} * \text{np.exp}(2 * \text{hc})) / 2$ 
 $\kappa = \text{np.exp}(a + (1 - \gamma) * z + b)$ 
A =  $\beta * \kappa * P * Q * R$ 
A = np.reshape(A, (N, N))
return A

```

Here's our function to compute the price-dividend ratio for the stochastic volatility model.

```

def sv_pd_ratio(sv_model, test_stable=True):
    """
    Computes the price-dividend ratio of the asset for the stochastic volatility
    model.

    Parameters
    -----
    sv_model: an instance of Model
              contains primitives

    Returns
    -----
    v : array_like
        price-dividend ratio

    """
    # unpack
    P, hc_grid, Q, hd_grid, R, z_grid,  $\beta$ ,  $\gamma$ ,  $\text{bar}_\sigma$ ,  $\mu_c$ ,  $\mu_d$  = sv_model
    I, J, K = len(hc_grid), len(hd_grid), len(z_grid)
    N = I * J * K

    A = compute_A(sv_model)
    # Make sure that a unique solution exists
    if test_stable:
        test_stability(A)

    # Compute v
    ones_array = np.ones(N)
    Id = np.identity(N)
    v = scipy.linalg.solve(Id - A, A @ ones_array)
    # Reshape into an array of the form v[i, j, k]
    v = np.reshape(v, (I, J, K))
    return v

```

Let's create an instance of the model and solve it.

```

sv_model = create_sv_model()
P, hc_grid, Q, hd_grid, R, z_grid,  $\beta$ ,  $\gamma$ ,  $\text{bar}_\sigma$ ,  $\mu_c$ ,  $\mu_d$  = sv_model

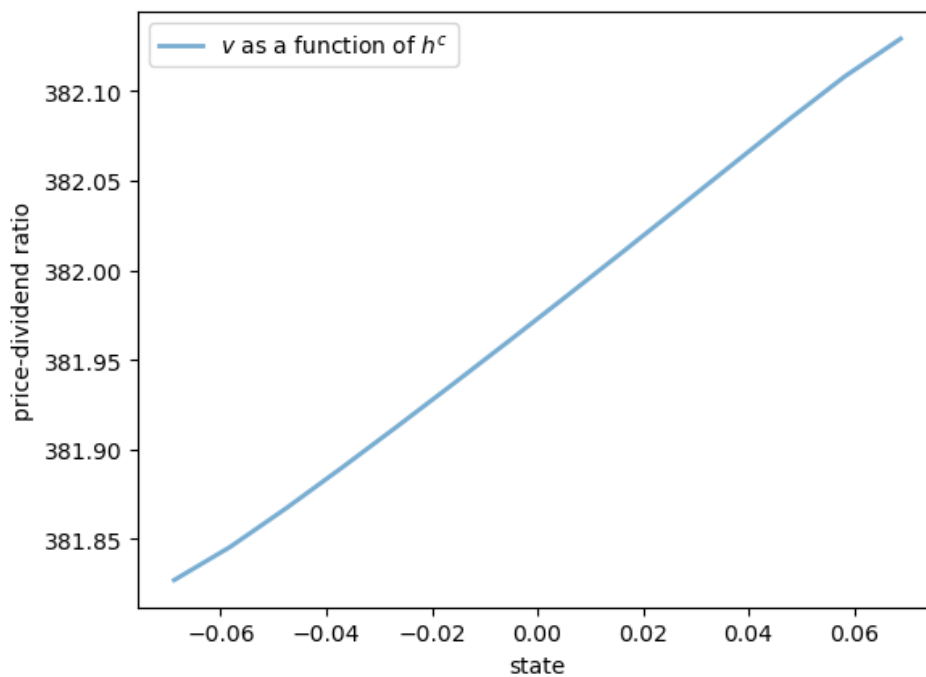
```

```
qe.tic()
v = sv_pd_ratio(sv_model)
np_time = qe.toc()
```

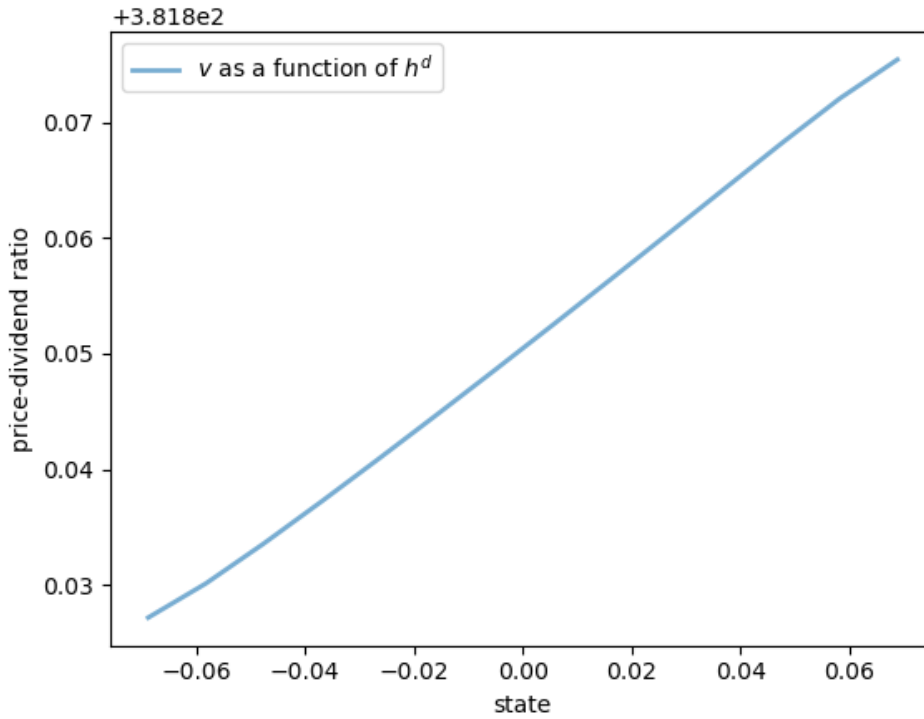
TOC: Elapsed: 0:00:0.95

Here are some plots of the solution  $v$  along the three dimensions.

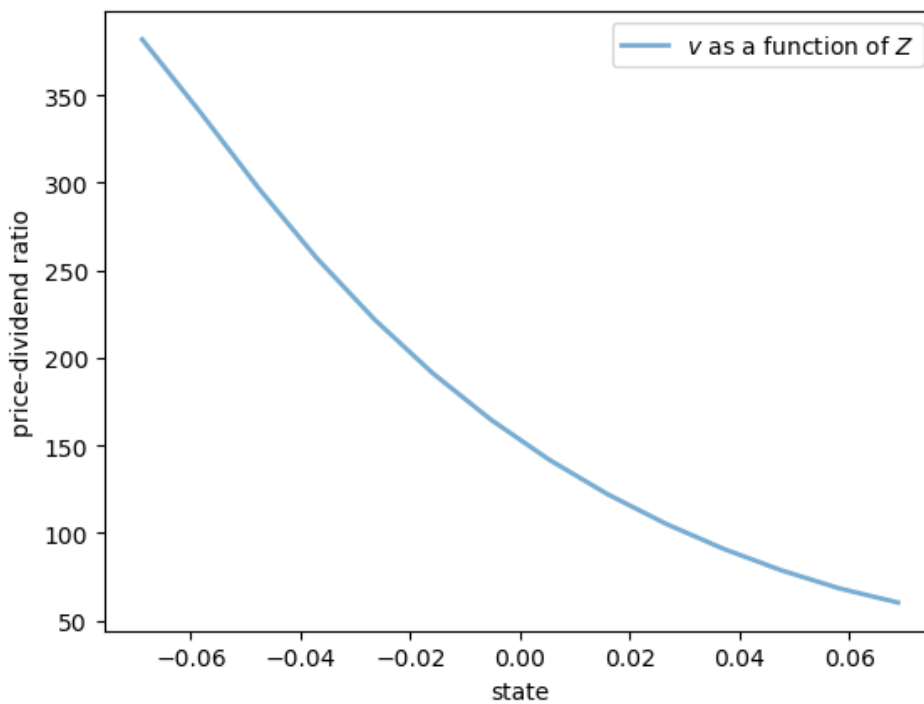
```
fig, ax = plt.subplots()
ax.plot(hc_grid, v[:, 0, 0], lw=2, alpha=0.6, label="$v$ as a function of $h^c$")
ax.set_ylabel("price-dividend ratio")
ax.set_xlabel("state")
ax.legend()
plt.show()
```



```
fig, ax = plt.subplots()
ax.plot(hd_grid, v[0, :, 0], lw=2, alpha=0.6, label="$v$ as a function of $h^d$")
ax.set_ylabel("price-dividend ratio")
ax.set_xlabel("state")
ax.legend()
plt.show()
```



```
fig, ax = plt.subplots()
ax.plot(z_grid, v[0, 0, :], lw=2, alpha=0.6, label="$v$ as a function of $Z$")
ax.set_ylabel("price-dividend ratio")
ax.set_xlabel("state")
ax.legend()
plt.show()
```



## 8.9 JAX Version

Now let's write a JAX version that is a simple transformation of the NumPy version.

(Below we will write a more efficient version using JAX's ability to work with linear operators.)

```
def create_sv_model_jax(sv_model):    # mean growth of dividends

    # Take the contents of a NumPy sv_model instance
    P, hc_grid, Q, hd_grid, R, z_grid,  $\beta$ ,  $\gamma$ , bar_ $\sigma$ ,  $\mu_c$ ,  $\mu_d$  = sv_model

    # Shift the arrays to the device (GPU if available)
    hc_grid, hd_grid, z_grid = map(jax.device_put, (hc_grid, hd_grid, z_grid))
    P, Q, R = map(jax.device_put, (P, Q, R))

    # Create a new instance and return it
    return SVModel(P=P, hc_grid=hc_grid,
                  Q=Q, hd_grid=hd_grid,
                  R=R, z_grid=z_grid,
                   $\beta$ = $\beta$ ,  $\gamma$ = $\gamma$ , bar_ $\sigma$ =bar_ $\sigma$ ,  $\mu_c$ = $\mu_c$ ,  $\mu_d$ = $\mu_d$ )
```

Here's a function to compute  $A$ .

We include the extra argument shapes to help the compiler understand the size of the arrays.

This is important when we JIT-compile the function below.

```
def compute_A_jax(sv_model, shapes):
    # Set up
    P, hc_grid, Q, hd_grid, R, z_grid,  $\beta$ ,  $\gamma$ , bar_ $\sigma$ ,  $\mu_c$ ,  $\mu_d$  = sv_model
    I, J, K = shapes
    N = I * J * K
    # Reshape and broadcast over (i, j, k, i', j', k')
    hc = jnp.reshape(hc_grid, (I, 1, 1, 1, 1, 1))
    hd = jnp.reshape(hd_grid, (1, J, 1, 1, 1, 1))
    z = jnp.reshape(z_grid, (1, 1, K, 1, 1, 1))
    P = jnp.reshape(P, (I, 1, 1, I, 1, 1))
    Q = jnp.reshape(Q, (1, J, 1, 1, J, 1))
    R = jnp.reshape(R, (1, 1, K, 1, 1, K))
    # Compute A and then reshape to create a matrix
    a =  $\mu_d$  -  $\gamma$  *  $\mu_c$ 
    b = bar_ $\sigma$ **2 * (jnp.exp(2 * hd) +  $\gamma$ **2 * jnp.exp(2 * hc)) / 2
     $\kappa$  = jnp.exp(a + (1 -  $\gamma$ ) * z + b)
    A =  $\beta$  *  $\kappa$  * P * Q * R
    A = jnp.reshape(A, (N, N))
    return A
```

Here's the function that computes the solution.

```
def sv_pd_ratio_jax(sv_model, shapes):
    """
    Computes the price-dividend ratio of the asset for the stochastic volatility
    model.

    Parameters
    -----
    sv_model: an instance of Model
```

(continues on next page)

(continued from previous page)

```

    contains primitives

Returns
-----
v : array_like
    price-dividend ratio

"""
# unpack
P, hc_grid, Q, hd_grid, R, z_grid, beta, y, bar_sigma, mu_c, mu_d = sv_model
I, J, K = len(hc_grid), len(hd_grid), len(z_grid)
shapes = I, J, K
N = I * J * K

A = compute_A_jax(sv_model, shapes)

# Compute v, reshape and return
ones_array = jnp.ones(N)
Id = jnp.identity(N)
v = jax.scipy.linalg.solve(Id - A, A @ ones_array)
return jnp.reshape(v, (I, J, K))

```

Now let's target these functions for JIT-compilation, while using `static_argnums` to indicate that the function will need to be recompiled when shapes changes.

```

compute_A_jax = jax.jit(compute_A_jax, static_argnums=(1,))
sv_pd_ratio_jax = jax.jit(sv_pd_ratio_jax, static_argnums=(1,))

```

```

sv_model = create_sv_model()
sv_model_jax = create_sv_model_jax(sv_model)
P, hc_grid, Q, hd_grid, R, z_grid, beta, y, bar_sigma, mu_c, mu_d = sv_model_jax
shapes = len(hc_grid), len(hd_grid), len(z_grid)

```

Let's see how long it takes to run with compile time included.

```

qe.tic()
v_jax = sv_pd_ratio_jax(sv_model_jax, shapes).block_until_ready()
jnp_time_0 = qe.toc()

```

```

TOC: Elapsed: 0:00:0.30

```

And now let's see without compile time.

```

qe.tic()
v_jax = sv_pd_ratio_jax(sv_model_jax, shapes).block_until_ready()
jnp_time = qe.toc()

```

```

TOC: Elapsed: 0:00:0.01

```

Here's the ratio of times:

```

jnp_time / np_time

```

```
0.01727917797132189
```

Let's check that the NumPy and JAX versions realize the same solution.

```
v = jax.device_put(v)
print(jnp.allclose(v, v_jax))
```

```
True
```

## 8.10 A memory-efficient JAX version

One problem with the code above is that we instantiate a matrix of size  $N = I \times J \times K$ .

This quickly becomes impossible as  $I, J, K$  increase.

Fortunately, JAX makes it possible to solve for the price-dividend ratio without instantiating this large matrix.

The first step is to think of  $A$  not as a matrix, but rather as the linear operator that transforms  $g$  into  $Ag$ .

```
def A(g, sv_model, shapes):
    # Set up
    P, hc_grid, Q, hd_grid, R, z_grid, beta, gamma, bar_sigma, mu_c, mu_d = sv_model
    I, J, K = shapes
    # Reshape and broadcast over (i, j, k, i', j', k')
    hc = jnp.reshape(hc_grid, (I, 1, 1, 1, 1, 1))
    hd = jnp.reshape(hd_grid, (1, J, 1, 1, 1, 1))
    z = jnp.reshape(z_grid, (1, 1, K, 1, 1, 1))
    P = jnp.reshape(P, (I, 1, 1, I, 1, 1))
    Q = jnp.reshape(Q, (1, J, 1, 1, J, 1))
    R = jnp.reshape(R, (1, 1, K, 1, 1, K))
    g = jnp.reshape(g, (1, 1, 1, I, J, K))
    a = mu_d - gamma * mu_c
    b = bar_sigma**2 * (jnp.exp(2 * hd) + gamma**2 * jnp.exp(2 * hc)) / 2
    kappa = jnp.exp(a + (1 - gamma) * z + b)
    A = beta * kappa * P * Q * R
    Ag = jnp.sum(A * g, axis=(3, 4, 5))
    return Ag
```

Now we write a version of the solution function for the price-dividend ratio that acts directly on the linear operator  $A$ .

```
def sv_pd_ratio_linop(sv_model, shapes):
    P, hc_grid, Q, hd_grid, R, z_grid, beta, gamma, bar_sigma, mu_c, mu_d = sv_model
    I, J, K = shapes

    ones_array = jnp.ones((I, J, K))
    # Set up the operator g -> (I - A) g
    J = lambda g: g - A(g, sv_model, shapes)
    # Solve v = (I - A)^{-1} A 1
    A1 = A(ones_array, sv_model, shapes)
    # Apply an iterative solver that works for linear operators
    v = jax.scipy.sparse.linalg.bicgstab(J, A1)[0]
    return v
```



Let's target these functions for JIT compilation.

```
A = jax.jit(A, static_argnums=(2,))
sv_pd_ratio_linop = jax.jit(sv_pd_ratio_linop, static_argnums=(1,))
```

Let's time the solution with compile time included.

```
qe.tic()
v_jax_linop = sv_pd_ratio_linop(sv_model, shapes).block_until_ready()
jnp_time_linop_0 = qe.toc()
```

```
TOC: Elapsed: 0:00:0.84
```

And now let's see without compile time.

```
qe.tic()
v_jax_linop = sv_pd_ratio_linop(sv_model, shapes).block_until_ready()
jnp_linop_time = qe.toc()
```

```
TOC: Elapsed: 0:00:0.00
```

Let's verify the solution again:

```
print(jnp.allclose(v, v_jax_linop))
```

```
True
```

Here's the ratio of times between memory-efficient and direct version:

```
jnp_linop_time / jnp_time
```

```
0.16594320984093563
```

The speed is somewhat faster and, moreover, we can now work with much larger grids.

Here's a moderately large example, where the state space has 15,625 elements.

```
sv_model = create_sv_model(I=25, J=25, K=25)
sv_model_jax = create_sv_model_jax(sv_model)
P, hc_grid, Q, hd_grid, R, z_grid, beta, y, bar_sigma, mu_c, mu_d = sv_model_jax
shapes = len(hc_grid), len(hd_grid), len(z_grid)

qe.tic()
_ = sv_pd_ratio_linop(sv_model, shapes).block_until_ready()
qe.toc()
```

```
TOC: Elapsed: 0:00:0.87
```

```
0.8700723648071289
```

The solution is computed relatively quickly and without memory issues.

Readers will find that they can push these numbers further, although we refrain from doing so here.



## **Part IV**

# **Dynamic Programming**



## JOB SEARCH

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

In this lecture we study a basic infinite-horizon job search with Markov wage draws

The exercise at the end asks you to add recursive preferences and compare the result.

In addition to what’s in Anaconda, this lecture will need the following libraries:

```
!pip install quantecon
```

We use the following imports.

```
import matplotlib.pyplot as plt
import quantecon as qe
import jax
import jax.numpy as jnp
from collections import namedtuple

jax.config.update("jax_enable_x64", True)
```

## 9.1 Model

We study an elementary model where

- jobs are permanent
- unemployed workers receive current compensation  $c$
- the wage offer distribution  $\{W_t\}$  is Markovian
- the horizon is infinite
- an unemployment agent discounts the future via discount factor  $\beta \in (0, 1)$

The wage process obeys

$$W_{t+1} = \rho W_t + \nu Z_{t+1}, \quad \{Z_t\} \text{ is IID and } N(0, 1)$$

We discretize this using Tauchen's method to produce a stochastic matrix  $P$

Since jobs are permanent, the return to accepting wage offer  $w$  today is

$$w + \beta w + \beta^2 w + \dots = \frac{w}{1 - \beta}$$

The Bellman equation is

$$v(w) = \max \left\{ \frac{w}{1 - \beta}, c + \beta \sum_{w'} v(w') P(w, w') \right\}$$

We solve this model using value function iteration.

Let's set up a namedtuple to store information needed to solve the model.

```
Model = namedtuple('Model', ('n', 'w_vals', 'P', 'beta', 'c'))
```

The function below holds default values and populates the namedtuple.

```
def create_js_model(
    n=500,          # wage grid size
    rho=0.9,       # wage persistence
    v=0.2,         # wage volatility
    beta=0.99,     # discount factor
    c=1.0          # unemployment compensation
):
    "Creates an instance of the job search model with Markov wages."
    mc = qe.tauchen(n, rho, v)
    w_vals, P = jnp.exp(mc.state_values), mc.P
    P = jnp.array(P)
    return Model(n, w_vals, P, beta, c)
```

Here's the Bellman operator.

```
@jax.jit
def T(v, model):
    """
    The Bellman operator  $Tv = \max\{e, c + \beta E v\}$  with
     $e(w) = w / (1 - \beta)$  and  $(Ev)(w) = E_w[v(W')]$ 
    """
    n, w_vals, P, beta, c = model
    h = c + beta * P @ v
    e = w_vals / (1 - beta)
    return jnp.maximum(e, h)
```

The next function computes the optimal policy under the assumption that  $v$  is the value function.

The policy takes the form

$$\sigma(w) = \mathbf{1} \left\{ \frac{w}{1 - \beta} \geq c + \beta \sum_{w'} v(w') P(w, w') \right\}$$

Here  $\mathbf{1}$  is an indicator function.

The statement above means that the worker accepts ( $\sigma(w) = 1$ ) when the value of stopping is higher than the value of continuing.

```
@jax.jit
def get_greedy(v, model):
    """Get a v-greedy policy."""
    n, w_vals, P, beta, c = model
    e = w_vals / (1 - beta)
    h = c + beta * P @ v
    sigma = jnp.where(e >= h, 1, 0)
    return sigma
```

Here's a routine for value function iteration.

```
def vfi(model, max_iter=10_000, tol=1e-4):
    """Solve the infinite-horizon Markov job search model by VFI."""

    print("Starting VFI iteration.")
    v = jnp.zeros_like(model.w_vals) # Initial guess
    i = 0
    error = tol + 1

    while error > tol and i < max_iter:
        new_v = T(v, model)
        error = jnp.max(jnp.abs(new_v - v))
        i += 1
        v = new_v

    v_star = v
    sigma_star = get_greedy(v_star, model)
    return v_star, sigma_star
```

### 9.1.1 Computing the solution

Let's set up and solve the model.

```
model = create_js_model()
n, w_vals, P, beta, c = model

qe.tic()
v_star, sigma_star = vfi(model)
vfi_time = qe.toc()
```

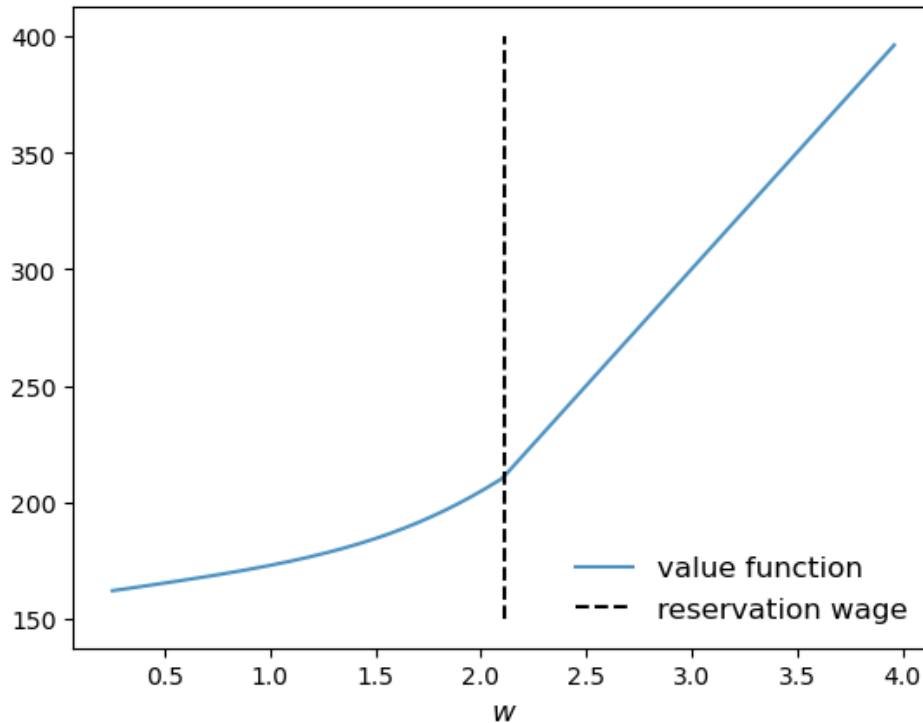
```
Starting VFI iteration.
```

```
TOC: Elapsed: 0:00:0.65
```

We compute the reservation wage as the first  $w$  such that  $\sigma(w) = 1$ .

```
res_wage = w_vals[jnp.searchsorted(sigma_star, 1.0)]
```

```
fig, ax = plt.subplots()
ax.plot(w_vals, v_star, alpha=0.8, label="value function")
ax.vlines((res_wage,), 150, 400, 'k', ls='--', label="reservation wage")
ax.legend(frameon=False, fontsize=12, loc="lower right")
ax.set_xlabel("$w$", fontsize=12)
plt.show()
```



## 9.2 Exercise

### Exercise 9.2.1

In the setting above, the agent is risk-neutral vis-a-vis future utility risk.

Now solve the same problem but this time assuming that the agent has risk-sensitive preferences, which are a type of nonlinear recursive preferences.

The Bellman equation becomes

$$v(w) = \max \left\{ \frac{w}{1-\beta}, c + \frac{\beta}{\theta} \ln \left[ \sum_{w'} \exp(\theta v(w')) P(w, w') \right] \right\}$$

When  $\theta < 0$  the agent is risk sensitive.

Solve the model when  $\theta = -0.1$  and compare your result to the risk neutral case.

Try to interpret your result.

### Solution to Exercise 9.2.1



```

RiskModel = namedtuple('Model', ('n', 'w_vals', 'P', 'β', 'c', 'θ'))

def create_risk_sensitive_js_model(
    n=500,          # wage grid size
    ρ=0.9,         # wage persistence
    v=0.2,         # wage volatility
    β=0.99,        # discount factor
    c=1.0,         # unemployment compensation
    θ=-0.1         # risk parameter
):
    "Creates an instance of the job search model with Markov wages."
    mc = qe.tauchen(n, ρ, v)
    w_vals, P = jnp.exp(mc.state_values), mc.P
    P = jnp.array(P)
    return RiskModel(n, w_vals, P, β, c, θ)

@jax.jit
def T_rs(v, model):
    """
    The Bellman operator  $Tv = \max\{e, c + \beta R v\}$  with

         $e(w) = w / (1-\beta)$  and

         $(Rv)(w) = (1/\theta) \ln\{E_w[\exp(\theta v(W'))]\}$ 

    """
    n, w_vals, P, β, c, θ = model
    h = c + (β / θ) * jnp.log(P @ (jnp.exp(θ * v)))
    e = w_vals / (1 - β)

    return jnp.maximum(e, h)

@jax.jit
def get_greedy_rs(v, model):
    "Get a v-greedy policy."
    n, w_vals, P, β, c, θ = model
    e = w_vals / (1 - β)
    h = c + (β / θ) * jnp.log(P @ (jnp.exp(θ * v)))
    σ = jnp.where(e >= h, 1, 0)
    return σ

def vfi(model, max_iter=10_000, tol=1e-4):
    "Solve the infinite-horizon Markov job search model by VFI."
    print("Starting VFI iteration.")
    v = jnp.zeros_like(model.w_vals) # Initial guess
    i = 0
    error = tol + 1

    while error > tol and i < max_iter:
        new_v = T_rs(v, model)
        error = jnp.max(jnp.abs(new_v - v))
        i += 1
        v = new_v

```

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```
v_star = v
σ_star = get_greedy_rs(v_star, model)
return v_star, σ_star

model_rs = create_risk_sensitive_js_model()

n, w_vals, P, β, c, θ = model_rs

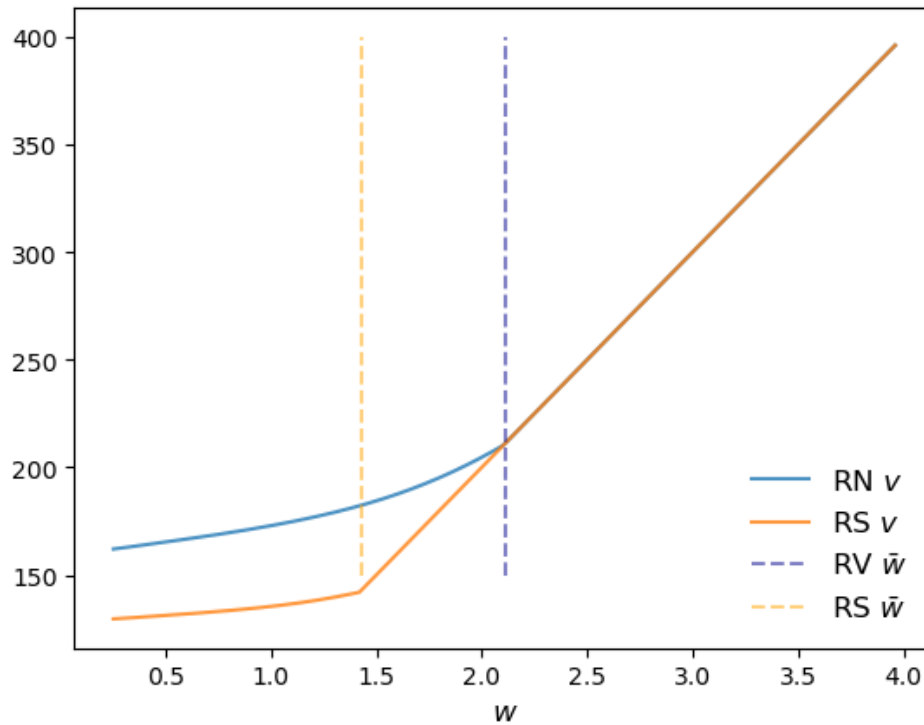
qe.tic()
v_star_rs, σ_star_rs = vfi(model_rs)
vfi_time = qe.toc()
```

```
Starting VFI iteration.
```

```
TOC: Elapsed: 0:00:0.69
```

```
res_wage_rs = w_vals[jnp.searchsorted(σ_star_rs, 1.0)]
```

```
fig, ax = plt.subplots()
ax.plot(w_vals, v_star, alpha=0.8, label="RN $v$")
ax.plot(w_vals, v_star_rs, alpha=0.8, label="RS $v$")
ax.vlines((res_wage,), 150, 400, ls='--', color='darkblue', alpha=0.5, label=r"RV $\backslash$
↳bar w$")
ax.vlines((res_wage_rs,), 150, 400, ls='--', color='orange', alpha=0.5, label=r"RS $\backslash$
↳bar w$")
ax.legend(frameon=False, fontsize=12, loc="lower right")
ax.set_xlabel("$w$", fontsize=12)
plt.show()
```



The figure shows that the reservation wage under risk sensitive preferences ( $RS \bar{w}$ ) shifts down.

This makes sense – the agent does not like risk and hence is more inclined to accept the current offer, even when it's lower.





```

| 0 Tesla V100-SXM2... Off | 00000000:00:1E.0 Off | 0 | | | |
| N/A 28C P0 38W / 300W | 0MiB / 16160MiB | 2% Default |
| | | | | | N/A |
+-----+-----+-----+
+-----+-----+-----+
| Processes: |
| GPU GI CI PID Type Process name GPU Memory |
| ID ID | Usage |
+-----+-----+-----+
| No running processes found |
+-----+-----+-----+

```

We'll use 64 bit floats to gain extra precision.

```
jax.config.update("jax_enable_x64", True)
```

## 10.1 Overview

We consider an optimal savings problem with CRRA utility and budget constraint

$$W_{t+1} + C_t \leq RW_t + Y_t$$

where

- $C_t$  is consumption and  $C_t \geq 0$ ,
- $W_t$  is wealth and  $W_t \geq 0$ ,
- $R > 0$  is a gross rate of return, and
- $(Y_t)$  is labor income.

We assume below that labor income is a discretized AR(1) process.

The Bellman equation is

$$v(w) = \max_{0 \leq w' \leq Rw+y} \left\{ u(Rw + y - w') + \beta \sum_{y'} v(w', y') Q(y, y') \right\}$$

where

$$u(c) = \frac{c^{1-\gamma}}{1-\gamma}$$

In the code we use the function

$$B((w, y), w', v) = u(Rw + y - w') + \beta \sum_{y'} v(w', y') Q(y, y').$$

the encapsulate the right hand side of the Bellman equation.

## 10.2 Starting with NumPy

Let's start with a standard NumPy version running on the CPU.

Starting with this traditional approach will allow us to record the speed gain associated with switching to JAX.

(NumPy operations are similar to MATLAB operations, so this also serves as a rough comparison with MATLAB.)

### 10.2.1 Functions and operators

The following function contains default parameters and returns tuples that contain the key computational components of the model.

```
def create_consumption_model(R=1.01,          # Gross interest rate
                             beta=0.98,     # Discount factor
                             gamma=2,       # CRRA parameter
                             w_min=0.01,    # Min wealth
                             w_max=5.0,    # Max wealth
                             w_size=150,    # Grid size
                             rho=0.9, v=0.1, y_size=100): # Income parameters
    """
    A function that takes in parameters and returns parameters and grids
    for the optimal savings problem.
    """
    # Build grids and transition probabilities
    w_grid = np.linspace(w_min, w_max, w_size)
    mc = qe.tauchen(n=y_size, rho=rho, sigma=v)
    y_grid, Q = np.exp(mc.state_values), mc.P
    # Pack and return
    params = beta, R, gamma
    sizes = w_size, y_size
    arrays = w_grid, y_grid, Q
    return params, sizes, arrays
```

(The function returns sizes of arrays because we use them later to help compile functions in JAX.)

To produce efficient NumPy code, we will use a vectorized approach.

The first step is to create the right hand side of the Bellman equation as a multi-dimensional array with dimensions over all states and controls.

```
def B(v, params, sizes, arrays):
    """
    A vectorized version of the right-hand side of the Bellman equation
    (before maximization), which is a 3D array representing

        
$$B(w, y, w') = u(Rw + y - w') + \beta \sum_{y'} v(w', y') Q(y, y')$$


    for all  $(w, y, w')$ .
    """
    # Unpack
    beta, R, gamma = params
    w_size, y_size = sizes
    w_grid, y_grid, Q = arrays
```

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```

# Compute current rewards r(w, y, wp) as array r[i, j, ip]
w = np.reshape(w_grid, (w_size, 1, 1)) # w[i] -> w[i, j, ip]
y = np.reshape(y_grid, (1, y_size, 1)) # z[j] -> z[i, j, ip]
wp = np.reshape(w_grid, (1, 1, w_size)) # wp[ip] -> wp[i, j, ip]
c = R * w + y - wp

# Calculate continuation rewards at all combinations of (w, y, wp)
v = np.reshape(v, (1, 1, w_size, y_size)) # v[ip, jp] -> v[i, j, ip, jp]
Q = np.reshape(Q, (1, y_size, 1, y_size)) # Q[j, jp] -> Q[i, j, ip, jp]
EV = np.sum(v * Q, axis=3) # sum over last index jp

# Compute the right-hand side of the Bellman equation
return np.where(c > 0, c**(1-y)/(1-y) + beta * EV, -np.inf)

```

Here are two functions we need for value function iteration.

The first is the Bellman operator.

The second computes a  $v$ -greedy policy given  $v$  (i.e., the policy that maximizes the right-hand side of the Bellman equation.)

```

def T(v, params, sizes, arrays):
    "The Bellman operator."
    return np.max(B(v, params, sizes, arrays), axis=2)

def get_greedy(v, params, sizes, arrays):
    "Computes a v-greedy policy, returned as a set of indices."
    return np.argmax(B(v, params, sizes, arrays), axis=2)

```

## 10.2.2 Value function iteration

Here's a routine that performs value function iteration.

```

def value_function_iteration(model, max_iter=10_000, tol=1e-5):
    params, sizes, arrays = model
    v = np.zeros(sizes)
    i, error = 0, tol + 1
    while error > tol and i < max_iter:
        v_new = T(v, params, sizes, arrays)
        error = np.max(np.abs(v_new - v))
        i += 1
        v = v_new
    return v, get_greedy(v, params, sizes, arrays)

```

Now we create an instance, unpack it, and test how long it takes to solve the model.

```

model = create_consumption_model()
# Unpack
params, sizes, arrays = model
beta, R, y = params
w_size, y_size = sizes
w_grid, y_grid, Q = arrays

print("Starting VFI.")

```

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```

start_time = time.time()
v_star, sigma_star = value_function_iteration(model)
numpy_elapsed = time.time() - start_time
print(f"VFI completed in {numpy_elapsed} seconds.")

```

```
Starting VFI.
```

```
VFI completed in 21.118168354034424 seconds.
```

Here's a plot of the policy function.

```

fig, ax = plt.subplots()
ax.plot(w_grid, w_grid, "k--", label="45")
ax.plot(w_grid, w_grid[sigma_star[:, 1]], label="$\\sigma^*(\\cdot, y_1)$")
ax.plot(w_grid, w_grid[sigma_star[:, -1]], label="$\\sigma^*(\\cdot, y_N)$")
ax.legend()
plt.show()

```

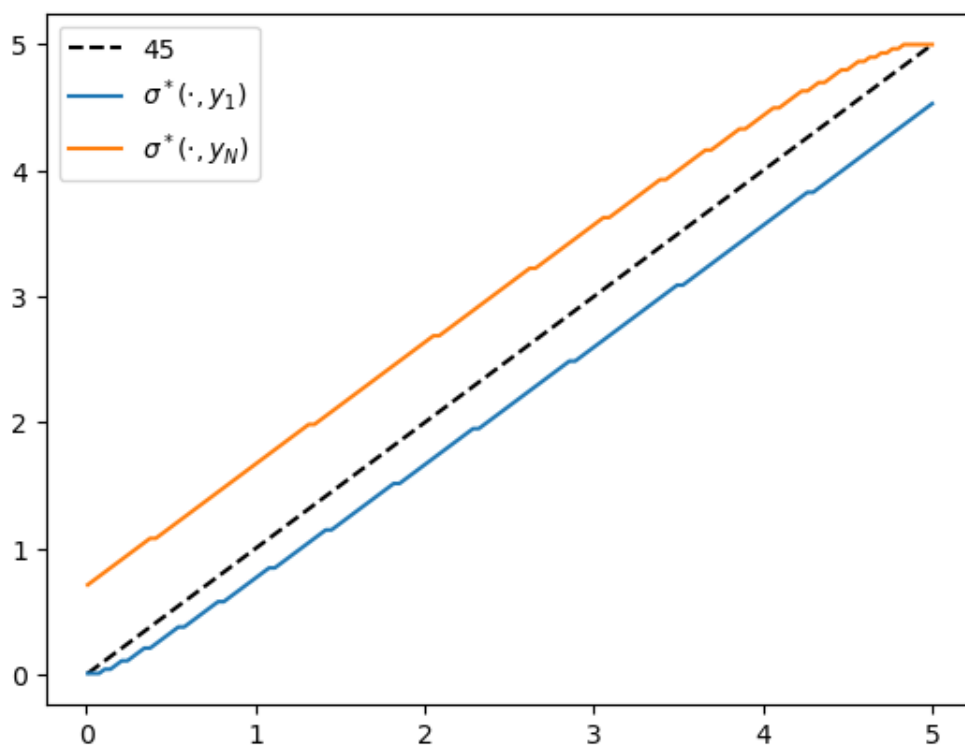


Fig. 10.1: Policy function

## 10.3 Switching to JAX

To switch over to JAX, we change `np` to `jnp` throughout and add some `jax.jit` requests.

### 10.3.1 Functions and operators

We redefine `create_consumption_model` to produce JAX arrays.

```
def create_consumption_model(R=1.01,          # Gross interest rate
                             beta=0.98,     # Discount factor
                             gamma=2,       # CRRA parameter
                             w_min=0.01,    # Min wealth
                             w_max=5.0,     # Max wealth
                             w_size=150,    # Grid side
                             rho=0.9, v=0.1, y_size=100): # Income parameters
    """
    A function that takes in parameters and returns parameters and grids
    for the optimal savings problem.
    """
    w_grid = jnp.linspace(w_min, w_max, w_size)
    mc = qe.tauchen(n=y_size, rho=rho, sigma=v)
    y_grid, Q = jnp.exp(mc.state_values), jax.device_put(mc.P)
    sizes = w_size, y_size
    return (beta, R, gamma, sizes, (w_grid, y_grid, Q))
```

The right hand side of the Bellman equation is the same as the NumPy version after switching `np` to `jnp`.

```
def B(v, params, sizes, arrays):
    """
    A vectorized version of the right-hand side of the Bellman equation
    (before maximization), which is a 3D array representing

         $B(w, y, w') = u(Rw + y - w') + \beta \sum_{y'} v(w', y') Q(y, y')$ 

    for all  $(w, y, w')$ .
    """

    # Unpack
    beta, R, gamma = params
    w_size, y_size = sizes
    w_grid, y_grid, Q = arrays

    # Compute current rewards  $r(w, y, wp)$  as array  $r[i, j, ip]$ 
    w = jnp.reshape(w_grid, (w_size, 1, 1)) #  $w[i]$  ->  $w[i, j, ip]$ 
    y = jnp.reshape(y_grid, (1, y_size, 1)) #  $z[j]$  ->  $z[i, j, ip]$ 
    wp = jnp.reshape(w_grid, (1, 1, w_size)) #  $wp[ip]$  ->  $wp[i, j, ip]$ 
    c = R * w + y - wp

    # Calculate continuation rewards at all combinations of  $(w, y, wp)$ 
    v = jnp.reshape(v, (1, 1, w_size, y_size)) #  $v[ip, jp]$  ->  $v[i, j, ip, jp]$ 
    Q = jnp.reshape(Q, (1, y_size, 1, y_size)) #  $Q[j, jp]$  ->  $Q[i, j, ip, jp]$ 
    EV = jnp.sum(v * Q, axis=3) # sum over last index  $jp$ 

    # Compute the right-hand side of the Bellman equation
    return jnp.where(c > 0, c**(1-gamma)/(1-gamma) + beta * EV, -jnp.inf)
```

Some readers might be concerned that we are creating high dimensional arrays, leading to inefficiency.

Could they be avoided by more careful vectorization?

In fact this is not necessary: this function will be JIT-compiled by JAX, and the JIT compiler will optimize compiled code to minimize memory use.

```
B = jax.jit(B, static_argnums=(2,))
```

In the call above, we indicate to the compiler that `sizes` is static, so the compiler can parallelize optimally while taking array sizes as fixed.

The Bellman operator  $T$  can be implemented by

```
def T(v, params, sizes, arrays):
    "The Bellman operator."
    return jnp.max(B(v, params, sizes, arrays), axis=2)

T = jax.jit(T, static_argnums=(2,))
```

The next function computes a  $v$ -greedy policy given  $v$  (i.e., the policy that maximizes the right-hand side of the Bellman equation.)

```
def get_greedy(v, params, sizes, arrays):
    "Computes a v-greedy policy, returned as a set of indices."
    return jnp.argmax(B(v, params, sizes, arrays), axis=2)

get_greedy = jax.jit(get_greedy, static_argnums=(2,))
```

### 10.3.2 Successive approximation

Now we define a solver that implements VFI.

We could use the one we built for NumPy above, after changing `np` to `jnp`.

Alternatively, we can push a bit harder and write a compiled version using `jax.lax.while_loop`.

This will give us just a bit more speed.

The first step is to write a compiled successive approximation routine that performs fixed point iteration on some given function  $T$ .

```
def successive_approx_jax(T,                # Operator (callable)
                         x_0,              # Initial condition
                         tolerance=1e-6,   # Error tolerance
                         max_iter=10_000): # Max iteration bound
    def body_fun(k_x_err):
        k, x, error = k_x_err
        x_new = T(x)
        error = jnp.max(jnp.abs(x_new - x))
        return k + 1, x_new, error

    def cond_fun(k_x_err):
        k, x, error = k_x_err
        return jnp.logical_and(error > tolerance, k < max_iter)

    k, x, error = jax.lax.while_loop(cond_fun, body_fun,
```

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```

                                (1, x_0, tolerance + 1))
    return x

    successive_approx_jax = \
        jax.jit(successive_approx_jax, static_argnums=(0,))

```

Our value function iteration routine calls `successive_approx_jax` while passing in the Bellman operator.

```

def value_function_iteration(model, tol=1e-5):
    params, sizes, arrays = model
    vz = jnp.zeros(sizes)
    _T = lambda v: T(v, params, sizes, arrays)
    v_star = successive_approx_jax(_T, vz, tolerance=tol)
    return v_star, get_greedy(v_star, params, sizes, arrays)

```

### 10.3.3 Timing

Let's create an instance and unpack it.

```

model = create_consumption_model()
# Unpack
params, sizes, arrays = model
beta, R, gamma = params
w_size, y_size = sizes
w_grid, y_grid, Q = arrays

```

Let's see how long it takes to solve this model.

```

print("Starting VFI using vectorization.")
start_time = time.time()
v_star_jax, sigma_star_jax = value_function_iteration(model)
jax_elapsed = time.time() - start_time
print(f"VFI completed in {jax_elapsed} seconds.")

```

```
Starting VFI using vectorization.
```

```
VFI completed in 0.5025434494018555 seconds.
```

The relative speed gain is

```
print(f"Relative speed gain = {numpy_elapsed / jax_elapsed}")
```

```
Relative speed gain = 42.02257213614066
```

This is an impressive speed up and in fact we can do better still by switching to alternative algorithms that are better suited to parallelization.

These algorithms are discussed in a *separate lecture*.

## 10.4 Switching to vmap

Before we discuss alternative algorithms, let's take another look at value function iteration.

For this simple optimal savings problem, direct vectorization is relatively easy.

In particular, it's straightforward to express the right hand side of the Bellman equation as an array that stores evaluations of the function at every state and control.

For more complex models direct vectorization can be much harder.

For this reason, it helps to have another approach to fast JAX implementations up our sleeves.

Here's a version that

1. writes the right hand side of the Bellman operator as a function of individual states and controls, and
2. applies `jax.vmap` on the outside to achieve a parallelized solution.

First let's rewrite `B`

```
def B(v, params, arrays, i, j, ip):
    """
    The right-hand side of the Bellman equation before maximization, which takes
    the form

         $B(w, y, w') = u(Rw + y - w') + \beta \mathbb{E}_{y'} v(w', y') Q(y, y')$ 

    The indices are  $(i, j, ip) \rightarrow (w, y, w')$ .
    """
    beta, R, gamma = params
    w_grid, y_grid, Q = arrays
    w, y, wp = w_grid[i], y_grid[j], w_grid[ip]
    c = R * w + y - wp
    EV = jnp.sum(v[ip, :] * Q[j, :])
    return jnp.where(c > 0, c**(1-gamma)/(1-gamma) + beta * EV, -jnp.inf)
```

Now we successively apply `vmap` to simulate nested loops.

```
B_1 = jax.vmap(B, in_axes=(None, None, None, None, None, 0))
B_2 = jax.vmap(B_1, in_axes=(None, None, None, None, 0, None))
B_vmap = jax.vmap(B_2, in_axes=(None, None, None, 0, None, None))
```

Here's the Bellman operator and the `get_greedy` functions for the `vmap` case.

```
def T_vmap(v, params, sizes, arrays):
    "The Bellman operator."
    w_size, y_size = sizes
    w_indices, y_indices = jnp.arange(w_size), jnp.arange(y_size)
    B_values = B_vmap(v, params, arrays, w_indices, y_indices, w_indices)
    return jnp.max(B_values, axis=-1)

T_vmap = jax.jit(T_vmap, static_argnums=(2,))

def get_greedy_vmap(v, params, sizes, arrays):
    "Computes a v-greedy policy, returned as a set of indices."
    w_size, y_size = sizes
    w_indices, y_indices = jnp.arange(w_size), jnp.arange(y_size)
    B_values = B_vmap(v, params, arrays, w_indices, y_indices, w_indices)
```

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```

return jnp.argmax(B_values, axis=-1)

get_greedy_vmap = jax.jit(get_greedy_vmap, static_argnums=(2,))

```

Here's the iteration routine.

```

def value_iteration_vmap(model, tol=1e-5):
    params, sizes, arrays = model
    vz = jnp.zeros(sizes)
    _T = lambda v: T_vmap(v, params, sizes, arrays)
    v_star = successive_approx_jax(_T, vz, tolerance=tol)
    return v_star, get_greedy(v_star, params, sizes, arrays)

```

Let's see how long it takes to solve the model using the vmap method.

```

print("Starting VFI using vmap.")
start_time = time.time()
v_star_vmap, sigma_star_vmap = value_iteration_vmap(model)
jax_vmap_elapsed = time.time() - start_time
print(f"VFI completed in {jax_vmap_elapsed} seconds.")

```

```
Starting VFI using vmap.
```

```
VFI completed in 0.3089144229888916 seconds.
```

We need to make sure that we got the same result.

```

print(jnp.allclose(v_star_vmap, v_star_jax))
print(jnp.allclose(sigma_star_vmap, sigma_star_jax))

```

```
True
True
```

Here's the speed gain associated with switching from the NumPy version to JAX with vmap:

```
print(f"Relative speed = {numpy_elapsed / jax_vmap_elapsed}")
```

```
Relative speed = 68.362519786892
```

And here's the comparison with the first JAX implementation (which used direct vectorization).

```
print(f"Relative speed = {jax_elapsed / jax_vmap_elapsed}")
```

```
Relative speed = 1.626804745921257
```

The execution times for the two JAX versions are relatively similar.

However, as emphasized above, having a second method up our sleeves (i.e., the vmap approach) will be helpful when confronting dynamic programs with more sophisticated Bellman equations.

## OPTIMAL SAVINGS II: ALTERNATIVE ALGORITHMS

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

In *Optimal Savings I: Value Function Iteration* we solved a simple version of the household optimal savings problem via value function iteration (VFI) using JAX.

In this lecture we tackle exactly the same problem while adding in two alternative algorithms:

- optimistic policy iteration (OPI) and
- Howard policy iteration (HPI).

We will see that both of these algorithms outperform traditional VFI.

One reason for this is that the algorithms have good convergence properties.

Another is that one of them, HPI, is particularly well suited to pairing with JAX.

The reason is that HPI uses a relatively small number of computationally expensive steps, whereas VFI uses a longer sequence of small steps.

In other words, VFI is inherently more sequential than HPI, and sequential routines are hard to parallelize.

By comparison, HPI is less sequential – the small number of computationally intensive steps can be effectively parallelized by JAX.

This is particularly valuable when the underlying hardware includes a GPU.

Details on VFI, HPI and OPI can be found in [this book](#), for which a PDF is freely available.

Here we assume readers have some knowledge of the algorithms and focus on computation.

For the details of the savings model, readers can refer to *Optimal Savings I: Value Function Iteration*.

In addition to what’s in Anaconda, this lecture will need the following libraries:

```
!pip install quantecon
```

We will use the following imports:

```
import quantecon as qc
import jax
import jax.numpy as jnp
import matplotlib.pyplot as plt
import time
```

Let's check the GPU we are running.

```
!nvidia-smi
```

```
/opt/conda/envs/quantecon/lib/python3.11/pty.py:89: RuntimeWarning: os.fork() was
called. os.fork() is incompatible with multithreaded code, and JAX is
multithreaded, so this will likely lead to a deadlock.
pid, fd = os.forkpty()
```

```
Thu May 2 02:31:31 2024
+-----+
| NVIDIA-SMI 470.182.03    Driver Version: 470.182.03    CUDA Version: 12.3    |
+-----+-----+-----+-----+
| GPU   Name               Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp  Perf    Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                           | MIG M.         |
+-----+-----+-----+-----+
|    0   Tesla V100-SXM2...    Off      | 00000000:00:1E:0  Off |                0 |
| N/A   27C    P0     38W / 300W |      0MiB / 16160MiB |          2%      Default |
|                                           | N/A            |
+-----+-----+-----+-----+
+-----+
| Processes:                                                       GPU Memory |
|  GPU   GI    CI          PID    Type   Process name                  Usage      |
|-----+-----+-----+-----+
| No running processes found                                         |
+-----+
```

We'll use 64 bit floats to gain extra precision.

```
jax.config.update("jax_enable_x64", True)
```

## 11.1 Model primitives

First we define a model that stores parameters and grids.

The following code is repeated from *Optimal Savings I: Value Function Iteration*.

```
def create_consumption_model(R=1.01,          # Gross interest rate
                             beta=0.98,      # Discount factor
                             gamma=2,        # CRRA parameter
                             w_min=0.01,     # Min wealth
```

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```

        w_max=5.0,                # Max wealth
        w_size=150,              # Grid side
        rho=0.9, v=0.1, y_size=100): # Income parameters
    """
    A function that takes in parameters and returns parameters and grids
    for the optimal savings problem.
    """
    # Build grids and transition probabilities
    w_grid = jnp.linspace(w_min, w_max, w_size)
    mc = qe.tauchen(n=y_size, rho=rho, sigma=v)
    y_grid, Q = jnp.exp(mc.state_values), mc.P
    # Pack and return
    params = beta, R, y
    sizes = w_size, y_size
    arrays = w_grid, y_grid, jnp.array(Q)
    return params, sizes, arrays

```

Here's the right hand side of the Bellman equation:

```

def _B(v, params, arrays, i, j, ip):
    """
    The right-hand side of the Bellman equation before maximization, which takes
    the form

         $B(w, y, w') = u(Rw + y - w') + \beta \sum_{y'} v(w', y') Q(y, y')$ 

    The indices are (i, j, ip) -> (w, y, w').
    """
    beta, R, y = params
    w_grid, y_grid, Q = arrays
    w, y, wp = w_grid[i], y_grid[j], w_grid[ip]
    c = R * w + y - wp
    EV = jnp.sum(v[ip, :] * Q[j, :])
    return jnp.where(c > 0, c**(1-y)/(1-y) + beta * EV, -jnp.inf)

```

Now we successively apply `vmap` to vectorize  $B$  by simulating nested loops.

```

B_1 = jax.vmap(_B, in_axes=(None, None, None, None, None, 0))
B_2 = jax.vmap(B_1, in_axes=(None, None, None, None, 0, None))
B_vmap = jax.vmap(B_2, in_axes=(None, None, None, 0, None, None))

```

Here's a fully vectorized version of  $B$ .

```

def B(v, params, sizes, arrays):
    w_size, y_size = sizes
    w_indices, y_indices = jnp.arange(w_size), jnp.arange(y_size)
    return B_vmap(v, params, arrays, w_indices, y_indices, w_indices)

B = jax.jit(B, static_argnums=(2,))

```

## 11.2 Operators

Here's the Bellman operator  $T$

```
def T(v, params, sizes, arrays):
    "The Bellman operator."
    return jnp.max(B(v, params, sizes, arrays), axis=-1)

T = jax.jit(T, static_argnums=(2,))
```

The next function computes a  $v$ -greedy policy given  $v$

```
def get_greedy(v, params, sizes, arrays):
    "Computes a v-greedy policy, returned as a set of indices."
    return jnp.argmax(B(v, params, sizes, arrays), axis=-1)

get_greedy = jax.jit(get_greedy, static_argnums=(2,))
```

We define a function to compute the current rewards  $r_\sigma$  given policy  $\sigma$ , which is defined as the vector

$$r_\sigma(w, y) := r(w, y, \sigma(w, y))$$

```
def _compute_r_sigma(sigma, params, arrays, i, j):
    """
    With indices (i, j) -> (w, y) and wp = sigma[i, j], compute

        r_sigma[i, j] = u(Rw + y - wp)

    which gives current rewards under policy sigma.
    """

    # Unpack model
    beta, R, gamma = params
    w_grid, y_grid, Q = arrays
    # Compute r_sigma[i, j]
    w, y, wp = w_grid[i], y_grid[j], w_grid[sigma[i, j]]
    c = R * w + y - wp
    r_sigma = c**(1-gamma)/(1-gamma)

    return r_sigma
```

Now we successively apply `vmap` to simulate nested loops.

```
r_1 = jax.vmap(_compute_r_sigma, in_axes=(None, None, None, None, 0))
r_sigma_vmap = jax.vmap(r_1, in_axes=(None, None, None, 0, None))
```

Here's a fully vectorized version of  $r_\sigma$ .

```
def compute_r_sigma(sigma, params, sizes, arrays):
    w_size, y_size = sizes
    w_indices, y_indices = jnp.arange(w_size), jnp.arange(y_size)
    return r_sigma_vmap(sigma, params, arrays, w_indices, y_indices)

compute_r_sigma = jax.jit(compute_r_sigma, static_argnums=(2,))
```

Now we define the policy operator  $T_\sigma$  going through similar steps

```

def _T_σ(v, σ, params, arrays, i, j):
    "The σ-policy operator."

    # Unpack model
    β, R, γ = params
    w_grid, y_grid, Q = arrays

    r_σ = _compute_r_σ(σ, params, arrays, i, j)
    # Calculate the expected sum Σ_jp v[σ[i, j], jp] * Q[i, j, jp]
    EV = jnp.sum(v[σ[i, j], :] * Q[j, :])

    return r_σ + β * EV

T_1 = jax.vmap(_T_σ, in_axes=(None, None, None, None, None, 0))
T_σ_vmap = jax.vmap(T_1, in_axes=(None, None, None, None, 0, None))

def T_σ(v, σ, params, sizes, arrays):
    w_size, y_size = sizes
    w_indices, y_indices = jnp.arange(w_size), jnp.arange(y_size)
    return T_σ_vmap(v, σ, params, arrays, w_indices, y_indices)

T_σ = jax.jit(T_σ, static_argnums=(3,))

```

The function below computes the value  $v_σ$  of following policy  $σ$ .

This lifetime value is a function  $v_σ$  that satisfies

$$v_σ(w, y) = r_σ(w, y) + β \sum_{y'} v_σ(σ(w, y), y') Q(y, y')$$

We wish to solve this equation for  $v_σ$ .

Suppose we define the linear operator  $L_σ$  by

$$(L_σ v)(w, y) = v(w, y) - β \sum_{y'} v(σ(w, y), y') Q(y, y')$$

With this notation, the problem is to solve for  $v$  via

$$(L_σ v)(w, y) = r_σ(w, y)$$

In vector for this is  $L_σ v = r_σ$ , which tells us that the function we seek is

$$v_σ = L_σ^{-1} r_σ$$

JAX allows us to solve linear systems defined in terms of operators; the first step is to define the function  $L_σ$ .

```

def _L_σ(v, σ, params, arrays, i, j):
    """
    Here we set up the linear map v -> L_σ v, where

        (L_σ v)(w, y) = v(w, y) - β Σ_y' v(σ(w, y), y') Q(y, y')

    """
    # Unpack
    β, R, γ = params

```

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```

w_grid, y_grid, Q = arrays
# Compute and return v[i, j] - beta sum_jp v[sigma[i, j], jp] * Q[j, jp]
return v[i, j] - beta * jnp.sum(v[sigma[i, j], :] * Q[j, :])

L_1 = jax.vmap(_L_sigma, in_axes=(None, None, None, None, None, 0))
L_sigma_vmap = jax.vmap(L_1, in_axes=(None, None, None, None, 0, None))

def L_sigma(v, sigma, params, sizes, arrays):
    w_size, y_size = sizes
    w_indices, y_indices = jnp.arange(w_size), jnp.arange(y_size)
    return L_sigma_vmap(v, sigma, params, arrays, w_indices, y_indices)

L_sigma = jax.jit(L_sigma, static_argnums=(3,))

```

Now we can define a function to compute  $v_\sigma$

```

def get_value(sigma, params, sizes, arrays):
    "Get the value v_sigma of policy sigma by inverting the linear map L_sigma."

    # Unpack
    beta, R, gamma = params
    w_size, y_size = sizes
    w_grid, y_grid, Q = arrays

    r_sigma = compute_r_sigma(sigma, params, sizes, arrays)

    # Reduce L_sigma to a function in v
    partial_L_sigma = lambda v: L_sigma(v, sigma, params, sizes, arrays)

    return jax.scipy.sparse.linalg.bicgstab(partial_L_sigma, r_sigma)[0]

get_value = jax.jit(get_value, static_argnums=(2,))

```

## 11.3 Iteration

We use successive approximation for VFI.

```

def successive_approx_jax(T, x_0, tol=1e-6, max_iter=10_000):
    # Operator (callable)
    # Initial condition
    # Error tolerance
    # Max iteration bound

    def update(inputs):
        k, x, error = inputs
        x_new = T(x)
        error = jnp.max(jnp.abs(x_new - x))
        return k + 1, x_new, error

    def condition_function(inputs):
        k, x, error = inputs
        return jnp.logical_and(error > tol, k < max_iter)

    k, x, error = jax.lax.while_loop(condition_function,
                                     update,

```

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```

                                (1, x_0, tol + 1))
    return x

successive_approx_jax = jax.jit(successive_approx_jax, static_argnums=(0,))

```

For OPI we'll add a compiled routine that computes  $T_\sigma^m v$ .

```

def iterate_policy_operator( $\sigma$ , v, m, params, sizes, arrays):

    def update(i, v):
        v = T_ $\sigma$ (v,  $\sigma$ , params, sizes, arrays)
        return v

    v = jax.lax.fori_loop(0, m, update, v)
    return v

iterate_policy_operator = jax.jit(iterate_policy_operator,
                                static_argnums=(4,))

```

## 11.4 Solvers

Now we define the solvers, which implement VFI, HPI and OPI.

Here's VFI.

```

def value_function_iteration(model, tol=1e-5):
    """
    Implements value function iteration.
    """
    params, sizes, arrays = model
    vz = jnp.zeros(sizes)
    _T = lambda v: T(v, params, sizes, arrays)
    v_star = successive_approx_jax(_T, vz, tol=tol)
    return get_greedy(v_star, params, sizes, arrays)

```

For OPI we will use a compiled JAX `lax.while_loop` operation to speed execution.

```

def opi_loop(params, sizes, arrays, m, tol, max_iter):
    """
    Implements optimistic policy iteration (see dp.quantecon.org) with
    step size m.

    """
    v_init = jnp.zeros(sizes)

    def condition_function(inputs):
        i, v, error = inputs
        return jnp.logical_and(error > tol, i < max_iter)

    def update(inputs):
        i, v, error = inputs
        last_v = v
         $\sigma$  = get_greedy(v, params, sizes, arrays)

```

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```

    v = iterate_policy_operator( $\sigma$ , v, m, params, sizes, arrays)
    error = jnp.max(jnp.abs(v - last_v))
    i += 1
    return i, v, error

    num_iter, v, error = jax.lax.while_loop(condition_function,
                                          update,
                                          (0, v_init, tol + 1))

    return get_greedy(v, params, sizes, arrays)

opi_loop = jax.jit(opi_loop, static_argnums=(1,))

```

Here's a friendly interface to OPI

```

def optimistic_policy_iteration(model, m=10, tol=1e-5, max_iter=10_000):
    params, sizes, arrays = model
     $\sigma$ _star = opi_loop(params, sizes, arrays, m, tol, max_iter)
    return  $\sigma$ _star

```

Here's HPI.

```

def howard_policy_iteration(model, maxiter=250):
    """
    Implements Howard policy iteration (see dp.quantecon.org)
    """
    params, sizes, arrays = model
     $\sigma$  = jnp.zeros(sizes, dtype=int)
    i, error = 0, 1.0
    while error > 0 and i < maxiter:
        v_ $\sigma$  = get_value( $\sigma$ , params, sizes, arrays)
         $\sigma$ _new = get_greedy(v_ $\sigma$ , params, sizes, arrays)
        error = jnp.max(jnp.abs( $\sigma$ _new -  $\sigma$ ))
         $\sigma$  =  $\sigma$ _new
        i = i + 1
        print(f"Concluded loop {i} with error {error}.")
    return  $\sigma$ 

```

## 11.5 Tests

Let's create a model for consumption, and plot the resulting optimal policy function using all the three algorithms and also check the time taken by each solver.

```

model = create_consumption_model()
# Unpack
params, sizes, arrays = model
 $\beta$ , R,  $\gamma$  = params
w_size, y_size = sizes
w_grid, y_grid, Q = arrays

```

```

print("Starting HPI.")
start_time = time.time()

```

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```

σ_star_hpi = howard_policy_iteration(model)
elapsed = time.time() - start_time
print(f"HPI completed in {elapsed} seconds.")

```

Starting HPI.

```

Concluded loop 1 with error 77.
Concluded loop 2 with error 53.
Concluded loop 3 with error 28.
Concluded loop 4 with error 17.
Concluded loop 5 with error 8.
Concluded loop 6 with error 4.
Concluded loop 7 with error 1.
Concluded loop 8 with error 1.
Concluded loop 9 with error 1.
Concluded loop 10 with error 0.
HPI completed in 1.1844747066497803 seconds.

```

```

fig, ax = plt.subplots()
ax.plot(w_grid, w_grid, "k--", label="45")
ax.plot(w_grid, w_grid[σ_star_hpi[:, 1]], label="$\\sigma^*_{HPI}(\cdot, y_1)$")
ax.plot(w_grid, w_grid[σ_star_hpi[:, -1]], label="$\\sigma^*_{HPI}(\cdot, y_N)$")
ax.legend()
plt.show()

```

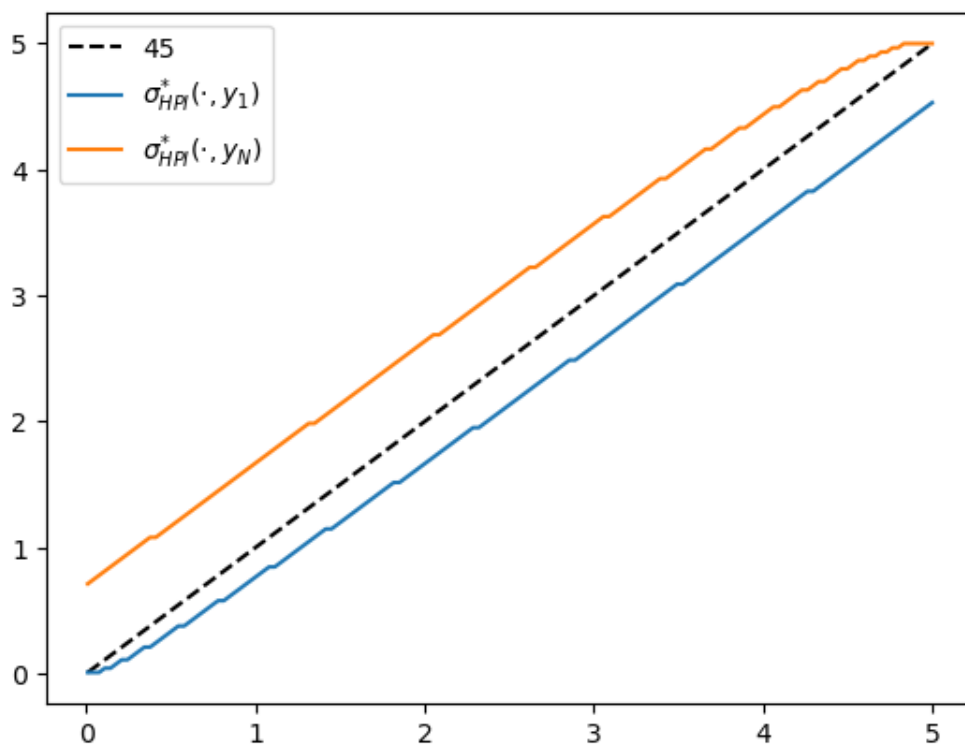


Fig. 11.1: Optimal policy function (HPI)

```
print("Starting VFI.")
start_time = time.time()
sigma_star_vfi = value_function_iteration(model)
elapsed = time.time() - start_time
print(f"VFI completed in {elapsed} seconds.")
```

Starting VFI.

VFI completed in 0.2878599166870117 seconds.

```
fig, ax = plt.subplots()
ax.plot(w_grid, w_grid, "k--", label="45")
ax.plot(w_grid, w_grid[sigma_star_vfi[:, 1]], label="$\\sigma^*_{VFI}(\cdot, y_1)$")
ax.plot(w_grid, w_grid[sigma_star_vfi[:, -1]], label="$\\sigma^*_{VFI}(\cdot, y_N)$")
ax.legend()
plt.show()
```

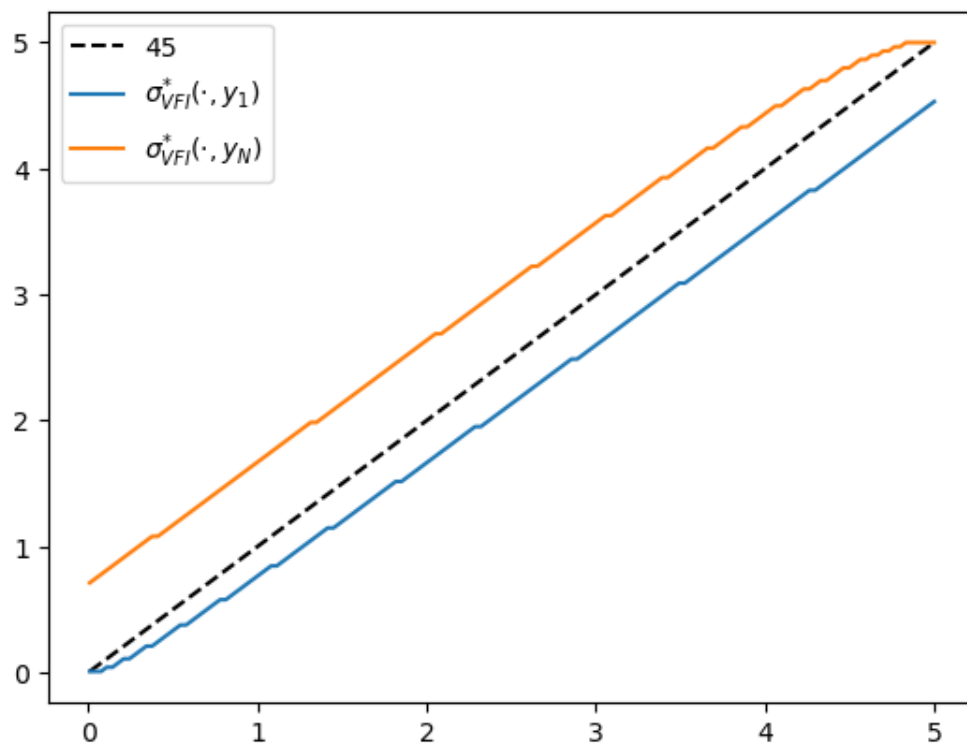


Fig. 11.2: Optimal policy function (VFI)

```
print("Starting OPI.")
start_time = time.time()
sigma_star_opi = optimistic_policy_iteration(model, m=100)
elapsed = time.time() - start_time
```

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```
print(f"OPI completed in {elapsed} seconds.")
```

```
Starting OPI.
```

```
OPI completed in 0.559664249420166 seconds.
```

```
fig, ax = plt.subplots()
ax.plot(w_grid, w_grid, "k--", label="45")
ax.plot(w_grid, w_grid[σ_star_opi[:, 1]], label="$\\sigma^{*}_{OPI}(\cdot, y_1)$")
ax.plot(w_grid, w_grid[σ_star_opi[:, -1]], label="$\\sigma^{*}_{OPI}(\cdot, y_N)$")
ax.legend()
plt.show()
```

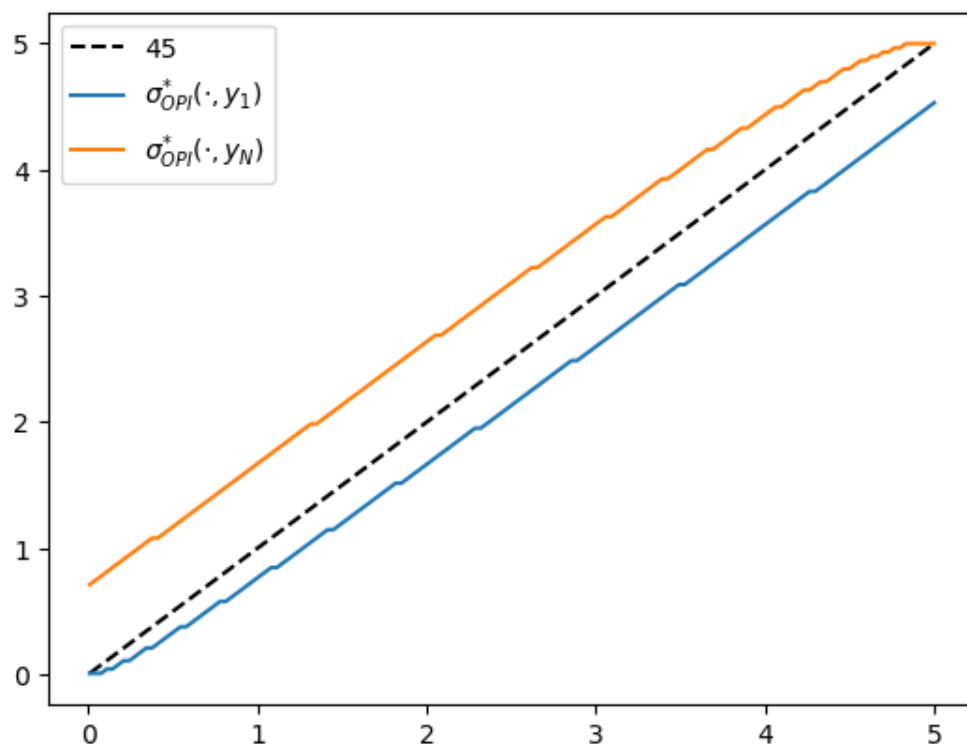


Fig. 11.3: Optimal policy function (OPI)

We observe that all the solvers produce the same output from the above three plots.

Now, let's create a plot to visualize the time differences among these algorithms.

```
def run_algorithm(algorithm, model, **kwargs):
    start_time = time.time()
    result = algorithm(model, **kwargs)
    end_time = time.time()
    elapsed_time = end_time - start_time
```

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```
print(f"{algorithm.__name__} completed in {elapsed_time:.2f} seconds.")
return result, elapsed_time
```

```
σ_pi, pi_time = run_algorithm(howard_policy_iteration, model)
σ_vfi, vfi_time = run_algorithm(value_function_iteration, model, tol=1e-5)

m_vals = range(5, 600, 40)
opi_times = []
for m in m_vals:
    σ_opti, opi_time = run_algorithm(optimistic_policy_iteration,
                                    model, m=m, tol=1e-5)
    opi_times.append(opi_time)
```

```
Concluded loop 1 with error 77.
Concluded loop 2 with error 53.
Concluded loop 3 with error 28.
Concluded loop 4 with error 17.
Concluded loop 5 with error 8.
Concluded loop 6 with error 4.
Concluded loop 7 with error 1.
Concluded loop 8 with error 1.
Concluded loop 9 with error 1.
Concluded loop 10 with error 0.
howard_policy_iteration completed in 0.04 seconds.
```

```
value_function_iteration completed in 0.17 seconds.
optimistic_policy_iteration completed in 0.04 seconds.
optimistic_policy_iteration completed in 0.03 seconds.
optimistic_policy_iteration completed in 0.03 seconds.
optimistic_policy_iteration completed in 0.04 seconds.
optimistic_policy_iteration completed in 0.05 seconds.
```

```
optimistic_policy_iteration completed in 0.06 seconds.
optimistic_policy_iteration completed in 0.07 seconds.
optimistic_policy_iteration completed in 0.09 seconds.
```

```
optimistic_policy_iteration completed in 0.10 seconds.
optimistic_policy_iteration completed in 0.11 seconds.
```

```
optimistic_policy_iteration completed in 0.12 seconds.
optimistic_policy_iteration completed in 0.13 seconds.
```

```
optimistic_policy_iteration completed in 0.14 seconds.
optimistic_policy_iteration completed in 0.15 seconds.
```

```
optimistic_policy_iteration completed in 0.17 seconds.
```

```
fig, ax = plt.subplots()
ax.plot(m_vals,
```

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```
jnp.full(len(m_vals), pi_time),
        lw=2, label="Howard policy iteration")
ax.plot(m_vals,
        jnp.full(len(m_vals), vfi_time),
        lw=2, label="value function iteration")
ax.plot(m_vals, opi_times,
        lw=2, label="optimistic policy iteration")
ax.legend(frameon=False)
ax.set_xlabel("$m$")
ax.set_ylabel("time")
plt.show()
```

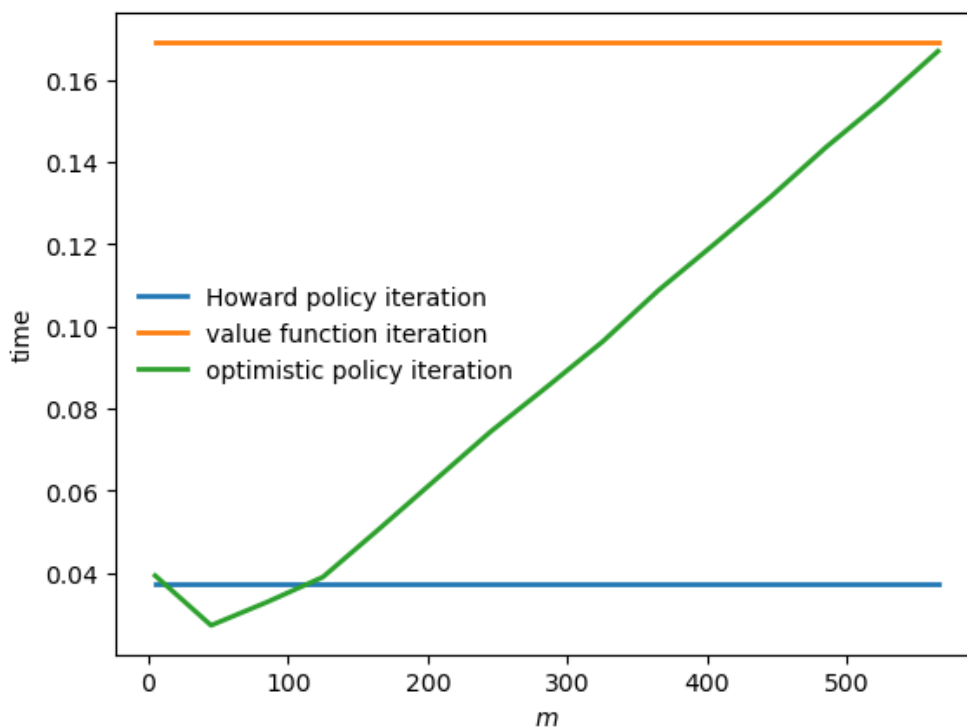


Fig. 11.4: Solver times



## SHORTEST PATHS

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

## 12.1 Overview

This lecture is the extended version of the [shortest path lecture](#) using JAX. Please see that lecture for all background and notation.

Let’s start by importing the libraries.

```
import numpy as np
import jax.numpy as jnp
import jax
```

Let’s check the GPU we are running

```
!nvidia-smi
```

```
/opt/conda/envs/quantecon/lib/python3.11/pty.py:89: RuntimeWarning: os.fork() was
↳called. os.fork() is incompatible with multithreaded code, and JAX is
↳multithreaded, so this will likely lead to a deadlock.
pid, fd = os.forkpty()
```

```
Thu May  2 02:32:25 2024
+-----+
| NVIDIA-SMI 470.182.03   Driver Version: 470.182.03   CUDA Version: 12.3   |
+-----+-----+-----+-----+
| GPU  Name           Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp  Perf    Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                       |                  |     MIG M.     |
+=====+=====+=====+=====+
```

```

| 0 Tesla V100-SXM2... Off | 00000000:00:1E.0 Off | 0 | | | | | |
| N/A 32C P0 39W / 300W | 0MiB / 16160MiB | 2% Default |
| | | | | | | | |
+-----+-----+-----+
+-----+
| Processes: |
| GPU GI CI PID Type Process name GPU Memory |
| ID ID | | | | | Usage |
|=====|
| No running processes found |
+-----+

```

## 12.2 Solving for Minimum Cost-to-Go

Let  $J(v)$  denote the minimum cost-to-go from node  $v$ , understood as the total cost from  $v$  if we take the best route.

Let's look at an algorithm for computing  $J$  and then think about how to implement it.

### 12.2.1 The Algorithm

The standard algorithm for finding  $J$  is to start an initial guess and then iterate.

This is a standard approach to solving nonlinear equations, often called the method of **successive approximations**.

Our initial guess will be

$$J_0(v) = 0 \text{ for all } v \quad (12.1)$$

Now

1. Set  $n = 0$
2. Set  $J_{n+1}(v) = \min_{w \in F_v} \{c(v, w) + J_n(w)\}$  for all  $v$
3. If  $J_{n+1}$  and  $J_n$  are not equal then increment  $n$ , go to 2

This sequence converges to  $J$ .

Let's start by defining the **distance matrix**  $Q$ .

```

inf = jnp.inf
Q = jnp.array([[inf, 1, 5, 3, inf, inf, inf],
               [inf, inf, inf, 9, 6, inf, inf],
               [inf, inf, inf, inf, inf, 2, inf],
               [inf, inf, inf, inf, inf, 4, 8],
               [inf, inf, inf, inf, inf, inf, 4],
               [inf, inf, inf, inf, inf, inf, 1],
               [inf, inf, inf, inf, inf, inf, 0]])

```

Notice that the cost of staying still (on the principle diagonal) is set to

- `jnp.inf` for non-destination nodes — moving on is required.
- `0` for the destination node — here is where we stop.

Let's try with this example using python `while` loop and some `jax` vectorized code:

```

%%time

num_nodes = Q.shape[0]
J = jnp.zeros(num_nodes)

max_iter = 500
i = 0

while i < max_iter:
    next_J = jnp.min(Q + J, axis=1)
    if jnp.allclose(next_J, J):
        break
    else:
        J = next_J.copy()
        i += 1

print("The cost-to-go function is", J)

```

```

The cost-to-go function is [ 8. 10.  3.  5.  4.  1.  0.]
CPU times: user 135 ms, sys: 3.79 ms, total: 139 ms
Wall time: 177 ms

```

We can further optimize the above code by using `jax.lax.while_loop`. The extra acceleration is due to the fact that the entire operation can be optimized by the JAX compiler and launched as a single kernel on the GPU.

```

max_iter = 500
num_nodes = Q.shape[0]
J = jnp.zeros(num_nodes)

```

```

def body_fun(values):
    # Define the body function of while loop
    i, J, break_cond = values

    # Update J and break condition
    next_J = jnp.min(Q + J, axis=1)
    break_condition = jnp.allclose(next_J, J)

    # Return next iteration values
    return i + 1, next_J, break_condition

```

```

def cond_fun(values):
    i, J, break_condition = values
    return ~break_condition & (i < max_iter)

```

Let's see the timing for JIT compilation of the functions and runtime results.

```

%%time

jax.lax.while_loop(cond_fun, body_fun, init_val=(0, J, False))[1]

```

```

CPU times: user 79.7 ms, sys: 5.14 ms, total: 84.9 ms
Wall time: 90.9 ms

```

```
Array([ 8., 10.,  3.,  5.,  4.,  1.,  0.], dtype=float32)
```

Now, this runs faster once we have the JIT compiled JAX version of the functions.

```
%%time
```

```
jax.lax.while_loop(cond_fun, body_fun, init_val=(0, J, False))[1]
```

```
CPU times: user 1.46 ms, sys: 1.37 ms, total: 2.83 ms  
Wall time: 1.35 ms
```

```
Array([ 8., 10.,  3.,  5.,  4.,  1.,  0.], dtype=float32)
```

---

**Note:** Large speed gains while using `jax.lax.while_loop` won't be realized unless the shortest path problem is relatively large.

---

## 12.3 Exercises

---

### Exercise 12.3.1

The text below describes a weighted directed graph.

The line `node0, node1 0.04, node8 11.11, node14 72.21` means that from `node0` we can go to

- `node1` at cost 0.04
- `node8` at cost 11.11
- `node14` at cost 72.21

No other nodes can be reached directly from `node0`.

Other lines have a similar interpretation.

Your task is to use the algorithm given above to find the optimal path and its cost.

```
%%file graph.txt  
node0, node1 0.04, node8 11.11, node14 72.21  
node1, node46 1247.25, node6 20.59, node13 64.94  
node2, node66 54.18, node31 166.80, node45 1561.45  
node3, node20 133.65, node6 2.06, node11 42.43  
node4, node75 3706.67, node5 0.73, node7 1.02  
node5, node45 1382.97, node7 3.33, node11 34.54  
node6, node31 63.17, node9 0.72, node10 13.10  
node7, node50 478.14, node9 3.15, node10 5.85  
node8, node69 577.91, node11 7.45, node12 3.18  
node9, node70 2454.28, node13 4.42, node20 16.53  
node10, node89 5352.79, node12 1.87, node16 25.16  
node11, node94 4961.32, node18 37.55, node20 65.08  
node12, node84 3914.62, node24 34.32, node28 170.04  
node13, node60 2135.95, node38 236.33, node40 475.33  
node14, node67 1878.96, node16 2.70, node24 38.65
```

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```

node15, node91 3597.11, node17 1.01, node18 2.57
node16, node36 392.92, node19 3.49, node38 278.71
node17, node76 783.29, node22 24.78, node23 26.45
node18, node91 3363.17, node23 16.23, node28 55.84
node19, node26 20.09, node20 0.24, node28 70.54
node20, node98 3523.33, node24 9.81, node33 145.80
node21, node56 626.04, node28 36.65, node31 27.06
node22, node72 1447.22, node39 136.32, node40 124.22
node23, node52 336.73, node26 2.66, node33 22.37
node24, node66 875.19, node26 1.80, node28 14.25
node25, node70 1343.63, node32 36.58, node35 45.55
node26, node47 135.78, node27 0.01, node42 122.00
node27, node65 480.55, node35 48.10, node43 246.24
node28, node82 2538.18, node34 21.79, node36 15.52
node29, node64 635.52, node32 4.22, node33 12.61
node30, node98 2616.03, node33 5.61, node35 13.95
node31, node98 3350.98, node36 20.44, node44 125.88
node32, node97 2613.92, node34 3.33, node35 1.46
node33, node81 1854.73, node41 3.23, node47 111.54
node34, node73 1075.38, node42 51.52, node48 129.45
node35, node52 17.57, node41 2.09, node50 78.81
node36, node71 1171.60, node54 101.08, node57 260.46
node37, node75 269.97, node38 0.36, node46 80.49
node38, node93 2767.85, node40 1.79, node42 8.78
node39, node50 39.88, node40 0.95, node41 1.34
node40, node75 548.68, node47 28.57, node54 53.46
node41, node53 18.23, node46 0.28, node54 162.24
node42, node59 141.86, node47 10.08, node72 437.49
node43, node98 2984.83, node54 95.06, node60 116.23
node44, node91 807.39, node46 1.56, node47 2.14
node45, node58 79.93, node47 3.68, node49 15.51
node46, node52 22.68, node57 27.50, node67 65.48
node47, node50 2.82, node56 49.31, node61 172.64
node48, node99 2564.12, node59 34.52, node60 66.44
node49, node78 53.79, node50 0.51, node56 10.89
node50, node85 251.76, node53 1.38, node55 20.10
node51, node98 2110.67, node59 23.67, node60 73.79
node52, node94 1471.80, node64 102.41, node66 123.03
node53, node72 22.85, node56 4.33, node67 88.35
node54, node88 967.59, node59 24.30, node73 238.61
node55, node84 86.09, node57 2.13, node64 60.80
node56, node76 197.03, node57 0.02, node61 11.06
node57, node86 701.09, node58 0.46, node60 7.01
node58, node83 556.70, node64 29.85, node65 34.32
node59, node90 820.66, node60 0.72, node71 0.67
node60, node76 48.03, node65 4.76, node67 1.63
node61, node98 1057.59, node63 0.95, node64 4.88
node62, node91 132.23, node64 2.94, node76 38.43
node63, node66 4.43, node72 70.08, node75 56.34
node64, node80 47.73, node65 0.30, node76 11.98
node65, node94 594.93, node66 0.64, node73 33.23
node66, node98 395.63, node68 2.66, node73 37.53
node67, node82 153.53, node68 0.09, node70 0.98
node68, node94 232.10, node70 3.35, node71 1.66
node69, node99 247.80, node70 0.06, node73 8.99
node70, node76 27.18, node72 1.50, node73 8.37

```

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```

node71, node89 104.50, node74 8.86, node91 284.64
node72, node76 15.32, node84 102.77, node92 133.06
node73, node83 52.22, node76 1.40, node90 243.00
node74, node81 1.07, node76 0.52, node78 8.08
node75, node92 68.53, node76 0.81, node77 1.19
node76, node85 13.18, node77 0.45, node78 2.36
node77, node80 8.94, node78 0.98, node86 64.32
node78, node98 355.90, node81 2.59
node79, node81 0.09, node85 1.45, node91 22.35
node80, node92 121.87, node88 28.78, node98 264.34
node81, node94 99.78, node89 39.52, node92 99.89
node82, node91 47.44, node88 28.05, node93 11.99
node83, node94 114.95, node86 8.75, node88 5.78
node84, node89 19.14, node94 30.41, node98 121.05
node85, node97 94.51, node87 2.66, node89 4.90
node86, node97 85.09
node87, node88 0.21, node91 11.14, node92 21.23
node88, node93 1.31, node91 6.83, node98 6.12
node89, node97 36.97, node99 82.12
node90, node96 23.53, node94 10.47, node99 50.99
node91, node97 22.17
node92, node96 10.83, node97 11.24, node99 34.68
node93, node94 0.19, node97 6.71, node99 32.77
node94, node98 5.91, node96 2.03
node95, node98 6.17, node99 0.27
node96, node98 3.32, node97 0.43, node99 5.87
node97, node98 0.30
node98, node99 0.33
node99,

```

```
Overwriting graph.txt
```

### Solution to Exercise 12.3.1

First let's write a function that reads in the graph data above and builds a distance matrix.

```

num_nodes = 100
destination_node = 99
def map_graph_to_distance_matrix(in_file):

    # First let's set of the distance matrix Q with inf everywhere
    Q = np.full((num_nodes, num_nodes), np.inf)

    # Now we read in the data and modify Q
    with open(in_file) as infile:
        for line in infile:
            elements = line.split(',')
            node = elements.pop(0)
            node = int(node[4:]) # convert node description to integer
            if node != destination_node:
                for element in elements:
                    destination, cost = element.split()
                    destination = int(destination[4:])

```

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```

        Q[node, destination] = float(cost)
        Q[destination_node, destination_node] = 0
    return jnp.array(Q)

```

Let's write a function `compute_cost_to_go` that returns  $J$  given any valid  $Q$ .

```

@jax.jit
def compute_cost_to_go(Q):
    num_nodes = Q.shape[0]
    J = jnp.zeros(num_nodes)      # Initial guess
    max_iter = 500
    i = 0

    def body_fun(values):
        # Define the body function of while loop
        i, J, break_cond = values

        # Update J and break condition
        next_J = jnp.min(Q + J, axis=1)
        break_condition = jnp.allclose(next_J, J)

        # Return next iteration values
        return i + 1, next_J, break_condition

    def cond_fun(values):
        i, J, break_condition = values
        return ~break_condition & (i < max_iter)

    return jax.lax.while_loop(cond_fun, body_fun,
                              init_val=(0, J, False))[1]

```

Finally, here's a function that uses the `cost-to-go` function to obtain the optimal path (and its cost).

```

def print_best_path(J, Q):
    sum_costs = 0
    current_node = 0
    while current_node != destination_node:
        print(current_node)
        # Move to the next node and increment costs
        next_node = jnp.argmin(Q[current_node, :] + J)
        sum_costs += Q[current_node, next_node]
        current_node = next_node
    print(destination_node)
    print('Cost: ', sum_costs)

```

Okay, now we have the necessary functions, let's call them to do the job we were assigned.

```
Q = map_graph_to_distance_matrix('graph.txt')
```

Let's see the timings for jitting the function and runtime results.

```

%%time

J = compute_cost_to_go(Q).block_until_ready()

```

```
CPU times: user 96.4 ms, sys: 4.81 ms, total: 101 ms  
Wall time: 116 ms
```

```
%%time  
J = compute_cost_to_go(Q).block_until_ready()
```

```
CPU times: user 1.2 ms, sys: 1.04 ms, total: 2.24 ms  
Wall time: 1.01 ms
```

```
print_best_path(J, Q)
```

```
0
```

```
8  
11  
18  
23  
33  
41  
53  
56  
57  
60  
67  
70  
73  
76  
85  
87  
88  
93  
94  
96  
97  
98  
99  
Cost: 160.55
```

The total cost of the path should agree with  $J[0]$  so let's check this.

```
J[0].item()
```

```
160.5500030517578
```

## OPTIMAL INVESTMENT

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

In addition to JAX and Anaconda, this lecture will need the following libraries:

```
!pip install --upgrade quantecon
```

We study a monopolist who faces inverse demand curve

$$P_t = a_0 - a_1 Y_t + Z_t,$$

where

- $P_t$  is price,
- $Y_t$  is output and
- $Z_t$  is a demand shock.

We assume that  $Z_t$  is a discretized AR(1) process, specified below.

Current profits are

$$P_t Y_t - c Y_t - \gamma (Y_{t+1} - Y_t)^2$$

Combining with the demand curve and writing  $y, y'$  for  $Y_t, Y_{t+1}$ , this becomes

$$r(y, z, y') := (a_0 - a_1 y + z - c)y - \gamma (y' - y)^2$$

The firm maximizes present value of expected discounted profits. The Bellman equation is

$$v(y, z) = \max_{y'} \left\{ r(y, z, y') + \beta \sum_{z'} v(y', z') Q(z, z') \right\}.$$

We discretize  $y$  to a finite grid `y_grid`.

In essence, the firm tries to choose output close to the monopolist profit maximizer, given  $Z_t$ , but is constrained by adjustment costs.

Let's begin with the following imports

---



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```

y_grid = jnp.linspace(y_min, y_max, y_size)
mc = qe.tauchen(z_size, p, v)
z_grid, Q = mc.state_values, mc.P

# Break up parameters into static and nonstatic components
constants = β, a_0, a_1, γ, c
sizes = y_size, z_size
arrays = y_grid, z_grid, Q

# Shift arrays to the device (e.g., GPU)
arrays = tuple(map(jax.device_put, arrays))
return constants, sizes, arrays

```

Let's re-write the vectorized version of the right-hand side of the Bellman equation (before maximization), which is a 3D array representing

$$B(y, z, y') = r(y, z, y') + \beta \sum_{z'} v(y', z') Q(z, z')$$

for all  $(y, z, y')$ .

```

def B(v, constants, sizes, arrays):
    """
    A vectorized version of the right-hand side of the Bellman equation
    (before maximization)
    """

    # Unpack
    β, a_0, a_1, γ, c = constants
    y_size, z_size = sizes
    y_grid, z_grid, Q = arrays

    # Compute current rewards r(y, z, yp) as array r[i, j, ip]
    y = jnp.reshape(y_grid, (y_size, 1, 1)) # y[i] -> y[i, j, ip]
    z = jnp.reshape(z_grid, (1, z_size, 1)) # z[j] -> z[i, j, ip]
    yp = jnp.reshape(y_grid, (1, 1, y_size)) # yp[ip] -> yp[i, j, ip]
    r = (a_0 - a_1 * y + z - c) * y - γ * (yp - y)**2

    # Calculate continuation rewards at all combinations of (y, z, yp)
    v = jnp.reshape(v, (1, 1, y_size, z_size)) # v[ip, jp] -> v[i, j, ip, jp]
    Q = jnp.reshape(Q, (1, z_size, 1, z_size)) # Q[j, jp] -> Q[i, j, ip, jp]
    EV = jnp.sum(v * Q, axis=3) # sum over last index jp

    # Compute the right-hand side of the Bellman equation
    return r + β * EV

# Create a jitted function
B = jax.jit(B, static_argnums=(2,))

```

We define a function to compute the current rewards  $r_\sigma$  given policy  $\sigma$ , which is defined as the vector

$$r_\sigma(y, z) := r(y, z, \sigma(y, z))$$

```

def compute_r_σ(σ, constants, sizes, arrays):
    """

```

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```

Compute the array  $r_{\sigma}[i, j] = r[i, j, \sigma[i, j]]$ , which gives current
rewards given policy  $\sigma$ .
"""

# Unpack model
 $\beta$ , a_0, a_1,  $\gamma$ , c = constants
y_size, z_size = sizes
y_grid, z_grid, Q = arrays

# Compute  $r_{\sigma}[i, j]$ 
y = jnp.reshape(y_grid, (y_size, 1))
z = jnp.reshape(z_grid, (1, z_size))
yp = y_grid[ $\sigma$ ]
 $r_{\sigma} = (a_0 - a_1 * y + z - c) * y - \gamma * (yp - y)**2$ 

return  $r_{\sigma}$ 

# Create the jitted function
compute_r_ $\sigma$  = jax.jit(compute_r_ $\sigma$ , static_argnums=(2,))

```

Define the Bellman operator.

```

def T(v, constants, sizes, arrays):
    """The Bellman operator."""
    return jnp.max(B(v, constants, sizes, arrays), axis=2)

T = jax.jit(T, static_argnums=(2,))

```

The following function computes a v-greedy policy.

```

def get_greedy(v, constants, sizes, arrays):
    """Computes a v-greedy policy, returned as a set of indices."""
    return jnp.argmax(B(v, constants, sizes, arrays), axis=2)

get_greedy = jax.jit(get_greedy, static_argnums=(2,))

```

Define the  $\sigma$ -policy operator.

```

def T_ $\sigma$ (v,  $\sigma$ , constants, sizes, arrays):
    """The  $\sigma$ -policy operator."""

    # Unpack model
     $\beta$ , a_0, a_1,  $\gamma$ , c = constants
    y_size, z_size = sizes
    y_grid, z_grid, Q = arrays

     $r_{\sigma} = \text{compute\_r\_}\sigma(\sigma, \text{constants}, \text{sizes}, \text{arrays})$ 

    # Compute the array  $v[\sigma[i, j], jp]$ 
    zp_idx = jnp.arange(z_size)
    zp_idx = jnp.reshape(zp_idx, (1, 1, z_size))
     $\sigma = \text{jnp.reshape}(\sigma, (y\_size, z\_size, 1))$ 
    V = v[ $\sigma$ , zp_idx]

```

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```

# Convert Q[j, jp] to Q[i, j, jp]
Q = jnp.reshape(Q, (1, z_size, z_size))

# Calculate the expected sum  $\sum_{jp} v[\sigma[i, j], jp] * Q[i, j, jp]$ 
Ev = jnp.sum(V * Q, axis=2)

return r_σ + β * Ev

T_σ = jax.jit(T_σ, static_argnums=(3,))

```

Next, we want to compute the lifetime value of following policy  $\sigma$ .

This lifetime value is a function  $v_\sigma$  that satisfies

$$v_\sigma(y, z) = r_\sigma(y, z) + \beta \sum_{z'} v_\sigma(\sigma(y, z), z') Q(z, z')$$

We wish to solve this equation for  $v_\sigma$ .

Suppose we define the linear operator  $L_\sigma$  by

$$(L_\sigma v)(y, z) = v(y, z) - \beta \sum_{z'} v(\sigma(y, z), z') Q(z, z')$$

With this notation, the problem is to solve for  $v$  via

$$(L_\sigma v)(y, z) = r_\sigma(y, z)$$

In vector form this is  $L_\sigma v = r_\sigma$ , which tells us that the function we seek is

$$v_\sigma = L_\sigma^{-1} r_\sigma$$

JAX allows us to solve linear systems defined in terms of operators; the first step is to define the function  $L_\sigma$ .

```

def L_σ(v, σ, constants, sizes, arrays):

    β, a_0, a_1, γ, c = constants
    y_size, z_size = sizes
    y_grid, z_grid, Q = arrays

    # Set up the array v[σ[i, j], jp]
    zp_idx = jnp.arange(z_size)
    zp_idx = jnp.reshape(zp_idx, (1, 1, z_size))
    σ = jnp.reshape(σ, (y_size, z_size, 1))
    V = v[σ, zp_idx]

    # Expand Q[j, jp] to Q[i, j, jp]
    Q = jnp.reshape(Q, (1, z_size, z_size))

    # Compute and return v[i, j] - β  $\sum_{jp} v[\sigma[i, j], jp] * Q[j, jp]$ 
    return v - β * jnp.sum(V * Q, axis=2)

L_σ = jax.jit(L_σ, static_argnums=(3,))

```

Now we can define a function to compute  $v_\sigma$

```

def get_value( $\sigma$ , constants, sizes, arrays):

    # Unpack
     $\beta$ , a_0, a_1,  $\gamma$ , c = constants
    y_size, z_size = sizes
    y_grid, z_grid, Q = arrays

    r_ $\sigma$  = compute_r_ $\sigma$ ( $\sigma$ , constants, sizes, arrays)

    # Reduce  $L_\sigma$  to a function in v
    partial_L_ $\sigma$  = lambda v: L_ $\sigma$ (v,  $\sigma$ , constants, sizes, arrays)

    return jax.scipy.sparse.linalg.bicgstab(partial_L_ $\sigma$ , r_ $\sigma$ )[0]

get_value = jax.jit(get_value, static_argnums=(2,))

```

We use successive approximation for VFI.

```

def successive_approx_jax(T, # Operator (callable)
                        x_0, # Initial condition
                        tol=1e-6, # Error tolerance
                        max_iter=10_000): # Max iteration bound

    def body_fun(k_x_err):
        k, x, error = k_x_err
        x_new = T(x)
        error = jnp.max(jnp.abs(x_new - x))
        return k + 1, x_new, error

    def cond_fun(k_x_err):
        k, x, error = k_x_err
        return jnp.logical_and(error > tol, k < max_iter)

    k, x, error = jax.lax.while_loop(cond_fun, body_fun, (1, x_0, tol + 1))
    return x

successive_approx_jax = jax.jit(successive_approx_jax, static_argnums=(0,))

```

For OPI we'll add a compiled routine that computes  $T_\sigma^m v$ .

```

def iterate_policy_operator( $\sigma$ , v, m, params, sizes, arrays):

    def update(i, v):
        v = T_ $\sigma$ (v,  $\sigma$ , params, sizes, arrays)
        return v

    v = jax.lax.fori_loop(0, m, update, v)
    return v

iterate_policy_operator = jax.jit(iterate_policy_operator,
                                static_argnums=(4,))

```

Finally, we introduce the solvers that implement VFI, HPI and OPI.

```

def value_function_iteration(model, tol=1e-5):
    """
    Implements value function iteration.

```

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```

"""
params, sizes, arrays = model
vz = jnp.zeros(sizes)
_T = lambda v: T(v, params, sizes, arrays)
v_star = successive_approx_jax(_T, vz, tol=tol)
return get_greedy(v_star, params, sizes, arrays)

```

For OPI we will use a compiled JAX `lax.while_loop` operation to speed execution.

```

def opi_loop(params, sizes, arrays, m, tol, max_iter):
    """
    Implements optimistic policy iteration (see dp.quantecon.org) with
    step size m.

    """
    v_init = jnp.zeros(sizes)

    def condition_function(inputs):
        i, v, error = inputs
        return jnp.logical_and(error > tol, i < max_iter)

    def update(inputs):
        i, v, error = inputs
        last_v = v
        sigma = get_greedy(v, params, sizes, arrays)
        v = iterate_policy_operator(sigma, v, m, params, sizes, arrays)
        error = jnp.max(jnp.abs(v - last_v))
        i += 1
        return i, v, error

    num_iter, v, error = jax.lax.while_loop(condition_function,
                                           update,
                                           (0, v_init, tol + 1))

    return get_greedy(v, params, sizes, arrays)

opi_loop = jax.jit(opi_loop, static_argnums=(1,))

```

Here's a friendly interface to OPI

```

def optimistic_policy_iteration(model, m=10, tol=1e-5, max_iter=10_000):
    params, sizes, arrays = model
    sigma_star = opi_loop(params, sizes, arrays, m, tol, max_iter)
    return sigma_star

```

Here's HPI

```

def howard_policy_iteration(model, maxiter=250):
    """
    Implements Howard policy iteration (see dp.quantecon.org)
    """
    params, sizes, arrays = model
    sigma = jnp.zeros(sizes, dtype=int)
    i, error = 0, 1.0
    while error > 0 and i < maxiter:

```

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```

v_σ = get_value(σ, params, sizes, arrays)
σ_new = get_greedy(v_σ, params, sizes, arrays)
error = jnp.max(jnp.abs(σ_new - σ))
σ = σ_new
i = i + 1
print(f"Concluded loop {i} with error {error}.")
return σ
    
```

```

model = create_investment_model()
constants, sizes, arrays = model
β, a_0, a_1, γ, c = constants
y_size, z_size = sizes
y_grid, z_grid, Q = arrays
    
```

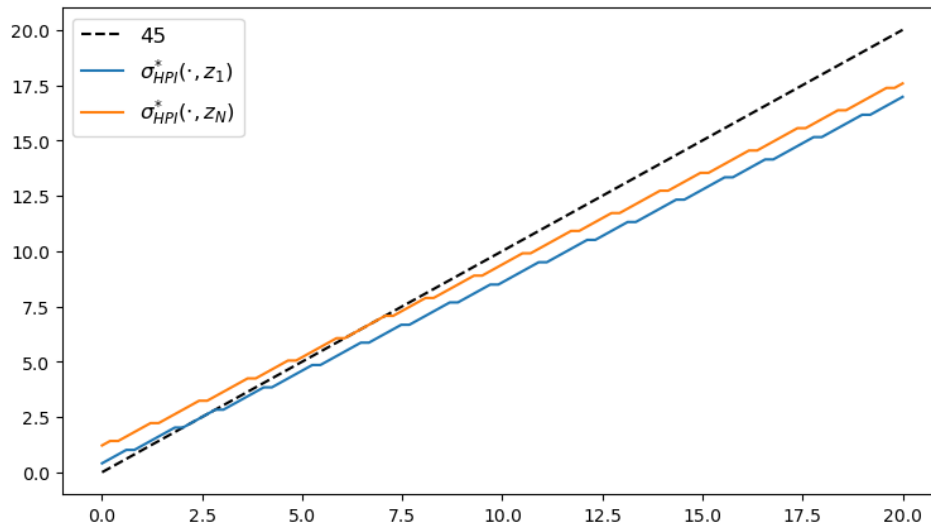
```

print("Starting HPI.")
qe.tic()
σ_star_hpi = howard_policy_iteration(model)
elapsed = qe.toc()
print(σ_star_hpi)
print(f"HPI completed in {elapsed} seconds.")
    
```

Here's the plot of the Howard policy, as a function of  $y$  at the highest and lowest values of  $z$ .

```

fig, ax = plt.subplots(figsize=(9, 5))
ax.plot(y_grid, y_grid, "k--", label="45")
ax.plot(y_grid, y_grid[σ_star_hpi[:, 1]], label="$\\sigma^*_{HPI}(\cdot, z_1)$")
ax.plot(y_grid, y_grid[σ_star_hpi[:, -1]], label="$\\sigma^*_{HPI}(\cdot, z_N)$")
ax.legend(fontsize=12)
plt.show()
    
```



```

print("Starting VFI.")
qe.tic()
σ_star_vfi = value_function_iteration(model)
elapsed = qe.toc()
    
```

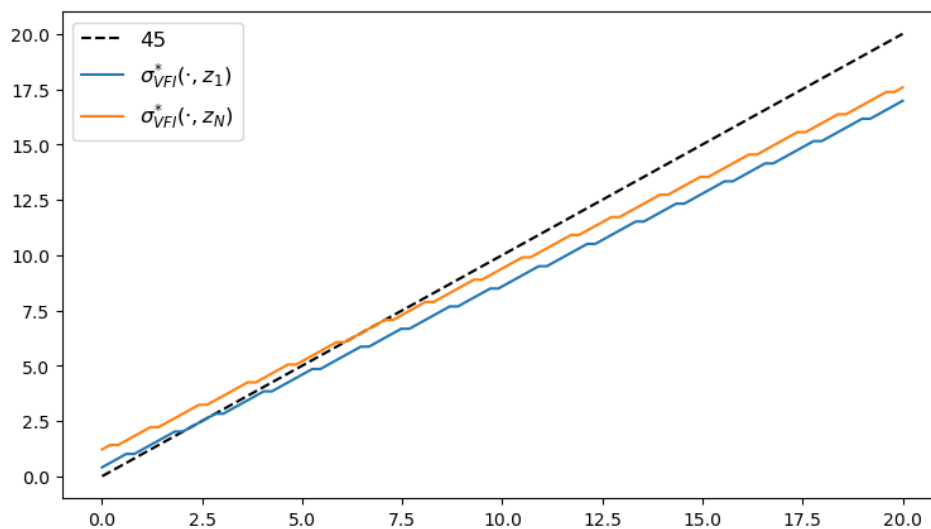
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```
print(σ_star_vfi)
print(f"VFI completed in {elapsed} seconds.")
```

Here's the plot of the VFI, as a function of  $y$  at the highest and lowest values of  $z$ .

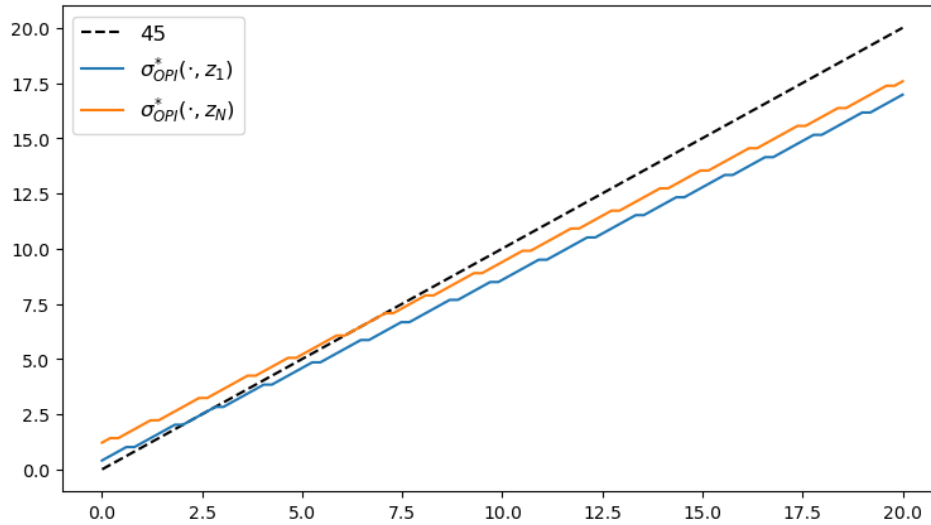
```
fig, ax = plt.subplots(figsize=(9, 5))
ax.plot(y_grid, y_grid, "k--", label="45")
ax.plot(y_grid, y_grid[σ_star_vfi[:, 1]], label="$\\sigma^{*}_{VFI}(\\cdot, z_1)$")
ax.plot(y_grid, y_grid[σ_star_vfi[:, -1]], label="$\\sigma^{*}_{VFI}(\\cdot, z_N)$")
ax.legend(fontsize=12)
plt.show()
```



```
print("Starting OPI.")
qe.tic()
σ_star_opi = optimistic_policy_iteration(model, m=100)
elapsed = qe.toc()
print(σ_star_opi)
print(f"OPI completed in {elapsed} seconds.")
```

Here's the plot of the optimal policy, as a function of  $y$  at the highest and lowest values of  $z$ .

```
fig, ax = plt.subplots(figsize=(9, 5))
ax.plot(y_grid, y_grid, "k--", label="45")
ax.plot(y_grid, y_grid[σ_star_opi[:, 1]], label="$\\sigma^{*}_{OPI}(\\cdot, z_1)$")
ax.plot(y_grid, y_grid[σ_star_opi[:, -1]], label="$\\sigma^{*}_{OPI}(\\cdot, z_N)$")
ax.legend(fontsize=12)
plt.show()
```



We observe that all the solvers produce the same output from the above three plots.

Let's plot the time taken by each of the solvers and compare them.

```
m_vals = range(5, 600, 40)
```

```
print("Running Howard policy iteration.")
qe.tic()
σ_pi = howard_policy_iteration(model)
pi_time = qe.toc()
```

```
Running Howard policy iteration.
Concluded loop 1 with error 50.
Concluded loop 2 with error 26.
Concluded loop 3 with error 17.
Concluded loop 4 with error 10.
Concluded loop 5 with error 7.
Concluded loop 6 with error 4.
Concluded loop 7 with error 3.
Concluded loop 8 with error 1.
Concluded loop 9 with error 1.
Concluded loop 10 with error 1.
Concluded loop 11 with error 1.
Concluded loop 12 with error 0.
TOC: Elapsed: 0:00:0.06
```

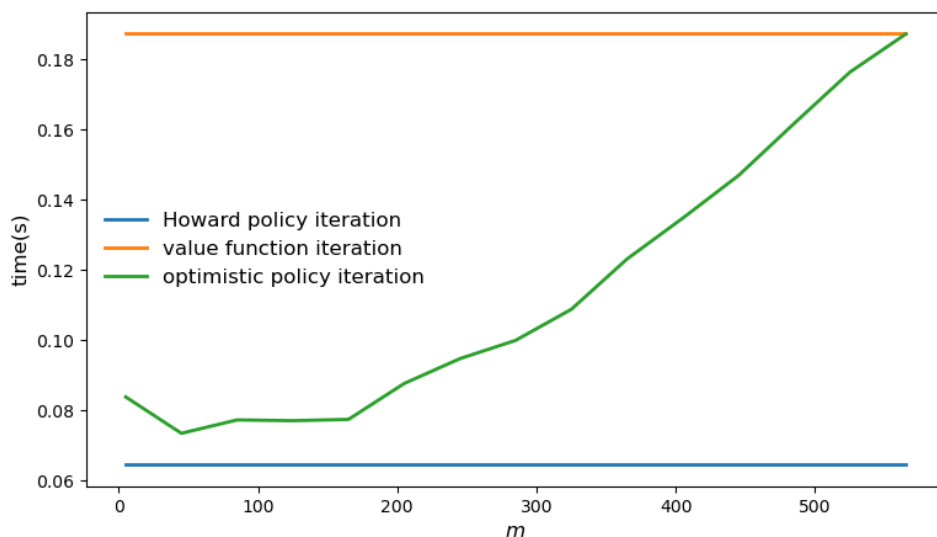
```
print(f"PI completed in {pi_time} seconds.")
print("Running value function iteration.")
qe.tic()
σ_vfi = value_function_iteration(model, tol=1e-5)
vfi_time = qe.toc()
print(f"VFI completed in {vfi_time} seconds.")
```

```
PI completed in 0.06439065933227539 seconds.
Running value function iteration.
```

TOC: Elapsed: 0:00:0.18  
 VFI completed in 0.18721866607666016 seconds.

```
opi_times = []
for m in m_vals:
    print(f"Running optimistic policy iteration with m={m}.")
    qe.tic()
     $\sigma_{opi}$  = optimistic_policy_iteration(model, m=m, tol=1e-5)
    opi_time = qe.toc()
    print(f"OPI with m={m} completed in {opi_time} seconds.")
    opi_times.append(opi_time)
```

```
fig, ax = plt.subplots(figsize=(9, 5))
ax.plot(m_vals, jnp.full(len(m_vals), pi_time),
        lw=2, label="Howard policy iteration")
ax.plot(m_vals, jnp.full(len(m_vals), vfi_time),
        lw=2, label="value function iteration")
ax.plot(m_vals, opi_times, lw=2, label="optimistic policy iteration")
ax.legend(fontsize=12, frameon=False)
ax.set_xlabel("$m$", fontsize=12)
ax.set_ylabel("time(s)", fontsize=12)
plt.show()
```







## INVENTORY MANAGEMENT MODEL

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

This lecture provides a JAX implementation of a model in [Dynamic Programming](#).

In addition to JAX and Anaconda, this lecture will need the following libraries:

```
!pip install --upgrade quantecon
```

## 14.1 A model with constant discounting

We study a firm where a manager tries to maximize shareholder value.

To simplify the problem, we assume that the firm only sells one product.

Letting  $\pi_t$  be profits at time  $t$  and  $r > 0$  be the interest rate, the value of the firm is

$$V_0 = \sum_{t \geq 0} \beta^t \pi_t \quad \text{where} \quad \beta := \frac{1}{1+r}.$$

Suppose the firm faces exogenous demand process  $(D_t)_{t \geq 0}$ .

We assume  $(D_t)_{t \geq 0}$  is IID with common distribution  $\phi \in (Z_+)$ .

Inventory  $(X_t)_{t \geq 0}$  of the product obeys

$$X_{t+1} = f(X_t, D_{t+1}, A_t) \quad \text{where} \quad f(x, a, d) := (x - d) \vee 0 + a.$$

The term  $A_t$  is units of stock ordered this period, which take one period to arrive.

We assume that the firm can store at most  $K$  items at one time.

Profits are given by

$$\pi_t := X_t \wedge D_{t+1} - cA_t - \kappa 1\{A_t > 0\}.$$

We take the minimum of current stock and demand because orders in excess of inventory are assumed to be lost rather than back-filled.

Here  $c$  is unit product cost and  $\kappa$  is a fixed cost of ordering inventory.

We can map our inventory problem into a dynamic program with state space  $X := \{0, \dots, K\}$  and action space  $A := X$ .

The feasible correspondence  $\Gamma$  is

$$\Gamma(x) := \{0, \dots, K - x\},$$

which represents the set of feasible orders when the current inventory state is  $x$ .

The reward function is expected current profits, or

$$r(x, a) := \sum_{d \geq 0} (x \wedge d) \phi(d) - ca - \kappa 1\{a > 0\}.$$

The stochastic kernel (i.e., state-transition probabilities) from the set of feasible state-action pairs is

$$P(x, a, x') := P\{f(x, a, D) = x'\} \quad \text{when } D \sim \phi.$$

When discounting is constant, the Bellman equation takes the form

$$v(x) = \max_{a \in \Gamma(x)} \left\{ r(x, a) + \beta \sum_{d \geq 0} v(f(x, a, d)) \phi(d) \right\} \quad (14.1)$$

## 14.2 Time varying discount rates

We wish to consider a more sophisticated model with time-varying discounting.

This time variation accommodates non-constant interest rates.

To this end, we replace the constant  $\beta$  in (14.1) with a stochastic process  $(\beta_t)$  where

- $\beta_t = 1/(1 + r_t)$  and
- $r_t$  is the interest rate at time  $t$

We suppose that the dynamics can be expressed as  $\beta_t = \beta(Z_t)$ , where the exogenous process  $(Z_t)_{t \geq 0}$  is a Markov chain on  $Z$  with Markov matrix  $Q$ .

After relabeling inventory  $X_t$  as  $Y_t$  and  $x$  as  $y$ , the Bellman equation becomes

$$v(y, z) = \max_{a \in \Gamma(y)} B((y, z), a, v)$$

where

$$B((y, z), a, v) = r(y, a) + \beta(z) \sum_{d, z'} v(f(y, a, d), z') \phi(d) Q(z, z'). \quad (14.2)$$

We set

$$R(y, a, y') := P\{f(y, a, d) = y'\} \quad \text{when } D \sim \phi,$$

Now  $R(y, a, y')$  is the probability of realizing next period inventory level  $y'$  when the current level is  $y$  and the action is  $a$ .

Hence we can rewrite (14.2) as

$$B((y, z), a, v) = r(y, a) + \beta(z) \sum_{y', z'} v(y', z') Q(z, z') R(y, a, y').$$

Let's begin with the following imports

```
import quantecon as qc
import jax
import jax.numpy as jnp
import numpy as np
import matplotlib.pyplot as plt
from collections import namedtuple
import time
from numba import njit, prange
```

Let's check the GPU we are running

```
!nvidia-smi
```

```
/opt/conda/envs/quantecon/lib/python3.11/pty.py:89: RuntimeWarning: os.fork() was
↳ called. os.fork() is incompatible with multithreaded code, and JAX is
↳ multithreaded, so this will likely lead to a deadlock.
pid, fd = os.forkpty()
```

```
Thu May  2 02:00:48 2024
+-----+
| NVIDIA-SMI 470.182.03    Driver Version: 470.182.03    CUDA Version: 12.3    |
+-----+-----+-----+
| GPU   Name               Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp  Perf  Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                           | MIG M.         |
+-----+-----+-----+-----+-----+-----+
|    0   Tesla V100-SXM2...  Off      | 00000000:00:1E:0  Off |                0    |
| N/A   27C    P0     38W / 300W |      0MiB / 16160MiB |      2%      Default |
|                                           |                N/A   |
+-----+-----+-----+-----+-----+
| Processes:
| GPU   GI    CI          PID    Type    Process name                        GPU Memory
|     ID  ID                                     Usage
+-----+-----+-----+-----+-----+
| No running processes found
+-----+-----+-----+-----+-----+-----+

```

```

|    0   Tesla V100-SXM2...  Off      | 00000000:00:1E:0  Off |                0    |
| N/A   27C    P0     38W / 300W |      0MiB / 16160MiB |      2%      Default |
|                                           |                N/A   |
+-----+-----+-----+-----+-----+-----+

```

```

+-----+-----+-----+-----+-----+-----+
| Processes:
| GPU   GI    CI          PID    Type    Process name                        GPU Memory
|     ID  ID                                     Usage
+-----+-----+-----+-----+-----+-----+
| No running processes found
+-----+-----+-----+-----+-----+-----+

```

We will use 64 bit floats with JAX in order to increase the precision.

```
jax.config.update("jax_enable_x64", True)
```

Let's define a model to represent the inventory management.

```
# NamedTuple Model
Model = namedtuple("Model", ("c", "k", "p", "z_vals", "Q"))
```

We need the following successive approximation function.

```
def successive_approx(T,                                # Operator (callable)
                      x_0,                              # Initial condition
```

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(continued from previous page)

```

        tolerance=1e-6,          # Error tolerance
        max_iter=10_000,        # Max iteration bound
        print_step=25,          # Print at multiples
        verbose=False):
    x = x_0
    error = tolerance + 1
    k = 1
    while error > tolerance and k <= max_iter:
        x_new = T(x)
        error = jnp.max(jnp.abs(x_new - x))
        if verbose and k % print_step == 0:
            print(f"Completed iteration {k} with error {error}.")
        x = x_new
        k += 1
    if error > tolerance:
        print(f"Warning: Iteration hit upper bound {max_iter}.")
    elif verbose:
        print(f"Terminated successfully in {k} iterations.")
    return x

```

```

@jax.jit
def demand_pdf(p, d):
    return (1 - p)**d * p

```

```

K = 100
D_MAX = 101

```

Let's define a function to create an inventory model using the given parameters.

```

def create_sdd_inventory_model(
    p=0.98, v=0.002, n_z=100, b=0.97,          # Z state parameters
    c=0.2, κ=0.8, p=0.6,                      # firm and demand parameters
    use_jax=True):
    mc = qe.tauchen(n_z, ρ, v)
    z_vals, Q = mc.state_values + b, mc.P
    if use_jax:
        z_vals, Q = map(jnp.array, (z_vals, Q))
    return Model(c=c, κ=κ, p=p, z_vals=z_vals, Q=Q)

```

Here's the function B on the right-hand side of the Bellman equation.

```

@jax.jit
def B(x, i_z, a, v, model):
    """
    The function  $B(x, z, a, v) = r(x, a) + \beta(z) \mathbb{E}_{x'} v(x') P(x, a, x')$ .
    """
    c, κ, p, z_vals, Q = model
    z = z_vals[i_z]
    d_vals = jnp.arange(D_MAX)
    φ_vals = demand_pdf(p, d_vals)
    revenue = jnp.sum(jnp.minimum(x, d_vals)*φ_vals)
    profit = revenue - c * a - κ * (a > 0)
    v_R = jnp.sum(v[jnp.maximum(x - d_vals, 0) + a].T * φ_vals, axis=1)
    cv = jnp.sum(v_R*Q[i_z])

```

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```
return profit + z * cv
```

We need to vectorize this function so that we can use it efficiently in JAX.

We apply a sequence of `vmap` operations to vectorize appropriately in each argument.

```
B_vec_a = jax.vmap(B, in_axes=(None, None, 0, None, None))
```

```
@jax.jit
def B2(x, i_z, v, model):
    """
    The function  $B(x, z, a, v) = r(x, a) + \beta(z) \sum_{x'} v(x') P(x, a, x')$ .
    """
    c, κ, p, z_vals, Q = model
    a_vals = jnp.arange(K)
    res = B_vec_a(x, i_z, a_vals, v, model)
    return jnp.where(a_vals < K - x + 1, res, -jnp.inf)
```

```
B2_vec_z = jax.vmap(B2, in_axes=(None, 0, None, None))
B2_vec_z_x = jax.vmap(B2_vec_z, in_axes=(0, None, None, None))
```

Next we define the Bellman operator.

```
@jax.jit
def T(v, model):
    """The Bellman operator."""
    c, κ, p, z_vals, Q = model
    i_z_range = jnp.arange(len(z_vals))
    x_range = jnp.arange(K + 1)
    res = B2_vec_z_x(x_range, i_z_range, v, model)
    return jnp.max(res, axis=2)
```

The following function computes a v-greedy policy.

```
@jax.jit
def get_greedy(v, model):
    """Get a v-greedy policy. Returns a zero-based array."""
    c, κ, p, z_vals, Q = model
    i_z_range = jnp.arange(len(z_vals))
    x_range = jnp.arange(K + 1)
    res = B2_vec_z_x(x_range, i_z_range, v, model)
    return jnp.argmax(res, axis=2)
```

Here's code to solve the model using value function iteration.

```
def solve_inventory_model(v_init, model):
    """Use successive_approx to get v_star and then compute greedy."""
    v_star = successive_approx(lambda v: T(v, model), v_init, verbose=True)
    σ_star = get_greedy(v_star, model)
    return v_star, σ_star
```

Now let's create an instance and solve it.

```

model = create_sdd_inventory_model()
c, k, p, z_vals, Q = model
n_z = len(z_vals)
v_init = jnp.zeros((K + 1, n_z), dtype=float)

```

```

in_time = time.time()
v_star, sigma_star = solve_inventory_model(v_init, model)
jax_time = time.time() - in_time

```

```

Completed iteration 25 with error 0.5613828428334706.
Completed iteration 50 with error 0.3776464347688062.
Completed iteration 75 with error 0.2272706235969011.
Completed iteration 100 with error 0.12872204940708798.
Completed iteration 125 with error 0.06744149371262154.

```

```

Completed iteration 150 with error 0.030374639547666504.
Completed iteration 175 with error 0.01423099032950148.
Completed iteration 200 with error 0.007396776219316337.
Completed iteration 225 with error 0.003912238304586424.
Completed iteration 250 with error 0.0020680914166604225.

```

```

Completed iteration 275 with error 0.001092307533355097.
Completed iteration 300 with error 0.0005766427105982075.
Completed iteration 325 with error 0.0003043321707139057.
Completed iteration 350 with error 0.0001605907367547843.
Completed iteration 375 with error 8.473334524694565e-05.

```

```

Completed iteration 400 with error 4.4706045166265085e-05.
Completed iteration 425 with error 2.3586619946058818e-05.
Completed iteration 450 with error 1.2443945941242873e-05.
Completed iteration 475 with error 6.565178331641164e-06.
Completed iteration 500 with error 3.463639430378862e-06.
Completed iteration 525 with error 1.827332347659194e-06.

```

```

Terminated successfully in 550 iterations.

```

```

z_mc = qe.MarkovChain(Q, z_vals)

```

```

def sim_inventories(ts_length, X_init=0):
    """Simulate given the optimal policy."""
    global p, z_mc
    i_z = z_mc.simulate_indices(ts_length, init=1)
    X = np.zeros(ts_length, dtype=np.int32)
    X[0] = X_init
    rand = np.random.default_rng().geometric(p=p, size=ts_length-1) - 1
    for t in range(ts_length-1):
        X[t+1] = np.maximum(X[t] - rand[t], 0) + sigma_star[X[t], i_z[t]]
    return X, z_vals[i_z]

```

```

def plot_ts(ts_length=400, fontsize=10):
    X, Z = sim_inventories(ts_length)
    fig, axes = plt.subplots(2, 1, figsize=(9, 5.5))

    ax = axes[0]
    ax.plot(X, label=r"$X_t$", alpha=0.7)
    ax.set_xlabel(r"$t$", fontsize=fontsize)
    ax.set_ylabel("inventory", fontsize=fontsize)
    ax.legend(fontsize=fontsize, frameon=False)
    ax.set_ylim(0, np.max(X)+3)

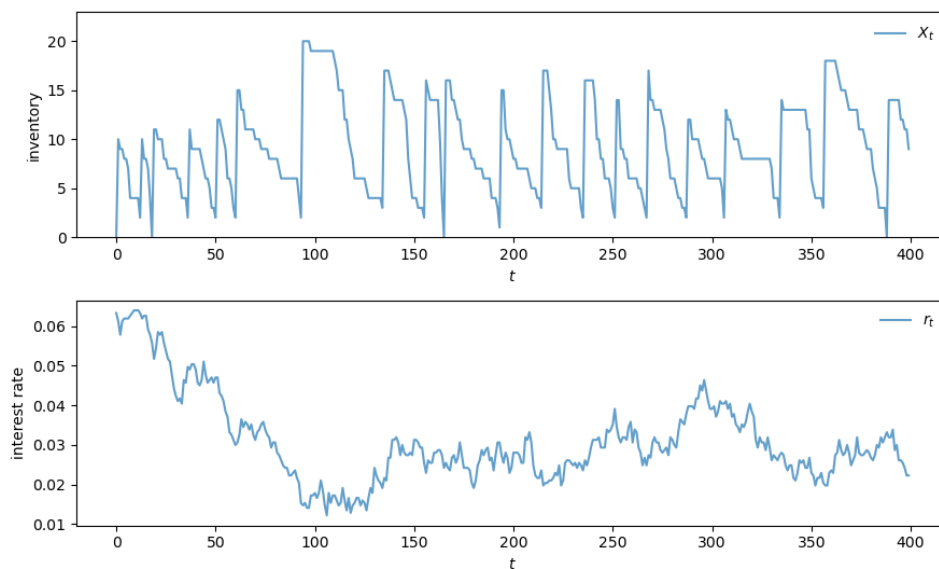
    # calculate interest rate from discount factors
    r = (1 / Z) - 1

    ax = axes[1]
    ax.plot(r, label=r"$r_t$", alpha=0.7)
    ax.set_xlabel(r"$t$", fontsize=fontsize)
    ax.set_ylabel("interest rate", fontsize=fontsize)
    ax.legend(fontsize=fontsize, frameon=False)

    plt.tight_layout()
    plt.show()

```

```
plot_ts()
```



## 14.3 Numba implementation

Let's try the same operations in Numba in order to compare the speed.

```

@njit
def demand_pdf_numba(p, d):
    return (1 - p)**d * p

@njit
def B_numba(x, i_z, a, v, model):
    """
    The function  $B(x, z, a, v) = r(x, a) + \beta(z) \sum_{x'} v(x') P(x, a, x')$ .
    """
    c, κ, p, z_vals, Q = model
    z = z_vals[i_z]
    d_vals = np.arange(D_MAX)
    φ_vals = demand_pdf_numba(p, d_vals)
    revenue = np.sum(np.minimum(x, d_vals) * φ_vals)
    profit = revenue - c * a - κ * (a > 0)
    v_R = np.sum(v[np.maximum(x - d_vals, 0) + a].T * φ_vals, axis=1)
    cv = np.sum(v_R * Q[i_z])
    return profit + z * cv

@njit(parallel=True)
def T_numba(v, model):
    """The Bellman operator."""
    c, κ, p, z_vals, Q = model
    new_v = np.empty_like(v)
    for i_z in prange(len(z_vals)):
        for x in prange(K+1):
            v_1 = np.array([B_numba(x, i_z, a, v, model)
                            for a in range(K-x+1)])
            new_v[x, i_z] = np.max(v_1)
    return new_v

@njit(parallel=True)
def get_greedy_numba(v, model):
    """Get a v-greedy policy. Returns a zero-based array."""
    c, κ, p, z_vals, Q = model
    n_z = len(z_vals)
    σ_star = np.zeros((K+1, n_z), dtype=np.int32)
    for i_z in prange(n_z):
        for x in range(K+1):
            v_1 = np.array([B_numba(x, i_z, a, v, model)
                            for a in range(K-x+1)])
            σ_star[x, i_z] = np.argmax(v_1)
    return σ_star

def solve_inventory_model_numba(v_init, model):
    """Use successive_approx to get v_star and then compute greedy."""
    v_star = successive_approx(lambda v: T_numba(v, model), v_init, verbose=True)
    σ_star = get_greedy_numba(v_star, model)
    return v_star, σ_star

```



```
model = create_sdd_inventory_model(use_jax=False)
c, k, p, z_vals, Q = model
n_z = len(z_vals)
v_init = np.zeros((K + 1, n_z), dtype=float)
```

```
in_time = time.time()
v_star_numba, sigma_star_numba = solve_inventory_model_numba(v_init, model)
nb_time = time.time() - in_time
```

Completed iteration 25 with error 0.5613828428334706.

Completed iteration 50 with error 0.37764643476879556.

Completed iteration 75 with error 0.22727062359689398.

Completed iteration 100 with error 0.12872204940708798.

Completed iteration 125 with error 0.06744149371262864.

Completed iteration 150 with error 0.030374639547666504.

Completed iteration 175 with error 0.01423099032948727.

Completed iteration 200 with error 0.007396776219316337.

Completed iteration 225 with error 0.003912238304593529.

Completed iteration 250 with error 0.002068091416653317.

Completed iteration 275 with error 0.0010923075333622023.

Completed iteration 300 with error 0.0005766427105911021.

Completed iteration 325 with error 0.0003043321707281166.

Completed iteration 350 with error 0.00016059073676188973.

Completed iteration 375 with error 8.473334525405107e-05.

Completed iteration 400 with error 4.470604518047594e-05.

Completed iteration 425 with error 2.3586619960269672e-05.

```
Completed iteration 450 with error 1.2443945934137446e-05.
```

```
Completed iteration 475 with error 6.565178331641164e-06.
```

```
Completed iteration 500 with error 3.4636394445897167e-06.
```

```
Completed iteration 525 with error 1.827332347659194e-06.
```

```
Terminated successfully in 550 iterations.
```

Let's verify that the Numba and JAX implementations converge to the same solution.

```
np.allclose(v_star_numba, v_star)
```

```
True
```

Here's the speed comparison.

```
print(f"JAX vectorized implementation is {nb_time/jax_time} faster "
      "than Numba's parallel implementation")
```

```
JAX vectorized implementation is 923.6138184282509 faster than Numba's parallel_
↳implementation
```

## ENDOGENOUS GRID METHOD

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

## 15.1 Overview

In this lecture we use the endogenous grid method (EGM) to solve a basic income fluctuation (optimal savings) problem.

Background on the endogenous grid method can be found in [an earlier QuantEcon lecture](#).

Here we focus on providing an efficient JAX implementation.

In addition to JAX and Anaconda, this lecture will need the following libraries:

```
!pip install --upgrade quantecon
```

```
import quantecon as qe
import matplotlib.pyplot as plt
import numpy as np
import jax
import jax.numpy as jnp
import numba
```

Let’s check the GPU we are running

```
!nvidia-smi
```

```
/opt/conda/envs/quantecon/lib/python3.11/pty.py:89: RuntimeWarning: os.fork() was
↳called. os.fork() is incompatible with multithreaded code, and JAX is
↳multithreaded, so this will likely lead to a deadlock.
  pid, fd = os.forkpty()
```

```
Thu May 2 01:56:31 2024
+-----+
| NVIDIA-SMI 470.182.03   Driver Version: 470.182.03   CUDA Version: 12.3   |
+-----+
| GPU  Name                Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp  Perf    Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                           MIG M.         |
+-----+-----+-----+-----+-----+-----+
|   0   Tesla V100-SXM2...    Off   | 00000000:00:1E:0  Off   |              0      |
| N/A   28C    P0     38W / 300W |  0MiB / 16160MiB |    2%      Default  |
|                                           |              N/A    |
+-----+-----+-----+-----+-----+

+-----+
| Processes:                                                       |
| GPU  GI    CI           PID  Type  Process name                        GPU Memory |
|                                           Usage |
+-----+-----+-----+-----+-----+
| No running processes found                                         |
+-----+
```

We use 64 bit floating point numbers for extra precision.

```
jax.config.update("jax_enable_x64", True)
```

## 15.2 Setup

We consider a household that chooses a state-contingent consumption plan  $\{c_t\}_{t \geq 0}$  to maximize

$$\mathbb{E} \sum_{t=0}^{\infty} \beta^t u(c_t)$$

subject to

$$a_{t+1} \leq R(a_t - c_t) + Y_{t+1}, \quad c_t \geq 0, \quad a_t \geq 0 \quad t = 0, 1, \dots$$

Here  $R = 1 + r$  where  $r$  is the interest rate.

The income process  $\{Y_t\}$  is a [Markov chain](#) generated by stochastic matrix  $P$ .

The matrix  $P$  and the grid of values taken by  $Y_t$  are obtained by discretizing the AR(1) process

$$Y_{t+1} = \rho Y_t + \nu \epsilon_{t+1}$$

where  $\{\epsilon_t\}$  is IID and standard normal.

Utility has the CRRA specification

$$u(c) = \frac{c^{1-\gamma}}{1-\gamma}$$

The following function stores default parameter values for the income fluctuation problem and creates suitable arrays.

```

def ifp(R=1.01,          # gross interest rate
       beta=0.99,      # discount factor
       gamma=1.5,      # CRRA preference parameter
       s_max=16,       # savings grid max
       s_size=200,     # savings grid size
       rho=0.99,       # income persistence
       v=0.02,         # income volatility
       y_size=25):    # income grid size

    # require R beta < 1 for convergence
    assert R * beta < 1, "Stability condition failed."
    # Create income Markov chain
    mc = qe.tauchen(y_size, rho, v)
    y_grid, P = jnp.exp(mc.state_values), mc.P
    # Shift to JAX arrays
    P, y_grid = jax.device_put((P, y_grid))
    s_grid = jnp.linspace(0, s_max, s_size)
    # Pack and return
    constants = beta, R, gamma
    sizes = s_size, y_size
    arrays = s_grid, y_grid, P
    return constants, sizes, arrays

```

## 15.3 Solution method

Let  $S = \mathbb{R}_+ \times \mathcal{Y}$  be the set of possible values for the state  $(a_t, Y_t)$ .

We aim to compute an optimal consumption policy  $\sigma^*: S \rightarrow \mathbb{R}$ , under which dynamics are given by

$$c_t = \sigma^*(a_t, Y_t) \quad \text{and} \quad a_{t+1} = R(a_t - c_t) + Y_{t+1}$$

In this section we discuss how we intend to solve for this policy.

### 15.3.1 Euler equation

The Euler equation for the optimization problem is

$$u'(c_t) = \max \{ \beta R \mathbb{E}_t u'(c_{t+1}), u'(a_t) \}$$

An explanation for this expression can be found [here](#).

We rewrite the Euler equation in functional form

$$(u' \circ \sigma)(a, y) = \max \{ \beta R \mathbb{E}_y (u' \circ \sigma) [R(a - \sigma(a, y)) + \hat{Y}, \hat{Y}], u'(a) \}$$

where  $(u' \circ \sigma)(a, y) := u'(\sigma(a, y))$  and  $\sigma$  is a consumption policy.

For given consumption policy  $\sigma$ , we define  $(K\sigma)(a, y)$  as the unique  $c \in [0, a]$  that solves

$$u'(c) = \max \{ \beta R \mathbb{E}_y (u' \circ \sigma) [R(a - c) + \hat{Y}, \hat{Y}], u'(a) \} \quad (15.1)$$

It can be shown that

1. iterating with  $K$  computes an optimal policy and

2. if  $\sigma$  is increasing in its first argument, then so is  $K\sigma$

Hence below we always assume that  $\sigma$  is increasing in its first argument.

The EGM is a technique for computing the update  $K\sigma$  given  $\sigma$  along a grid of asset values.

Notice that, since  $u'(a) \rightarrow \infty$  as  $a \downarrow 0$ , the second term in the max in (15.3.1) dominates for sufficiently small  $a$ .

Also, again using (15.3.1), we have  $c = a$  for all such  $a$ .

Hence, for sufficiently small  $a$ ,

$$u'(a) \geq \beta R \mathbb{E}_y(u' \circ \sigma) [\hat{Y}, \hat{Y}]$$

Equality holds at  $\bar{a}(y)$  given by

$$\bar{a}(y) = (u')^{-1} \left\{ \beta R \mathbb{E}_y(u' \circ \sigma) [\hat{Y}, \hat{Y}] \right\}$$

We can now write

$$u'(c) = \begin{cases} \beta R \mathbb{E}_y(u' \circ \sigma) [R(a - c) + \hat{Y}, \hat{Y}] & \text{if } a > \bar{a}(y) \\ u'(a) & \text{if } a \leq \bar{a}(y) \end{cases}$$

Equivalently, we can state that the  $c$  satisfying  $c = (K\sigma)(a, y)$  obeys

$$c = \begin{cases} (u')^{-1} \left\{ \beta R \mathbb{E}_y(u' \circ \sigma) [R(a - c) + \hat{Y}, \hat{Y}] \right\} & \text{if } a > \bar{a}(y) \\ a & \text{if } a \leq \bar{a}(y) \end{cases} \quad (15.2)$$

We begin with an *exogenous* grid of saving values  $0 = s_0 < \dots < s_{N-1}$

Using the exogenous savings grid, and a fixed value of  $y$ , we create an *endogenous* asset grid  $a_0, \dots, a_{N-1}$  and a consumption grid  $c_0, \dots, c_{N-1}$  as follows.

First we set  $a_0 = c_0 = 0$ , since zero consumption is an optimal (in fact the only) choice when  $a = 0$ .

Then, for  $i > 0$ , we compute

$$c_i = (u')^{-1} \left\{ \beta R \mathbb{E}_y(u' \circ \sigma) [Rs_i + \hat{Y}, \hat{Y}] \right\} \quad \text{for all } i \quad (15.3)$$

and we set

$$a_i = s_i + c_i$$

We claim that each pair  $a_i, c_i$  obeys (15.3.2).

Indeed, since  $s_i > 0$ , choosing  $c_i$  according to (15.3.3) gives

$$c_i = (u')^{-1} \left\{ \beta R \mathbb{E}_y(u' \circ \sigma) [Rs_i + \hat{Y}, \hat{Y}] \right\} \geq \bar{a}(y)$$

where the inequality uses the fact that  $\sigma$  is increasing in its first argument.

If we now take  $a_i = s_i + c_i$  we get  $a_i > \bar{a}(y)$ , so the pair  $(a_i, c_i)$  satisfies

$$c_i = (u')^{-1} \left\{ \beta R \mathbb{E}_y(u' \circ \sigma) [R(a_i - c_i) + \hat{Y}, \hat{Y}] \right\} \quad \text{and} \quad a_i > \bar{a}(y)$$

Hence (15.3.2) holds.

We are now ready to iterate with  $K$ .

### 15.3.2 JAX version

First we define a vectorized operator  $K$  based on the EGM.

Notice in the code below that

- we avoid all loops and any mutation of arrays
- the function is pure (no globals, no mutation of inputs)

```
def K_egm(a_in,  $\sigma$ _in, constants, sizes, arrays):
    """
    The vectorized operator  $K$  using EGM.
    """

    # Unpack
     $\beta$ , R,  $\gamma$  = constants
    s_size, y_size = sizes
    s_grid, y_grid, P = arrays

    def u_prime(c):
        return c**(- $\gamma$ )

    def u_prime_inv(u):
        return u**(-1/ $\gamma$ )

    # Linearly interpolate  $\sigma(a, y)$ 
    def  $\sigma$ (a, y):
        return jnp.interp(a, a_in[:, y],  $\sigma$ _in[:, y])
     $\sigma$ _vec = jnp.vectorize( $\sigma$ )

    # Broadcast and vectorize
    y_hat = jnp.reshape(y_grid, (1, 1, y_size))
    y_hat_idx = jnp.reshape(jnp.arange(y_size), (1, 1, y_size))
    s = jnp.reshape(s_grid, (s_size, 1, 1))
    P = jnp.reshape(P, (1, y_size, y_size))

    # Evaluate consumption choice
    a_next = R * s + y_hat
     $\sigma$ _next =  $\sigma$ _vec(a_next, y_hat_idx)
    up = u_prime( $\sigma$ _next)
    E = jnp.sum(up * P, axis=-1)
    c = u_prime_inv( $\beta$  * R * E)

    # Set up a column vector with zero in the first row and ones elsewhere
    e_0 = jnp.ones(s_size) - jnp.identity(s_size)[:, 0]
    e_0 = jnp.reshape(e_0, (s_size, 1))

    # The policy is computed consumption with the first row set to zero
     $\sigma$ _out = c * e_0

    # Compute a_out by  $a = s + c$ 
    a_out = np.reshape(s_grid, (s_size, 1)) +  $\sigma$ _out

    return a_out,  $\sigma$ _out
```

Then we use `jax.jit` to compile  $K$ .

We use `static_argnums` to allow a recompile whenever sizes changes, since the compiler likes to specialize on

shapes.

```
K_egm_jax = jax.jit(K_egm, static_argnums=(3,))
```

Next we define a successive approximator that repeatedly applies  $K$ .

```
def successive_approx_jax(model,
                          tol=1e-5,
                          max_iter=100_000,
                          verbose=True,
                          print_skip=25):

    # Unpack
    constants, sizes, arrays = model
    beta, R, y = constants
    s_size, y_size = sizes
    s_grid, y_grid, P = arrays

    # Initial condition is to consume all in every state
    sigma_init = jnp.repeat(s_grid, y_size)
    sigma_init = jnp.reshape(sigma_init, (s_size, y_size))
    a_init = jnp.copy(sigma_init)
    a_vec, sigma_vec = a_init, sigma_init

    i = 0
    error = tol + 1

    while i < max_iter and error > tol:
        a_new, sigma_new = K_egm_jax(a_vec, sigma_vec, constants, sizes, arrays)
        error = jnp.max(jnp.abs(sigma_vec - sigma_new))
        i += 1
        if verbose and i % print_skip == 0:
            print(f"Error at iteration {i} is {error}.")
            a_vec, sigma_vec = jnp.copy(a_new), jnp.copy(sigma_new)

    if error > tol:
        print("Failed to converge!")
    else:
        print(f"\nConverged in {i} iterations.")

    return a_new, sigma_new
```

### 15.3.3 Numba version

Below we provide a second set of code, which solves the same model with Numba.

The purpose of this code is to cross-check our results from the JAX version, as well as to do a runtime comparison.

Most readers will want to skip ahead to the next section, where we solve the model and run the cross-check.

```
@numba.jit
def K_egm_nb(a_in, sigma_in, constants, sizes, arrays):
    """
    The operator K using Numba.

    """
```

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```

# Simplify names
β, R, γ = constants
s_size, y_size = sizes
s_grid, y_grid, P = arrays

def u_prime(c):
    return c**(-γ)

def u_prime_inv(u):
    return u**(-1/γ)

# Linear interpolation of policy using endogenous grid
def σ(a, z):
    return np.interp(a, a_in[:, z], σ_in[:, z])

# Allocate memory for new consumption array
σ_out = np.zeros_like(σ_in)
a_out = np.zeros_like(σ_out)

for i, s in enumerate(s_grid[1:]):
    i += 1
    for z in range(y_size):
        expect = 0.0
        for z_hat in range(y_size):
            expect += u_prime(σ(R * s + y_grid[z_hat], z_hat)) * \
                P[z, z_hat]
        c = u_prime_inv(β * R * expect)
        σ_out[i, z] = c
        a_out[i, z] = s + c

return a_out, σ_out

```

```

def successive_approx_numba(model, # Class with model information
                            tol=1e-5,
                            max_iter=100_000,
                            verbose=True,
                            print_skip=25):

    # Unpack
    constants, sizes, arrays = model
    s_size, y_size = sizes
    # make NumPy versions of arrays
    arrays = tuple(map(np.array, arrays))
    s_grid, y_grid, P = arrays

    σ_init = np.repeat(s_grid, y_size)
    σ_init = np.reshape(σ_init, (s_size, y_size))
    a_init = np.copy(σ_init)
    a_vec, σ_vec = a_init, σ_init

    # Set up loop
    i = 0
    error = tol + 1

```

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```

while i < max_iter and error > tol:
    a_new,  $\sigma$ _new = K_egm_nb(a_vec,  $\sigma$ _vec, constants, sizes, arrays)
    error = np.max(np.abs( $\sigma$ _vec -  $\sigma$ _new))
    i += 1
    if verbose and i % print_skip == 0:
        print(f"Error at iteration {i} is {error}.")
    a_vec,  $\sigma$ _vec = np.copy(a_new), np.copy( $\sigma$ _new)

if error > tol:
    print("Failed to converge!")
else:
    print(f"\nConverged in {i} iterations.")

return a_new,  $\sigma$ _new

```

## 15.4 Solutions

Here we solve the IFP with JAX and Numba.

We will compare both the outputs and the execution time.

### 15.4.1 Outputs

```
model = ifp()
```

Here's a first run of the JAX code.

```
a_star_egm_jax,  $\sigma$ _star_egm_jax = successive_approx_jax(model,
                                                         print_skip=100)
```

```
Error at iteration 100 is 0.003274240577000098.
Error at iteration 200 is 0.0013133107388259013.
```

```
Error at iteration 300 is 0.0006550972250753961.
Error at iteration 400 is 0.00038003859326907197.
```

```
Error at iteration 500 is 0.00024736616926013255.
Error at iteration 600 is 0.00017446354504913053.
```

```
Error at iteration 700 is 0.000129892015863442.
Error at iteration 800 is 0.00010058769447773841.
```

```
Error at iteration 900 is 7.993256952376626e-05.
Error at iteration 1000 is 6.472028596182788e-05.
```

```
Error at iteration 1100 is 5.316228631624398e-05.
Error at iteration 1200 is 4.425450893941196e-05.
```

```
Error at iteration 1300 is 3.7260418253914906e-05.
Error at iteration 1400 is 3.1614060126861077e-05.
```

```
Error at iteration 1500 is 2.6984975752375462e-05.
Error at iteration 1600 is 2.3148392509719784e-05.
```

```
Error at iteration 1700 is 1.9940474091262317e-05.
Error at iteration 1800 is 1.723818132703947e-05.
```

```
Error at iteration 1900 is 1.4947303633494613e-05.
Error at iteration 2000 is 1.2994575430580468e-05.
```

```
Error at iteration 2100 is 1.132223596411741e-05.
```

```
Converged in 2192 iterations.
```

Next let's solve the same IFP with Numba.

```
qe.tic()
a_star_egm_nb,  $\sigma$ _star_egm_nb = successive_approx_numba(model,
                                                             print_skip=100)
qe.toc()
```

```
Error at iteration 100 is 0.0032742405770003202.
```

```
Error at iteration 200 is 0.0013133107388259013.
```

```
Error at iteration 300 is 0.0006550972250753961.
```

```
Error at iteration 400 is 0.0003800385932688499.
```

```
Error at iteration 500 is 0.00024736616926013255.
```

```
Error at iteration 600 is 0.00017446354504935258.
```

```
Error at iteration 700 is 0.000129892015863442.
```

```
Error at iteration 800 is 0.00010058769447773841.
```

```
Error at iteration 900 is 7.993256952354422e-05.
```

```
Error at iteration 1000 is 6.472028596182788e-05.
```

```
Error at iteration 1100 is 5.316228631624398e-05.
```

```
Error at iteration 1200 is 4.425450893941196e-05.
```

```
Error at iteration 1300 is 3.7260418253914906e-05.
```

```
Error at iteration 1400 is 3.1614060126861077e-05.
```

```
Error at iteration 1500 is 2.6984975752597506e-05.
```

```
Error at iteration 1600 is 2.3148392509719784e-05.
```

```
Error at iteration 1700 is 1.9940474091262317e-05.
```

```
Error at iteration 1800 is 1.7238181326817426e-05.
```

```
Error at iteration 1900 is 1.4947303633494613e-05.
```

```
Error at iteration 2000 is 1.2994575430802513e-05.
```

```
Error at iteration 2100 is 1.132223596411741e-05.
```

```
Converged in 2192 iterations.  
TOC: Elapsed: 0:01:21.14
```

```
81.14271950721741
```

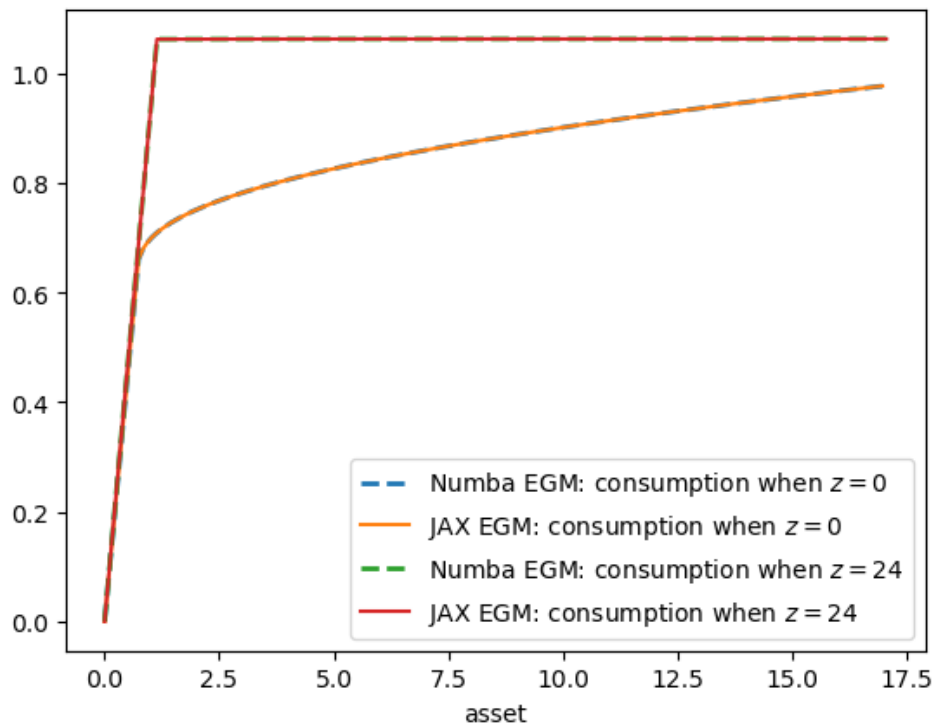
Now let's check the outputs in a plot to make sure they are the same.

```
constants, sizes, arrays = model
β, R, γ = constants
s_size, y_size = sizes
s_grid, y_grid, P = arrays

fig, ax = plt.subplots()

for z in (0, y_size-1):
    ax.plot(a_star_egm_nb[:, z],
            σ_star_egm_nb[:, z],
            '--', lw=2,
            label=f"Numba EGM: consumption when $z={z}$")
    ax.plot(a_star_egm_jax[:, z],
            σ_star_egm_jax[:, z],
            label=f"JAX EGM: consumption when $z={z}$")

ax.set_xlabel('asset')
plt.legend()
plt.show()
```



## 15.4.2 Timing

Now let's compare execution time of the two methods

```
qe.tic()
a_star_egm_jax, sigma_star_egm_jax = successive_approx_jax(model,
                                                         print_skip=1000)
jax_time = qe.toc()
```

```
Error at iteration 1000 is 6.472028596182788e-05.
```

```
Error at iteration 2000 is 1.2994575430580468e-05.
```

```
Converged in 2192 iterations.
TOC: Elapsed: 0:00:3.61
```

```
qe.tic()
a_star_egm_nb, sigma_star_egm_nb = successive_approx_numba(model,
                                                           print_skip=1000)
numba_time = qe.toc()
```

```
Error at iteration 1000 is 6.472028596182788e-05.
```

```
Error at iteration 2000 is 1.2994575430802513e-05.
```

```
Converged in 2192 iterations.  
TOC: Elapsed: 0:01:18.11
```

```
jax_time / numba_time
```

```
0.04631337127101406
```

The JAX code is significantly faster, as expected.

This difference will increase when more features (and state variables) are added to the model.



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```

=====+=====+=====+
| 0 Tesla V100-SXM2... Off | 00000000:00:1E.0 Off | 0 | | | |
| N/A 28C P0 38W / 300W | 0MiB / 16160MiB | 2% Default |
| | | | | | N/A |
+-----+-----+-----+

+-----+
| Processes: |
| GPU GI CI PID Type Process name GPU Memory |
| ID ID | Usage |
+-----+
| No running processes found |
+-----+

```

## 16.1 Reviewing the Model

Recall in particular that the Bellman equation is

$$v(x) = \max_{0 \leq c \leq x} \{u(c) + \beta v(x - c)\} \quad \text{for all } x \geq 0. \quad (16.1)$$

where  $u$  is the CRRA utility function.

## 16.2 Implementation using JAX

The analytical solutions for the value function and optimal policy were found to be as follows.

```

@jax.jit
def c_star(x, beta, gamma):
    return (1 - beta ** (1/gamma)) * x

@jax.jit
def v_star(x, beta, gamma):
    return (1 - beta**(1 / gamma))**(-gamma) * (x**(1-gamma) / (1-gamma))

```

Let's define a model to represent the Cake Eating Problem.

```

CEM = namedtuple('CakeEatingModel',
                 ('beta', 'gamma', 'x_grid', 'c_grid'))

```

```

def create_cake_eating_model(beta=0.96,          # discount factor
                             gamma=1.5,         # degree of relative risk aversion
                             x_grid_min=1e-3,   # exclude zero for numerical stability
                             x_grid_max=2.5,    # size of cake
                             x_grid_size=200):
    x_grid = jnp.linspace(x_grid_min, x_grid_max, x_grid_size)

    # c_grid used for finding maximize function values using brute force
    c_grid = jnp.linspace(x_grid_min, x_grid_max, 100*x_grid_size)
    return CEM(beta=beta, gamma=gamma, x_grid=x_grid, c_grid=c_grid)

```

Now let's define the CRRA utility function.



```
# Utility function
@jax.jit
def u(c, cem):
    return (c ** (1 - cem.γ)) / (1 - cem.γ)
```

## 16.2.1 The Bellman Operator

We introduce the **Bellman operator**  $T$  that takes a function  $v$  as an argument and returns a new function  $Tv$  defined by

$$Tv(x) = \max_{0 \leq c \leq x} \{u(c) + \beta v(x - c)\}$$

From  $v$  we get  $Tv$ , and applying  $T$  to this yields  $T^2v := T(Tv)$  and so on.

This is called **iterating with the Bellman operator** from initial guess  $v$ .

```
@jax.jit
def state_action_value(x, c, v_array, ce):
    """
    Right hand side of the Bellman equation given x and c.
    * x: scalar element `x`
    * c: c_grid, 1-D array
    * v_array: value function array guess, 1-D array
    * ce: Cake Eating Model instance
    """

    return jnp.where(c <= x,
                     u(c, ce) + ce.β * jnp.interp(x - c, ce.x_grid, v_array),
                     -jnp.inf)
```

In order to create a vectorized function using `state_action_value`, we use `jax.vmap`. This function returns a new vectorized version of the above function which is vectorized on the argument  $x$ .

```
state_action_value_vec = jax.vmap(state_action_value, (0, None, None, None))
```

```
@jax.jit
def T(v, ce):
    """
    The Bellman operator. Updates the guess of the value function.

    * ce: Cake Eating Model instance
    * v: value function array guess, 1-D array

    """
    return jnp.max(state_action_value_vec(ce.x_grid, ce.c_grid, v, ce), axis=1)
```

Let's start by creating a Cake Eating Model instance using the default parameterization.

```
ce = create_cake_eating_model()
```

Now let's see the iteration of the value function in action.

We start from guess  $v$  given by  $v(x) = u(x)$  for every  $x$  grid point.

```

x_grid = ce.x_grid
v = u(x_grid, ce)      # Initial guess
n = 12                 # Number of iterations

fig, ax = plt.subplots()

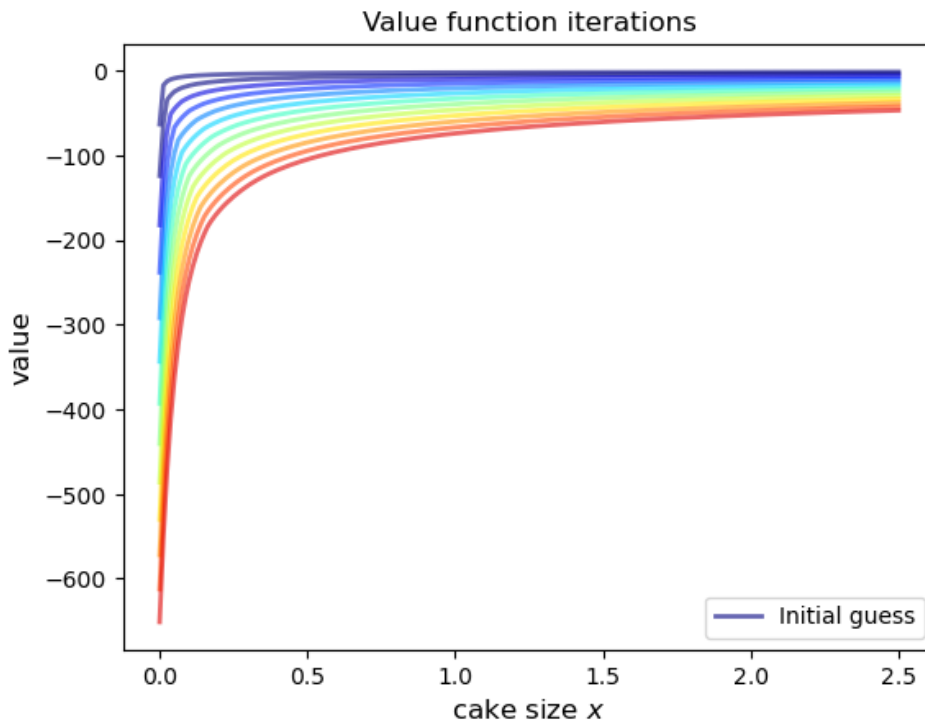
ax.plot(x_grid, v, color=plt.cm.jet(0),
        lw=2, alpha=0.6, label='Initial guess')

for i in range(n):
    v = T(v, ce) # Apply the Bellman operator
    ax.plot(x_grid, v, color=plt.cm.jet(i / n), lw=2, alpha=0.6)

ax.legend()
ax.set_ylabel('value', fontsize=12)
ax.set_xlabel('cake size $x$', fontsize=12)
ax.set_title('Value function iterations')

plt.show()

```



Let's introduce a wrapper function called `compute_value_function` that iterates until some convergence conditions are satisfied.

```

def compute_value_function(ce,
                           tol=1e-4,
                           max_iter=1000,
                           verbose=True,
                           print_skip=25):

    # Set up loop

```

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```

v = jnp.zeros(len(ce.x_grid)) # Initial guess
i = 0
error = tol + 1

while i < max_iter and error > tol:
    v_new = T(v, ce)

    error = jnp.max(jnp.abs(v - v_new))
    i += 1

    if verbose and i % print_skip == 0:
        print(f"Error at iteration {i} is {error}.")

    v = v_new

if error > tol:
    print("Failed to converge!")
elif verbose:
    print(f"\nConverged in {i} iterations.")

return v_new

```

```

in_time = time.time()
v_jax = compute_value_function(ce)
jax_time = time.time() - in_time

```

```

Error at iteration 25 is 23.74322509765625.
Error at iteration 50 is 8.5570068359375.
Error at iteration 75 is 3.083984375.

```

```

Error at iteration 100 is 1.11151123046875.
Error at iteration 125 is 0.40069580078125.
Error at iteration 150 is 0.14447021484375.

```

```

Error at iteration 175 is 0.0521240234375.
Error at iteration 200 is 0.01885986328125.
Error at iteration 225 is 0.006866455078125.

```

```

Error at iteration 250 is 0.0025634765625.
Error at iteration 275 is 0.0009765625.
Error at iteration 300 is 0.00048828125.

```

```

Error at iteration 325 is 0.000244140625.
Error at iteration 350 is 0.0001220703125.

```

```

Converged in 351 iterations.

```

```

fig, ax = plt.subplots()

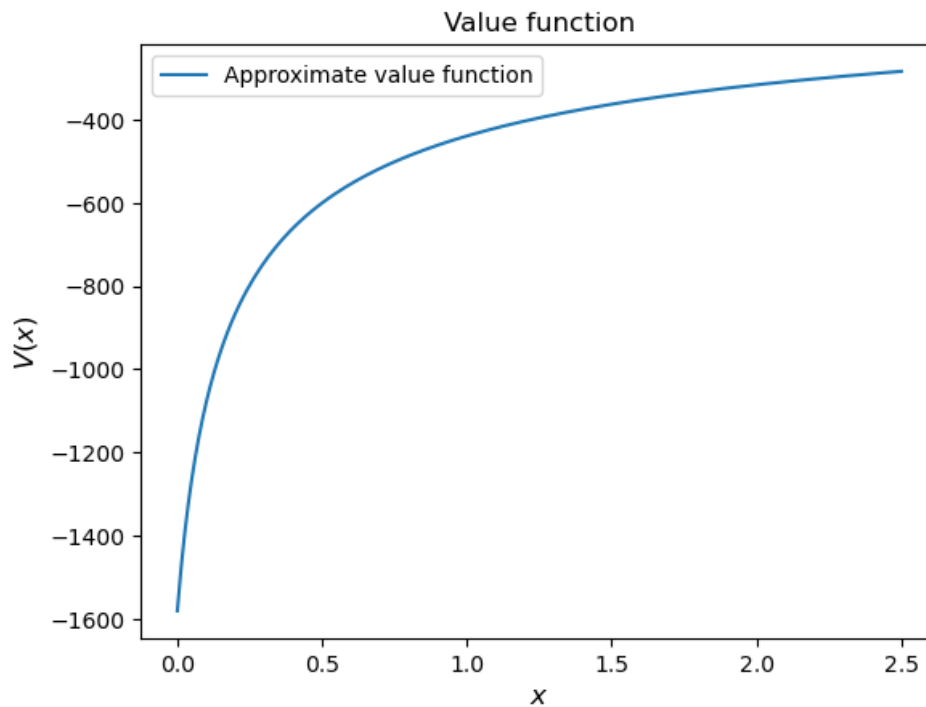
ax.plot(x_grid, v_jax, label='Approximate value function')
ax.set_ylabel('$V(x)$', fontsize=12)

```

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```
ax.set_xlabel('$x$', fontsize=12)
ax.set_title('Value function')
ax.legend()
plt.show()
```

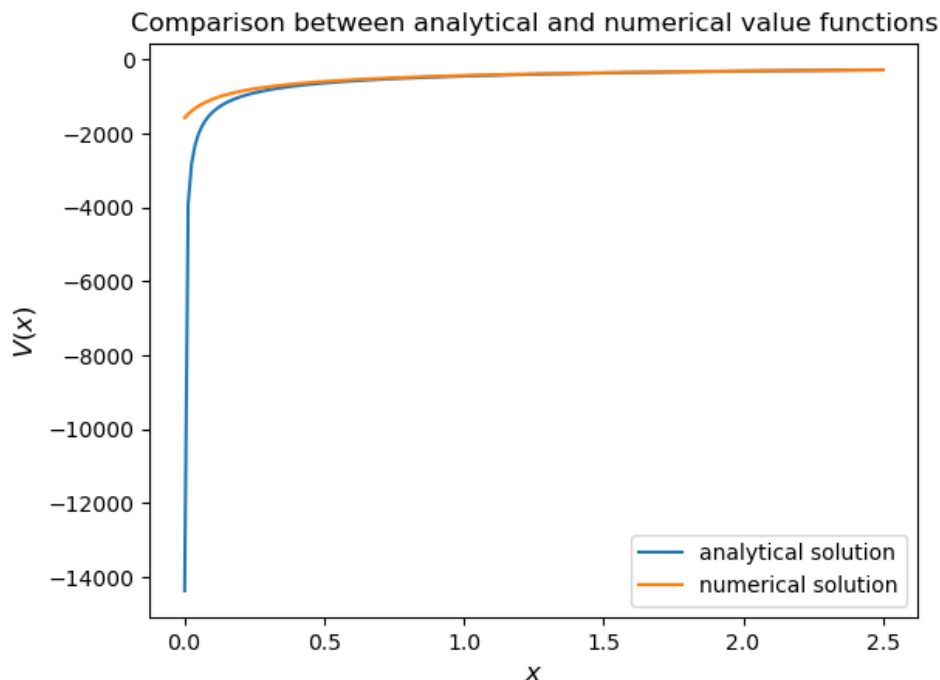


Next let's compare it to the analytical solution.

```
v_analytical = v_star(ce.x_grid, ce.β, ce.y)
```

```
fig, ax = plt.subplots()

ax.plot(x_grid, v_analytical, label='analytical solution')
ax.plot(x_grid, v_jax, label='numerical solution')
ax.set_ylabel('$V(x)$', fontsize=12)
ax.set_xlabel('$x$', fontsize=12)
ax.legend()
ax.set_title('Comparison between analytical and numerical value functions')
plt.show()
```



## 16.2.2 Policy Function

Recall that the optimal consumption policy was shown to be

$$\sigma^*(x) = (1 - \beta^{1/\gamma}) x$$

Let's see if our numerical results lead to something similar.

Our numerical strategy will be to compute

$$\sigma(x) = \arg \max_{0 \leq c \leq x} \{u(c) + \beta v(x - c)\}$$

on a grid of  $x$  points and then interpolate.

For  $v$  we will use the approximation of the value function we obtained above.

Here's the function:

```
@jax.jit
def sigma(ce, v):
    """
    The optimal policy function. Given the value function,
    it finds optimal consumption in each state.

    * ce: Cake Eating Model instance
    * v: value function array guess, 1-D array

    """
    i_cs = jnp.argmax(state_action_value_vec(ce.x_grid, ce.c_grid, v, ce), axis=1)
    return ce.c_grid[i_cs]
```

Now let's pass the approximate value function and compute optimal consumption:

```
c = σ(ce, v_jax)
```

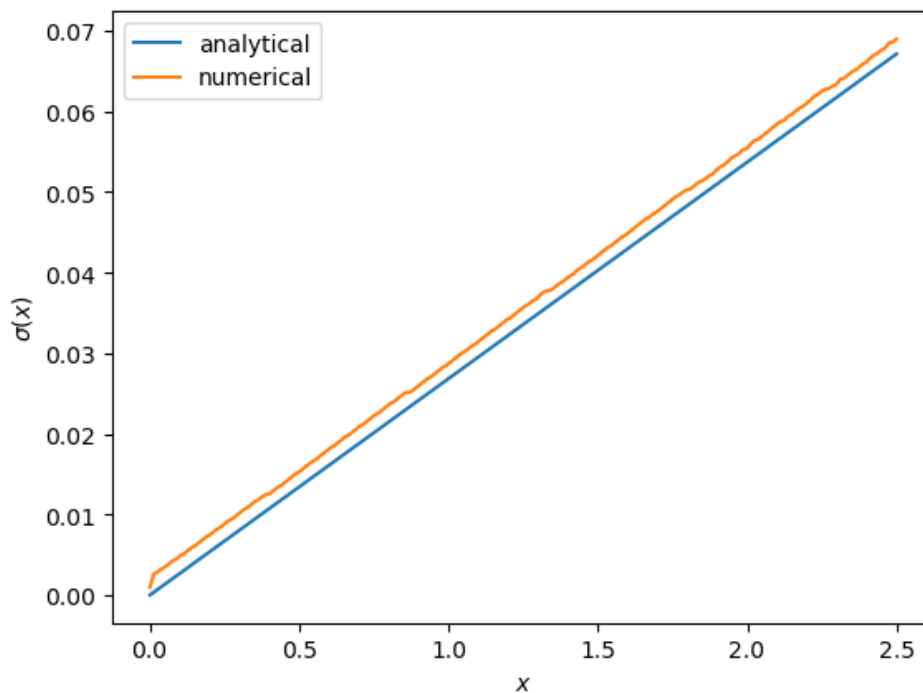
Let's plot this next to the true analytical solution

```
c_analytical = c_star(ce.x_grid, ce.β, ce.γ)

fig, ax = plt.subplots()

ax.plot(ce.x_grid, c_analytical, label='analytical')
ax.plot(ce.x_grid, c, label='numerical')
ax.set_ylabel(r'$\sigma(x)$')
ax.set_xlabel('$x$')
ax.legend()

plt.show()
```



## 16.3 Numba implementation

This section of the lecture is directly adapted from [this lecture](#) for the purpose of comparing the results of JAX implementation.

```
import numpy as np
from numba import prange, njit
from quantecon.optimize import brent_max
```

```
CEMN = namedtuple('CakeEatingModelNumba',
                 ('β', 'γ', 'x_grid'))
```

```

def create_cake_eating_model_numba( $\beta$ =0.96,          # discount factor
                                    $\gamma$ =1.5,          # degree of relative risk_
                                   ↪aversion
                                   x_grid_min=1e-3,    # exclude zero for numerical_
                                   ↪stability
                                   x_grid_max=2.5,     # size of cake
                                   x_grid_size=200):
    x_grid = np.linspace(x_grid_min, x_grid_max, x_grid_size)
    return CEMN( $\beta$ = $\beta$ ,  $\gamma$ = $\gamma$ , x_grid=x_grid)

```

```

# Utility function
@njit
def u_numba(c, cem):
    return (c ** (1 - cem. $\gamma$ )) / (1 - cem. $\gamma$ )

```

```

@njit
def state_action_value_numba(c, x, v_array, cem):
    """
    Right hand side of the Bellman equation given x and c.
    * x: scalar element `x`
    * c: consumption
    * v_array: value function array guess, 1-D array
    * cem: Cake Eating Numba Model instance
    """
    return u_numba(c, cem) + cem. $\beta$  * np.interp(x - c, cem.x_grid, v_array)

```

```

@njit
def T_numba(v, ce):
    """
    The Bellman operator. Updates the guess of the value function.

    * ce is an instance of CakeEatingNumba Model
    * v is an array representing a guess of the value function

    """
    v_new = np.empty_like(v)

    for i in prange(len(ce.x_grid)):
        # Maximize RHS of Bellman equation at state x
        v_new[i] = brent_max(state_action_value_numba, 1e-10, ce.x_grid[i],
                            args=(ce.x_grid[i], v, ce))[1]

    return v_new

```

```

def compute_value_function_numba(ce,
                                  tol=1e-4,
                                  max_iter=1000,
                                  verbose=True,
                                  print_skip=25):

    # Set up loop
    v = np.zeros(len(ce.x_grid)) # Initial guess
    i = 0
    error = tol + 1

```

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```

while i < max_iter and error > tol:
    v_new = T_numba(v, ce)

    error = np.max(np.abs(v - v_new))
    i += 1

    if verbose and i % print_skip == 0:
        print(f"Error at iteration {i} is {error}.")

    v = v_new

if error > tol:
    print("Failed to converge!")
elif verbose:
    print(f"\nConverged in {i} iterations.")

return v_new

```

```
cen = create_cake_eating_model_numba()
```

```

in_time = time.time()
v_np = compute_value_function_numba(cen)
numba_time = time.time() - in_time

```

```

Error at iteration 25 is 23.8003755134813.
Error at iteration 50 is 8.577577195046615.
Error at iteration 75 is 3.091330659691039.
Error at iteration 100 is 1.1141054204751981.
Error at iteration 125 is 0.4015199357729671.
Error at iteration 150 is 0.14470646660583952.
Error at iteration 175 is 0.05215173547298946.
Error at iteration 200 is 0.018795314243106986.

```

```

Error at iteration 225 is 0.006773769545986852.
Error at iteration 250 is 0.002441244305884993.
Error at iteration 275 is 0.0008798164334962166.
Error at iteration 300 is 0.00031708295477983484.
Error at iteration 325 is 0.00011427565664234862.

```

```
Converged in 329 iterations.
```

```

ratio = numba_time/jax_time
print(f"JAX implementation is {ratio} times faster than NumPy.")
print(f"JAX time: {jax_time}")
print(f"Numba time: {numba_time}")

```

```

JAX implementation is 2.678356913319815 times faster than NumPy.
JAX time: 1.1903409957885742
Numba time: 3.1881580352783203

```



## **Part V**

# **Macroeconomic Models**



## DEFAULT RISK AND INCOME FLUCTUATIONS

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

In addition to JAX and Anaconda, this lecture will need the following libraries:

```
!pip install quantecon
```

### 17.1 Overview

This lecture computes versions of Arellano’s [[Arellano, 2008](#)] model of sovereign default.

The model describes interactions among default risk, output, and an equilibrium interest rate that includes a premium for endogenous default risk.

The decision maker is a government of a small open economy that borrows from risk-neutral foreign creditors.

The foreign lenders must be compensated for default risk.

The government borrows and lends abroad in order to smooth the consumption of its citizens.

The government repays its debt only if it wants to, but declining to pay has adverse consequences.

The interest rate on government debt adjusts in response to the state-dependent default probability chosen by government.

The model yields outcomes that help interpret sovereign default experiences, including

- countercyclical interest rates on sovereign debt
- countercyclical trade balances
- high volatility of consumption relative to output

Notably, long recessions caused by bad draws in the income process increase the government’s incentive to default.

This can lead to

- spikes in interest rates
- temporary losses of access to international credit markets

- large drops in output, consumption, and welfare
- large capital outflows during recessions

Such dynamics are consistent with experiences of many countries.

Let's start with some imports:

```
import matplotlib.pyplot as plt
import quantecon as qe
import random

import jax
import jax.numpy as jnp
from collections import namedtuple
```

Let's check the GPU we are running

```
!nvidia-smi
```

```
/opt/conda/envs/quantecon/lib/python3.11/pty.py:89: RuntimeWarning: os.fork() was
↳called. os.fork() is incompatible with multithreaded code, and JAX is
↳multithreaded, so this will likely lead to a deadlock.
pid, fd = os.forkpty()
```

```
Thu May  2 01:51:52 2024
+-----+
| NVIDIA-SMI 470.182.03   Driver Version: 470.182.03   CUDA Version: 12.3   |
+-----+
| GPU   Name               Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp  Perf    Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                           | MIG M.         |
+-----+-----+
|    0   Tesla V100-SXM2...    Off      | 00000000:00:1E:00 Off |                    0 |
| N/A   28C    P0      38W / 300W |      0MiB / 16160MiB |      2%      Default |
|                                           | N/A            |
+-----+-----+
+-----+
| Processes:                                                       GPU Memory |
|  GPU   GI    CI          PID    Type   Process name                  Usage      |
|-----+-----+
| No running processes found                                         |
+-----+
```

We will use 64 bit floats with JAX in order to increase the precision.

```
jax.config.update("jax_enable_x64", True)
```

## 17.2 Structure

In this section we describe the main features of the model.

### 17.2.1 Output, Consumption and Debt

A small open economy is endowed with an exogenous stochastically fluctuating potential output stream  $\{y_t\}$ .

Potential output is realized only in periods in which the government honors its sovereign debt.

The output good can be traded or consumed.

The sequence  $\{y_t\}$  is described by a Markov process with stochastic density kernel  $p(y, y')$ .

Households within the country are identical and rank stochastic consumption streams according to

$$\mathbb{E} \sum_{t=0}^{\infty} \beta^t u(c_t) \quad (17.1)$$

Here

- $0 < \beta < 1$  is a time discount factor
- $u$  is an increasing and strictly concave utility function

Consumption sequences enjoyed by households are affected by the government's decision to borrow or lend internationally.

The government is benevolent in the sense that its aim is to maximize (17.1).

The government is the only domestic actor with access to foreign credit.

Because households are averse to consumption fluctuations, the government will try to smooth consumption by borrowing from (and lending to) foreign creditors.

### 17.2.2 Asset Markets

The only credit instrument available to the government is a one-period bond traded in international credit markets.

The bond market has the following features

- The bond matures in one period and is not state contingent.
- A purchase of a bond with face value  $B'$  is a claim to  $B'$  units of the consumption good next period.
- To purchase  $B'$  next period costs  $qB'$  now, or, what is equivalent.
- For selling  $-B'$  units of next period goods the seller earns  $-qB'$  of today's goods.
  - If  $B' < 0$ , then  $-qB'$  units of the good are received in the current period, for a promise to repay  $-B'$  units next period.
  - There is an equilibrium price function  $q(B', y)$  that makes  $q$  depend on both  $B'$  and  $y$ .

Earnings on the government portfolio are distributed (or, if negative, taxed) lump sum to households.

When the government is not excluded from financial markets, the one-period national budget constraint is

$$c = y + B - q(B', y)B' \quad (17.2)$$

Here and below, a prime denotes a next period value or a claim maturing next period.

To rule out Ponzi schemes, we also require that  $B \geq -Z$  in every period.

- $Z$  is chosen to be sufficiently large that the constraint never binds in equilibrium.

### 17.2.3 Financial Markets

Foreign creditors

- are risk neutral
- know the domestic output stochastic process  $\{y_t\}$  and observe  $y_t, y_{t-1}, \dots$ , at time  $t$
- can borrow or lend without limit in an international credit market at a constant international interest rate  $r$
- receive full payment if the government chooses to pay
- receive zero if the government defaults on its one-period debt due

When a government is expected to default next period with probability  $\delta$ , the expected value of a promise to pay one unit of consumption next period is  $1 - \delta$ .

Therefore, the discounted expected value of a promise to pay  $B$  next period is

$$q = \frac{1 - \delta}{1 + r} \quad (17.3)$$

Next we turn to how the government in effect chooses the default probability  $\delta$ .

### 17.2.4 Government's Decisions

At each point in time  $t$ , the government chooses between

1. defaulting
2. meeting its current obligations and purchasing or selling an optimal quantity of one-period sovereign debt

Defaulting means declining to repay all of its current obligations.

If the government defaults in the current period, then consumption equals current output.

But a sovereign default has two consequences:

1. Output immediately falls from  $y$  to  $h(y)$ , where  $0 \leq h(y) \leq y$ .
  - It returns to  $y$  only after the country regains access to international credit markets.
1. The country loses access to foreign credit markets.

### 17.2.5 Reentering International Credit Market

While in a state of default, the economy regains access to foreign credit in each subsequent period with probability  $\theta$ .

## 17.3 Equilibrium

Informally, an equilibrium is a sequence of interest rates on its sovereign debt, a stochastic sequence of government default decisions and an implied flow of household consumption such that

1. Consumption and assets satisfy the national budget constraint.
2. The government maximizes household utility taking into account
  - the resource constraint
  - the effect of its choices on the price of bonds

- consequences of defaulting now for future net output and future borrowing and lending opportunities
1. The interest rate on the government's debt includes a risk-premium sufficient to make foreign creditors expect on average to earn the constant risk-free international interest rate.

To express these ideas more precisely, consider first the choices of the government, which

1. enters a period with initial assets  $B$ , or what is the same thing, initial debt to be repaid now of  $-B$
2. observes current output  $y$ , and
3. chooses either
4. to default, or
5. to pay  $-B$  and set next period's debt due to  $-B'$

In a recursive formulation,

- state variables for the government comprise the pair  $(B, y)$
- $v(B, y)$  is the optimum value of the government's problem when at the beginning of a period it faces the choice of whether to honor or default
- $v_c(B, y)$  is the value of choosing to pay obligations falling due
- $v_d(y)$  is the value of choosing to default

$v_d(y)$  does not depend on  $B$  because, when access to credit is eventually regained, net foreign assets equal 0.

Expressed recursively, the value of defaulting is

$$v_d(y) = u(h(y)) + \beta \int \{\theta v(0, y') + (1 - \theta)v_d(y')\} p(y, y') dy'$$

The value of paying is

$$v_c(B, y) = \max_{B' \geq -Z} \left\{ u(y - q(B', y)B' + B) + \beta \int v(B', y') p(y, y') dy' \right\}$$

The three value functions are linked by

$$v(B, y) = \max\{v_c(B, y), v_d(y)\}$$

The government chooses to default when

$$v_c(B, y) < v_d(y)$$

and hence given  $B'$  the probability of default next period is

$$\delta(B', y) := \int \mathbb{1}\{v_c(B', y') < v_d(y')\} p(y, y') dy' \quad (17.4)$$

Given zero profits for foreign creditors in equilibrium, we can combine (17.3) and (17.4) to pin down the bond price function:

$$q(B', y) = \frac{1 - \delta(B', y)}{1 + r} \quad (17.5)$$

### 17.3.1 Definition of Equilibrium

An *equilibrium* is

- a pricing function  $q(B', y)$ ,
- a triple of value functions  $(v_c(B, y), v_d(y), v(B, y))$ ,
- a decision rule telling the government when to default and when to pay as a function of the state  $(B, y)$ , and
- an asset accumulation rule that, conditional on choosing not to default, maps  $(B, y)$  into  $B'$

such that

- The three Bellman equations for  $(v_c(B, y), v_d(y), v(B, y))$  are satisfied
- Given the price function  $q(B', y)$ , the default decision rule and the asset accumulation decision rule attain the optimal value function  $v(B, y)$ , and
- The price function  $q(B', y)$  satisfies equation (17.5)

## 17.4 Computation

Let's now compute an equilibrium of Arellano's model.

The equilibrium objects are the value function  $v(B, y)$ , the associated default decision rule, and the pricing function  $q(B', y)$ .

We'll use our code to replicate Arellano's results.

After that we'll perform some additional simulations.

We use a slightly modified version of the algorithm recommended by Arellano.

- The appendix to [Arellano, 2008] recommends value function iteration until convergence, updating the price, and then repeating.
- Instead, we update the bond price at every value function iteration step.

The second approach is faster and the two different procedures deliver very similar results.

Here is a more detailed description of our algorithm:

1. Guess a pair of non-default and default value functions  $v_c$  and  $v_d$ .
2. Using these functions, calculate the value function  $v$ , the corresponding default probabilities and the price function  $q$ .
3. At each pair  $(B, y)$ ,
4. update the value of defaulting  $v_d(y)$ .
5. update the value of remaining  $v_c(B, y)$ .
6. Check for convergence. If converged, stop – if not, go to step 2.

We use simple discretization on a grid of asset holdings and income levels.

The output process is discretized using a [quadrature method due to Tauchen](#).

As we have in other places, we accelerate our code using Numba.

We define a namedtuple to store parameters, grids and transition probabilities.



```

ArellanoEconomy = namedtuple('ArellanoEconomy',
    ('β',      # Time discount parameter
     'γ',      # Utility parameter
     'r',      # Lending rate
     'ρ',      # Persistence in the income process
     'η',      # Standard deviation of the income process
     'θ',      # Prob of re-entering financial markets
     'B_size', # Grid size for bonds
     'y_size', # Grid size for income
     'P',      # Markov matrix governing the income process
     'B_grid', # Bond unit grid
     'y_grid', # State values of the income process
     'def_y')) # Default income process

```

```

def create_arellano(B_size=251,      # Grid size for bonds
    B_min=-0.45,      # Smallest B value
    B_max=0.45,      # Largest B value
    y_size=51,      # Grid size for income
    β=0.953,      # Time discount parameter
    γ=2.0,      # Utility parameter
    r=0.017,      # Lending rate
    ρ=0.945,      # Persistence in the income process
    η=0.025,      # Standard deviation of the income process
    θ=0.282,      # Prob of re-entering financial markets
    def_y_param=0.969): # Parameter governing income in default

    # Set up grids
    B_grid = jnp.linspace(B_min, B_max, B_size)
    mc = qe.markov.tauchen(y_size, ρ, η)
    y_grid, P = jnp.exp(mc.state_values), mc.P

    # Put grids on the device
    P = jax.device_put(P)

    # Output received while in default, with same shape as y_grid
    def_y = jnp.minimum(def_y_param * jnp.mean(y_grid), y_grid)

    return ArellanoEconomy(β=β, γ=γ, r=r, ρ=ρ, η=η, θ=θ, B_size=B_size,
        y_size=y_size, P=P,
        B_grid=B_grid, y_grid=y_grid,
        def_y=def_y)

```

Here is the utility function.

```

@jax.jit
def u(c, γ):
    return c**(1-γ)/(1-γ)

```

Here is a function to compute the bond price at each state, given  $v_c$  and  $v_d$ .

```

def compute_q(v_c, v_d, params, sizes, arrays):
    """
    Compute the bond price function  $q(B, y)$  at each  $(B, y)$  pair. The first
    step is to calculate the default probabilities

```

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```


$$\delta(B, y) := \int_{\{y'\} \{v_c(B, y') < v_d(y')\}} P(y, y') dy'$$

"""
# Unpack
 $\beta, \gamma, r, \rho, \eta, \theta$  = params
B_size, y_size = sizes
P, B_grid, y_grid, def_y = arrays

# Set up arrays with indices [i_B, i_y, i_yp]
v_d = jnp.reshape(v_d, (1, 1, y_size))
v_c = jnp.reshape(v_c, (B_size, 1, y_size))
P = jnp.reshape(P, (1, y_size, y_size))

# Compute  $\delta[i_B, i_y]$ 
default_states = v_c < v_d
delta = jnp.sum(default_states * P, axis=(2,))

q = (1 - delta) / (1 + r)
return q

```

Next we introduce Bellman operators that updated  $v_d$  and  $v_c$ .

```

def T_d(v_c, v_d, params, sizes, arrays):
    """
    The RHS of the Bellman equation when income is at index y_idx and
    the country has chosen to default. Returns an update of v_d.
    """
    # Unpack
     $\beta, \gamma, r, \rho, \eta, \theta$  = params
    B_size, y_size = sizes
    P, B_grid, y_grid, def_y = arrays

    B0_idx = jnp.searchsorted(B_grid, 1e-10) # Index at which B is near zero

    current_utility = u(def_y,  $\gamma$ )
    v = jnp.maximum(v_c[B0_idx, :], v_d)
    w =  $\theta * v + (1 - \theta) * v_d$ 
    A = jnp.reshape(w, (1, y_size))
    cont_value = jnp.sum(A * P, axis=(1,))

    return current_utility +  $\beta * cont_value$ 

```

```

def bellman(v_c, v_d, q, params, sizes, arrays):
    """
    The RHS of the Bellman equation when the country is not in a
    defaulted state on their debt. That is,

    bellman(B, y) =
        u(y - q(B', y) B' + B) +  $\beta \int_{\{y'\}} v(B', y') P(y, y')$ 

    If consumption is not positive then returns -np.inf
    """
    # Unpack

```

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```

β, γ, r, ρ, η, θ = params
B_size, y_size = sizes
P, B_grid, y_grid, def_y = arrays

# Set up c[i_B, i_y, i_Bp]
y_idx = jnp.reshape(jnp.arange(y_size), (1, y_size, 1))
B_idx = jnp.reshape(jnp.arange(B_size), (B_size, 1, 1))
Bp_idx = jnp.reshape(jnp.arange(B_size), (1, 1, B_size))
c = y_grid[y_idx] - q[Bp_idx, y_idx] * B_grid[Bp_idx] + B_grid[B_idx]

# Set up v[i_B, i_y, i_Bp, i_yp] and P[i_B, i_y, i_Bp, i_yp]
v_d = jnp.reshape(v_d, (1, 1, 1, y_size))
v_c = jnp.reshape(v_c, (1, 1, B_size, y_size))
v = jnp.maximum(v_c, v_d)
P = jnp.reshape(P, (1, y_size, 1, y_size))
# Sum over i_yp
continuation_value = jnp.sum(v * P, axis=(3,))

# Return new_v_c[i_B, i_y, i_Bp]
val = jnp.where(c > 0, u(c, γ) + β * continuation_value, -jnp.inf)
return val

```

```

def T_c(v_c, v_d, q, params, sizes, arrays):
    vals = bellman(v_c, v_d, q, params, sizes, arrays)
    return jnp.max(vals, axis=2)

```

```

def get_greedy(v_c, v_d, q, params, sizes, arrays):
    vals = bellman(v_c, v_d, q, params, sizes, arrays)
    return jnp.argmax(vals, axis=2)

```

Let's make JIT-compiled versions of these functions, with the sizes of the arrays declared as static (compile-time constants) in order to help the compiler.

```

compute_q = jax.jit(compute_q, static_argnums=(3,))
T_d = jax.jit(T_d, static_argnums=(3,))
bellman = jax.jit(bellman, static_argnums=(4,))
T_c = jax.jit(T_c, static_argnums=(4,))
get_greedy = jax.jit(get_greedy, static_argnums=(4,))

```

Here is a function that calls these operators in the right sequence.

```

def update_values_and_prices(v_c, v_d, params, sizes, arrays):

    q = compute_q(v_c, v_d, params, sizes, arrays)
    new_v_d = T_d(v_c, v_d, params, sizes, arrays)
    new_v_c = T_c(v_c, v_d, q, params, sizes, arrays)

    return new_v_c, new_v_d

```

We can now write a function that will use an instance of `ArellanoEconomy` and the functions defined above to compute the solution to our model.

One of the jobs of this function is to take an instance of `ArellanoEconomy`, which is hard for the JIT compiler to handle, and strip it down to more basic objects, which are then passed out to jitted functions.

```

def solve(model, tol=1e-8, max_iter=10_000):
    """
    Given an instance of `ArellanoEconomy`, this function computes the optimal
    policy and value functions.
    """
    # Unpack
    beta, gamma, r, rho, eta, theta, B_size, y_size, P, B_grid, y_grid, def_y = model

    params = beta, gamma, r, rho, eta, theta
    sizes = B_size, y_size
    arrays = P, B_grid, y_grid, def_y

    beta, gamma, r, rho, eta, theta, B_size, y_size, P, B_grid, y_grid, def_y = model

    params = beta, gamma, r, rho, eta, theta
    sizes = B_size, y_size
    arrays = P, B_grid, y_grid, def_y

    # Initial conditions for v_c and v_d
    v_c = jnp.zeros((B_size, y_size))
    v_d = jnp.zeros((y_size,))

    current_iter = 0
    error = tol + 1
    while (current_iter < max_iter) and (error > tol):
        if current_iter % 100 == 0:
            print(f"Entering iteration {current_iter} with error {error}.")
            new_v_c, new_v_d = update_values_and_prices(v_c, v_d, params,
                                                    sizes, arrays)
            error = jnp.max(jnp.abs(new_v_c - v_c)) + jnp.max(jnp.abs(new_v_d - v_d))
            v_c, v_d = new_v_c, new_v_d
            current_iter += 1

    print(f"Terminating at iteration {current_iter}.")

    q = compute_q(v_c, v_d, params, sizes, arrays)
    B_star = get_greedy(v_c, v_d, q, params, sizes, arrays)
    return v_c, v_d, q, B_star

```

Let's try solving the model.

```
ae = create_arellano()
```

```
v_c, v_d, q, B_star = solve(ae)
```

```
Entering iteration 0 with error 1.00000001.
```

```
Entering iteration 100 with error 0.017499341639204857.
Entering iteration 200 with error 0.00014189363558969603.
```

```
Entering iteration 300 with error 1.151467966309383e-06.
Terminating at iteration 399.
```

```
%%time
v_c, v_d, q, B_star = solve(ae)
```

```
Entering iteration 0 with error 1.00000001.
Entering iteration 100 with error 0.017499341639204857.
```

```
Entering iteration 200 with error 0.00014189363558969603.
Entering iteration 300 with error 1.151467966309383e-06.
```

```
Terminating at iteration 399.
CPU times: user 1.46 s, sys: 416 ms, total: 1.87 s
Wall time: 689 ms
```

Finally, we write a function that will allow us to simulate the economy once we have the policy functions

```
def simulate(model, T, v_c, v_d, q, B_star, key):
    """
    Simulates the Arellano 2008 model of sovereign debt

    Here `model` is an instance of `ArellanoEconomy` and `T` is the length of
    the simulation. Endogenous objects `v_c`, `v_d`, `q` and `B_star` are
    assumed to come from a solution to `model`.

    """
    # Unpack elements of the model
    B_size, y_size = model.B_size, model.y_size
    B_grid, y_grid, P = model.B_grid, model.y_grid, model.P

    B0_idx = jnp.searchsorted(B_grid, 1e-10) # Index at which B is near zero

    # Set initial conditions
    y_idx = y_size // 2
    B_idx = B0_idx
    in_default = False

    # Create Markov chain and simulate income process
    mc = qe.MarkovChain(P, y_grid)
    y_sim_indices = mc.simulate_indices(T+1, init=y_idx)

    # Allocate memory for outputs
    y_sim = jnp.empty(T)
    y_a_sim = jnp.empty(T)
    B_sim = jnp.empty(T)
    q_sim = jnp.empty(T)
    d_sim = jnp.empty(T, dtype=int)

    # Perform simulation
    t = 0
    while t < T:

        # Update y_sim and B_sim
        y_sim = y_sim.at[t].set(y_grid[y_idx])
        B_sim = B_sim.at[t].set(B_grid[B_idx])
```

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```

# if in default:
if v_c[B_idx, y_idx] < v_d[y_idx] or in_default:
    # Update y_a_sim
    y_a_sim = y_a_sim.at[t].set(model.def_y[y_idx])
    d_sim = d_sim.at[t].set(1)
    Bp_idx = B0_idx
    # Re-enter financial markets next period with prob  $\theta$ 
    # in_default = False if jnp.random.rand() < model. $\theta$  else True
    in_default = False if random.uniform(key) < model. $\theta$  else True
    key, _ = random.split(key) # Update the random key
else:
    # Update y_a_sim
    y_a_sim = y_a_sim.at[t].set(y_sim[t])
    d_sim = d_sim.at[t].set(0)
    Bp_idx = B_star[B_idx, y_idx]

q_sim = q_sim.at[t].set(q[Bp_idx, y_idx])

# Update time and indices
t += 1
y_idx = y_sim_indices[t]
B_idx = Bp_idx

return y_sim, y_a_sim, B_sim, q_sim, d_sim

```

## 17.5 Results

Let's start by trying to replicate the results obtained in [Arellano, 2008].

In what follows, all results are computed using parameter values of `ArellanoEconomy` created by `create_arellano`.

For example,  $r=0.017$  matches the average quarterly rate on a 5 year US treasury over the period 1983–2001.

Details on how to compute the figures are reported as solutions to the exercises.

The first figure shows the bond price schedule and replicates Figure 3 of [Arellano, 2008], where  $y_L$  and  $y_H$  are particular below average and above average values of output  $y$ .

- $y_L$  is 5% below the mean of the  $y$  grid values
- $y_H$  is 5% above the mean of the  $y$  grid values

The grid used to compute this figure was relatively fine (`y_size, B_size = 51, 251`), which explains the minor differences between this and Arellano's figure.

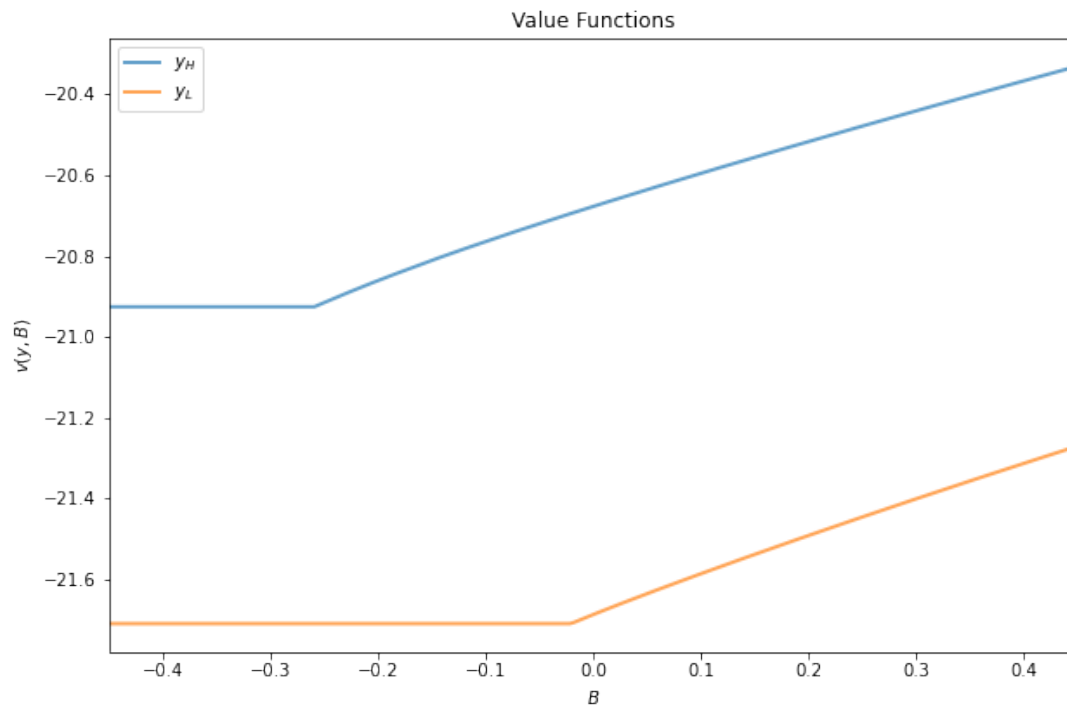
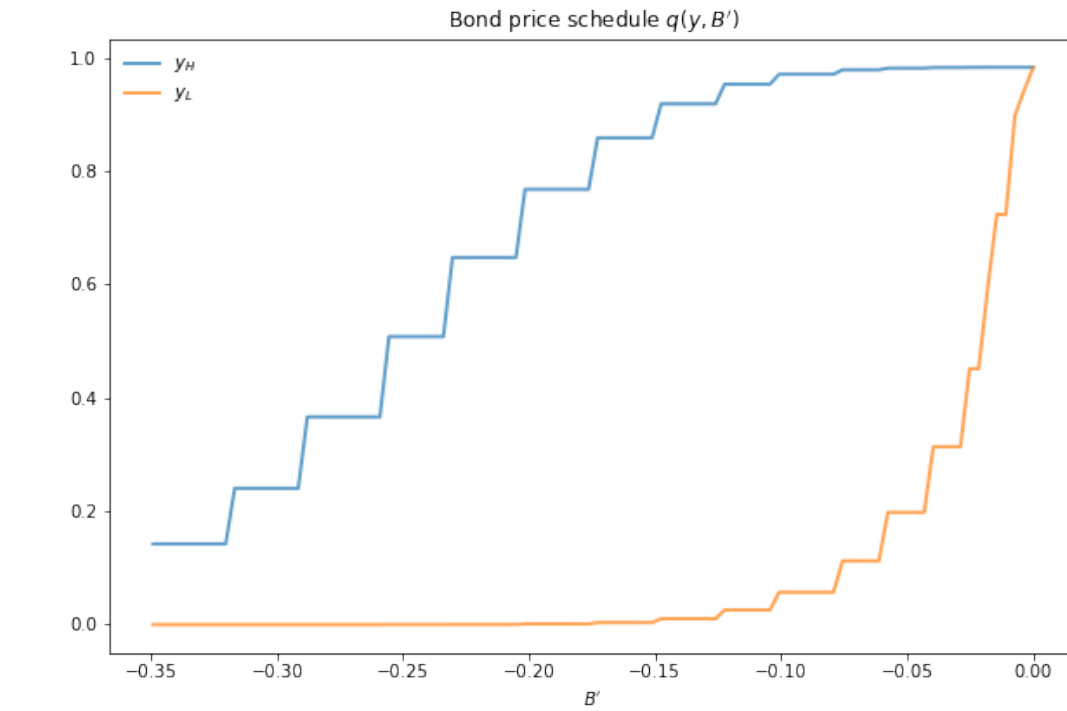
The figure shows that

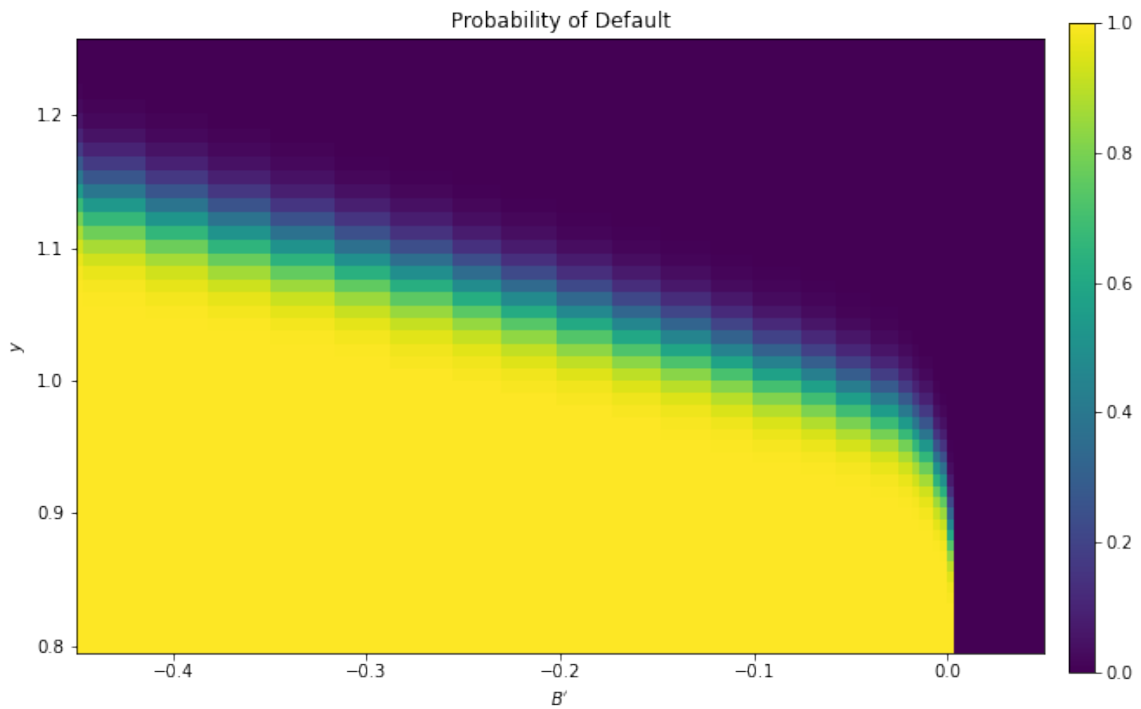
- Higher levels of debt (larger  $-B'$ ) induce larger discounts on the face value, which correspond to higher interest rates.
- Lower income also causes more discounting, as foreign creditors anticipate greater likelihood of default.

The next figure plots value functions and replicates the right hand panel of Figure 4 of [Arellano, 2008].

We can use the results of the computation to study the default probability  $\delta(B', y)$  defined in (17.4).

The next plot shows these default probabilities over  $(B', y)$  as a heat map.





As anticipated, the probability that the government chooses to default in the following period increases with indebtedness and falls with income.

Next let's run a time series simulation of  $\{y_t\}$ ,  $\{B_t\}$  and  $q(B_{t+1}, y_t)$ .

The grey vertical bars correspond to periods when the economy is excluded from financial markets because of a past default.

One notable feature of the simulated data is the nonlinear response of interest rates.

Periods of relative stability are followed by sharp spikes in the discount rate on government debt.

## 17.6 Exercises

### Exercise 17.6.1

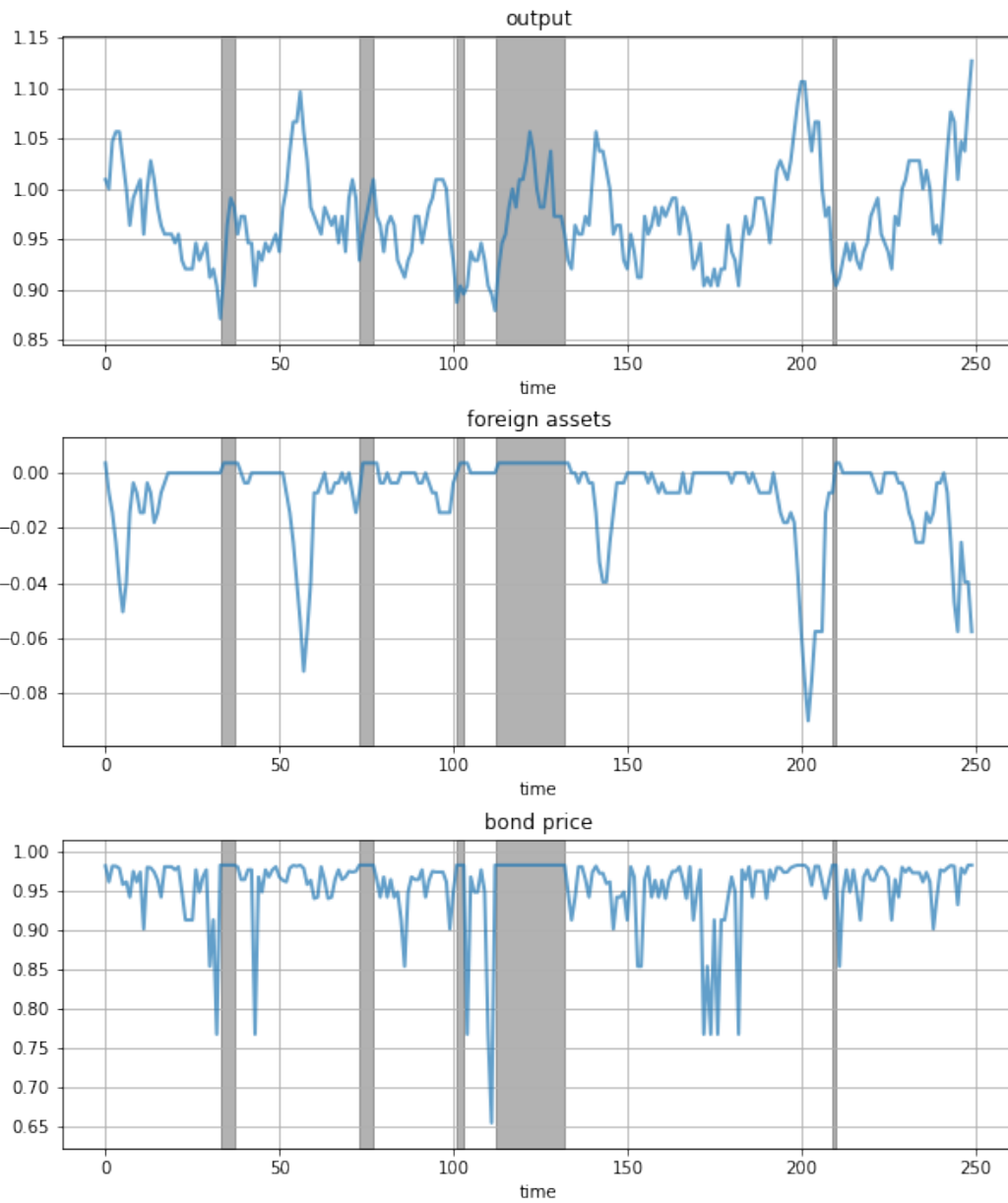
To the extent that you can, replicate the figures shown above

- Use the parameter values listed as defaults in `ArellanoEconomy` created by `create_arellano`.
- The time series will of course vary depending on the shock draws.

### Solution to Exercise 17.6.1

Compute the value function, policy and equilibrium prices





```
ae = create_arellano()
v_c, v_d, q, B_star = solve(ae)
```

```
Entering iteration 0 with error 1.00000001.
```

```
Entering iteration 100 with error 0.017499341639204857.
```

```
Entering iteration 200 with error 0.00014189363558969603.
```

```
Entering iteration 300 with error 1.151467966309383e-06.
```

```
Terminating at iteration 399.
```

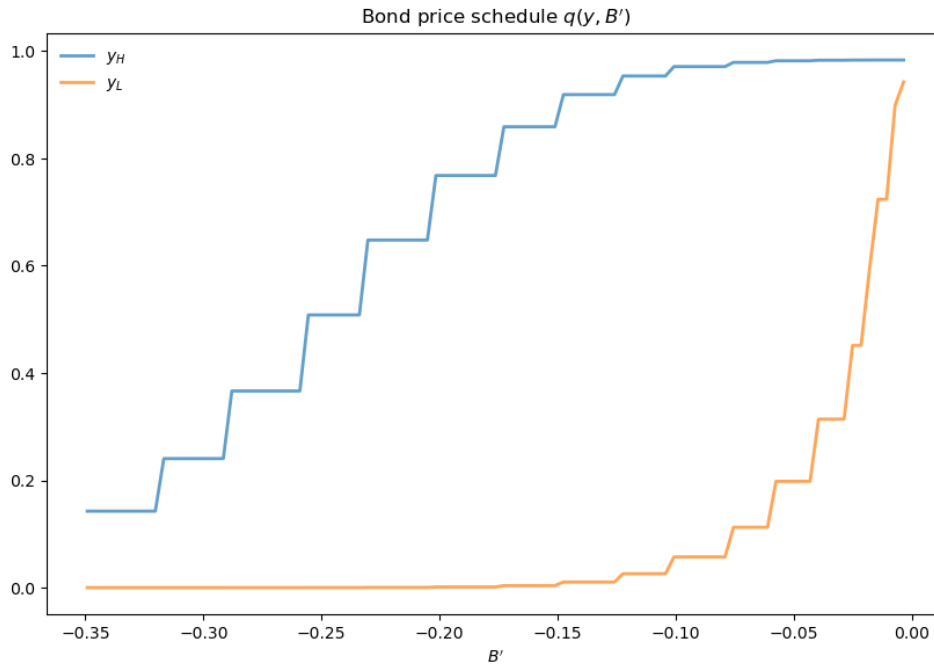
Compute the bond price schedule as seen in figure 3 of [Arellano, 2008]

```
# Unpack some useful names
B_grid, y_grid, P = ae.B_grid, ae.y_grid, ae.P
B_size, y_size = ae.B_size, ae.y_size
r = ae.r

# Create "Y High" and "Y Low" values as 5% devs from mean
high, low = jnp.mean(y_grid) * 1.05, jnp.mean(y_grid) * .95
iy_high, iy_low = (jnp.searchsorted(y_grid, x) for x in (high, low))

fig, ax = plt.subplots(figsize=(10, 6.5))
ax.set_title("Bond price schedule $q(y, B)$")

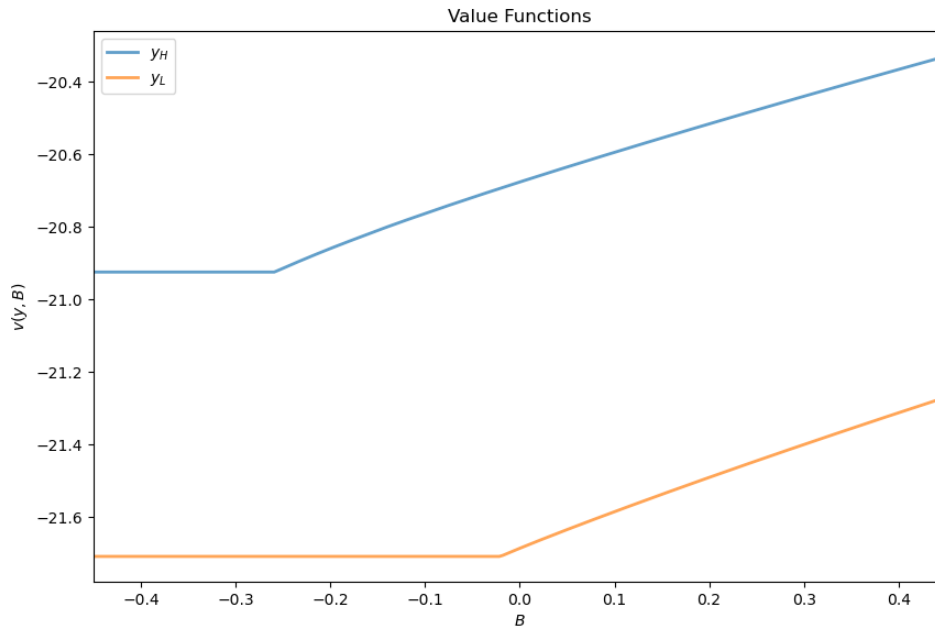
# Extract a suitable plot grid
x = []
q_low = []
q_high = []
for i, B in enumerate(B_grid):
    if -0.35 <= B <= 0: # To match fig 3 of Arellano (2008)
        x.append(B)
        q_low.append(q[i, iy_low])
        q_high.append(q[i, iy_high])
ax.plot(x, q_high, label="$y_H$", lw=2, alpha=0.7)
ax.plot(x, q_low, label="$y_L$", lw=2, alpha=0.7)
ax.set_xlabel("$B$")
ax.legend(loc='upper left', frameon=False)
plt.show()
```



Draw a plot of the value functions

```
v = jnp.maximum(v_c, jnp.reshape(v_d, (1, y_size)))

fig, ax = plt.subplots(figsize=(10, 6.5))
ax.set_title("Value Functions")
ax.plot(B_grid, v[:, iy_high], label="$y_H$", lw=2, alpha=0.7)
ax.plot(B_grid, v[:, iy_low], label="$y_L$", lw=2, alpha=0.7)
ax.legend(loc='upper left')
ax.set_xlabel="$B$", ylabel="$v(y, B)$"
ax.set_xlim(min(B_grid), max(B_grid))
plt.show()
```

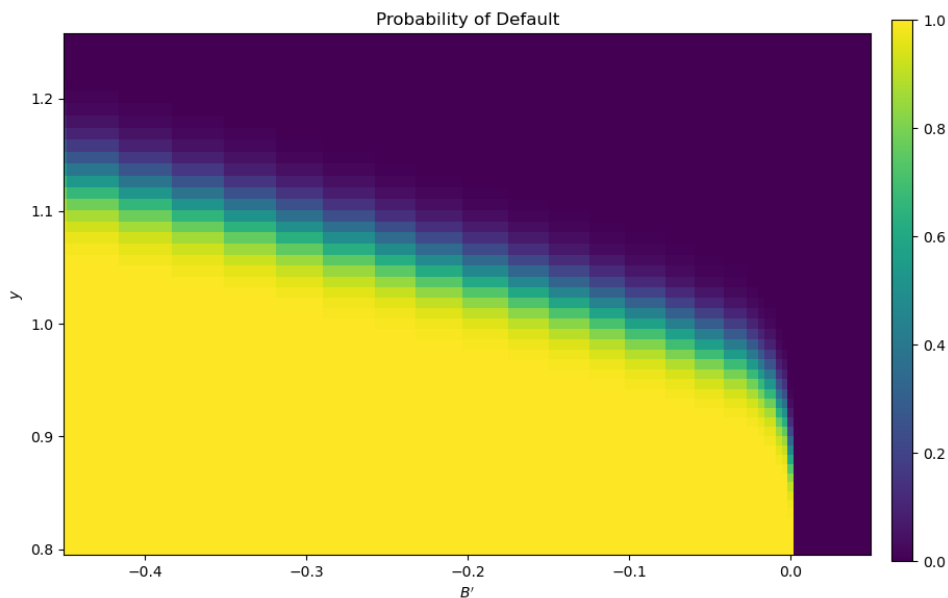


Draw a heat map for default probability

```
# Set up arrays with indices [i_B, i_y, i_yp]
shaped_v_d = jnp.reshape(v_d, (1, 1, y_size))
shaped_v_c = jnp.reshape(v_c, (B_size, 1, y_size))
shaped_P = jnp.reshape(P, (1, y_size, y_size))

# Compute delta[i_B, i_y]
default_states = 1.0 * (shaped_v_c < shaped_v_d)
delta = jnp.sum(default_states * shaped_P, axis=(2,))

# Create figure
fig, ax = plt.subplots(figsize=(10, 6.5))
hm = ax.pcolormesh(B_grid, y_grid, delta.T)
cax = fig.add_axes([.92, .1, .02, .8])
fig.colorbar(hm, cax=cax)
ax.axis([B_grid.min(), 0.05, y_grid.min(), y_grid.max()])
ax.set(xlabel="$B$", ylabel="$y$", title="Probability of Default")
plt.show()
```



Plot a time series of major variables simulated from the model

```
import jax.random as random
T = 250
key = random.PRNGKey(42)
y_sim, y_a_sim, B_sim, q_sim, d_sim = simulate(ae, T, v_c, v_d, q, B_star, key)

# T = 250
# jnp.random.seed(42)
# y_sim, y_a_sim, B_sim, q_sim, d_sim = simulate(ae, T, v_c, v_d, q, B_star)
```

```
# Pick up default start and end dates
start_end_pairs = []
i = 0
while i < len(d_sim):
    if d_sim[i] == 0:
        i += 1
    else:
        # If we get to here we're in default
        start_default = i
        while i < len(d_sim) and d_sim[i] == 1:
            i += 1
        end_default = i - 1
        start_end_pairs.append((start_default, end_default))

plot_series = (y_sim, B_sim, q_sim)
titles = 'output', 'foreign assets', 'bond price'

fig, axes = plt.subplots(len(plot_series), 1, figsize=(10, 12))
fig.subplots_adjust(hspace=0.3)

for ax, series, title in zip(axes, plot_series, titles):
    # Determine suitable y limits
    s_max, s_min = max(series), min(series)
    s_range = s_max - s_min
```

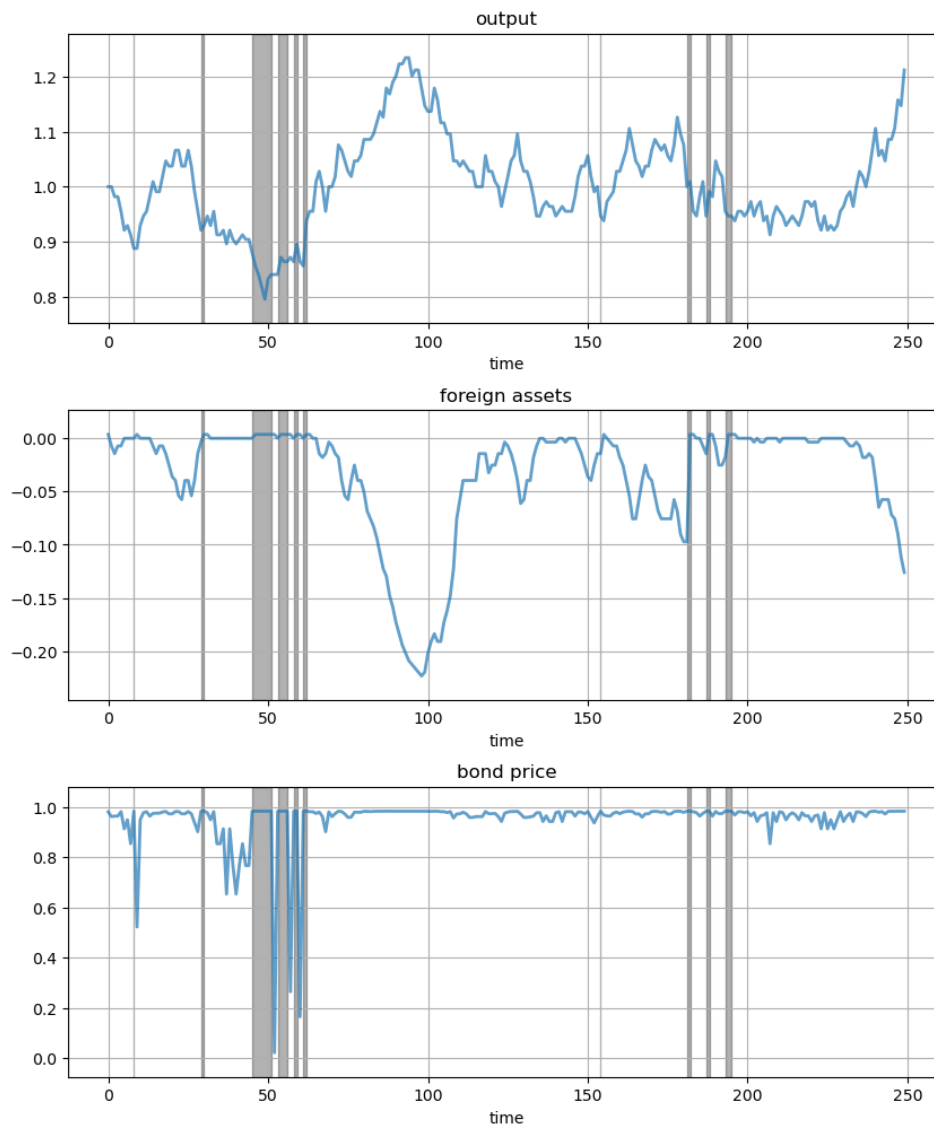
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```
y_max = s_max + s_range * 0.1
y_min = s_min - s_range * 0.1
ax.set_ylim(y_min, y_max)
for pair in start_end_pairs:
    ax.fill_between(pair, (y_min, y_min), (y_max, y_max),
                   color='k', alpha=0.3)

ax.grid()
ax.plot(range(T), series, lw=2, alpha=0.7)
ax.set(title=title, xlabel="time")

plt.show()
```



## THE AIYAGARI MODEL

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

## 18.1 Overview

In this lecture, we describe the structure of a class of models that build on work by Truman Bewley [[Bew77](#)].

We begin by discussing an example of a Bewley model due to Rao Aiyagari [[Aiy94](#)].

The model features

- Heterogeneous agents
- A single exogenous vehicle for borrowing and lending
- Limits on amounts individual agents may borrow

The Aiyagari model has been used to investigate many topics, including

- precautionary savings and the effect of liquidity constraints [[Aiy94](#)]
- risk sharing and asset pricing [[HL96](#)]
- the shape of the wealth distribution [[BBZ15](#)]

### 18.1.1 References

The primary reference for this lecture is [[Aiy94](#)].

A textbook treatment is available in chapter 18 of [[LS18](#)].

A less sophisticated version of this lecture (without JAX) can be found [here](#).

## 18.1.2 Preliminaries

We use the following imports

```
import time
import matplotlib.pyplot as plt
import numpy as np
import jax
import jax.numpy as jnp
from collections import namedtuple
```

Let's check the GPU we are running

```
!nvidia-smi
```

```
/opt/conda/envs/quantecon/lib/python3.11/pty.py:89: RuntimeWarning: os.fork() was
called. os.fork() is incompatible with multithreaded code, and JAX is
multithreaded, so this will likely lead to a deadlock.
pid, fd = os.forkpty()
```

```
Thu May 2 01:50:35 2024
+-----+
| NVIDIA-SMI 470.182.03      Driver Version: 470.182.03      CUDA Version: 12.3      |
+-----+-----+-----+-----+-----+-----+
| GPU   Name                Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
| Fan  Temp  Perf    Pwr:Usage/Cap|      Memory-Usage | GPU-Util  Compute M. |
|                                           |              | MIG M.     |
+-----+-----+-----+-----+-----+-----+
|    0   Tesla V100-SXM2...    Off      | 00000000:00:1E:0  Off  |                0 |
| N/A   27C    P0     38W / 300W |      0MiB / 16160MiB |          2%      Default |
|                                           |              | N/A        |
+-----+-----+-----+-----+-----+
+-----+
| Processes:
| GPU   GI    CI          PID    Type   Process name                      GPU Memory
|      ID    ID                                   |              Usage              |
+-----+-----+-----+-----+-----+
| No running processes found
+-----+
```

We will use 64 bit floats with JAX in order to increase the precision.

```
jax.config.update("jax_enable_x64", True)
```

We will use the following function to compute stationary distributions of stochastic matrices. (For a reference to the algorithm, see p. 88 of [Economic Dynamics](#).)

```
# Compute the stationary distribution of P by matrix inversion.

@jax.jit
def compute_stationary(P):
    n = P.shape[0]
```

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```

I = jnp.identity(n)
O = jnp.ones((n, n))
A = I - jnp.transpose(P) + O
return jnp.linalg.solve(A, jnp.ones(n))

```

## 18.2 Firms

Firms produce output by hiring capital and labor.

Firms act competitively and face constant returns to scale.

Since returns to scale are constant the number of firms does not matter.

Hence we can consider a single (but nonetheless competitive) representative firm.

The firm's output is

$$Y_t = AK_t^\alpha N^{1-\alpha}$$

where

- $A$  and  $\alpha$  are parameters with  $A > 0$  and  $\alpha \in (0, 1)$
- $K_t$  is aggregate capital
- $N$  is total labor supply (which is constant in this simple version of the model)

The firm's problem is

$$\max_{K,N} \{AK_t^\alpha N^{1-\alpha} - (r + \delta)K - wN\}$$

The parameter  $\delta$  is the depreciation rate.

These parameters are stored in the following namedtuple.

```

Firm = namedtuple('Firm', ('A', 'N', 'alpha', 'beta', 'delta'))

def create_firm(A=1.0,
               N=1.0,
               alpha=0.33,
               beta=0.96,
               delta=0.05):

    return Firm(A=A, N=N, alpha=alpha, beta=beta, delta=delta)

```

From the first-order condition with respect to capital,

the firm's inverse demand for capital is

$$r = A\alpha \left(\frac{N}{K}\right)^{1-\alpha} - \delta \quad (18.1)$$

```

def r_given_k(K, firm):
    """
    Inverse demand curve for capital. The interest rate associated with a
    given demand for capital K.

```

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```

"""
A, N, alpha, beta, delta = firm
return A * alpha * (N / K)**(1 - alpha) - delta

```

Using (18.1) and the firm's first-order condition for labor,

we can pin down the equilibrium wage rate as a function of  $r$  as

$$w(r) = A(1 - \alpha)(A\alpha/(r + \delta))^{\alpha/(1-\alpha)} \quad (18.2)$$

```

def r_to_w(r, f):
    """
    Equilibrium wages associated with a given interest rate r.
    """
    A, N, alpha, beta, delta = f
    return A * (1 - alpha) * (A * alpha / (r + delta))**(alpha / (1 - alpha))

```

## 18.3 Households

Infinitely lived households / consumers face idiosyncratic income shocks.

A unit interval of *ex-ante* identical households face a common borrowing constraint.

The savings problem faced by a typical household is

$$\max \mathbb{E} \sum_{t=0}^{\infty} \beta^t u(c_t)$$

subject to

$$a_{t+1} + c_t \leq wz_t + (1 + r)a_t \quad c_t \geq 0, \quad \text{and} \quad a_t \geq -B$$

where

- $c_t$  is current consumption
- $a_t$  is assets
- $z_t$  is an exogenous component of labor income capturing stochastic unemployment risk, etc.
- $w$  is a wage rate
- $r$  is a net interest rate
- $B$  is the maximum amount that the agent is allowed to borrow

The exogenous process  $\{z_t\}$  follows a finite state Markov chain with given stochastic matrix  $P$ .

In this simple version of the model, households supply labor inelastically because they do not value leisure.

Below we provide code to solve the household problem, taking  $r$  and  $w$  as fixed.

For now we assume that  $u(c) = \log(c)$ .

(CRRA utility is treated in the exercises.)

### 18.3.1 Primitives and Operators

This namedtuple stores the parameters that define a household asset accumulation problem and the grids used to solve it.

```
Household = namedtuple('Household', ('r', 'w', 'β', 'a_size', 'z_size', \
                                     'a_grid', 'z_grid', 'Π'))

def create_household(r=0.01,                # Interest rate
                    w=1.0,                  # Wages
                    β=0.96,                 # Discount factor
                    Π=[[0.9, 0.1], [0.1, 0.9]], # Markov chain
                    z_grid=[0.1, 1.0],      # Exogenous states
                    a_min=1e-10, a_max=20,   # Asset grid
                    a_size=200):

    a_grid = jnp.linspace(a_min, a_max, a_size)
    z_grid, Π = map(jnp.array, (z_grid, Π))
    Π = jax.device_put(Π)
    z_grid = jax.device_put(z_grid)
    z_size = len(z_grid)
    a_grid, z_grid, Π = jax.device_put((a_grid, z_grid, Π))

    return Household(r=r, w=w, β=β, a_size=a_size, z_size=z_size, \
                    a_grid=a_grid, z_grid=z_grid, Π=Π)
```

```
def u(c):
    return jnp.log(c)
```

This is the vectorized version of the right-hand side of the Bellman equation (before maximization), which is a 3D array representing

$$B(a, z, a') = u(wz + (1 + r)a - a') + \beta \sum_{z'} v(a', z') \Pi(z, z')$$

for all  $(a, z, a')$ .

```
def B(v, constants, sizes, arrays):
    # Unpack
    r, w, β = constants
    a_size, z_size = sizes
    a_grid, z_grid, Π = arrays

    # Compute current consumption as array c[i, j, ip]
    a = jnp.reshape(a_grid, (a_size, 1, 1)) # a[i] -> a[i, j, ip]
    z = jnp.reshape(z_grid, (1, z_size, 1)) # z[j] -> z[i, j, ip]
    ap = jnp.reshape(a_grid, (1, 1, a_size)) # ap[ip] -> ap[i, j, ip]
    c = w*z + (1 + r)*a - ap

    # Calculate continuation rewards at all combinations of (a, z, ap)
    v = jnp.reshape(v, (1, 1, a_size, z_size)) # v[ip, jp] -> v[i, j, ip, jp]
    Π = jnp.reshape(Π, (1, z_size, 1, z_size)) # Π[j, jp] -> Π[i, j, ip, jp]
    EV = jnp.sum(v * Π, axis=3) # sum over last index jp

    # Compute the right-hand side of the Bellman equation
    return jnp.where(c > 0, u(c) + β * EV, -jnp.inf)

B = jax.jit(B, static_argnums=(2,))
```

The next function computes greedy policies.

```
# Computes a v-greedy policy, returned as a set of indices
def get_greedy(v, constants, sizes, arrays):
    return jnp.argmax(B(v, constants, sizes, arrays), axis=2)

get_greedy = jax.jit(get_greedy, static_argnums=(2,))
```

We need to know rewards at a given policy for policy iteration.

The following functions computes the array  $r_\sigma$  which gives current rewards given policy  $\sigma$ .

That is,

$$r_\sigma[i, j] = r[i, j, \sigma[i, j]]$$

```
def compute_r_sigma(sigma, constants, sizes, arrays):
    # Unpack
    r, w, beta = constants
    a_size, z_size = sizes
    a_grid, z_grid, Pi = arrays

    # Compute r_sigma[i, j]
    a = jnp.reshape(a_grid, (a_size, 1))
    z = jnp.reshape(z_grid, (1, z_size))
    ap = a_grid[sigma]
    c = (1 + r)*a + w*z - ap
    r_sigma = u(c)

    return r_sigma

compute_r_sigma = jax.jit(compute_r_sigma, static_argnums=(2,))
```

The value  $v_\sigma$  of a policy  $\sigma$  is defined as

$$v_\sigma = (I - \beta P_\sigma)^{-1} r_\sigma$$

Here we set up the linear map  $v \rightarrow R_\sigma v$ , where  $R_\sigma := I - \beta P_\sigma$ .

In the consumption problem, this map can be expressed as

$$(R_\sigma v)(a, z) = v(a, z) - \beta \sum_{z'} v(\sigma(a, z), z') \Pi(z, z')$$

Defining the map as above works in a more intuitive multi-index setting

(e.g. working with  $v[i, j]$  rather than flattening  $v$  to a one-dimensional array)

and avoids instantiating the large matrix  $P_\sigma$ .

```
def R_sigma(v, sigma, constants, sizes, arrays):
    # Unpack
    r, w, beta = constants
    a_size, z_size = sizes
    a_grid, z_grid, Pi = arrays

    # Set up the array v[sigma[i, j], jp]
    zp_idx = jnp.arange(z_size)
```

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```

zp_idx = jnp.reshape(zp_idx, (1, 1, z_size))
σ = jnp.reshape(σ, (a_size, z_size, 1))
V = v[σ, zp_idx]

# Expand Π[j, jp] to Π[i, j, jp]
Π = jnp.reshape(Π, (1, z_size, z_size))

# Compute and return v[i, j] - β Σ_jp v[σ[i, j], jp] * Π[j, jp]
return v - β * jnp.sum(V * Π, axis=2)

R_σ = jax.jit(R_σ, static_argnums=(3,))

```

The next function computes the lifetime value of a given policy.

```

# Get the value v_σ of policy σ by inverting the linear map R_σ

def get_value(σ, constants, sizes, arrays):

    r_σ = compute_r_σ(σ, constants, sizes, arrays)
    # Reduce R_σ to a function in v
    partial_R_σ = lambda v: R_σ(v, σ, constants, sizes, arrays)
    # Compute inverse v_σ = (I - β P_σ)^{-1} r_σ
    return jax.scipy.sparse.linalg.bicgstab(partial_R_σ, r_σ)[0]

get_value = jax.jit(get_value, static_argnums=(2,))

```

## 18.4 Solvers

We will solve the household problem using Howard policy iteration.

```

def policy_iteration(household, tol=1e-4, max_iter=10_000, verbose=False):
    """Howard policy iteration routine."""

    γ, w, β, a_size, z_size, a_grid, z_grid, Π = household

    constants = γ, w, β
    sizes = a_size, z_size
    arrays = a_grid, z_grid, Π

    σ = jnp.zeros(sizes, dtype=int)
    v_σ = get_value(σ, constants, sizes, arrays)
    i = 0
    error = tol + 1
    while error > tol and i < max_iter:
        σ_new = get_greedy(v_σ, constants, sizes, arrays)
        v_σ_new = get_value(σ_new, constants, sizes, arrays)
        error = jnp.max(jnp.abs(v_σ_new - v_σ))
        σ = σ_new
        v_σ = v_σ_new
        i = i + 1
        if verbose:
            print(f"Concluded loop {i} with error {error}.")
    return σ

```

As a first example of what we can do, let's compute and plot an optimal accumulation policy at fixed prices.

```
# Create an instance of Household
household = create_household()
```

```
%%time
```

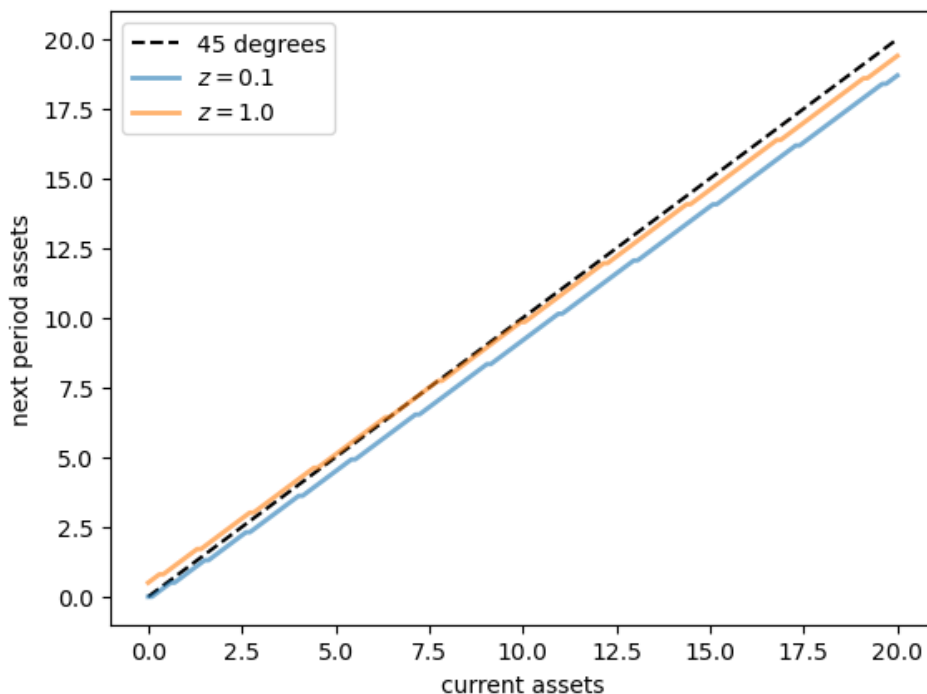
```
 $\sigma_{\text{star}}$  = policy_iteration(household, verbose=True)
```

```
# The next plot shows asset accumulation policies at different values of the
exogenous state.
```

```
Concluded loop 1 with error 11.366831579022996.
Concluded loop 2 with error 9.574522771860245.
Concluded loop 3 with error 3.9654760004604777.
Concluded loop 4 with error 1.1207075306313232.
Concluded loop 5 with error 0.2524013153055833.
Concluded loop 6 with error 0.12172293662906064.
Concluded loop 7 with error 0.043395682867316765.
Concluded loop 8 with error 0.012132319676439351.
Concluded loop 9 with error 0.005822155404443308.
Concluded loop 10 with error 0.002863165320343697.
Concluded loop 11 with error 0.0016657175376657563.
Concluded loop 12 with error 0.0004143776102245589.
Concluded loop 13 with error 0.0.
CPU times: user 595 ms, sys: 41.5 ms, total: 636 ms
Wall time: 787 ms
```

```
 $y$ ,  $w$ ,  $\beta$ ,  $a_{\text{size}}$ ,  $z_{\text{size}}$ ,  $a_{\text{grid}}$ ,  $z_{\text{grid}}$ ,  $\Pi$  = household

fig, ax = plt.subplots()
ax.plot( $a_{\text{grid}}$ ,  $a_{\text{grid}}$ , 'k--', label="45 degrees")
for j, z in enumerate( $z_{\text{grid}}$ ):
    lb = f' $z = \{z:.2\}$ '
    policy_vals =  $a_{\text{grid}}[\sigma_{\text{star}}[:, j]]$ 
    ax.plot( $a_{\text{grid}}$ , policy_vals, lw=2, alpha=0.6, label=lb)
    ax.set_xlabel('current assets')
    ax.set_ylabel('next period assets')
ax.legend(loc='upper left')
plt.show()
```



### 18.4.1 Capital Supply

To start thinking about equilibrium, we need to know how much capital households supply at a given interest rate  $r$ .

This quantity can be calculated by taking the stationary distribution of assets under the optimal policy and computing the mean.

The next function implements this calculation for a given policy  $\sigma$ .

First we compute the stationary distribution of  $P_\sigma$ , which is for the bivariate Markov chain of the state  $(a_t, z_t)$ . Then we sum out  $z_t$  to get the marginal distribution for  $a_t$ .

```
def compute_asset_stationary( $\sigma$ , constants, sizes, arrays):

    # Unpack
    r, w,  $\beta$  = constants
    a_size, z_size = sizes
    a_grid, z_grid,  $\Pi$  = arrays

    # Construct  $P_\sigma$  as an array of the form  $P_\sigma[i, j, ip, jp]$ 
    ap_idx = jnp.arange(a_size)
    ap_idx = jnp.reshape(ap_idx, (1, 1, a_size, 1))
     $\sigma$  = jnp.reshape( $\sigma$ , (a_size, z_size, 1, 1))
    A = jnp.where( $\sigma$  == ap_idx, 1, 0)
     $\Pi$  = jnp.reshape( $\Pi$ , (1, z_size, 1, z_size))
     $P_\sigma$  = A *  $\Pi$ 

    # Reshape  $P_\sigma$  into a matrix
    n = a_size * z_size
     $P_\sigma$  = jnp.reshape( $P_\sigma$ , (n, n))

    # Get stationary distribution and reshape onto  $[i, j]$  grid
```

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```

ψ = compute_stationary(P_σ)
ψ = jnp.reshape(ψ, (a_size, z_size))

# Sum along the rows to get the marginal distribution of assets
ψ_a = jnp.sum(ψ, axis=1)
return ψ_a

compute_asset_stationary = jax.jit(compute_asset_stationary,
                                   static_argnums=(2,))

```

Let's give this a test run.

```

γ, w, β, a_size, z_size, a_grid, z_grid, Π = household
constants = γ, w, β
sizes = a_size, z_size
arrays = a_grid, z_grid, Π
ψ = compute_asset_stationary(σ_star, constants, sizes, arrays)

```

The distribution should sum to one:

```
ψ.sum()
```

```
Array(1., dtype=float64)
```

Now we are ready to compute capital supply by households given wages and interest rates.

```

def capital_supply(household):
    """
    Map household decisions to the induced level of capital stock.
    """

    # Unpack
    γ, w, β, a_size, z_size, a_grid, z_grid, Π = household

    constants = γ, w, β
    sizes = a_size, z_size
    arrays = a_grid, z_grid, Π

    # Compute the optimal policy
    σ_star = policy_iteration(household)
    # Compute the stationary distribution
    ψ_a = compute_asset_stationary(σ_star, constants, sizes, arrays)

    # Return K
    return float(jnp.sum(ψ_a * a_grid))

```



## 18.5 Equilibrium

We construct a *stationary rational expectations equilibrium* (SREE).

In such an equilibrium

- prices induce behavior that generates aggregate quantities consistent with the prices
- aggregate quantities and prices are constant over time

In more detail, an SREE lists a set of prices, savings and production policies such that

- households want to choose the specified savings policies taking the prices as given
- firms maximize profits taking the same prices as given
- the resulting aggregate quantities are consistent with the prices; in particular, the demand for capital equals the supply
- aggregate quantities (defined as cross-sectional averages) are constant

In practice, once parameter values are set, we can check for an SREE by the following steps

1. pick a proposed quantity  $K$  for aggregate capital
2. determine corresponding prices, with interest rate  $r$  determined by (18.1) and a wage rate  $w(r)$  as given in (18.2).
3. determine the common optimal savings policy of the households given these prices
4. compute aggregate capital as the mean of steady state capital given this savings policy

If this final quantity agrees with  $K$  then we have a SREE. Otherwise we adjust  $K$ .

These steps describe a fixed point problem which we solve below.

### 18.5.1 Visual inspection

Let's inspect visually as a first pass.

The following code draws aggregate supply and demand curves for capital.

The intersection gives equilibrium interest rates and capital.

```
# Create default instances
household = create_household()
firm = create_firm()

# Create a grid of r values at which to compute demand and supply of capital
num_points = 50
r_vals = np.linspace(0.005, 0.04, num_points)
```

```
%%time

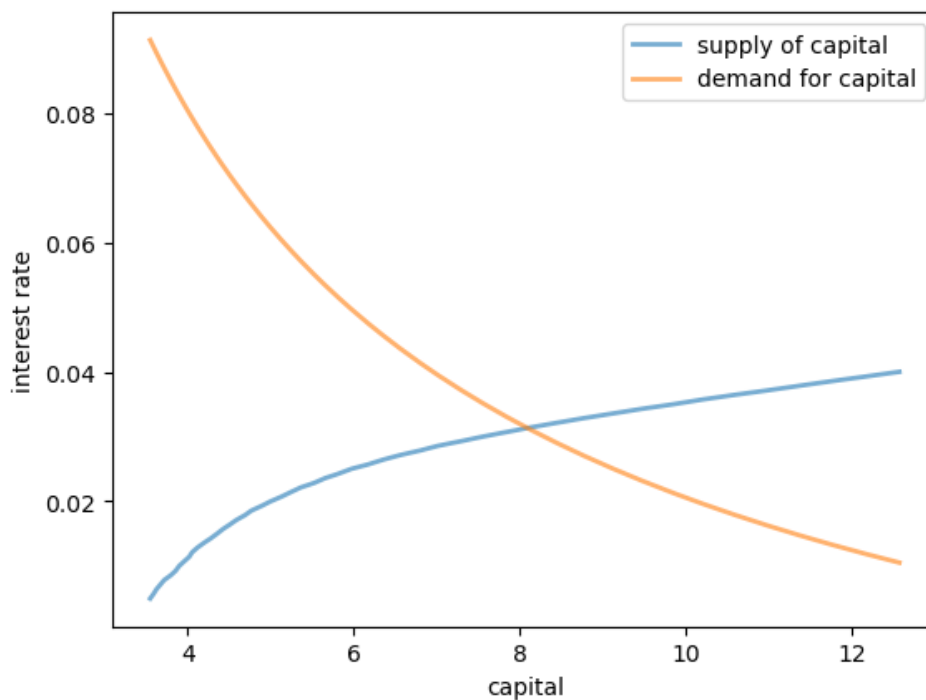
# Compute supply of capital
k_vals = np.empty(num_points)
for i, r in enumerate(r_vals):
    # _replace create a new namedtuple with the updated parameters
    household = household._replace(r=r, w=r_to_w(r, firm))
    k_vals[i] = capital_supply(household)
```

```
CPU times: user 3.95 s, sys: 1.05 s, total: 4.99 s
Wall time: 2.91 s
```

```
# Plot against demand for capital by firms

fig, ax = plt.subplots()
ax.plot(k_vals, r_vals, lw=2, alpha=0.6, label='supply of capital')
ax.plot(k_vals, r_given_k(k_vals, firm), lw=2, alpha=0.6, label='demand for capital')
ax.set_xlabel('capital')
ax.set_ylabel('interest rate')
ax.legend(loc='upper right')

plt.show()
```



Here's a plot of the excess demand function.

The equilibrium is the zero (root) of this function.

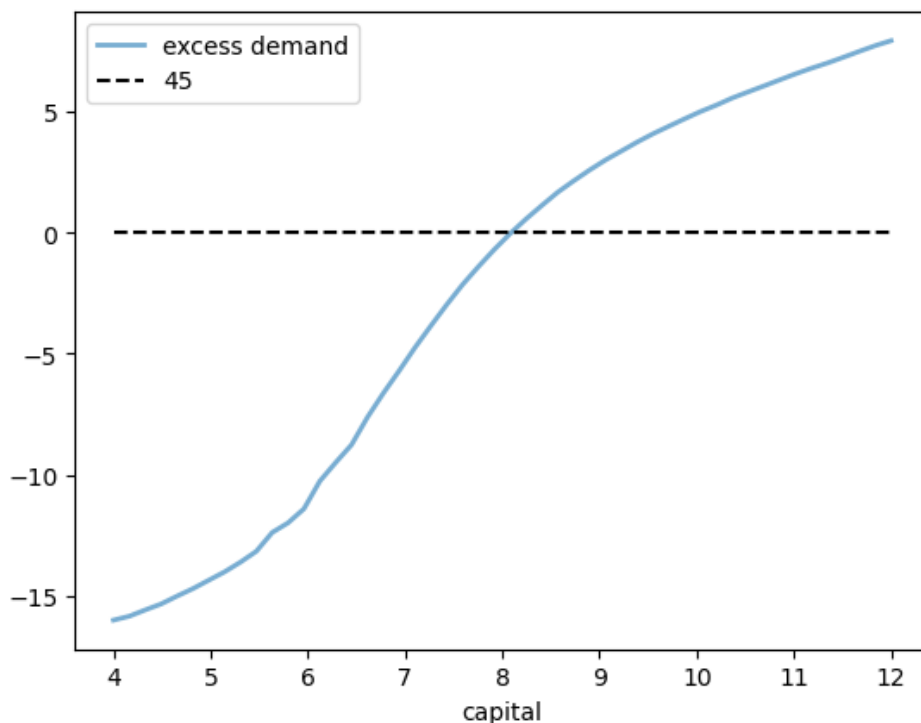
```
def excess_demand(K, firm, household):
    r = r_given_k(K, firm)
    w = r_to_w(r, firm)
    household = household._replace(r=r, w=w)
    return K - capital_supply(household)
```

```
%%time

num_points = 50
k_vals = np.linspace(4, 12, num_points)
out = [excess_demand(k, firm, household) for k in k_vals]
```

```
CPU times: user 3.6 s, sys: 992 ms, total: 4.6 s
Wall time: 2.45 s
```

```
fig, ax = plt.subplots()
ax.plot(k_vals, out, lw=2, alpha=0.6, label='excess demand')
ax.plot(k_vals, np.zeros_like(k_vals), 'k--', label="45")
ax.set_xlabel('capital')
ax.legend()
plt.show()
```



## 18.5.2 Computing the equilibrium

Now let's compute the equilibrium

To do so, we use the bisection method, which is implemented in the next function.

```
def bisection(f, a, b, *args, tol=10e-2):
    """
    Implements the bisection root finding algorithm, assuming that f is a
    real-valued function on [a, b] satisfying f(a) < 0 < f(b).
    """
    lower, upper = a, b
    count = 0
    while upper - lower > tol and count < 10000:
        middle = 0.5 * (upper + lower)
        if f(middle, *args) > 0: # root is between lower and middle
            lower, upper = lower, middle
        else:
            # root is between middle and upper
```

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```

        lower, upper = middle, upper
    count += 1
    if count == 10000:
        print("Root might not be accurate")
    return 0.5 * (upper + lower), count

```

Now we call the bisection function on excess demand.

```

def compute_equilibrium(firm, household):
    print("\nComputing equilibrium capital stock")
    start = time.time()
    solution, count = bisect(excess_demand, 6.0, 10.0, firm, household)
    elapsed = time.time() - start
    print(f"Computed equilibrium in {count} iterations and {elapsed} seconds")
    return solution

```

```

%%time

household = create_household()
firm = create_firm()
compute_equilibrium(firm, household)

```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.30374884605407715 seconds
CPU times: user 443 ms, sys: 109 ms, total: 553 ms
Wall time: 305 ms
```

```
8.09375
```

Notice how quickly we can compute the equilibrium capital stock using a simple method such as bisection.

## 18.6 Exercises

### Exercise 18.6.1

Using the default household and firm model, produce a graph showing the behaviour of equilibrium capital stock with the increase in  $\beta$ .

### Solution to Exercise 18.6.1

```

beta_vals = np.linspace(0.9, 0.99, 40)
eq_vals = np.empty_like(beta_vals)

for i, beta in enumerate(beta_vals):
    household = create_household(beta=beta)
    firm = create_firm(beta=beta)
    eq_vals[i] = compute_equilibrium(firm, household)

```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.6440865993499756 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.1762845516204834 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.18233895301818848 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.1839618682861328 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.18913006782531738 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.1808149814605713 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.17767858505249023 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.19258689880371094 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.19076752662658691 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.19883275032043457 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.22058820724487305 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.20551848411560059 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.2043321132659912 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.22719836235046387 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.22914814949035645 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.23547005653381348 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.24303531646728516 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.2442009449005127 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.25627613067626953 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.280437707901001 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.2600374221801758 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.28091001510620117 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.26703929901123047 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.3008382320404053 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.3082144260406494 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.3183417320251465 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.30644798278808594 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 38.3795599937439 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.3095548152923584 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.31540918350219727 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.30086827278137207 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.3164796829223633 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.3096179962158203 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.3447446823120117 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.35950565338134766 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.38883280754089355 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.41268157958984375 seconds  
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.4145534038543701 seconds
```

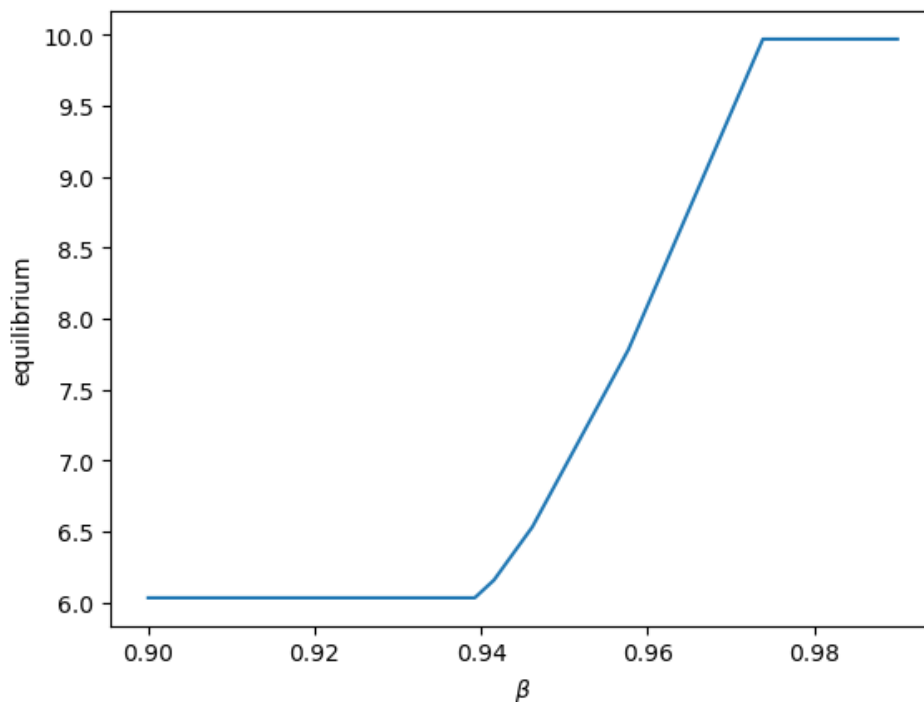
```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.4279360771179199 seconds
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.42888665199279785 seconds
```

```
fig, ax = plt.subplots()
ax.plot(beta_vals, eq_vals, ms=2)
ax.set_xlabel(r'$\beta$')
ax.set_ylabel('equilibrium')
plt.show()
```



---

### Exercise 18.6.2

Switch to the CRRA utility function

$$u(c) = \frac{c^{1-\gamma}}{1-\gamma}$$

and re-do the plot of demand for capital by firms against the supply of capital.

Also, recompute the equilibrium.

Use the default parameters for households and firms.



Set  $\gamma = 2$ .

### Solution to Exercise 18.6.2

Let's define the utility function

```
def u(c,  $\gamma=2$ ):
    return c**(1 -  $\gamma$ ) / (1 -  $\gamma$ )
```

We need to re-compile all the jitted functions in order notice the change in the utility function.

```
B = jax.jit(B, static_argnums=(2,))
get_greedy = jax.jit(get_greedy, static_argnums=(2,))
compute_r_ $\sigma$  = jax.jit(compute_r_ $\sigma$ , static_argnums=(2,))
R_ $\sigma$  = jax.jit(R_ $\sigma$ , static_argnums=(3,))
get_value = jax.jit(get_value, static_argnums=(2,))
compute_asset_stationary = jax.jit(compute_asset_stationary,
                                   static_argnums=(2,))
```

Now, let's plot the the demand for capital by firms

```
# Create default instances
household = create_household()
firm = create_firm()

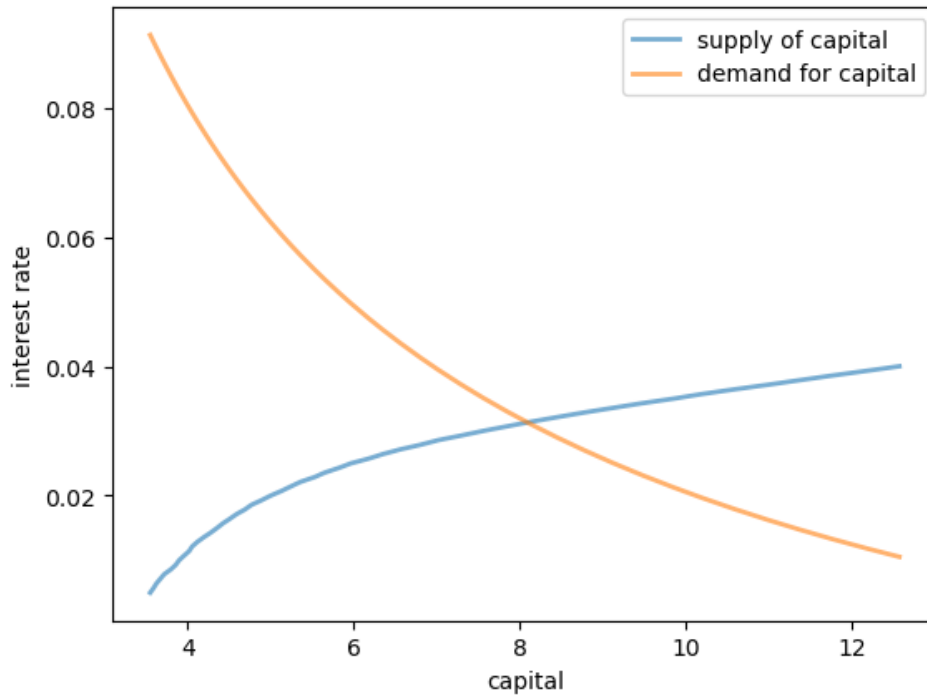
# Create a grid of r values at which to compute demand and supply of capital
num_points = 50
r_vals = np.linspace(0.005, 0.04, num_points)

# Compute supply of capital
k_vals = np.empty(num_points)
for i, r in enumerate(r_vals):
    household = household._replace(r=r, w=r_to_w(r, firm))
    k_vals[i] = capital_supply(household)
```

```
# Plot against demand for capital by firms

fig, ax = plt.subplots()
ax.plot(k_vals, r_vals, lw=2, alpha=0.6, label='supply of capital')
ax.plot(k_vals, r_given_k(k_vals, firm), lw=2, alpha=0.6, label='demand for capital')
ax.set_xlabel('capital')
ax.set_ylabel('interest rate')
ax.legend()

plt.show()
```



Compute the equilibrium

```
%%time  
household = create_household()  
firm = create_firm()  
compute_equilibrium(firm, household)
```

```
Computing equilibrium capital stock
```

```
Computed equilibrium in 6 iterations and 0.7010283470153809 seconds  
CPU times: user 948 ms, sys: 73.3 ms, total: 1.02 s  
Wall time: 703 ms
```

```
8.09375
```

## THE HOPENHAYN ENTRY-EXIT MODEL

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

### 19.1 Outline

The Hopenhayn (1992, ECMA) entry-exit model is a highly influential (partial equilibrium) heterogeneous agent model where

- the agents receiving idiosyncratic shocks are firms, and
- the model produces a non-trivial firm size distribution and a range of predictions for firm dynamics.

We are going to study an extension of the basic model that has unbounded productivity.

Among other things, this allows us to match the heavy tail observed in the firm size distribution data.

In addition to what’s in Anaconda, this lecture will need the following libraries:

```
!pip install quantecon
```

We will use the following imports.

```
import jax.numpy as jnp
import jax
import quantecon as qc
import matplotlib.pyplot as plt
from collections import namedtuple
```

## 19.2 The Model

### 19.2.1 Environment

There is a single good produced by a continuum of competitive firms.

The productivity  $\varphi_t = \varphi_t^i$  of each firm evolves randomly on  $\mathbb{R}_+$ .

- the  $i$  superscript indicates the  $i$ -th firm and we drop it in what follows

A firm with productivity  $\varphi$  facing output price  $p$  and wage rate  $w$  earns current profits

$$\pi(\varphi, p) = p\varphi n^\theta - c - wn$$

Here

- $\theta \in (0, 1)$  is a productivity parameter,
- $c$  is a fixed cost and
- $n$  is labor input.

Maximizing over  $n$  leads to

$$\pi(\varphi, p) = (1 - \theta)(p\varphi)^\eta \left(\frac{\theta}{w}\right)^{\theta/\eta} - c$$

where  $\eta := 1/(1 - \theta)$ .

Output is

$$q(\varphi, p) = \varphi^\eta \left(\frac{p\theta}{w}\right)^{\theta/\eta}$$

Productivity of incumbents is independent across firms and grows according to

$$\varphi_{t+1} \sim \Gamma(\varphi_t, d\varphi')$$

Here  $\Gamma$  is a Markov transition kernel, so that  $\Gamma(\varphi, d\varphi')$  is the distribution over  $\mathbb{R}_+$  given  $\varphi \in \mathbb{R}_+$ .

For example,

$$\int \pi(\varphi', p) \Gamma(\varphi, d\varphi') = \mathbb{E}[\pi(\varphi_{t+1}, p) \mid \varphi_t = \varphi]$$

New entrants obtain their productivity draw from a fixed distribution  $\gamma$ .

Demand is

$$D(p) = 1/p$$

### 19.2.2 Firm decisions

The intertemporal firm decision problem is choosing when to exit.

The timing is:

1. produce and receive current profits  $\pi(\varphi, p)$
2. decide whether to continue or exit.

Scrap value is set to zero and the discount rate is  $\beta \in (0, 1)$ .

The firm makes their stop-continue choice by first solving for the value function, which is the unique solution in a class of continuous functions  $\mathcal{C}$  (details omitted) to

$$v(\varphi, p) = \pi(\varphi, p) + \beta \max \left\{ 0, \int v(\varphi', p) \Gamma(\varphi, d\varphi') \right\}. \quad (19.1)$$

Let  $\bar{v}$  be the unique solution to this functional equation.

Given  $\bar{v}$ , we let  $\bar{\varphi}$  be the exit threshold function defined by

$$\bar{\varphi}(p) := \min \left\{ \varphi \geq 0 \mid \int \bar{v}(\varphi', p) \Gamma(\varphi, d\varphi') \geq 0 \right\}. \quad (19.2)$$

With the convention that incumbents who are indifferent remain rather than exit, an incumbent with productivity  $\varphi$  exits if and only if  $\varphi < \bar{\varphi}(p)$ .

### 19.2.3 Equilibrium

Now we describe a stationary recursive equilibrium in the model, where

- the goods market clears (supply equals demand)
- the firm size distribution is stationary over time (an invariance condition)
- the mass of entrants equals the mass of exiting firms, and
- entering firms satisfy a break-even condition.

The break-even condition means that expected lifetime value given an initial draw from  $\gamma$  is just equal to the fixed cost of entry, which we denote by  $c_e$ .

Let's now state this more formally

To begin, let  $\mathcal{B}$  be the Borel subsets of  $\mathbb{R}_+$  and  $\mathcal{M}$  be all measures on  $\mathcal{B}$ .

Taking  $\bar{v}$  and  $\bar{\varphi}$  as defined in the previous section, a **stationary recursive equilibrium** is a triple

$$(p, M, \mu) \quad \text{in} \quad \mathcal{E} := (0, \infty) \times (0, \infty) \times \mathcal{M},$$

with  $p$  understood as price,  $M$  as mass of entrants, and  $\mu$  as a distribution of firms over productivity levels, such that the goods market clears, or

$$\int q(\varphi, p) \mu(d\varphi) = D(p), \quad (19.3)$$

the *invariance condition* over the firm distribution

$$\mu(B) = \int \Gamma(\varphi, B) \mathbf{1}\{\varphi \geq \bar{\varphi}(p)\} \mu(d\varphi) + M \gamma(B) \quad \text{for all } B \in \mathcal{B}, \quad (19.4)$$

holds (see below for intuition), the *equilibrium entry condition*

$$\int \bar{v}(\varphi, p) \gamma(d\varphi) = c_e \quad (19.5)$$

holds, and the *balanced entry and exit condition*

$$M = \mu\{\varphi < \bar{\varphi}(p)\} \quad (19.6)$$

is verified.

The invariance condition says that, for any subset  $B$  of the state space, the mass of firms with productivity in set  $B$  today (the left-hand side) is equal to the mass of firms with productivity in set  $B$  tomorrow (the right-hand side).

## 19.2.4 Computing equilibrium

We compute the equilibrium as follows:

For the purposes of this section, we insert balanced entry and exit into the time invariance condition, yielding

$$\mu(B) = \int \Pi(\varphi, B) \mu(d\varphi) \quad \text{for all } B \in \mathcal{B}, \quad (19.7)$$

where  $\Pi$  is the transition kernel on  $\mathbb{R}_+$  defined by

$$\Pi(\varphi, B) = \Gamma(\varphi, B) \mathbf{1}\{\varphi \geq \bar{\varphi}(p)\} + \mathbf{1}\{\varphi < \bar{\varphi}(p)\} \gamma(B). \quad (19.8)$$

Under our assumptions, for each  $p > 0$ , there exists a unique  $\mu$  satisfying this invariance law.

Let  $\mathcal{P}$  be the probability measures on  $\mathbb{R}_+$ .

The unique stationary equilibrium can be computed as follows:

1. Obtain  $\bar{v}$  as the unique solution to the Bellman equation, and then calculate the exit threshold function  $\bar{\varphi}$ .
2. Solve for the equilibrium entry price  $p^*$  by solving the entry condition.
3. Define  $\Pi$  as above, using  $p^*$  as the price, and compute  $\mu$  as the unique solution to the invariance condition.
4. Rescale  $\mu$  by setting  $s := D(p^*) / \int q(\varphi, p^*) \mu(d\varphi)$  and then  $\mu^* := s \mu$ .
5. Obtain the mass of entrants via  $M^* = \mu^* \{\varphi < \bar{\varphi}(p^*)\}$ .

When we compute the distribution  $\mu$  in step 3, we will use the fact that it is the stationary distribution of the Markov transition kernel  $\Pi(\varphi, d\varphi)$ .

This transition kernel turns out to be *ergodic*, which means that if we simulate a cross-section of firms according to  $\Pi$  for a large number of periods, the resulting sample (cross-section of productivities) will approach a set of IID draws from  $\mu$ .

This allows us to

1. compute integrals with respect to the distribution using Monte Carlo, and
2. investigate the shape and properties of the stationary distribution.

## 19.2.5 Specification of dynamics

Before solving the model we need to specify  $\Gamma$  and  $\gamma$ .

We assume  $\Gamma(\varphi, d\varphi')$  is given by

$$\varphi_{t+1} = A_{t+1} \varphi_t$$

We assume that  $(A_t)$  is IID over time, independent across firms, and lognormal  $LN(m_a, \sigma_a)$ .

(This means that incumbents follow Gibrat's law, which is a reasonable assumption for medium to large firms – and hence for incumbents.)

New entrants are drawn from a lognormal distribution  $LN(m_e, \sigma_e)$ .

## 19.3 Code

We use 64 bit floats for extra precision.

```
jax.config.update("jax_enable_x64", True)
```

We store the parameters, grids and Monte Carlo draws in a namedtuple.

```
Parameters = namedtuple("Parameters",
    ("β",          # discount factor
     "θ",          # labor productivity
     "c",          # fixed cost in production
     "c_e",        # entry cost
     "w",          # wages
     "m_a",        # productivity shock location parameter
     "σ_a",        # productivity shock scale parameter
     "m_e",        # new entrant location parameter
     "σ_e"))       # new entrant scale parameter
```

```
Grids = namedtuple("Grids",
    ("ψ_grid",    # productivity grid
     "E_draws",   # entry size draws for Monte Carlo
     "A_draws"))  # productivity shock draws for Monte Carlo
```

```
Model = namedtuple("Model",
    ("parameters", # instance of Parameters
     "grids"))     # instance of Grids
```

```
def create_model(β=0.95,          # discount factor
                θ=0.3,           # labor productivity
                c=4.0,           # fixed cost in production
                c_e=1.0,         # entry cost
                w=1.0,           # wages
                m_a=-0.012,      # productivity shock location parameter
                σ_a=0.1,         # productivity shock scale parameter
                m_e=1.0,         # new entrant location parameter
                σ_e=0.2,         # new entrant scale parameter
                ψ_grid_max=5,     # productivity grid max
                ψ_grid_size=100,  # productivity grid size
                E_draw_size=200,  # entry MC integration size
                A_draw_size=200,  # prod shock MC integration size
                seed=1234):       # Seed for MC draws
    """
    Create an instance of the `namedtuple` Model using default parameter values.
    """

    # Test stability
    assert m_a + σ_a**2 / (2 * (1 - θ)) < 0, "Stability condition fails"
    # Build grids and initialize random number generator
    ψ_grid = jnp.linspace(0, ψ_grid_max, ψ_grid_size)
    key, subkey = jax.random.split(jax.random.PRNGKey(seed))
    # Generate a sample of draws of A for Monte Carlo integration
    A_draws = jnp.exp(m_a + σ_a * jax.random.normal(key, (A_draw_size,)))
    # Generate a sample of draws from γ for Monte Carlo
```

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```

E_draws = jnp.exp(m_e +  $\sigma_e$  * jax.random.normal(subkey, (E_draw_size,)))
# Build namedtuple and return
parameters = Parameters( $\beta$ ,  $\theta$ , c, c_e, w, m_a,  $\sigma_a$ , m_e,  $\sigma_e$ )
grids = Grids( $\psi$ _grid, E_draws, A_draws)
model = Model(parameters, grids)
return model

```

Let us write down functions for profits and output.

```

@jax.jit
def  $\pi$ ( $\psi$ , p, parameters):
    """ Profits. """
    # Unpack
     $\beta$ ,  $\theta$ , c, c_e, w, m_a,  $\sigma_a$ , m_e,  $\sigma_e$  = parameters
    # Compute profits
    return (1 -  $\theta$ ) * (p *  $\psi$ )**(1/(1 -  $\theta$ )) * ( $\theta$ /w)**( $\theta$ /(1 -  $\theta$ )) - c

```

```

@jax.jit
def q( $\psi$ , p, parameters):
    """ Output. """
    # Unpack
     $\beta$ ,  $\theta$ , c, c_e, w, m_a,  $\sigma_a$ , m_e,  $\sigma_e$  = parameters
    # Compute output
    return  $\psi$ ** (1/(1 -  $\theta$ )) * (p *  $\theta$ /w)**( $\theta$ /(1 -  $\theta$ ))

```

Let's write code to simulate a cross-section of firms given a particular value for the exit threshold (rather than an exit threshold function).

Firms that exit are immediately replaced by a new entrant, drawn from  $\gamma$ .

Our first function updates by one step

```

def update_cross_section( $\psi$ _bar,  $\psi$ _vec, key, parameters, num_firms):
    # Unpack
     $\beta$ ,  $\theta$ , c, c_e, w, m_a,  $\sigma_a$ , m_e,  $\sigma_e$  = parameters
    # Update
    Z = jax.random.normal(key, (2, num_firms)) # long rows for row-major arrays
    incumbent_draws =  $\psi$ _vec * jnp.exp(m_a +  $\sigma_a$  * Z[0, :])
    new_firm_draws = jnp.exp(m_e +  $\sigma_e$  * Z[1, :])
    return jnp.where( $\psi$ _vec >=  $\psi$ _bar, incumbent_draws, new_firm_draws)

```

```
update_cross_section = jax.jit(update_cross_section, static_argnums=(4,))
```

Our next function runs the cross-section forward in time `sim_length` periods.

```

def simulate_firms( $\psi$ _bar, parameters, grids,
                  sim_length=200, num_firms=1_000_000, seed=12):
    """
    Simulate a cross-section of firms when the exit threshold is  $\psi$ _bar.

    """
    # Set initial conditions to the threshold value
     $\psi$ _vec = jnp.ones((num_firms,)) *  $\psi$ _bar
    key = jax.random.PRNGKey(seed)

```

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```

# Iterate forward in time
for t in range(sim_length):
    key, subkey = jax.random.split(key)
    psi_vec = update_cross_section(psi_bar, psi_vec, subkey, parameters, num_firms)
return psi_vec

```

Here's a utility function to compute the expected value

$$\int v(\varphi') \Gamma(\varphi, d\varphi') = \mathbb{E}v(A_{t+1}\varphi)$$

given  $\varphi$

```

@jax.jit
def _compute_exp_value_at_phi(v, psi, grids):
    """
    Compute

         $E[v(\psi') | \psi] = Ev(A \psi)$ 

    using linear interpolation and Monte Carlo.
    """
    # Unpack
    psi_grid, E_draws, A_draws = grids
    # Set up V
    Apsi = A_draws * psi
    vApsi = jnp.interp(Apsi, psi_grid, v) # v(A_j psi) for all j
    # Return mean
    return jnp.mean(vApsi) # (1/n) \sum_j v(A_j psi)

```

Now let's vectorize this function in  $\varphi$  and then write another function that computes the expected value across all  $\varphi$  in  $\psi\_grid$

```
compute_exp_value_at_phi = jax.vmap(_compute_exp_value_at_phi, (None, 0, None))
```

```

@jax.jit
def compute_exp_value(v, grids):
    """
    Compute

         $E[v(\psi_{prime}) | \psi] = Ev(A \psi)$  for all  $\psi$ , as a vector

    """
    # Unpack
    psi_grid, E_draws, A_draws = grids
    return compute_exp_value_at_phi(v, psi_grid, grids)

```

Here is the Bellman operator  $T$ .

```

@jax.jit
def T(v, p, parameters, grids):
    """ Bellman operator. """
    # Unpack
    beta, theta, c, c_e, w, m_a, sigma_a, m_e, sigma_e = parameters
    psi_grid, E_draws, A_draws = grids

```

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```

# Compute Tv
EvAψ = compute_exp_value(v, grids)
return π(ψ_grid, p, parameters) + β * jnp.maximum(0.0, EvAψ)

```

The next function takes  $v, p$  as inputs and, conditional on the value function  $v$ , computes the value  $\bar{\varphi}(p)$  that corresponds to the exit value.

```

@jax.jit
def get_threshold(v, grids):
    """ Compute the exit threshold. """
    # Unpack
    ψ_grid, E_draws, A_draws = grids
    # Compute exit threshold: ψ such that E v(A ψ) = 0
    EvAψ = compute_exp_value(v, grids)
    i = jnp.searchsorted(EvAψ, 0.0)
    return ψ_grid[i]

```

We use value function iteration (VFI) to compute the value function  $\bar{v}(\cdot, p)$ , taking  $p$  as given.

VFI is relatively cheap and simple in this setting.

```

@jax.jit
def vfi(p, v_init, parameters, grids, tol=1e-6, max_iter=10_000):
    """
    Implement value function iteration to solve for the value function.
    """
    # Unpack
    ψ_grid, E_draws, A_draws = grids
    # Set up
    def cond_function(state):
        i, v, error = state
        return jnp.logical_and(i < max_iter, error > tol)

    def body_function(state):
        i, v, error = state
        new_v = T(v, p, parameters, grids)
        error = jnp.max(jnp.abs(v - new_v))
        i += 1
        return i, new_v, error

    # Loop till convergence
    init_state = 0, v_init, tol + 1
    state = jax.lax.while_loop(cond_function, body_function, init_state)
    i, v, error = state
    return v

```

```

@jax.jit
def compute_net_entry_value(p, v_init, parameters, grids):
    """
    Returns the net value of entry, which is

    \int v_bar(ψ, p) γ(d ψ) - c_e

    This is the break-even condition for new entrants. The argument
    v_init is used as an initial condition when computing v_bar for VFI.
    """

```

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```

"""
c_e = parameters.c_e
psi_grid = grids.psi_grid
E_draws = grids.E_draws
v_bar = vfi(p, v_init, parameters, grids)
v_psi = jnp.interp(E_draws, psi_grid, v_bar)
Ev_psi = jnp.mean(v_psi)
return Ev_psi - c_e, v_bar

```

We need to solve for the equilibrium price, which is the  $p$  satisfying

$$\int \bar{v}(\varphi', p) \gamma(d\varphi') = c_e$$

At each price  $p$ , we need to recompute  $\bar{v}(\cdot, p)$  and then take the expectation.

The technique we will use is bisection.

We will write our own bisection routine because, when we shift to a new price, we want to update the initial condition for value function iteration to the value function from the previous price.

```

def compute_p_star(parameters, grids, p_min=1.0, p_max=2.0, tol=10e-5):
    """
    Compute the equilibrium entry price p^* via bisection.

    Return both p^* and the corresponding value function v_bar, which is
    computed as a byproduct.

    Implements the bisection root finding algorithm to find p_star

    """
    psi_grid, E_draws, A_draws = grids
    lower, upper = p_min, p_max
    v_bar = jnp.zeros_like(psi_grid) # Initial condition at first price guess

    while upper - lower > tol:
        mid = 0.5 * (upper + lower)
        entry_val, v_bar = compute_net_entry_value(mid, v_bar, parameters, grids)
        if entry_val > 0: # Root is between lower and mid
            lower, upper = lower, mid
        else: # Root is between mid and upper
            lower, upper = mid, upper

    p_star = 0.5 * (upper + lower)
    return p_star, v_bar

```

We are now ready to compute all elements of the stationary recursive equilibrium.

```

def compute_equilibrium_prices_and_quantities(model):
    """
    Compute

    1. The equilibrium outcomes for p^*, v^* and psi^*, where psi^* is the
    equilibrium exit threshold psi_bar(p^*).
    1. The scaling factor necessary to convert the stationary probability
    distribution mu into the equilibrium firm distribution mu^* = s mu.

```

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```

2. The equilibrium mass of entrants  $M^* = \mu \{ \psi < \psi^* \}$ 

"""
# Unpack
parameters, grids = model
# Compute prices and values
p_star, v_bar = compute_p_star(parameters, grids)
# Get  $\psi_{star} = \psi_{bar}(p_{star})$ , the equilibrium exit threshold
psi_star = get_threshold(v_bar, grids)
# Generate an array of draws from  $\mu$ , the normalized stationary distribution.
psi_sample = simulate_firms(psi_star, parameters, grids)
# Compute  $s$  to scale  $\mu$ 
demand = 1 / p_star
pre_normalized_supply = jnp.mean(q(psi_sample, p_star, parameters))
s = demand / pre_normalized_supply
# Compute  $M^* = \mu \{ \psi < \psi_{star} \}$ 
m_star = s * jnp.mean(psi_sample < psi_star)
# return computed objects
return p_star, v_bar, psi_star, psi_sample, s, m_star

```

## 19.4 Solving the model

### 19.4.1 Preliminary calculations

Let's create an instance of the model.

```

model = create_model()
parameters, grids = model

```

Let's see how long it takes to compute the value function at a given price from a cold start.

```

p = 2.0
v_init = jnp.zeros_like(grids.psi_grid) # Initial condition
%time v_bar = vfi(p, v_init, parameters, grids)

```

```

CPU times: user 420 ms, sys: 23.5 ms, total: 443 ms
Wall time: 465 ms

```

```

%time v_bar = vfi(p, v_init, parameters, grids)

```

```

CPU times: user 18.2 ms, sys: 4.75 ms, total: 23 ms
Wall time: 19.6 ms

```

Let's have a look at the net entry value as a function of price

The root is the equilibrium price at the given parameters

```

p_min, p_max, p_size = 1.0, 2.0, 20
p_vec = jnp.linspace(p_min, p_max, p_size)
entry_vals = []

```

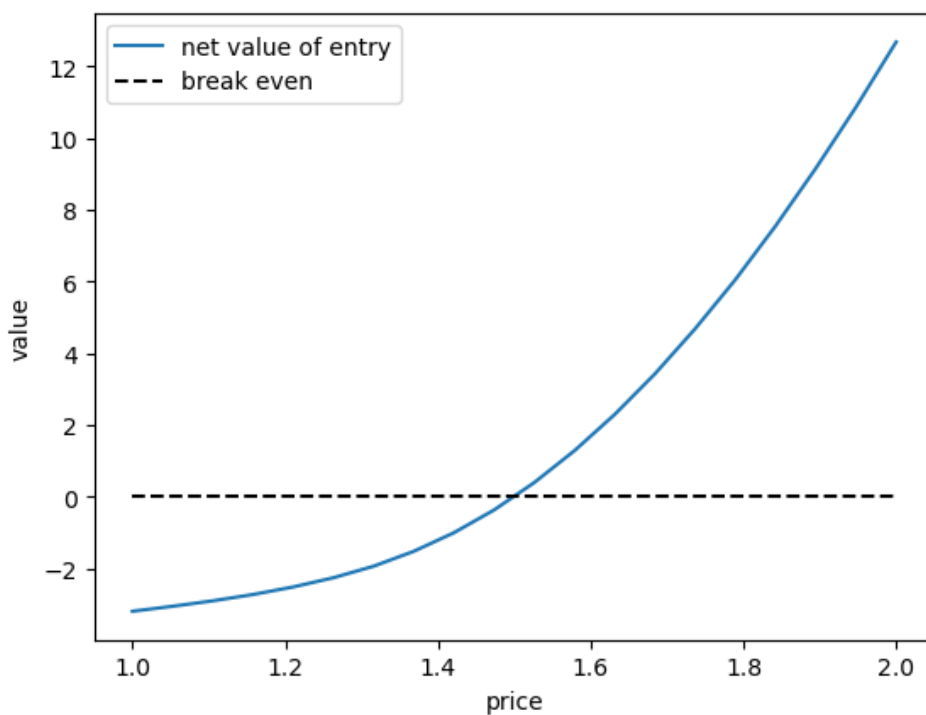
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```

v_bar = jnp.zeros_like(grid.ψ_grid) # Initial condition at first price guess
for i, p in enumerate(p_vec):
    entry_val, v_bar = compute_net_entry_value(p, v_bar, parameters, grids)
    entry_vals.append(entry_val)
fig, ax = plt.subplots()
ax.plot(p_vec, entry_vals, label="net value of entry")
ax.plot(p_vec, jnp.zeros_like(p_vec), 'k', ls='--', label="break even")
ax.legend()
ax.set_xlabel("price")
ax.set_ylabel("value")
plt.show()

```



Below we solve for the zero of this function to calculate  $p^*$ .

From the figure it looks like  $p^*$  will be close to 1.5.

## 19.4.2 Computing the equilibrium

Now let's try computing the equilibrium

```

%%time
p_star, v_bar, ψ_star, ψ_sample, s, m_star = \
    compute_equilibrium_prices_and_quantities(model)

```

```

CPU times: user 2.98 s, sys: 180 ms, total: 3.16 s
Wall time: 2.21 s

```

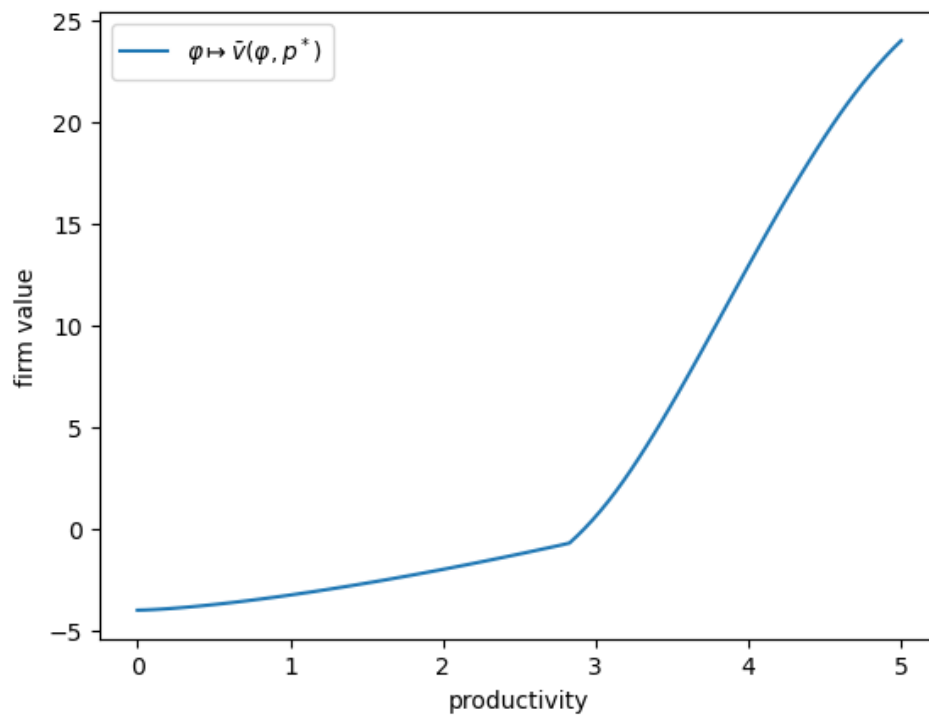
Let's check that  $p^*$  is close to 1.5

```
p_star
```

```
1.500213623046875
```

Here is a plot of the value function  $\bar{v}(\cdot, p^*)$ .

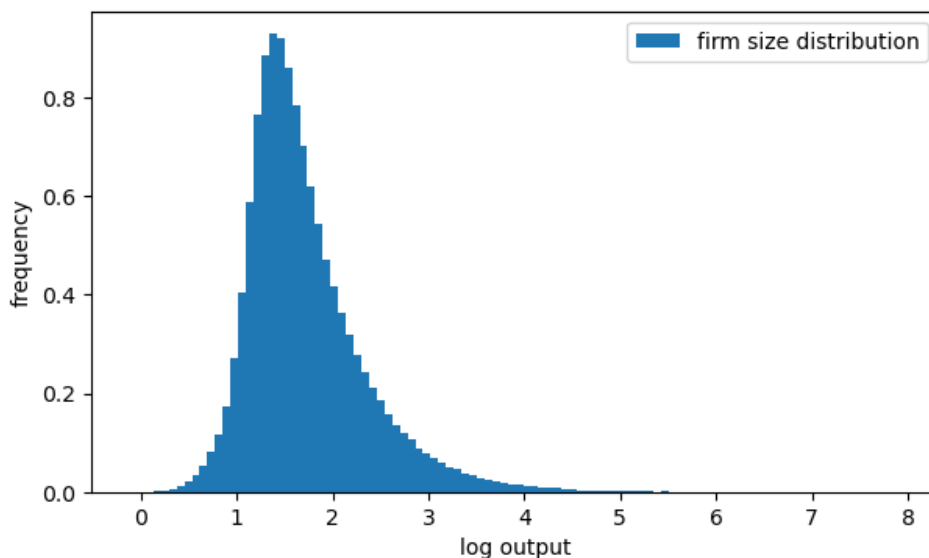
```
fig, ax = plt.subplots()
ax.plot(grids.φ_grid, v_bar, label=r'$\varphi \mapsto \bar{v}(\varphi, p^*)$')
ax.set_xlabel("productivity")
ax.set_ylabel("firm value")
ax.legend()
plt.show()
```



Let's have a look at the firm size distribution, with firm size measured by output.

```
output_dist = q(φ_sample, p_star, parameters)
```

```
fig, ax = plt.subplots(figsize=(7, 4))
ax.hist(jnp.log(output_dist), bins=100, density=True,
        label="firm size distribution")
ax.set_xlabel("log output")
ax.set_ylabel("frequency")
ax.legend()
plt.show()
```



## 19.5 Pareto tails

The firm size distribution shown above appears to have a long right tail.

This matches the observed firm size distribution.

In fact the firm size distribution obeys a **power law**.

More mathematically, the distribution of firm size has a Pareto right hand tail, so that there exist constants  $k, \alpha > 0$  with

$$\mu((x, \infty)) \approx kx^{-\alpha} \text{ when } x \text{ is large}$$

Here  $\alpha$  is called the tail index.

Does the model replicate this feature?

One option is to look at the empirical counter CDF (cumulative distribution).

The idea is as follows: The counter CDF of a random variable  $X$  is

$$G(x) := \mathbb{P}\{X > x\}$$

In the case of a Pareto tailed distribution we have  $\mathbb{P}\{X > x\} \approx kx^{-\alpha}$  for large  $x$ .

Hence, for large  $x$ ,

$$\ln G(x) \approx \ln k - \alpha \ln x$$

The empirical counterpart of  $G$  given sample  $X_1, \dots, X_n$  is

$$G_n(x) := \frac{1}{n} \sum_{i=1}^n \mathbf{1}\{X_i > x\}$$

For large  $k$  (implying  $G_n \approx G$ ) and large  $x$ , we expect that, for a Pareto-tailed sample,  $\ln G_n$  is approximately linear.

Here's a function to compute the empirical counter CDF:

```

def ECCDF(data):
    """
    Return a function that implements the ECCDF given the data.
    """
    def eccdf(x):
        return jnp.mean(data > x)
    return eccdf

```

Let's plot the empirical counter CDF of the output distribution.

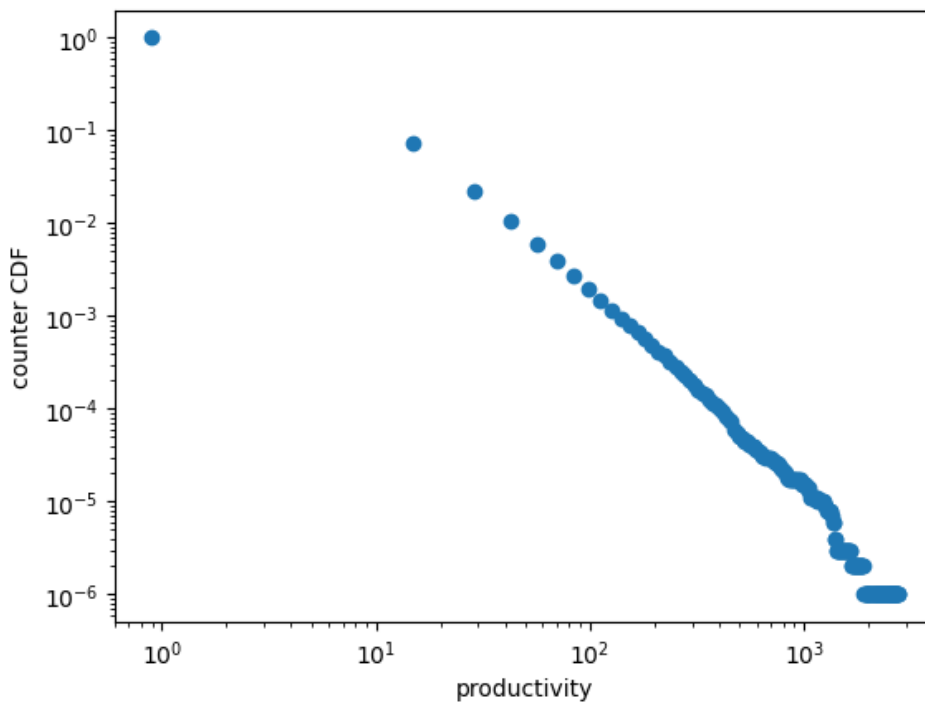
```

eccdf = ECCDF(output_dist)

epsilon = 10e-10
x_grid = jnp.linspace(output_dist.min() + epsilon, output_dist.max() - epsilon, 200)
y = [eccdf(x) for x in x_grid]

fig, ax = plt.subplots()
ax.loglog(x_grid, y, 'o', label="ECCDF")
ax.set_xlabel("productivity")
ax.set_ylabel("counter CDF")
plt.show()

```





## 19.6 Exercise

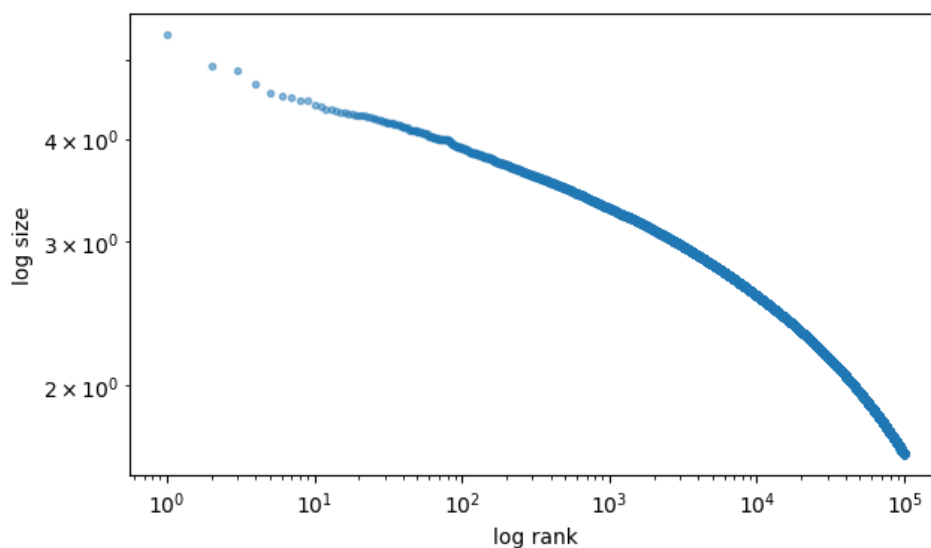
### Exercise 19.6.1

Plot the same output distribution, but this time using a rank-size plot.

If the rank-size plot is approximately linear, the data suggests a Pareto tail.

You can use QuantEcon's `rank_size` function — here's an example of usage.

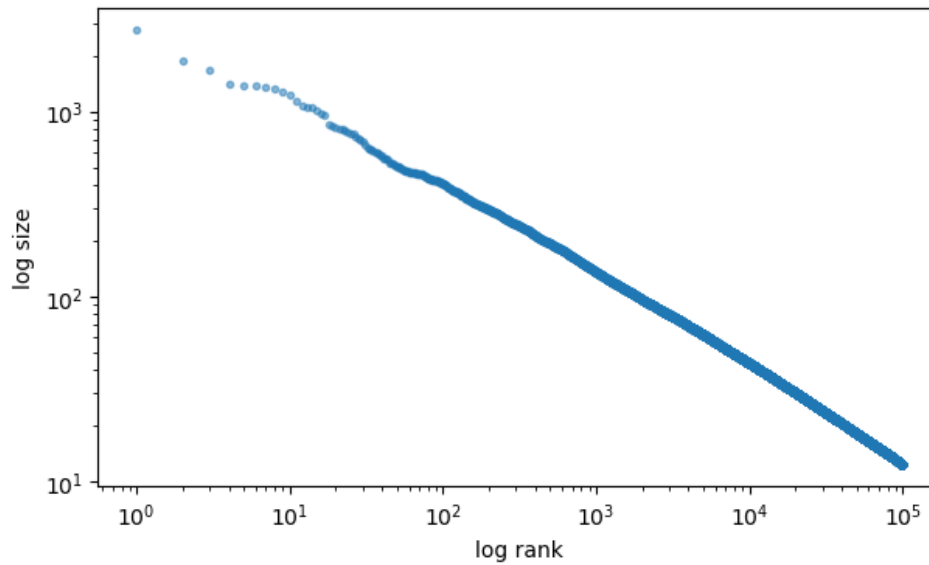
```
x = jnp.abs(jax.random.normal(jax.random.PRNGKey(42), (1_000_000,)))
rank_data, size_data = qe.rank_size(x, c=0.1)
fig, ax = plt.subplots(figsize=(7,4))
ax.loglog(rank_data, size_data, "o", markersize=3.0, alpha=0.5)
ax.set_xlabel("log rank")
ax.set_ylabel("log size")
plt.show()
```



This plot is not linear — as expected, since we are using a folded normal distribution.

### Solution to Exercise 19.6.1

```
rank_data, size_data = qe.rank_size(output_dist, c=0.1)
fig, ax = plt.subplots(figsize=(7,4))
ax.loglog(rank_data, size_data, "o", markersize=3.0, alpha=0.5)
ax.set_xlabel("log rank")
ax.set_ylabel("log size")
plt.show()
```



This looks very linear — the model generates Pareto tails.

(In fact it's possible to prove this.)

### Exercise 19.6.2

As an exercise, let's look at the fixed cost paid by incumbents each period and how it relates to the equilibrium price.

We expect that a higher fixed cost will reduce supply and hence increase the market price.

For the fixed costs, use

```
c_values = jnp.linspace(2.5, 5.0, 10)
```

### Solution to Exercise 19.6.2

```
eq_prices = []
for i, c in enumerate(c_values):
    model = create_model(c=c)
    p_star, v_bar, psi_star, psi_sample, s, m_star = \
        compute_equilibrium_prices_and_quantities(model)
    eq_prices.append(p_star)
    print(f"Equilibrium price when c = {c:.2} is {p_star:.2}")

fig, ax = plt.subplots()
ax.plot(c_values, eq_prices, label="$p^*$")
ax.set_xlabel("fixed cost for incumbents")
ax.set_ylabel("price")
ax.legend()
plt.show()
```

```
Equilibrium price when c = 2.5 is 1.1
```

Equilibrium price when  $c = 2.8$  is 1.2

Equilibrium price when  $c = 3.1$  is 1.3

Equilibrium price when  $c = 3.3$  is 1.3

Equilibrium price when  $c = 3.6$  is 1.4

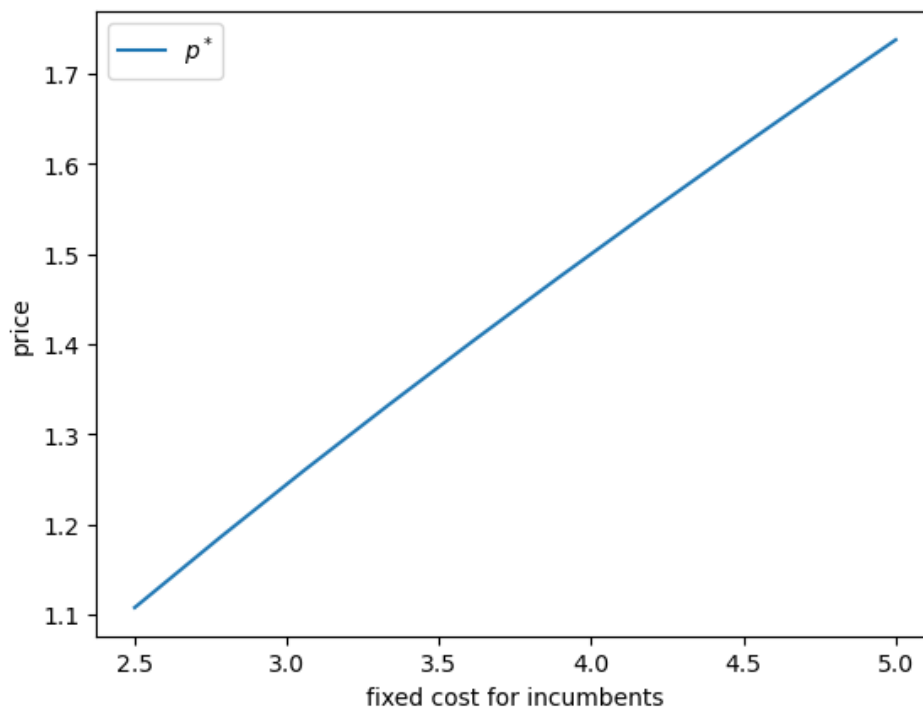
Equilibrium price when  $c = 3.9$  is 1.5

Equilibrium price when  $c = 4.2$  is 1.5

Equilibrium price when  $c = 4.4$  is 1.6

Equilibrium price when  $c = 4.7$  is 1.7

Equilibrium price when  $c = 5.0$  is 1.7





## BIANCHI OVERBORROWING MODEL

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

This lecture provides a JAX implementation of “Overborrowing and Systemic Externalities” [[Bianchi, 2011](#)] by [Javier Bianchi](#).

In addition to what’s in Anaconda, this lecture will need the following libraries:

```
!pip install quantecon
```

We use the following imports.

```
import time
import jax
import numba
import jax.numpy as jnp
import matplotlib.pyplot as plt
import numpy as np
import quantecon as qe
import scipy as sp
import matplotlib.pyplot as plt
import seaborn
```

### 20.1 Description of the model

The model seeks to explain sudden stops in emerging market economies, where painful financial disruption follows a period of sustained heavy borrowing.

A representative household chooses how much to borrow on international markets and how much to consume.

The household is credit constrained, with the constraint depending on both current income and the real exchange rate.

The model shows that household overborrow because they do not internalize the effect of borrowing on the credit constraint.

This overborrowing leaves them vulnerable to bad shocks in current income.

In essence, the model works as follows

1. During good times, households borrow more and consume more
2. Increased consumption pushes up the price of nontradables and hence the real exchange rate
3. A rising real exchange rate loosens the credit constraint and encourages more borrowing
4. This leads to excessive borrowing relative to a planner.

This overborrowing leads to vulnerability vis-a-vis bad shocks.

1. When a bad shock hits, borrowing is restricted.
2. Consumption now falls, pushing down the real exchange rate.
3. This fall in the exchange rate further tightens the borrowing constraint, amplifying the shock

### 20.1.1 Decentralized equilibrium

The model contains a representative household that seeks to maximize an expected sum of discounted utility where

- the flow utility function  $u$  is CRRA, with  $u(c) = c^{1-\sigma}/(1-\sigma)$  and
- $c = (\omega c_t^{-\eta} + (1-\omega)c_n^{-\eta})^{-1/\eta}$

Here  $c_t$  ( $c_n$ ) is consumption of tradables (nontradables).

The household maximizes subject to the budget constraint

$$b' + c_t + p_n c_n = b(1+r) + y_t + p_n y_n$$

where

- $b$  is bond holdings (positive values denote assets)
- primes denote next period values
- the interest rate  $r$  is exogenous
- $p_n$  is the price of nontradables, while the price of tradables is normalized to 1
- $y_t$  and  $y_n$  are current tradable and nontradable income

The process for  $y := (y_t, y_n)$  is first-order Markov.

The household also faces the credit constraint

$$b' \geq -\kappa(y_t + p_n y_n)$$

Market clearing implies

$$c_n = y_n \quad \text{and} \quad c_t = y_t + (1+r)b - b'$$

The household takes the aggregate timepath for bonds as given by  $B' = H(B, y)$  and solves

$$V(b, B, y) = \max_{c, b'} \{u(c) + \beta \mathbb{E}_y v(b', B', y')\}$$

subject to the budget and credit constraints.

A decentralized equilibrium is a law of motion  $H$  such that the implied savings policy  $b' = b'(b, B, y)$  verifies

$$b'(B, B, y) = H(B, y) \quad \text{for all } B, y$$

## 20.1.2 Notation

Let

$$w(c_t, y_n) = \frac{c^{1-\sigma}}{1-\sigma} \quad \text{where} \quad c = [\omega c_t^{-\eta} + (1-\omega)y_n^{-\eta}]^{-1/\eta}$$

Using the market clearing conditions, we can write the household problem as

$$V(b, B, y) = \max_{b'} \{w((1+r)b + y_t - b', y_n) + \beta \mathbb{E}_y v(b', H(B, y), y')\}$$

subject to

$$-\kappa(p_n y_n + y_t) \leq b' \leq (1+r)b + y_t$$

where  $p_n$  is given by

$$p_n = ((1-\omega)/\omega)(C/y_n)^{\eta+1} \quad \text{with} \quad C := (1+r)B + y_t - H(B, y)$$

## 20.1.3 Constrained planner

The constrained planner solves

$$V(b, B, y) = \max_{c, b'} \{u(c) + \beta \mathbb{E}_y v(b', B', y')\}$$

subject to the market clearing conditions and the same constraint

$$-\kappa(y_t + p_n y_n) \leq b' \leq (1+r)b + y_t$$

although the price of nontradable is now given by

$$p_n = ((1-\omega)/\omega)(c_t/y_n)^{\eta+1} \quad \text{with} \quad c_t := (1+r)b + y_t - b'$$

We see that the planner internalizes the impact of the savings choice  $b'$  on the price of nontradables and hence the credit constraint.

## 20.2 Markov dynamics

We develop some functions for working with the VAR process

$$\ln y' = A \ln y + u' \quad (\text{prime indicates next period value})$$

where

- $y = (y_t, y_n) = (\text{tradables}, \text{nontradables})$
- $A$  is  $2 \times 2$
- $u' \sim N(0, \Omega)$
- the log function is applied pointwise

We use the following estimated values, reported on p. 12 of [Yamada \(2023\)](#).

```
A = [[0.2425, 0.3297],
      [-0.1984, 0.7576]]
Ω = [[0.0052, 0.002],
      [0.002, 0.0059]]
```

We'll store the data in  $\Omega$  using its square root:

```
C = sp.linalg.sqrtm(Ω)
A = np.array(A)
```

Here's a function to convert the VAR process to a Markov chain evolving on a rectilinear grid of points in  $\mathbb{R}^2$ .

Under the hood, this function uses the QuantEcon function `discrete_var`.

```
def discretize_income_var(A=A, C=C, grid_size=4, seed=1234):
    """
    Discretize the VAR model, returning

    y_t_nodes, a grid of y_t values
    y_n_nodes, a grid of y_n values
    Q, a Markov operator

    Let n = grid_size. The format is that Q is n x n x n x n, with

    Q[i, j, i', j'] = one step transition prob from
    (y_t_nodes[i], y_n_nodes[j]) to (y_t_nodes[i'], y_n_nodes[j'])

    """

    n = grid_size
    rng = np.random.default_rng(seed)
    mc = qe.markov.discrete_var(A, C, (n, n),
                               sim_length=1_000_000,
                               std_devs=np.sqrt(3),
                               random_state=rng)
    y_nodes, Q = np.exp(mc.state_values), mc.P
    # The array y_nodes is currently an array listing all 2 x 1 state pairs
    # (y_t, y_n), so that y_nodes[i] is the i-th such pair, while Q[l, m]
    # is the probability of transitioning from state l to state m in one step.
    # We switch the representation to the one described in the docstring.
    y_t_nodes = [y_nodes[n*i, 0] for i in range(n)]
    y_n_nodes = y_nodes[0:4, 1]
    Q = np.reshape(Q, (n, n, n, n))

    return y_t_nodes, y_n_nodes, Q
```

Here's code for sampling from the Markov chain.

```
def generate_discrete_var(A=A, C=C, grid_size=4, seed=1234,
                          ts_length=1_000_000,
                          indices=False):
    """
    Generate a time series from the discretized model, returning y_t_series and
    y_n_series. If `indices=True`, then these series are returned as grid
    indices.
    """
```

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```

n = grid_size
rng = np.random.default_rng(seed)
mc = qe.markov.discrete_var(A, C, (n, n),
                           sim_length=1_000_000,
                           std_devs=np.sqrt(3),
                           random_state=rng)

if indices:
    y_series = mc.simulate_indices(ts_length=ts_length)
    y_t_series, y_n_series = y_series % grid_size, y_series // grid_size
else:
    y_series = np.exp(mc.simulate(ts_length=ts_length))
    y_t_series, y_n_series = y_series[:, 0], y_series[:, 1]
return y_t_series, y_n_series

```

Here's code for generating the original VAR process, which can be used for testing.

```

@numba.jit
def generate_var_process(A=A, C=C, ts_length=1_000_000):
    """
    Generate the original VAR process.

    """
    y_series = np.empty((ts_length, 2))
    y_series[0, :] = np.zeros(2)
    for t in range(ts_length-1):
        y_series[t+1, :] = A @ y_series[t, :] + C @ np.random.randn(2)
    y_t_series = np.exp(y_series[:, 0])
    y_n_series = np.exp(y_series[:, 1])
    return y_t_series, y_n_series

```

Let's check some statistics for both the original and the discretized processes.

```

def corr(x, y):
    m_x, m_y = x.mean(), y.mean()
    s_xy = np.sqrt(np.sum((x - m_x)**2) * np.sum((y - m_y)**2))
    return np.sum((x - m_x) * (y - m_y)) / (s_xy)

```

```

def print_stats(y_t_series, y_n_series):
    print(f"Std dev of y_t is {y_t_series.std()}")
    print(f"Std dev of y_n is {y_n_series.std()}")
    print(f"corr(y_t, y_n) is {corr(y_t_series, y_n_series)}")
    print(f"auto_corr(y_t) is {corr(y_t_series[:-1], y_t_series[1:])}")
    print(f"auto_corr(y_n) is {corr(y_n_series[:-1], y_n_series[1:])}")
    print("\n")

```

```

print("Statistics for original process.\n")
print_stats(*generate_var_process())

```

```

Statistics for original process.

```

```
Std dev of y_t is 0.08792023320305366
Std dev of y_n is 0.10591740180881054
corr(y_t, y_n) is 0.5406067234281369
auto_corr(y_t) is 0.4557022367907824
auto_corr(y_n) is 0.6663854759385045
```

```
print("Statistics for discretized process.\n")
print_stats(*generate_discrete_var())
```

```
Statistics for discretized process.
```

```
Std dev of y_t is 0.08751160850922726
Std dev of y_n is 0.10548847773923896
corr(y_t, y_n) is 0.477029911830029
auto_corr(y_t) is 0.4020239759921668
auto_corr(y_n) is 0.589923590264531
```

## 20.3 Overborrowing Model

In what follows

- $y = (y_t, y_n)$  is the exogenous state process

Individual states and actions are

- $c$  = consumption of tradables ( $c$  rather than  $c_t$ )
- $b$  = household savings (bond holdings)
- $bp$  = household savings decision

Aggregate quantities and prices are

- $p$  = price of nontradables ( $p$  rather than  $p_n$ )
- $B$  = aggregate savings (bond holdings)
- $C$  = aggregate consumption
- $H$  = current guess of update rule as an array of the form  $H(B, y)$

Here's code to create three tuples that store model data relevant for computation.

```
def create_overborrowing_model(
    sigma=2,                # CRRA utility parameter
    eta=(1/0.83)-1,         # Elasticity = 0.83, eta = 0.2048
    beta=0.91,              # Discount factor
    omega=0.31,             # Aggregation constant
    kappa=0.3235,          # Constraint parameter
    r=0.04,                 # Interest rate
    b_size=400,             # Bond grid size
    b_grid_min=-1.02,      # Bond grid min
    b_grid_max=-0.2        # Bond grid max (originally -0.6 to match fig)
):
    """
    Creates an instance of the overborrowing model using
```

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```

    * default parameter values from Bianchi (2011)
    * Markov dynamics from Yamada (2023)

The Markov kernel  $Q$  has the interpretation

 $Q[i, j, ip, jp]$  = one step prob of moving

    (y_t[i], y_n[j]) -> (y_t[ip], y_n[jp])

"""
# Read in Markov data and shift to JAX arrays
data = discretize_income_var()
y_t_nodes, y_n_nodes, Q = tuple(map(jnp.array, data))
# Set up grid for bond holdings
b_grid = jnp.linspace(b_grid_min, b_grid_max, b_size)
# Pack and return
parameters =  $\sigma$ ,  $\eta$ ,  $\beta$ ,  $\omega$ ,  $\kappa$ ,  $r$ 
sizes = b_size, len(y_t_nodes)
arrays = b_grid, y_t_nodes, y_n_nodes, Q
return parameters, sizes, arrays

```

Here's flow utility.

```

@jax.jit
def w(parameters, c, y_n):
    """
    Current utility when  $c_t = c$  and  $c_n = y_n$ .

     $a = [\omega c^{(-\eta)} + (1 - \omega) y_n^{(-\eta)}]^{(-1/\eta)}$ 

     $w(c, y_n) := a^{(1 - \sigma)} / (1 - \sigma)$ 

    """
     $\sigma$ ,  $\eta$ ,  $\beta$ ,  $\omega$ ,  $\kappa$ ,  $r$  = parameters
    a = ( $\omega * c^{(-\eta)} + (1 - \omega) * y_n^{(-\eta)}$ )**(-1/ $\eta$ )
    return a**(1 -  $\sigma$ ) / (1 -  $\sigma$ )

```

We need code to generate an initial guess of  $H$ .

```

def generate_initial_H(parameters, sizes, arrays, at_constraint=False):
    """
    Compute an initial guess for  $H$ . Repeat the indices for  $b_{grid}$  over  $y_t$  and
     $y_n$  axes.

    """
    b_size, y_size = sizes
    b_indices = jnp.arange(b_size)
    O = jnp.ones((b_size, y_size, y_size), dtype=int)
    return O * jnp.reshape(b_indices, (b_size, 1, 1))

```

```
generate_initial_H = jax.jit(generate_initial_H, static_argnums=(1,))
```

We need to construct the Bellman operator for the household.

Our first function returns the (unmaximized) RHS of the Bellman equation.

```

@jax.jit
def T_generator(v, H, parameters, arrays, i_b, i_B, i_y_t, i_y_n, i_bp):
    """
    Given current state (b, B, y_t, y_n) with indices (i_b, i_B, i_y_t, i_y_n),
    compute the unmaximized right hand side (RHS) of the Bellman equation as a
    function of the next period choice bp = b', with index i_bp.
    """
    # Unpack
    σ, η, β, ω, κ, r = parameters
    b_grid, y_t_nodes, y_n_nodes, Q = arrays
    # Compute next period aggregate bonds given H
    i_Bp = H[i_B, i_y_t, i_y_n]
    # Evaluate states and actions at indices
    B, Bp, b, bp = b_grid[i_B], b_grid[i_Bp], b_grid[i_b], b_grid[i_bp]
    y_t = y_t_nodes[i_y_t]
    y_n = y_n_nodes[i_y_n]
    # Compute price of nontradables using aggregates
    C = (1 + r) * B + y_t - Bp
    p = ((1 - ω) / ω) * (C / y_n)**(η + 1)
    # Compute household flow utility
    c = (1 + r) * b + y_t - bp
    utility = w(parameters, c, y_n)
    # Compute expected value  $E\{y'\}$   $v(b', B', y')$   $Q(y, y')$ 
    EV = jnp.sum(v[i_bp, i_Bp, :, :] * Q[i_y_t, i_y_n, :, :])
    # Set up constraints
    credit_constraint_holds = - κ * (p * y_n + y_t) <= bp
    budget_constraint_holds = bp <= (1 + r) * b + y_t
    constraints_hold = jnp.logical_and(credit_constraint_holds,
                                      budget_constraint_holds)

    # Compute and return
    return jnp.where(constraints_hold, utility + β * EV, -jnp.inf)

```

Let's now vectorize and jit-compile this map.

```

# Vectorize over the control bp and all the current states
T_vec_1 = jax.vmap(T_generator,
                  in_axes=(None, None, None, None, None, None, None, None, 0))
T_vec_2 = jax.vmap(T_vec_1,
                  in_axes=(None, None, None, None, None, None, None, 0, None))
T_vec_3 = jax.vmap(T_vec_2,
                  in_axes=(None, None, None, None, None, None, 0, None, None))
T_vec_4 = jax.vmap(T_vec_3,
                  in_axes=(None, None, None, None, None, 0, None, None, None))
T_vectorized = jax.vmap(T_vec_4,
                       in_axes=(None, None, None, None, 0, None, None, None, None))

```

Now we can set up the Bellman operator by maximizing over the choice variable  $b'$ .

```

def T(parameters, sizes, arrays, v, H):
    """
    Evaluate the RHS of the Bellman equation at all states and actions and then
    maximize with respect to actions.

    Return

    * Tv as an array of shape (b_size, b_size, y_size, y_size).

```

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```

"""
b_size, y_size = sizes
b_grid, y_t_nodes, y_n_nodes, Q = arrays
b_indices, y_indices = jnp.arange(b_size), jnp.arange(y_size)
val = T_vectorized(v, H, parameters, arrays,
                  b_indices, b_indices, y_indices, y_indices, b_indices)
# Maximize over bp
return jnp.max(val, axis=-1)

```

```
T = jax.jit(T, static_argnums=(1,))
```

Here's a function that computes a greedy policy (best response to  $v$ ).

```

def get_greedy(parameters, sizes, arrays, v, H):
    """
    Compute the greedy policy for the household, which maximizes the right hand
    side of the Bellman equation given  $v$  and  $H$ . The greedy policy is recorded
    as an array giving the index  $i$  in  $b\_grid$  such that  $b\_grid[i]$  is the optimal
    choice, for every state.

    Return

    *  $bp\_policy$  as an array of shape  $(b\_size, b\_size, y\_size, y\_size)$ .

    """
    b_size, y_size = sizes
    b_grid, y_t_nodes, y_n_nodes, Q = arrays
    b_indices, y_indices = jnp.arange(b_size), jnp.arange(y_size)
    val = T_vectorized(v, H, parameters, arrays,
                      b_indices, b_indices, y_indices, y_indices, b_indices)
    return jnp.argmax(val, axis=-1)

```

```
get_greedy = jax.jit(get_greedy, static_argnums=(1,))
```

Here's some code for value function iteration (VFI).

```

def vfi(T, v_init, max_iter=10_000, tol=1e-5):
    """
    Use successive approximation to compute the fixed point of  $T$ , starting from
     $v\_init$ .

    """
    v = v_init

    def cond_fun(state):
        error, i, v = state
        return (error > tol) & (i < max_iter)

    def body_fun(state):
        error, i, v = state
        v_new = T(v)
        error = jnp.max(jnp.abs(v_new - v))
        return error, i+1, v_new

```

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```

error, i, v_new = jax.lax.while_loop(cond_fun, body_fun,
                                   (tol+1, 0, v))
return v_new, i

vfi = jax.jit(vfi, static_argnums=(0,))

```

This is how we update our guess of  $H$ , using the current policy  $b'$  and a damped fixed point iteration scheme.

```

def update_H(parameters, sizes, arrays, H, a):
    """
    Update guess of the aggregate update rule.

    """
    # Set up
    b_size, y_size = sizes
    b_grid, y_t_nodes, y_n_nodes, Q = arrays
    b_indices = jnp.arange(b_size)
    # Compute household response to current guess H
    v_init = jnp.ones((b_size, b_size, y_size, y_size))
    _T = lambda v: T(parameters, sizes, arrays, v, H)
    v, vfi_num_iter = vfi(_T, v_init)
    bp_policy = get_greedy(parameters, sizes, arrays, v, H)
    # Switch policy arrays to values rather than indices
    H_vals = b_grid[H]
    bp_vals = b_grid[bp_policy]
    # Update guess
    new_H_vals = a * bp_vals[b_indices, b_indices, :, :] + (1 - a) * H_vals
    # Switch back to indices
    new_H = jnp.searchsorted(b_grid, new_H_vals)
    return new_H, vfi_num_iter

```

```
update_H = jax.jit(update_H, static_argnums=(1,))
```

Now we can write code to compute an equilibrium law of motion  $H$ .

```

def compute_equilibrium(parameters, sizes, arrays,
                       a=0.5, tol=0.005, max_iter=500):
    """
    Compute the equilibrium law of motion.

    """
    H = generate_initial_H(parameters, sizes, arrays)
    error = tol + 1
    i = 0
    while error > tol and i < max_iter:
        H_new, vfi_num_iter = update_H(parameters, sizes, arrays, H, a)
        print(f"VFI terminated after {vfi_num_iter} iterations.")
        error = jnp.max(jnp.abs(b_grid[H] - b_grid[H_new]))
        print(f"Updated H at iteration {i} with error {error}.")
        H = H_new
        i += 1
    if i == max_iter:
        print("Warning: Equilibrium search iteration hit upper bound.")
    return H

```

## 20.4 Planner problem

Now we switch to the planner problem.

Our first function returns the (unmaximized) RHS of the Bellman equation.

```
@jax.jit
def planner_T_generator(v, parameters, arrays, i_b, i_y_t, i_y_n, i_bp):
    """
    Given current state (b, y_t, y_n) with indices (i_b, i_y_t, i_y_n),
    compute the unmaximized right hand side (RHS) of the Bellman equation as a
    function of the next period choice bp = b'.
    """
    σ, η, β, ω, κ, r = parameters
    b_grid, y_t_nodes, y_n_nodes, Q = arrays
    y_t = y_t_nodes[i_y_t]
    y_n = y_n_nodes[i_y_n]
    b, bp = b_grid[i_b], b_grid[i_bp]
    # Compute price of nontradables using aggregates
    c = (1 + r) * b + y_t - bp
    p = ((1 - ω) / ω) * (c / y_n)**(η + 1)
    # Compute household flow utility
    utility = w(parameters, c, y_n)
    # Compute expected value (continuation)
    EV = jnp.sum(v[i_bp, :, :] * Q[i_y_t, i_y_n, :, :])
    # Set up constraints and evaluate
    credit_constraint_holds = - κ * (p * y_n + y_t) <= bp
    budget_constraint_holds = bp <= (1 + r) * b + y_t
    return jnp.where(jnp.logical_and(credit_constraint_holds,
                                     budget_constraint_holds),
                    utility + β * EV,
                    -jnp.inf)
```

```
# Vectorize over the control bp and all the current states
planner_T_vec_1 = jax.vmap(planner_T_generator,
                           in_axes=(None, None, None, None, None, 0))
planner_T_vec_2 = jax.vmap(planner_T_vec_1,
                           in_axes=(None, None, None, None, None, 0, None))
planner_T_vec_3 = jax.vmap(planner_T_vec_2,
                           in_axes=(None, None, None, None, 0, None, None))
planner_T_vectorized = jax.vmap(planner_T_vec_3,
                                in_axes=(None, None, None, 0, None, None, None))
```

Now we construct the Bellman operator.

```
def planner_T(parameters, sizes, arrays, v):
    b_size, y_size = sizes
    b_grid, y_t_nodes, y_n_nodes, Q = arrays
    b_indices, y_indices = jnp.arange(b_size), jnp.arange(y_size)
    # Evaluate RHS of Bellman equation at all states and actions
    val = planner_T_vectorized(v, parameters, arrays,
                              b_indices, y_indices, y_indices, b_indices)
    # Maximize over bp
    return jnp.max(val, axis=-1)
```

```
planner_T = jax.jit(planner_T, static_argnums=(1,))
```

Here's a function that computes a greedy policy (best response to  $v$ ).

```
def planner_get_greedy(parameters, sizes, arrays, v):
    b_size, y_size = sizes
    b_grid, y_t_nodes, y_n_nodes, Q = arrays
    b_indices, y_indices = jnp.arange(b_size), jnp.arange(y_size)
    # Evaluate RHS of Bellman equation at all states and actions
    val = planner_T_vectorized(v, parameters, arrays,
                              b_indices, y_indices, b_indices)
    # Maximize over bp
    return jnp.argmax(val, axis=-1)
```

```
planner_get_greedy = jax.jit(planner_get_greedy, static_argnums=(1,))
```

Computing the planner solution is straightforward value function iteration:

```
def compute_planner_solution(model):
    """
    Compute the constrained planner solution.

    """
    parameters, sizes, arrays = model
    b_size, y_size = sizes
    b_indices = jnp.arange(b_size)
    v_init = jnp.ones((b_size, y_size, y_size))
    _T = lambda v: planner_T(parameters, sizes, arrays, v)
    # Compute household response to current guess H
    v, vfi_num_iter = vfi(_T, v_init)
    bp_policy = planner_get_greedy(parameters, sizes, arrays, v)
    return v, bp_policy, vfi_num_iter
```

## 20.5 Numerical solution

Let's now solve the model and compare the decentralized and planner solutions

### 20.5.1 Generating solutions

Here we compute the two solutions.

```
model = create_overborrowing_model()
parameters, sizes, arrays = model
b_size, y_size = sizes
b_grid, y_t_nodes, y_n_nodes, Q = arrays
```

```
print("Computing decentralized solution.")
in_time = time.time()
H_eq = compute_equilibrium(parameters, sizes, arrays)
out_time = time.time()
```

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```
diff = out_time - in_time  
print(f"Computed decentralized equilibrium in {diff} seconds")
```

Computing decentralized solution.

VFI terminated after 128 iterations.

Updated H at iteration 0 with error 0.15619052946567535.

VFI terminated after 128 iterations.  
Updated H at iteration 1 with error 0.08837097883224487.

VFI terminated after 129 iterations.  
Updated H at iteration 2 with error 0.0780951976776123.

VFI terminated after 128 iterations.  
Updated H at iteration 3 with error 0.06987470388412476.

VFI terminated after 128 iterations.  
Updated H at iteration 4 with error 0.05959904193878174.

VFI terminated after 128 iterations.  
Updated H at iteration 5 with error 0.05137842893600464.

VFI terminated after 128 iterations.  
Updated H at iteration 6 with error 0.04315793514251709.

VFI terminated after 128 iterations.  
Updated H at iteration 7 with error 0.03904759883880615.

VFI terminated after 128 iterations.  
Updated H at iteration 8 with error 0.0328822135925293.

VFI terminated after 129 iterations.  
Updated H at iteration 9 with error 0.02877199649810791.

VFI terminated after 128 iterations.  
Updated H at iteration 10 with error 0.024661660194396973.

VFI terminated after 128 iterations.  
Updated H at iteration 11 with error 0.020551443099975586.

VFI terminated after 128 iterations.  
Updated H at iteration 12 with error 0.018496274948120117.

```
VFI terminated after 128 iterations.  
Updated H at iteration 13 with error 0.01438605785369873.
```

```
VFI terminated after 128 iterations.  
Updated H at iteration 14 with error 0.012330859899520874.
```

```
VFI terminated after 129 iterations.  
Updated H at iteration 15 with error 0.010275721549987793.
```

```
VFI terminated after 128 iterations.  
Updated H at iteration 16 with error 0.010275721549987793.
```

```
VFI terminated after 128 iterations.  
Updated H at iteration 17 with error 0.0082206130027771.
```

```
VFI terminated after 128 iterations.  
Updated H at iteration 18 with error 0.0082206130027771.
```

```
VFI terminated after 128 iterations.  
Updated H at iteration 19 with error 0.0061654746532440186.
```

```
VFI terminated after 128 iterations.  
Updated H at iteration 20 with error 0.006165444850921631.
```

```
VFI terminated after 128 iterations.  
Updated H at iteration 21 with error 0.006165444850921631.
```

```
VFI terminated after 128 iterations.  
Updated H at iteration 22 with error 0.0041103363037109375.  
Computed decentralized equilibrium in 16.474924564361572 seconds
```

```
print("Computing planner's solution.")  
in_time = time.time()  
planner_v, H_plan, vfi_num_iter = compute_planner_solution(model)  
out_time = time.time()  
diff = out_time - in_time  
print(f"Computed decentralized equilibrium in {diff} seconds")
```

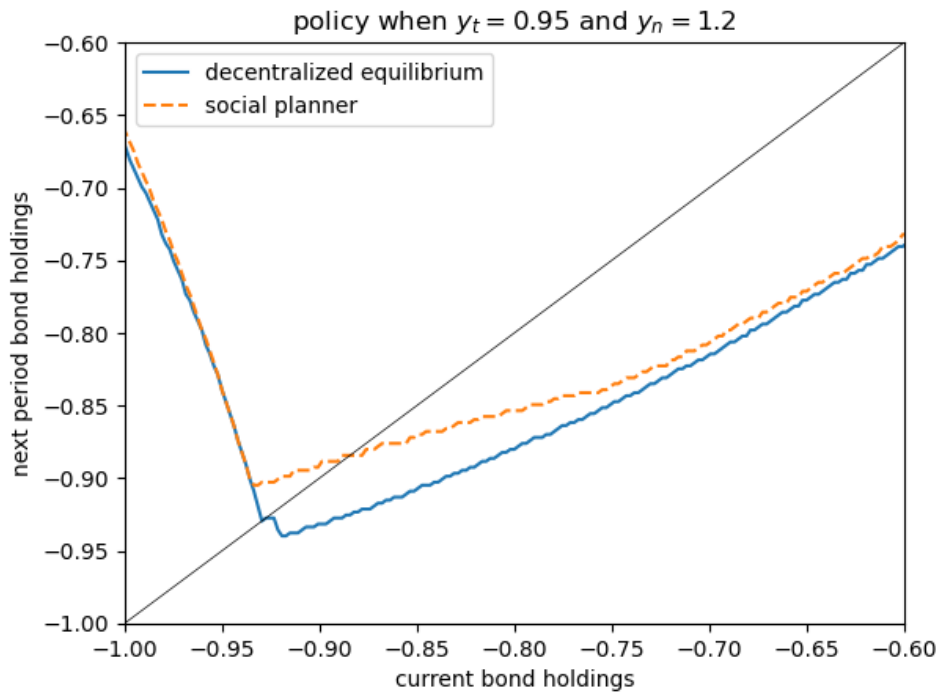
```
Computing planner's solution.
```

```
Computed decentralized equilibrium in 1.1924936771392822 seconds
```

## 20.5.2 Policy plots

We produce a policy plot that is similar to Figure 1 in [Bianchi, 2011].

```
i, j = 1, 3
y_t, y_n = y_t_nodes[i], y_n_nodes[j]
fig, ax = plt.subplots()
ax.plot(b_grid, b_grid[H_eq[:, i, j]], label='decentralized equilibrium')
ax.plot(b_grid, b_grid[H_plan[:, i, j]], ls='--', label='social planner')
ax.plot(b_grid, b_grid, color='black', lw=0.5)
ax.set_ylim((-1.0, -0.6))
ax.set_xlim((-1.0, -0.6))
ax.set_xlabel("current bond holdings")
ax.set_ylabel("next period bond holdings")
ax.set_title(f"policy when $y_t = {y_t:.2}$ and $y_n = {y_n:.2}$")
ax.legend()
plt.show()
```



The match is not exact because we use a different estimate of the Markov dynamics for income.

Nonetheless, it is qualitatively similar.

## 20.6 Exercise

### Exercise 20.6.1

Your task is to examine the ergodic distribution of borrowing in the decentralized and planner equilibria.

We recommend that you use simulation and a kernel density estimate.

Here's a function for generating the borrowing sequence.

We use Numba because we want to compile a long for loop.

```
@numba.jit
def generate_borrowing_sequence(H, y_t_series, y_n_series):
    """
    Generate the borrowing sequence  $B' = H(B, y_t, y_n)$ .

    *  $H$  is a policy array
    *  $y_t$  and  $y_n$  are simulated time paths

    Both  $y_t$  and  $y_n$  are stored as indices rather than values.

    """
    B = np.empty_like(y_t_series)
    B[0] = 0
    for t in range(len(y_t_series)-1):
        B[t+1] = H[B[t], y_t_series[t], y_n_series[t]]
    return B
```

Note that you will have to convert JAX arrays into NumPy arrays if you want to use this function.

From here you will need to

- generate a time path for income  $y = (y_t, y_n)$  using one of the functions provided above.
- use the function `generate_borrowing_sequence` plus `H_eq` and `H_plan` to calculate bond holdings for the planner and the decentralized equilibrium
- produce a kernel density plot for each of these data sets

If you are successful, your plot should look something like Fig 2 of [Bianchi, 2011] — although not exactly the same, due to the alternative specification of the Markov process.

To generate a kernel density plot, we recommend that you use `kdeplot` from the package `seaborn`, which is included in Anaconda.

### Solution to Exercise 20.6.1

```
sim_length = 100_000
y_t_series, y_n_series = generate_discrete_var(ts_length=sim_length,
                                              indices=True)
```

We convert JAX arrays to NumPy arrays in order to use Numba.

```
y_t_series, y_n_series, H_eq, H_plan = \
    [np.array(v) for v in (y_t_series, y_n_series, H_eq, H_plan)]
```

Now let's compute borrowing for the decentralized equilibrium and the planner.

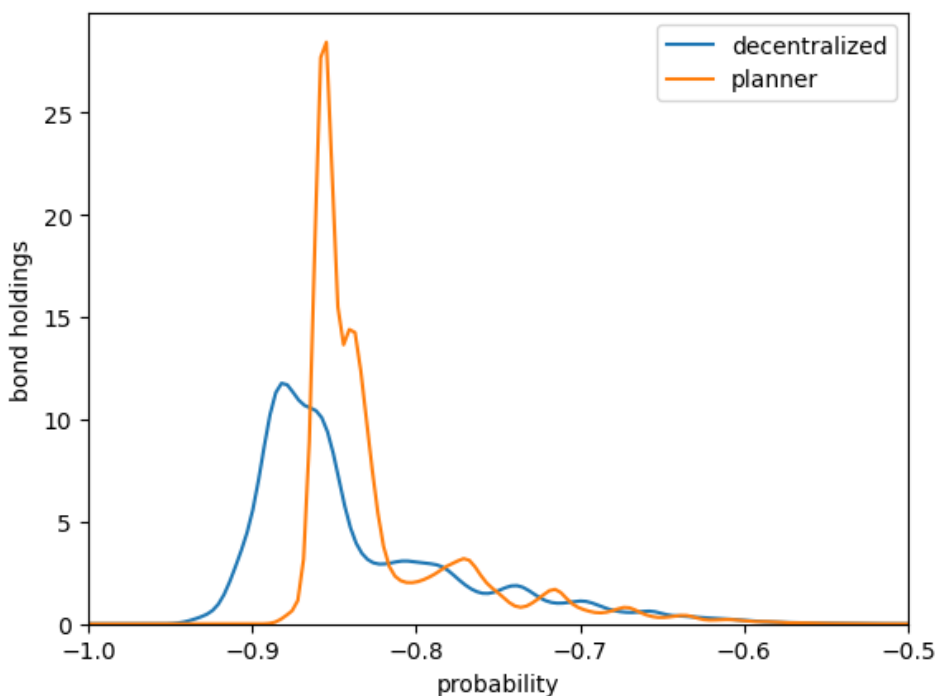
```
B_eq = generate_borrowing_sequence(H_eq, y_t_series, y_n_series)
eq_b_sequence = b_grid[B_eq]
B_plan = generate_borrowing_sequence(H_plan, y_t_series, y_n_series)
plan_b_sequence = b_grid[B_plan]
```

We suppress some annoying warnings produced by the current version of seaborn

```
import warnings
warnings.simplefilter(action='ignore', category=FutureWarning)
```

Now let's plot the distributions using a kernel density estimator.

```
fig, ax = plt.subplots()
seaborn.kdeplot(eq_b_sequence, ax=ax, label='decentralized')
seaborn.kdeplot(plan_b_sequence, ax=ax, label='planner')
ax.legend()
ax.set_xlim((-1, -0.5))
ax.set_xlabel("probability")
ax.set_ylabel("bond holdings")
plt.show()
```



This corresponds to Figure 2 in [Bianchi, 2011].

Again, the match is not exact but it is qualitatively similar.

Asset holding has a longer left hand tail under the decentralized equilibrium, leaving the economy more vulnerable to bad shocks.



## **Part VI**

# **Data and Empirics**





## MAXIMUM LIKELIHOOD ESTIMATION

---

### GPU

This lecture was built using a machine with JAX installed and access to a GPU.

To run this lecture on [Google Colab](#), click on the “play” icon top right, select Colab, and set the runtime environment to include a GPU.

To run this lecture on your own machine, you need to install [Google JAX](#).

---

## 21.1 Overview

This lecture is the extended JAX implementation of [this section](#) of [this lecture](#).

Please refer that lecture for all background and notation.

Here we will exploit the automatic differentiation capabilities of JAX rather than calculating derivatives by hand.

We’ll require the following imports:

```
import matplotlib.pyplot as plt
from collections import namedtuple
import jax.numpy as jnp
import jax
from statsmodels.api import Poisson
```

Let’s check the GPU we are running

```
!nvidia-smi
```

```
/opt/conda/envs/quantecon/lib/python3.11/pty.py:89: RuntimeWarning: os.fork() was
↳called. os.fork() is incompatible with multithreaded code, and JAX is
↳multithreaded, so this will likely lead to a deadlock.
pid, fd = os.forkpty()
```

```
Thu May  2 02:27:37 2024
+-----+
| NVIDIA-SMI 470.182.03    Driver Version: 470.182.03    CUDA Version: 12.3    |
+-----+-----+-----+
| GPU   Name               Persistence-M| Bus-Id        Disp.A | Volatile Uncorr. ECC |
+-----+-----+-----+-----+-----+
```

(continues on next page)



```
dlogL = jax.vmap(jax.grad(logL))
```

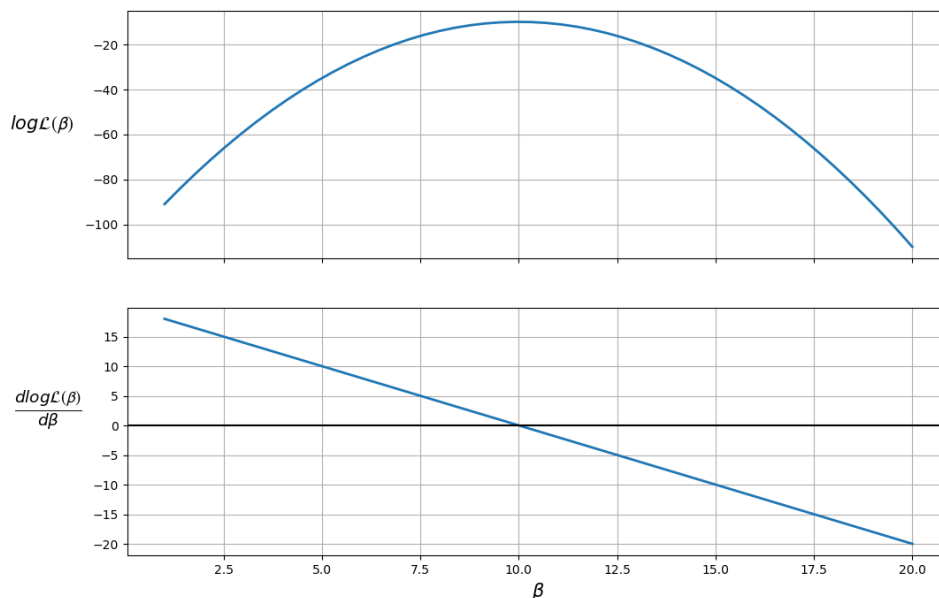
```
β = jnp.linspace(1, 20)

fig, (ax1, ax2) = plt.subplots(2, sharex=True, figsize=(12, 8))

ax1.plot(β, logL(β), lw=2)
ax2.plot(β, dlogL(β), lw=2)

ax1.set_ylabel(r'$\log \mathcal{L}(\beta)$',
               rotation=0,
               labelpad=35,
               fontsize=15)
ax2.set_ylabel(r'$\frac{d \log \mathcal{L}(\beta)}{d\beta}$',
               rotation=0,
               labelpad=35,
               fontsize=19)

ax2.set_xlabel(r'$\beta$', fontsize=15)
ax1.grid(), ax2.grid()
plt.axhline(c='black')
plt.show()
```



The plot shows that the maximum likelihood value (the top plot) occurs when  $\frac{d \log \mathcal{L}(\beta)}{d\beta} = 0$  (the bottom plot).

Therefore, the likelihood is maximized when  $\beta = 10$ .

We can also ensure that this value is a *maximum* (as opposed to a minimum) by checking that the second derivative (slope of the bottom plot) is negative.

The Newton-Raphson algorithm finds a point where the first derivative is 0.

To use the algorithm, we take an initial guess at the maximum value,  $\beta_0$  (the OLS parameter estimates might be a reasonable guess).

Then we use the updating rule involving gradient information to iterate the algorithm until the error is sufficiently small or the algorithm reaches the maximum number of iterations.

Please refer to [this section](#) for the detailed algorithm.

## 21.2.2 A Poisson model

Let's have a go at implementing the Newton-Raphson algorithm to calculate the maximum likelihood estimations of a Poisson regression.

The Poisson regression has a joint pmf:

$$f(y_1, y_2, \dots, y_n \mid \mathbf{x}_1, \mathbf{x}_2, \dots, \mathbf{x}_n; \beta) = \prod_{i=1}^n \frac{\mu_i^{y_i}}{y_i!} e^{-\mu_i}$$

$$\text{where } \mu_i = \exp(\mathbf{x}_i' \beta) = \exp(\beta_0 + \beta_1 x_{i1} + \dots + \beta_k x_{ik})$$

We create a namedtuple to store the observed values

```
RegressionModel = namedtuple('RegressionModel', ['X', 'y'])

def create_regression_model(X, y):
    n, k = X.shape
    # Reshape y as a n_by_1 column vector
    y = y.reshape(n, 1)
    X, y = jax.device_put((X, y))
    return RegressionModel(X=X, y=y)
```

The log likelihood function of the Poisson regression is

$$\max_{\beta} \left( \sum_{i=1}^n y_i \log \mu_i - \sum_{i=1}^n \mu_i - \sum_{i=1}^n \log y_i! \right)$$

The full derivation can be found [here](#).

The log likelihood function involves factorial, but JAX doesn't have a readily available implementation to compute factorial directly.

In order to compute the factorial efficiently such that we can JIT it, we use

$$n! = e^{\log(\Gamma(n+1))}$$

since `jax.lax.lgamma` and `jax.lax.exp` are available.

The following function `jax_factorial` computes the factorial using this idea.

Let's define this function in Python

```
@jax.jit
def _factorial(n):
    return jax.lax.exp(jax.lax.lgamma(n + 1.0)).astype(int)

jax_factorial = jax.vmap(_factorial)
```

Now we can define the log likelihood function in Python

```
@jax.jit
def poisson_logL(beta, model):
    y = model.y
    mu = jnp.exp(model.X @ beta)
    return jnp.sum(model.y * jnp.log(mu) - mu - jnp.log(jax_factorial(y)))
```

To find the gradient of the `poisson_logL`, we again use `jax.grad`.

According to the [documentation](#),

- `jax.jacfwd` uses forward-mode automatic differentiation, which is more efficient for “tall” Jacobian matrices, while
- `jax.jacrev` uses reverse-mode, which is more efficient for “wide” Jacobian matrices.

(The documentation also states that when matrices that are near-square, `jax.jacfwd` probably has an edge over `jax.jacrev`.)

Therefore, to find the Hessian, we can directly use `jax.jacfwd`.

```
G_poisson_logL = jax.grad(poisson_logL)
H_poisson_logL = jax.jacfwd(G_poisson_logL)
```

Our function `newton_raphson` will take a `RegressionModel` object that has an initial guess of the parameter vector  $\beta_0$ .

The algorithm will update the parameter vector according to the updating rule, and recalculate the gradient and Hessian matrices at the new parameter estimates.

```
def newton_raphson(model, beta, tol=1e-3, max_iter=100, display=True):

    i = 0
    error = 100 # Initial error value

    # Print header of output
    if display:
        header = f'{"Iteration_k":<13>{"Log-likelihood":<16>{"theta":<60}'
        print(header)
        print("-" * len(header))

    # While loop runs while any value in error is greater
    # than the tolerance until max iterations are reached
    while jnp.any(error > tol) and i < max_iter:
        H, G = jnp.squeeze(H_poisson_logL(beta, model)), G_poisson_logL(beta, model)
        beta_new = beta - (jnp.dot(jnp.linalg.inv(H), G))
        error = jnp.abs(beta_new - beta)
        beta = beta_new

        if display:
            beta_list = [f'{t:.3}' for t in list(beta.flatten())]
            update = f'{"i":<13>{"poisson_logL(beta, model)":<16.8>{"beta_list"}'
            print(update)

        i += 1

    print(f'Number of iterations: {i}')
    print(f'beta_hat = {beta.flatten()}')

    return beta
```

Let's try out our algorithm with a small dataset of 5 observations and 3 variables in **X**.

```
X = jnp.array([[1, 2, 5],
               [1, 1, 3],
               [1, 4, 2],
```

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(continued from previous page)

```

        [1, 5, 2],
        [1, 3, 1]])

y = jnp.array([1, 0, 1, 1, 0])

# Take a guess at initial βs
init_β = jnp.array([0.1, 0.1, 0.1]).reshape(X.shape[1], 1)

# Create an object with Poisson model values
poi = create_regression_model(X, y)

# Use newton_raphson to find the MLE
β_hat = newton_raphson(poi, init_β, display=True)

```

```

Iteration_k  Log-likelihood  θ
-----
↵-----

0           -4.3447622      ['-1.49', '0.265', '0.244']
1           -3.5742413      ['-3.38', '0.528', '0.474']
2           -3.3999526      ['-5.06', '0.782', '0.702']
3           -3.3788646      ['-5.92', '0.909', '0.82']
4           -3.3783559      ['-6.07', '0.933', '0.843']
5           -3.3783555      ['-6.08', '0.933', '0.843']
6           -3.3783555      ['-6.08', '0.933', '0.843']
Number of iterations: 7
β_hat = [-6.07848573  0.9334028  0.84329677]

```

As this was a simple model with few observations, the algorithm achieved convergence in only 7 iterations.

The gradient vector should be close to 0 at  $\hat{\beta}$

```
G_poisson_logL(β_hat, poi)
```

```

Array([[ -2.56406008e-13],
       [-6.50202114e-13],
       [-5.05540054e-13]], dtype=float64)

```

## 21.3 MLE with statsmodels

We'll use the Poisson regression model in `statsmodels` to verify the results obtained using JAX.

`statsmodels` uses the same algorithm as above to find the maximum likelihood estimates.

Now, as `statsmodels` accepts only NumPy arrays, we can use the `__array__` method of JAX arrays to convert it to NumPy arrays.

```

X_numpy = X.__array__()
y_numpy = y.__array__()

```

```
stats_poisson = Poisson(y_numpy, X_numpy).fit()
print(stats_poisson.summary())
```

```
Optimization terminated successfully.
      Current function value: 0.675671
      Iterations 7

                        Poisson Regression Results
=====
Dep. Variable:          y      No. Observations:          5
Model:                 Poisson  Df Residuals:              2
Method:                MLE     Df Model:                  2
Date:                 Thu, 02 May 2024  Pseudo R-squ.:          0.2546
Time:                 02:27:42     Log-Likelihood:          -3.3784
converged:              True     LL-Null:                  -4.5325
Covariance Type:      nonrobust  LLR p-value:              0.3153
=====
                        coef      std err          z      P>|z|      [0.025      0.975]
-----
const                -6.0785      5.279      -1.151      0.250     -16.425      4.268
x1                   0.9334      0.829       1.126      0.260      -0.691      2.558
x2                   0.8433      0.798       1.057      0.291      -0.720      2.407
=====
```

The benefit of writing our own procedure, relative to statsmodels is that

- we can exploit the power of the GPU and
- we learn the underlying methodology, which can be extended to complex situations where no existing routines are available.

---

### Exercise 21.3.1

We define a quadratic model for a single explanatory variable by

$$\log(\lambda_t) = \beta_0 + \beta_1 x_t + \beta_2 x_t^2$$

We calculate the mean on the original scale instead of the log scale by exponentiating both sides of the above equation, which gives

$$\lambda_t = \exp(\beta_0 + \beta_1 x_t + \beta_2 x_t^2) \quad (21.1)$$

Simulate the values of  $x_t$  by sampling from a normal distribution and  $\lambda_t$  by using (21.1) and the following constants:

$$\beta_0 = -2.5, \quad \beta_1 = 0.25, \quad \beta_2 = 0.5$$

Try to obtain the approximate values of  $\beta_0, \beta_1, \beta_2$ , by simulating a Poisson Regression Model such that

$$y_t \sim \text{Poisson}(\lambda_t) \quad \text{for all } t.$$

Using our `newton_raphson` function on the data set  $X = [1, x_t, x_t^2]$  and  $y$ , obtain the maximum likelihood estimates of  $\beta_0, \beta_1, \beta_2$ .

With a sufficient large sample size, you should approximately recover the true values of these parameters.

---

### Solution to Exercise 21.3.1

Let's start by defining "true" parameter values.

```

β_0 = -2.5
β_1 = 0.25
β_2 = 0.5

```

To simulate the model, we sample 500,000 values of  $x_t$  from the standard normal distribution.

```

seed = 32
shape = (500_000, 1)
key = jax.random.PRNGKey(seed)
x = jax.random.normal(key, shape)

```

We compute  $\lambda$  using (21.1)

```

λ = jnp.exp(β_0 + β_1 * x + β_2 * x**2)

```

Let's define  $y_t$  by sampling from a Poisson distribution with mean as  $\lambda_t$ .

```

y = jax.random.poisson(key, λ, shape)

```

Now let's try to recover the true parameter values using the Newton-Raphson method described above.

```

X = jnp.hstack((jnp.ones(shape), x, x**2))

# Take a guess at initial βs
init_β = jnp.array([0.1, 0.1, 0.1]).reshape(X.shape[1], 1)

# Create an object with Poisson model values
poi = create_regression_model(X, y)

# Use newton_raphson to find the MLE
β_hat = newton_raphson(poi, init_β, tol=1e-5, display=True)

```

```

Iteration_k  Log-likelihood  θ
-----

```

```

↵-----

```

```

0          -4.5444745e+07  ['-1.49', '0.312', '0.794']
1          -1.6303734e+07  ['-2.42', '0.311', '0.79']
2          -5689832.6      ['-3.22', '0.31', '0.78']
3          -1869457.7     ['-3.73', '0.306', '0.756']
4          -510284.64     ['-3.71', '0.297', '0.705']
5          -28066.381     ['-3.2', '0.283', '0.63']
6           127470.33     ['-2.77', '0.268', '0.563']
7           163044.64     ['-2.57', '0.257', '0.52']
8           166608.12     ['-2.51', '0.252', '0.503']
9           166666.4      ['-2.5', '0.251', '0.5']
10          166666.42     ['-2.5', '0.251', '0.5']
11          166666.42     ['-2.5', '0.251', '0.5']
Number of iterations: 12
β_hat = [-2.50016027  0.25079345  0.50008394]

```

The maximum likelihood estimates are similar to the true parameter values.

---



## **Part VII**

### **Other**



## TROUBLESHOOTING

### Contents

- *Troubleshooting*
  - *Fixing Your Local Environment*
  - *Reporting an Issue*

This page is for readers experiencing errors when running the code from the lectures.

### 22.1 Fixing Your Local Environment

The basic assumption of the lectures is that code in a lecture should execute whenever

1. it is executed in a Jupyter notebook and
2. the notebook is running on a machine with the latest version of Anaconda Python.

You have installed Anaconda, haven't you, following the instructions in [this lecture](#)?

Assuming that you have, the most common source of problems for our readers is that their Anaconda distribution is not up to date.

[Here's a useful article](#) on how to update Anaconda.

Another option is to simply remove Anaconda and reinstall.

You also need to keep the external code libraries, such as [QuantEcon.py](#) up to date.

For this task you can either

- use `conda install -y quantecon` on the command line, or
- execute `!conda install -y quantecon` within a Jupyter notebook.

If your local environment is still not working you can do two things.

First, you can use a remote machine instead, by clicking on the Launch Notebook icon available for each lecture



Second, you can report an issue, so we can try to fix your local set up.

We like getting feedback on the lectures so please don't hesitate to get in touch.

## 22.2 Reporting an Issue

One way to give feedback is to raise an issue through our [issue tracker](#).

Please be as specific as possible. Tell us where the problem is and as much detail about your local set up as you can provide.

Another feedback option is to use our [discourse forum](#).

Finally, you can provide direct feedback to [contact@quantecon.org](mailto:contact@quantecon.org)

---

CHAPTER  
**TWENTYTHREE**

---

**REFERENCES**



## EXECUTION STATISTICS

This table contains the latest execution statistics.

Document	Modified	Method	Run Time (s)	Status
<i>aiyagari_jax</i>	2024-05-02 01:51	cache	71.01	✓
<i>arellano</i>	2024-05-02 01:52	cache	28.88	✓
<i>cake_eating_numerical</i>	2024-05-02 01:52	cache	19.85	✓
<i>hopenhayn</i>	2024-05-02 01:56	cache	232.7	✓
<i>ifp_egm</i>	2024-05-02 01:59	cache	182.06	✓
<i>intro</i>	2024-05-02 01:59	cache	1.16	✓
<i>inventory_dynamics</i>	2024-05-02 02:00	cache	72.98	✓
<i>inventory_ssd</i>	2024-05-02 02:25	cache	1512.47	✓
<i>jax_intro</i>	2024-05-02 02:26	cache	27.25	✓
<i>job_search</i>	2024-05-02 02:26	cache	13.39	✓
<i>kesten_processes</i>	2024-05-02 02:26	cache	21.55	✓
<i>lucas_model</i>	2024-05-02 02:27	cache	20.49	✓
<i>markov_asset</i>	2024-05-02 02:27	cache	18.56	✓
<i>mle</i>	2024-05-02 02:27	cache	14.91	✓
<i>newtons_method</i>	2024-05-02 02:30	cache	159.73	✓
<i>opt_invest</i>	2024-05-02 02:30	cache	18.54	✓
<i>opt_savings_1</i>	2024-05-02 02:31	cache	35.2	✓
<i>opt_savings_2</i>	2024-05-02 02:31	cache	18.39	✓
<i>overborrowing</i>	2024-05-02 02:32	cache	41.16	✓
<i>short_path</i>	2024-05-02 02:32	cache	6.8	✓
<i>status</i>	2024-05-02 02:32	cache	3.85	✓
<i>troubleshooting</i>	2024-05-02 01:59	cache	1.16	✓
<i>wealth_dynamics</i>	2024-05-02 02:32	cache	26.03	✓
<i>zreferences</i>	2024-05-02 01:59	cache	1.16	✓

These lectures are built on linux instances through github actions and amazon web services (aws) to enable access to a gpu. These lectures are built on a p3.2xlarge that has access to 8 vcpu's, a V100 NVIDIA Tesla GPU, and 61 Gb of memory.

You can check the backend used by JAX using:

```
import jax
# Check if JAX is using GPU
print(f"JAX backend: {jax.devices()[0].platform}")
```

```
JAX backend: gpu
```





## BIBLIOGRAPHY

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