

Lecture 10

Firm Heterogeneity, Distribution and Dynamics Stopping Time Problems

Distributional Macroeconomics

Part II of ECON 2149

Benjamin Moll

Harvard University, Spring 2018

Plan

Firm heterogeneity, distribution and dynamics

1. motivating facts
2. workhorse model of firm dynamics: Hopenhayn (1992)
3. stopping time problems
4. Luttmer (2007)

Motivating Facts

- So far: income and wealth distribution in macroeconomics
- Firm size distribution shares many similarities with income, wealth distributions
 - extremely skewed
 - lots of heterogeneity conditional on other observables
 - e.g. Chad Syverson: within typical 4-digit SIC industries 90th percentile firm is **twice** as productive as 10th percentile firm
 - other key references: work by John Haltiwanger, Steve Davis and co-authors
- Tools for theoretically modeling heterogeneous firms are **exactly the same** as those for modeling heterogeneous individuals
 - state variable = cross-sectional distribution
 - key ideas: stationary distribution & distributional dynamics

Firm Size Distribution: Very Skewed and Fat Right Tail

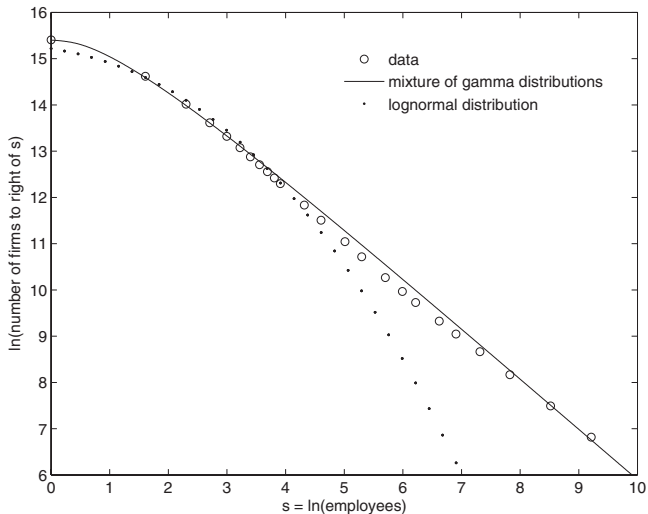


FIGURE I
Size Distribution of U. S. Firms in 2002

Workhorse Model: Hopenhayn (1992)

- Will present my own version
 - notes: <http://www.princeton.edu/~moll/HACTproject/hopenhayn.pdf>
 - code: <http://www.princeton.edu/~moll/HACTproject/hopenhayn.m>
- For some good, concise lecture notes on original see <https://web.stanford.edu/~jtlevin/Econ%20257/Industry%20Dynamics.pdf>
Also good discussion of Jovanovic 82, Olley-Pakes 96
- Before I forget, potentially confusing notation in Hopenhayn 92
 - p.1130: “the total mass $M_t = \mu_t(S)$ ”
 - p.1132: “Let M_t denote the mass of entrants in period t ”
 - latter is one that’s used throughout
- Only dynamic decisions in Hopenhayn model: entry and exit
- Will walk you through two versions
 1. mechanical entry (= assumption in Luttmer: “return process”)
 2. optimal entry (= assumption in Hopenhayn)

Hopenhayn Model with Mechanical Entry

- Continuum of firms, heterogeneous in productivity $z \in [0, 1]$, solve

$$v(z) = \max_{\{n_t\}_{t \geq 0}, \tau} \mathbb{E}_0 \left[\int_0^\tau e^{-\rho t} (pf(z_t, n_t) - wn_t - c_f) dt + e^{-\rho \tau} v^* \right]$$

$$dz_t = \mu(z_t)dt + \sigma(z_t)dW_t, \quad z_0 = z.$$

- n : employment, w : wage rate
- $f(z, n)$: production, p : price of final goods
- c_f : per-period operating cost, v^* : scrap value
- Assumption: for each exiting firm, new entrant with $z_0 \sim \psi(z)$
 - \Rightarrow mass of active firms constant, normalize to 1
 - assume lowest z in support of ψ s.t. don't immediately exit
- Equilibrium: exogenous product demand, labor supply to industry

$$p = D(Q), \quad w = W(N), \quad Q := \int_0^1 q(z)g(z)dz, \quad N := \int_0^1 n(z)g(z)dz$$

Write this more compactly

- Continuum of firms, heterogeneous in productivity $z \in [0, 1]$, solve

$$v(z) = \max_{\tau} \mathbb{E}_0 \left[\int_0^{\tau} e^{-\rho t} \pi(z_t) dt + e^{-\rho \tau} v^* \right]$$

$$dz_t = \mu(z_t) dt + \sigma(z_t) dW_t, \quad z_0 = z,$$

$$\pi(z) = \max_n \{ p f(z, n) - wn \} - c_f$$

- Assumption: for each exiting firm, new entrant with $z_0 \sim \psi(z)$
 - \Rightarrow mass of active firms constant, normalize to 1
 - assume lowest z in support of ψ s.t. don't immediately exit
- Equilibrium: exogenous product demand, labor supply to industry

$$p = D(Q), \quad w = W(N), \quad Q := \int_0^1 q(z) g(z) dz, \quad N := \int_0^1 n(z) g(z) dz$$

Hopenhayn Model with Optimal Entry

- Continuum of firms, heterogeneous in productivity $z \in [0, 1]$, solve

$$v(z) = \max_{\tau} \mathbb{E}_0 \left[\int_0^{\tau} e^{-\rho t} \pi(z_t) dt + e^{-\rho \tau} v^* \right]$$

$$dz_t = \mu(z_t) dt + \sigma(z_t) dW_t, \quad z_0 = z,$$

$$\pi(z) = \max_n \{p f(z, n) - wn\} - c_f$$

- Previous slide: flow of entrants determined mechanically
- Now: flow of entrants satisfies **free entry condition**

$$\int_0^1 v(z) \psi(z) dz = c_e$$

- \Rightarrow total mass of firms endogenous, cannot normalize it to one

3-Slide Discussion of Hopenhagen (1992)

Stopping Time Problems

Stopping Time Problems

- In lots of problems in economics, agents have to choose an optimal **stopping time**
- Quite often these problems entail some form of **non-convexity**
- Examples:
 - how long should a low productivity firm wait before it exits an industry?
 - how long should a firm wait before it resets its prices?
 - when should you exercise an option?
 - etc... Stokey's book is all about these kind of problems
- These problems are very awkward in discrete time because you run into integer problems
- **Big payoff** from working in continuous time
- Next: flexible algorithm for solving such problems, also works if don't have simple threshold rules and with states > 1

Exercising an Option: Deterministic Warmup

- Problem from chapter 6 of Stokey's "Economics of Inaction"
- Plant has profits

$$\pi(z(t))$$

- $z(t)$: state variable = stand in for demand, plant capacity etc

$$z(t) = z_0 + \mu t \quad \Leftrightarrow \quad \dot{z}(t) = \mu$$

- Can shut down plant at any time, get scrap value S , but cannot reopen
- Problem: choose **stopping time** τ to solve

$$v(z_0) = \max_{\tau \geq 0} \left[\int_0^{\tau} e^{-rt} \pi(z(t)) dt + e^{-r\tau} S \right]$$

- Assumptions to make sure $\tau^* < \infty$:

$$\pi'(z) > 0, \quad \mu < 0, \quad \lim_{z \rightarrow -\infty} \pi(z) < rS < \lim_{z \rightarrow +\infty} \pi(z)$$

Exercising an Option: Deterministic Warmup

- FOC

$$e^{-\rho\tau^*} [\pi(z(\tau^*)) - rS] \leq 0, \quad \text{with equality if } \tau^* > 0$$

- Can write this in terms of cutoff $b^* = z(\tau^*)$

$$\pi(b^*) = rS$$

- Optimal stopping time is

$$\tau^* = \begin{cases} 0, & \text{if } z < b^*, \\ (b^* - z)/\mu, & \text{if } z \geq b^* \end{cases}$$

Exercising an Option: Stochastic Problem

- Problem: choose **stopping time** τ to solve

$$v(z) = \max_{\tau \geq 0} \mathbb{E}_0 \left[\int_0^\tau e^{-\rho t} \pi(z_t) dt + e^{-\rho \tau} S(z_\tau) \right]$$

$$dz_t = \mu(z_t) dt + \sigma(z_t) dW_t, \quad z_0 = z$$

- Same assumptions as before to ensure $\tau^* < \infty$
- Analytic solution if $\mu(z) = \bar{\mu}$, $\sigma(z) = \bar{\sigma}$, $S(z) = \bar{S}$, but not in general
- Two approaches for tackling this problem
 1. standard approach: “smooth pasting”
 2. more powerful approach: HJB “Variational Inequality”
- Discuss these in turn

Exercising an Option: Standard Approach

- Assume scrap value is independent of z : $S(z) = \bar{S}$
- Optimal policy = **threshold rule**: exit if z_t falls below b
- Standard approach (see e.g. Stokey, Ch.6):

$$\rho v(z) = \pi(z) + \mu(z)v'(z) + \frac{\sigma^2(z)}{2}v''(z), \quad z > b$$

with “value matching” and “smooth pasting” at b :

$$v(b) = \bar{S}, \quad v'(b) = 0$$

- Derivation? See [Appendix](#)
- **But things more complicated if**
 - S depends on z ...
 - ... or if dimension > 1
- \Rightarrow can't use threshold property
- want algorithm that works also in those cases

Exercising an Option: HJBVI Approach

- Denote \mathcal{Z} = set of z such that don't exit:

$$z \in \mathcal{Z} : \quad v(z) \geq S(z), \quad \rho v(z) = \pi(z) + \mu(z)v'(z) + \frac{\sigma^2(z)}{2}v''(z)$$

$$z \notin \mathcal{Z} : \quad v(z) = S(z), \quad \rho v(z) \geq \pi(z) + \mu(z)v'(z) + \frac{\sigma^2(z)}{2}v''(z)$$

- Can write compactly as:

$$\min \left\{ \rho v(z) - \pi(z) - \mu(z)v'(z) - \frac{\sigma^2(z)}{2}v''(z), v(z) - S(z) \right\} = 0 \quad (*)$$

- Note: have used that following two statements are equivalent

1. for all z , either $f(z) \geq 0, g(z) = 0$ or $f(z) = 0, g(z) \geq 0$
2. $\min\{f(z), g(z)\} = 0$ for all z

- (*) is called “HJB variational inequality” (HJBVI)

- Important: did not impose **smooth pasting**

- instead, it's a result: can prove that (*) implies $v'(b) = S'(b)$

- see e.g. Oksendal <http://th.if.uj.edu.pl/~gudowska/dydaktyka/Oksendal.pdf> (who calls “smooth pasting” “high contact (or smooth fit) principle”) 16

Finite Difference Scheme for solving HJBVI

- Codes

http://www.princeton.edu/~moll/HACTproject/option_simple_LCP.m,

<http://www.mathworks.com/matlabcentral/fileexchange/20952>

- Main insight: discretized HJBVI = **Linear Complementarity Problem (LCP)** https://en.wikipedia.org/wiki/Linear_complementarity_problem

- Prototypical LCP: given matrix **B** and vector **q**, find **x** such that

$$\mathbf{x}^T (\mathbf{B}\mathbf{x} + \mathbf{q}) = 0$$

$$\mathbf{x} \geq 0$$

$$\mathbf{B}\mathbf{x} + \mathbf{q} \geq 0$$

- There are many good LCP solvers in Matlab and other languages

- Best one I've found if **B** large but sparse (Newton-based):

<http://www.mathworks.com/matlabcentral/fileexchange/20952>

Finite Difference Scheme for solving HJBVI

- Recall HJBVI

$$\min \left\{ \rho v(z) - \pi(z) - \mu(z)v'(z) - \frac{\sigma^2(z)}{2}v''(z), v(z) - S(z) \right\} = 0$$

- Without exit, discretize as

$$\rho v_i = \pi_i + \mu_i(v_i)' + \frac{\sigma_i^2}{2}(v_i)'' \quad \Leftrightarrow \quad \rho \mathbf{v} = \boldsymbol{\pi} + \mathbf{A} \mathbf{v}$$

- With exit:

$$\min\{\rho \mathbf{v} - \boldsymbol{\pi} - \mathbf{A} \mathbf{v}, \mathbf{v} - \mathbf{S}\} = 0$$

- Equivalently:

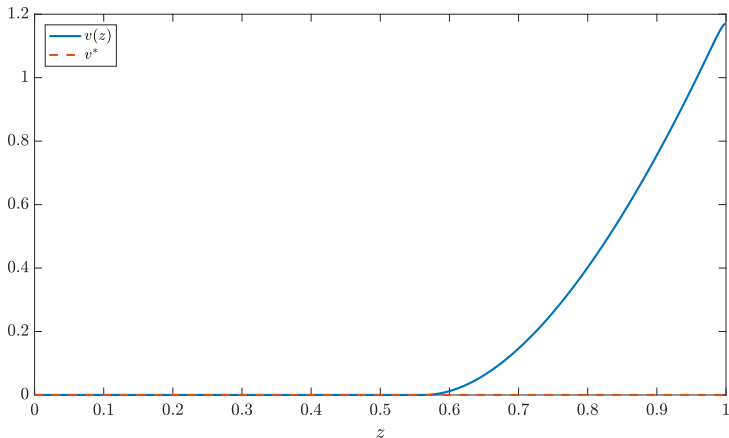
$$(\mathbf{v} - \mathbf{S})^\top (\rho \mathbf{v} - \boldsymbol{\pi} - \mathbf{A} \mathbf{v}) = 0$$

$$\mathbf{v} \geq \mathbf{S}$$

$$\rho \mathbf{v} - \boldsymbol{\pi} - \mathbf{A} \mathbf{v} \geq 0$$

- But this is just an LCP with $\mathbf{x} = \mathbf{v} - \mathbf{S}$, $\mathbf{B} = \rho \mathbf{I} - \mathbf{A}$, $\mathbf{q} = -\boldsymbol{\pi} + \mathbf{B} \mathbf{S}$!!

The solution satisfies smooth pasting even though we didn't impose it!



An Impulse Control Problem: Buying & Selling a Car

- Flow utility $u(c_t) + \kappa d_t$, $d_t \in \{0, 1\}$ (car or no car)
- Buy car at p_0 , sell at p_1 with $p_1 < p_0$
- When not buying/selling, wealth accumulates in standard fashion

$$\dot{a}_t = y + ra_t - c_t$$

- Notation: $v_d(a)$ = value of wealth a , car ownership state $d \in \{0, 1\}$
- Problem of individual **without car**: choose c_t and **stopping time τ**

$$v_0(a) = \max_{\{c_t\}_{t \geq 0}, \tau} \int_0^{\tau} e^{-\rho t} u(c_t) dt + e^{-\rho \tau} v_0^*(a_\tau)$$

$$\dot{a}_t = y + ra_t - c_t, \quad a_t \geq \underline{a}, \quad a_0 = a.$$

where $v_0^*(a)$ = value of buying car

$$v_0^*(a) = \begin{cases} v_1(a - p_0), & \text{if } a - p_0 \geq \underline{a} \\ -\infty, & \text{if } a - p_0 < \underline{a} \end{cases}$$

- Symmetric problem for individual **with car**, value $v_1(a)$

A Problem with an Indivisible Durable (a.k.a. a **Car**)

- System of HJBVI's

$$0 = \min\{\rho v_0(a) - \max_c \{u(c) + v_0'(a)(y + ra - c)\}, v_0(a) - v_0^*(a)\},$$

$$0 = \min\{\rho v_1(a) - \max_c \{u(c) + \kappa + v_1'(a)(y + ra - c)\}, v_1(a) - v_1^*(a)\}$$

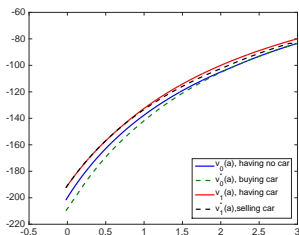
- Discretize as

$$0 = \min\{\rho v_0 - u(v_0) - \mathbf{A}(v_0)v_0, v_0 - v_0^*(v_1)\},$$

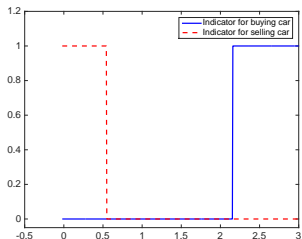
$$0 = \min\{\rho v_1 - u(v_1) + \kappa - \mathbf{A}(v_1)v_1, v_1 - v_1^*(v_0)\}$$

- Solve using LCP solver
- Code: <http://www.princeton.edu/~moll/HACTproject/car.m>

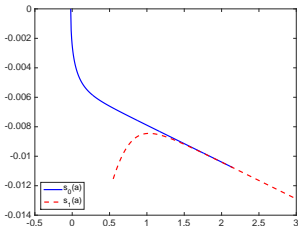
A Problem with an Indivisible Durable (a.k.a. a Car)



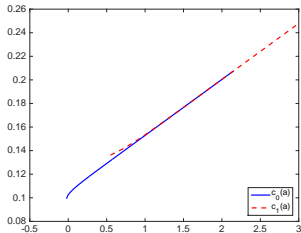
(a) Value Function



(b) Value Function



(c) Saving Policy Function



(d) Cons Policy Function

Numerical Solution of Hopenhagen Model

<http://www.princeton.edu/~moll/HACTproject/hopenhagen.pdf>

<http://www.princeton.edu/~moll/HACTproject/hopenhagen.m>

Hopenhayn Model with Mechanical Entry

- Write more compactly

$$v(z) = \max_{\tau} \mathbb{E}_0 \left\{ \int_0^{\tau} e^{-\rho t} \pi(z_t) dt + e^{-\rho \tau} v^* \right\}$$

$$dz_t = \mu(z_t) dt + \sigma(z_t) dW_t, \quad z_0 = z,$$

$$\pi(z) = \max_n \{ \rho f(z, n) - wn \} - c_f$$

- Assumption: for each exiting firm, new entrant with $z_0 \sim \psi(z)$
 - \Rightarrow mass of active firms constant, normalize to 1
 - assume lowest z in support of ψ s.t. don't immediately exit

Equations for Stationary Equilibrium, Mechanical Entry

- Denote \mathcal{Z} = inaction region, i.e. set of z 's such that don't exit...
- ... and m = entry rate (by assumption also = exit rate)

$$0 = \min \left\{ \rho v(z) - v'(z)\mu(z) - \frac{1}{2}v''(z)\sigma^2(z) - \pi(z), v(z) - v^* \right\}, \quad \text{all } z \in (0, 1)$$

$$0 = -(\mu(z)g(z))' + \frac{1}{2}(\sigma^2(z)g(z))'' + m\psi(z), \quad \text{all } z \in \mathcal{Z},$$

$$\rho = D(Q), \quad w = W(N), \quad Q = \int_{\mathcal{Z}} q(z)g(z)dz, \quad N = \int_{\mathcal{Z}} n(z)g(z)dz$$

- Remains to determine m , find it from $\int_{\mathcal{Z}} g(z, t)dz = 1$ for all t

$$\partial_t g = \mathcal{A}^* g + m(t)\psi(z) \quad \text{and} \quad \int_{\mathcal{Z}} \partial_t g(z, t)dz = 0$$

$$\Rightarrow \quad m = - \int_{\mathcal{Z}} (\mathcal{A}^* g)(z)dz$$

- If threshold rule (stay when $z \geq b$), then $m = -\frac{1}{2}\partial_z (\sigma^2(b)g(b))$

Equations for Stationary Equilibrium with Optimal Entry

Now: Mass of entrants m pinned down by free entry condition

$$0 = \min \left\{ \rho v(z) - v'(z)\mu(z) - \frac{1}{2}v''(z)\sigma^2(z) - \pi(z), v(z) - v^* \right\}, \quad \text{all } z \in (0, 1)$$

$$0 = -(\mu(z)g(z))' + \frac{1}{2}(\sigma^2(z)g(z))'' + m\psi(z), \quad \text{all } z \in \mathcal{Z},$$

$$c_e = \int_0^1 v(z)\psi(z)dz$$

$$p = D(Q), \quad w = W(N), \quad Q = \int_{\mathcal{Z}} q(z)g(z)dz, \quad N = \int_{\mathcal{Z}} n(z)g(z)dz$$

Equations for Stationary Equilibrium with Optimal Entry

Free-entry condition not particularly well behaved numerically \Rightarrow replace

$$0 = \min \left\{ \rho v(z) - v'(z)\mu(z) - \frac{1}{2}v''(z)\sigma^2(z) - \pi(z), v(z) - v^* \right\}, \quad \text{all } z \in (0, 1)$$

$$0 = -(\mu(z)g(z))' + \frac{1}{2}(\sigma^2(z)g(z))'' + m\psi(z), \quad \text{all } z \in \mathcal{Z},$$

$$m = \bar{m} \exp \left(\eta \left(\int_0^1 v(z)\psi(z)dz - c_e \right) \right), \quad \eta, \bar{m} > 0$$

$$p = D(Q), \quad w = W(N), \quad Q = \int_{\mathcal{Z}} q(z)g(z)dz, \quad N = \int_{\mathcal{Z}} n(z)g(z)dz$$

- $\int_0^1 v(z)\psi(z)dz = c_e$ is special case $\eta \rightarrow \infty$
- to see this, write as $\frac{\log(m/\bar{m})}{\eta} = \int_0^1 v(z)\psi(z)dz - c_e$
- that is, Hopenhayn model has infinitely elastic supply of entrants

Discretization of KF equation

- Discretized KF equation is

$$0 = \sum_{j=1}^I A_{j,i} g_j + m\psi_i, \quad \text{all } i \in \mathcal{I}$$
$$g_i = 0, \quad \text{all } i \notin \mathcal{I}$$

- Write this in matrix notation as

$$0 = \tilde{\mathbf{A}}^T \mathbf{g} + m\psi$$

- where $\tilde{A}_{i,j} = A_{i,j}$ for all columns in inaction region $j \in \mathcal{I} \dots$
- ... columns in exit region $j \notin \mathcal{I}$ are replaced by a column of zeros everywhere except for 1 on the diagonal
- hence $0 = \tilde{\mathbf{A}}^T \mathbf{g} + m\psi$ implies that $g_i = 0$ for all $i \notin \mathcal{I}$
- \Rightarrow non-singular $\tilde{\mathbf{A}}^T \Rightarrow$ can simply solve (no eigenvalue problem)

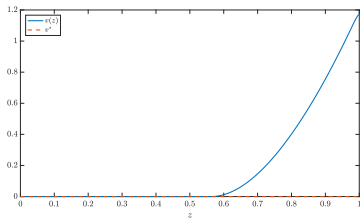
$$\mathbf{g} = -(\tilde{\mathbf{A}}^T)^{-1} m\psi$$

Solution Algorithm

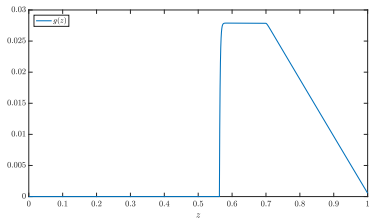
<http://www.princeton.edu/~moll/HACTproject/hopenhayn.m>

- (i) Guess w^0
- (ii)
 - 1. Guess p^0
 - 2. Given (p^j, w^k) solve the HJBVI equation. This yields v and exit region \mathcal{Z}
 - 3. Given v , compute m from supply of entrants. To approximate perfectly elastic supply of entrants, set $\eta = 1,000$
 - 4. Given exit region \mathcal{Z} , and entry rate m , solve KF equation to get g . Note that g will, in general, not integrate to one
 - 5. Given g , compute Q & update p : $p^{j+1} = (1 - \lambda_p)p^j + \lambda_p Q^{-\varepsilon}$
 - 6. If p^{j+1} and $Q^{-\varepsilon}$ are close enough, go to *iii*, otherwise back to 2
- (iii) Given g , compute N & update w : $w^{k+1} = (1 - \lambda_w)w^k + \lambda_w N^\phi$
- (iv) If w^{k+1} and N^ϕ are close enough, exit, otherwise back to *ii*

Results: Value Function and Size Distribution



(e) Value function $v(z)$



(f) Size distribution of active firms $g(z)$

Luttmer (2007) – Short Version

Luttmer (2007): Overview

- Firms are monopolistic competitors
- Permanent shocks to preferences and technologies associated with firms
- Low productivity firms exit, new firms imitate and attempt to enter
 - selection produces Pareto right tail rather than log-normal
 - population productivity grows faster than mean of incumbents
 - thickness of right tail depends on the difference
 - Zipf tail when entry costs are high or imitation is difficult

Luttmer (2007): Key Mechanism for Pareto Distribution

- Exactly same logic as in Gabaix, Gabaix-Lasry-Lions-Moll
- Logarithm of size s_t follows “return process”/“exit with reinjection”

$$ds_t = \mu dt + \sigma dW_t$$

- assume $\mu < 0$
- if s_t ever reaches b , exit and get reinjected at $x > b$
- \Rightarrow exponential tail for log size s , **Pareto tail** for size e^s
- More precisely, a double-Pareto distribution
- Remaining model ingredients only make economics nicer, model less mechanical

Stationary Size Distribution, $s = \log$ size

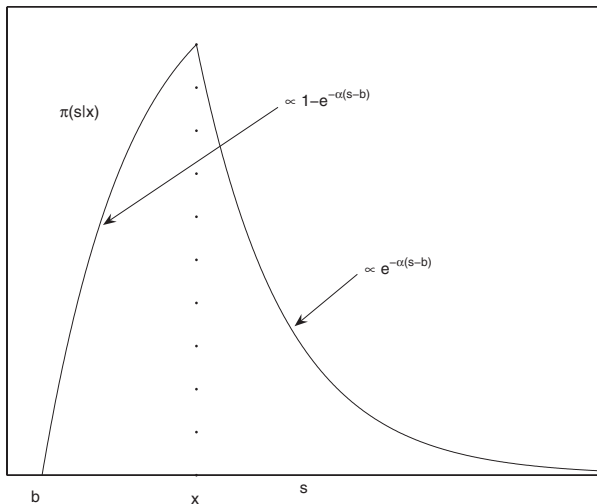


FIGURE II
Size Density Conditional on Initial Size

3-Slide Discussion of Luttmer

Appendix:
Smooth Pasting and All That

Deterministic Problem: HJB Approach

Claim (Stokey, Proposition 6.2): The value function, V , and optimal threshold, b^* , have the following properties:

(i) v satisfies the **HJB equation**

$$rV(z) = \pi(z) + V'(z)\mu, \quad z \geq b^*$$

$$V(z) = S, \quad z \leq b^*$$

(ii) V is continuous at b^* (**value matching**)

$$\lim_{z \downarrow b^*} V(z) = S$$

(iii) V' is continuous at b^* (**smooth pasting**)

$$\lim_{z \downarrow b^*} V'(z) = 0$$

Intuitive Derivation

- Periods of length Δt ,
- Value of a firm with $z_0 = z$:

$$V(z) = \max\{\tilde{V}(z), S\}$$

- S : value of exiting
- $\tilde{V}(z)$: value of staying in industry satisfying

$$\tilde{V}(z) = \pi(z)\Delta t + (1 - r\Delta t)V(z + \mu\Delta t)$$

Derivation: Value Matching $\lim_{z \downarrow b} V(z) = S$

- Consider some (not necessarily optimal) threshold b
- By definition of b :

$$V(z) = \begin{cases} \tilde{V}(z), & z > b \\ S, & z \leq b \end{cases}$$

(Note: could write $z \geq b$ and $z < b$, would need to slightly change argument below; just definition of b in any case.)

- Subtract $(1 - r\Delta t)\tilde{V}(z)$ from both sides and divide by Δt

$$r\tilde{V}(z) = \pi(z) + (1 - r\Delta t) \frac{V(z + \mu\Delta t) - \tilde{V}(z)}{\Delta t}$$

Derivation: Value Matching $\lim_{z \downarrow b} V(z) = S$

- Evaluate \tilde{V} at $z = b - \mu\Delta t$, i.e. at an x just above the threshold (recall $\mu < 0$).

$$r\tilde{V}(b - \mu\Delta t) = \pi(b - \mu\Delta t) + (1 - r\Delta t) \frac{S - \tilde{V}(b - \mu\Delta t)}{\Delta t}$$

- Want to take $\Delta t \rightarrow 0$. Note:

$$\lim_{\Delta t \rightarrow 0} \tilde{V}(b - \mu\Delta t) = \lim_{z \downarrow b} \tilde{V}(z)$$

- **Proof** by contradiction. Suppose $\lim_{z \downarrow b} \tilde{V}(z) < S$.
 - then $\frac{S - \tilde{V}(b - \mu\Delta t)}{\Delta t} \rightarrow \infty$ and hence $r\tilde{V}(b - \mu\Delta t) \rightarrow \infty$.
 - but $\lim_{z \downarrow b} \tilde{V}(z) = \infty$ contradicts $\lim_{z \downarrow b} \tilde{V}(z) < S$.
- Symmetric argument for $\lim_{z \downarrow b} \tilde{V}(z) > S$
- Since $V(z) = \tilde{V}(z)$ for $z > b$, also $\lim_{z \downarrow b} V(z) = S$
- Note: this has to hold for any threshold b , also suboptimal ones. Continuous problems have continuous value functions.

Derivation: Smooth Pasting $\lim_{z \downarrow b^*} V'(z) = 0$

- Now consider the optimal threshold choice.
- The value of staying, \tilde{V} , satisfies the Bellman equation

$$\tilde{V}(z) = \pi(z)\Delta t + (1 - r\Delta t) \max \{ \tilde{V}(z + \mu\Delta t), S \}$$

where the max is over **stay**, **exit**

- Subtract $(1 - r\Delta t)\tilde{V}(z)$ from both sides and divide by Δt

$$r\tilde{V}(z) = \pi(z) + (1 - r\Delta t) \max \left\{ \frac{\tilde{V}(z + \mu\Delta t) - \tilde{V}(z)}{\Delta t}, \frac{S - \tilde{V}(z)}{\Delta t} \right\}$$

- Evaluate at $z = b - \mu\Delta t$

$$r\tilde{V}(b - \mu\Delta t) = \pi(b - \mu\Delta t) + (1 - r\Delta t) \max \left\{ \frac{\tilde{V}(b) - \tilde{V}(b - \mu\Delta t)}{\Delta t}, \frac{S - \tilde{V}(b - \mu\Delta t)}{\Delta t} \right\}$$

Derivation: Smooth Pasting $\lim_{z \downarrow b^*} V'(z) = 0$

- Given value matching, $\lim_{z \downarrow b} \tilde{V}(z) = S$, can take $\Delta t \rightarrow 0$

$$r\tilde{V}(b) = \pi(b) + \max \left\{ \lim_{z \downarrow b} \tilde{V}'(z)\mu, 0 \right\}$$

- At the **optimal** b^* need to be indifferent so

$$\lim_{z \downarrow b^*} \tilde{V}'(z) = 0$$

This is **smooth pasting**:

- if $\lim_{z \downarrow b} \tilde{V}'(z)\mu > 0$: should wait longer, i.e. decrease b
- if $\lim_{z \downarrow b} \tilde{V}'(z)\mu < 0$: waited too long, i.e. increase b
- Since $V(z) = \tilde{V}(z)$ for $z > b^*$, we also have

$$\lim_{z \downarrow b^*} V'(z) = 0$$

- Note: at b^* also obtain the FOC from before $rS = \pi(b^*)$

Deterministic Problem: Extensions

- Suppose the scrap value is $S(z)$ rather than S .
- And further that drift is $\mu(z)$ rather than μ
- Can use the same approach as above to show that
 - **Value Matching:**

$$\lim_{z \downarrow b^*} V(z) = S(b^*)$$

- **Smooth Pasting:**

$$\lim_{z \downarrow b^*} V'(z) = S'(b^*)$$

Luttmer (2007) – Long Version

Luttmer (2007)

- Preferences:
 - differentiated commodities with permanent taste shocks
- Technologies:
 - at a cost, entrants draw technologies from some distribution
 - fixed overhead labor, asymptotic constant returns to scale
 - random productivity, quality growth.

Consumers

- A population $He^{\eta t}$ with preferences over per-capita consumption $C_t e^{-\eta t}$:

$$\mathbb{E}_0 \int_0^{\infty} e^{-\rho t} \frac{(C_t e^{-\eta t})^{1-\gamma}}{1-\gamma} dt$$

- where

$$C_t = \left[\int u^{1-\beta} c_t^\beta(u) dM_t(u) \right]^{1/\beta}$$

- Elasticity of substitution is $\sigma = 1/(1-\beta)$
- Demands

$$c_t(u, p) = \left(\frac{p}{P_t} \right)^{-1/(1-\beta)} u C_t$$

where

$$P_t = \left(\int u p^{-\beta/(1-\beta)} dM_t(u) \right)^{-(1-\beta)/\beta}$$

Firms

- Firms indexed by age a and date of birth t .
- Calendar time = $t + a$
- Production function

$$y_{t,a} = z_{t,a} L_{t,a}$$

- Revenues

$$R_{t,a} = C_{t+a}^{1-\beta} (Z_{t,a} L_{t,a})^\beta, \quad Z_{t,a} \equiv (u_{t,a}^{1-\beta} z_{t,a}^\beta)^{1/\beta}$$

- $Z_{t,a}$: combined quality and technology shock

Firms

- $Z_{t,a}$: combined quality and technology shock (“productivity”) evolves according to

$$Z_{t,a} = Z \exp(\theta_E t + \theta_I a + \sigma_Z dW_{t,a})$$

- That is, $Z_{t,a}$ is a geometric Brownian motion

$$\frac{dZ_{t,a}}{Z_{t,a}} = \theta_E dt + \theta_I da + \sigma_Z dW_{t,a}, \quad Z_{0,0} = Z$$

- θ_E : growth of productivity of new firms
- θ_I : growth of productivity of incumbent firms
- $\theta_I - \theta_E$ is key parameter.

Firms

- Continuation requires λ_F units of labor per unit of time.
- Value of a firm:

$$V_t(Z) = \max_{L, \tau} \mathbb{E}_t \int_0^{\tau} e^{-ra} (R_{t,a} - w_{t+a} [L_{t,a} + \lambda_F]) da$$

- τ : stopping time

Balanced Growth Path

- Will look for equilibria where a bunch of things are growing at a constant growth rate κ
- Aggregate labor supply: $H_t = He^{\eta t}$
- Number of firms: $M_t = Me^{\eta t}$
- Initial productivity $Z_{t,0} = Ze^{\theta_E t}$
- Total consumption $C_t = Ce^{\kappa t}$. Per capita $C_t e^{-\eta t} = Ce^{(\kappa-\eta)t}$.
- Revenues $R_{t,a} = C_{t+a}^{1-\beta} (Z_{t,a} L_{t,a})^\beta$ also grow at κ .
- Growth rate

$$\kappa = \theta_E + \left(\frac{1-\beta}{\beta} \right) \eta$$

Production Decisions along BGP

- Firms maximize variable profits $R_{t,a} - w_{t+a}L_{t,a}$. Solution:

$$R_{t,a} - w_{t+a}L_{t,a} = (1 - \beta) \left(\frac{\beta Z_{t,a}}{w_{t+a}} \right)^{\beta/(1-\beta)} C_{t+a}$$

- Therefore total profits can be written as

$$R_{t,a} - w_{t+a}L_{t,a} - w_{t+a}\lambda_F = w_{t+a}\lambda_F(e^{s_a} - 1)$$

$$\text{where } s_a \equiv S(Z) + \frac{\beta}{1-\beta} \left[\ln \left(\frac{Z_{t,a}}{Z_{t,0}} - \theta_E a \right) \right]$$

$$\text{and } e^{S(Z)} \equiv \frac{1-\beta}{\lambda_F} \frac{C}{w} \left(\frac{\beta Z}{w} \right)^{\beta/(1-\beta)}$$

- s_a : firm size relative to fixed costs. This is a Brownian motion

$$ds_a = \mu da + \sigma dW_{t,a}$$

$$\text{where } \mu \equiv \frac{\beta}{1-\beta}(\theta_I - \theta_E), \quad \sigma = \frac{\beta}{1-\beta}\sigma_Z$$

Exit Decision: Stopping Time Problem

- Value of a firm is

$$V_t(Z) = w_t \lambda_F V(S(Z))$$

where

$$V(s) = \max_{\tau} \mathbb{E} \left[\int_0^{\tau} e^{-(r-\kappa)a} (e^{s_a} - 1) \right]$$

- Stopping time problem \Rightarrow threshold policy: shut down when s falls below b .
- For $s > b$, the **HJB equation** holds

$$(r - \kappa)V(s) = e^s - 1 + V'(s)\mu + \frac{1}{2}V''(s)\sigma^2$$

- b determined by **value matching** and **smooth pasting**

$$V(b) = 0, \quad V'(b) = 0$$

Exit Decision: Stopping Time Problem

- Can show: exit barrier determined by

$$e^b = \left(\frac{\xi}{1 + \xi} \right) \left(1 - \frac{\mu + \sigma^2/2}{r - \kappa} \right)$$

$$\text{where } \xi \equiv \frac{\mu}{\sigma^2} + \sqrt{\left(\frac{\mu}{\sigma^2} \right)^2 + \frac{r - \kappa}{\sigma^2/2}}$$

and the HJB equation has solution

$$V(s) = \frac{1}{r - \kappa} \left(\frac{\xi}{1 + \xi} \right) \left(e^{s-b} - 1 - \frac{1 - e^{-\xi(s-b)}}{\xi} \right), \quad s \geq b$$

- Faster aggregate productivity growth $\theta_E \uparrow \Rightarrow \mu \propto \theta_I - \theta_E \downarrow \Rightarrow b \uparrow$,
i.e. incumbents more likely to exit.

Entry

- Labor cost of an arrival rate of ℓ_t entry opportunities per unit of time:

$$L_{E,t} = \lambda_E \ell_t$$

- An entry opportunity yields a draw Z from a distribution J
- Zero profit condition

$$\lambda_E = \lambda_F \int V(S(Z)) dJ(Z)$$

- For now: J exogenous

Kolmogorov Forward Equation

- Density of measure of firms of age a and size s at time t

$$f(a, s, t) = m(a, s)l e^{\eta t}$$

- The KFE is

$$\frac{\partial f(a, s, t)}{\partial t} = -\frac{\partial}{\partial a} f(a, s, t) - \frac{\partial}{\partial s} [\mu f(a, s, t)] + \frac{1}{2} \frac{\partial^2}{\partial s^2} [\sigma^2 f(a, s, t)]$$

- Note: unit drift of age $da = dt$
- Substituting in $f(a, s, t) = m(a, s)l e^{\eta t}$ yields

$$\frac{\partial m(a, s)}{\partial a} = -\eta m(a, s) - \frac{\partial}{\partial s} [\mu m(a, s)] + \frac{1}{2} \frac{\partial^2}{\partial s^2} [\sigma^2 m(a, s)]$$

Boundary Conditions

- Denote size distribution of entering firms by $G(s)$, derived from $J(Z) = G(S(Z))$

- First boundary condition: at age zero

$$\int_b^s m(0, x) dx = G(s) - G(b) \quad \text{all } s > b$$

or more intuitively in terms of the density $g(s) = G'(s)$

$$m(0, s) = g(s), \quad \text{all } s > b$$

- Second boundary condition: at the exit threshold

$$m(a, b) = 0, \quad \text{all } a > 0$$

Boundary Conditions

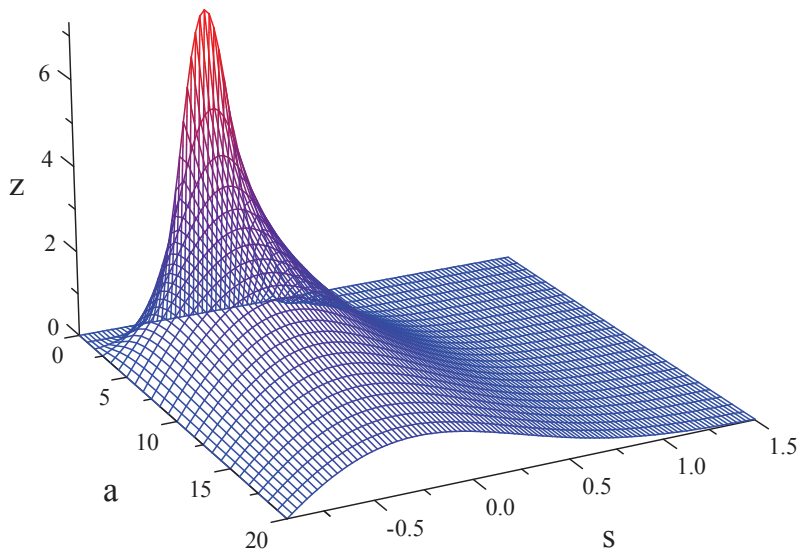
- **Lemma 1** the solution to the KFE subject to the boundary conditions is

$$m(a, s) = \int_b^{\infty} e^{-\eta a} \psi(a, s|x) dG(x)$$

$$\psi(a, s|x) = \frac{1}{\sigma\sqrt{a}} \left[\phi\left(\frac{s-x-\mu a}{\sigma\sqrt{a}}\right) - e^{-\mu(x-b)/(\sigma^2/2)} \phi\left(\frac{s+x-2b-\mu a}{\sigma\sqrt{a}}\right) \right]$$

- where ϕ is the standard normal probability density.
- $\psi(a, s|x)$ is the density of survivors at age a with size s of the cohort that entered with the same initial size x (not a p.d.f.)

Life of a Cohort: evolution of $m(a, s)$



Aside: Practical Advice

- Question: how to find solutions for these kinds of ODEs/PDEs?
- Answer: there is a collection of **known solutions** to a big number of ODEs/PDEs. This one apparently from Harrison (1985, p.46)
- if you ever encounter an ODE or PDE that you need to solve, plug into **Mathematica** (function DSolve). Knows **all known solutions**.

Size Distribution

- Want to obtain size distribution. Almost there.
- Denote by $\pi(a, s|x)$ the probability density of survivors at age a with size s of the cohort that entered with the same initial size x (proportional to $\psi(a, s|x)$)

$$\pi(a, s|x) = \left(\frac{1 - e^{-\alpha_*(x-b)}}{\eta} \right)^{-1} e^{-\eta a} \psi(a, s|x)$$

- Integrate this over all ages, a , to get density conditional on initial size

$$\pi(s|x) \propto e^{-\alpha(s-b)} \min \left\{ e^{(\alpha+\alpha_*)(s-b)} - 1, e^{(\alpha+\alpha_*)(x-b)} - 1 \right\}$$

- Density of e^s is our friend the double Pareto distribution. Can write in a better way.
- From fact: if s has an exponential distribution, then e^s has a Pareto distribution.

Special Case: $\eta = 0$

- when $\eta = 0$, then the tail exponents are $\alpha_* = 0$ and

$$\alpha = -\frac{\mu}{\sigma^2/2} = \frac{\theta_E - \theta_I}{\left(\frac{\beta}{1-\beta}\sigma_Z^2/2\right)}$$