

Numerical Analysis of a Free-Boundary Singular Control Problem in Financial Economics (Classic Reprint)



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Forgotten Books, United States, 2015. Paperback. Book Condition: New. 229 x 152 mm. Language: English . Brand New Book ***** Print on Demand *****.Excerpt from Numerical Analysis of a Free-Boundary Singular Control Problem in Financial Economics We analyze a numerical scheme for solving the problem of optimal life-time consumption and investment allocation studied in a companion paper by Hindy, Huang, and Zhu (1993), denoted HHZ henceforth. HHZ study a model that represents, among other things, habit forming preferences over the service flows from irreversible purchases of a durable good whose stock decays over time. We provide a brief statement of a special case of the control problem in section 2. HHZ contains the complete formulation, the motivation of the study, the economic interpretations of the variables, and a detailed discussion of the numerical solution. In this paper, we only provide the theoretical framework that supports the analysis in HHZ. We use dynamic programming to solve the optimal stochastic control for the continuous time problem formulated in HHZ. The important feature of this problem is that the admissible controls allow for cumulative consumption processes with possible jumps and singular sample paths. Furthermore, the controls do not appear directly in the objective functional. As a result, the associated Bellman s equation, formula (7) in the sequel, takes the form of a differential inequality involving a nonlinear second order partial differential equation with gradient constraint. The differential inequality reveals the free-boundary nature of the solution. In particular, consumption occurs only at some boundary surface in the domain of definition of the value function. This free-boundary is the area in the state space at which both the second order differential equation and the gradient constraint arc equal to zero. Furthermore, the optimal consumption is the amount required to keep the trajectory of the controlled...

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