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EXHAUSTABLE RESOURCES

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DIFFUSION APPROXIMATION IN ARROW'S MODEL OF EXHAUSTABLE RESOURCES*

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1. Introduction

What we shall call "Arrow's Model" for resource exploration and use under uncertainty was first formulated by Arrow [1977] and analyzed by Arrow and Chang [1978]. This model proved to be very successful and stimulated a lot of research. The most interesting further analyses of Arrow's model and some numerical results have since been produced by Hagan, Caflisch, and Keller [1980] (henceforth "H-C-K"), and independently by Derzko and Sethi [1981]. The purpose of this paper is to bring to a "common denominator" the results of previous studies and to introduce a new diffusion model approach to the same problem. The problem is posed roughly as follows.

A central planner charged with the exploration and use of some natural resource (for example, oil) has knowledge of the current stockpile of the resource ($R > 0$), the remaining unexplored land ($A > 0$), and the probability distribution of undiscovered resources over the remaining land. For simplicity it is assumed that the random quantities of the resource to be extracted from any two disjoint sections of land of equal area are independently and identically distributed. Then any exploration policy is merely a specification for a decreasing process

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$A = \{A(t); t \geq 0\}$, where $A(t)$ is the amount of unexplored land remaining at time t when policy A is followed. We define $N^A(t)$ to be the (random) cumulative amount of resource extracted by time t when the policy A is followed.

The economy has utility at the rate $u(c)$ for consuming the resource at the rate $c > 0$, where $u(\cdot)$ is differentiable, increasing, and strictly concave. With time discounting at the rate $\rho > 0$, the total utility for a particular path of consumption $\{c_t, t \geq 0\}$ is then:

$$\int_0^{\infty} e^{-\rho t} u(c_t) dt .$$

Exploration requires inputs of "goods in general" at a constant ratio of $P > 0$ per unit of land explored. Arrow and Chang argue that we can also scale $u(\cdot)$ to be approximately linear in terms of goods in general. Under the standard von Neumann-Morgenstern axioms for expected utility maximization we can now formulate the problem as

$$(1.1) \quad V(A_0, R_0) = \text{Max}_{A, c} E_{A_0, R_0}^{A, c} \int_0^{\infty} e^{-\rho t} [u(c_t) dt + P dA(t)]$$

subject to:

$$(1.2) \quad R(t) = \int_0^t [-c_s ds + dN^A(s)] > 0 \quad \forall t > 0, \quad R(0) = R_0; \quad A(0) = A_0,$$

where $E_{x, y}^{A, c}$ denotes expectation under the exploration policy A and the consumption policy c , with initial resource stocks x and initial

unexplored land y . Note that the second (Stieltjes) integral of (1.1) is negative and decreasing, since A is decreasing.

In each of the above cited papers resources are located at discrete points (in "lumps") according to a Poisson distribution. See Feller [1968] page 159 for a good interpretation of Poisson distributions of points in Euclidean space. Thus, for example, the exploration policy $A(t) \equiv A_0 - t$ would generate new discoveries at Poisson arrival times.

Both Arrow and Chang [1978] and Derzko and Sethi [1981] assume that each discovery yields a fixed amount of the resource, while H-C-K allow the size of the discovery to be random according to some general probability distribution with positive support.

One of the purposes of this paper is to reformulate N^A as a controlled diffusion process and obtain the insights which this allows. To do this requires a careful specification of what "instantaneous control" means for Arrow's model. This also serves to place a more rigorous foundation under the previously cited studies. For the remainder of this section, however, we will proceed at a heuristic level to give the basic flavor of stochastic dynamic programming applied to Arrow's model. All of the above mentioned papers proceed roughly along the following lines.

Given the (i.i.d.) probability assumptions, the usual line of attack of Markovian stochastic dynamic programming can be taken. Under an optimal policy, at any time t , $V(A_t, R_t)$ from (1.1) (reinitialized at time t) can be equated with the expected accumulation of utility over

any interval of time Δt , plus the expected discounted value of V at time $t + \Delta t$. There are some formal mathematical difficulties (which are not resolved in any of the previous studies) in taking the limit of this sum divided by Δt as $\Delta t \rightarrow 0$. These difficulties are resolved by the technique introduced in Section 2, but for the present we will proceed loosely. First assume that A is purely discontinuous with "very small" jumps. Let ΔA_t denote the jump of A at time t (and bear in mind in the following calculations that $\Delta A_t \leq 0$). We then have from (1.1) the approximation for "small" Δt

$$\begin{aligned}
 (1.3) \quad V(A_t, R_t) &\approx \text{Max}_{c_t, \Delta A_t} \{u(c_t)\Delta t + P\Delta A_t + e^{-\rho(t+\Delta t)} E[V(A_t + \Delta A_t, R + \Delta R_t)]\} \\
 &\approx \text{Max}_{c_t, \Delta A_t} \{u(c_t)\Delta t + P\Delta A_t + (1 - \rho\Delta t)V(A_t, R_t) - V_R c_t \Delta t \\
 &\quad + V_A \Delta A_t - \Delta V(A, R)\Delta A_t\} ,
 \end{aligned}$$

where

$$V_A(A, R) \equiv \frac{\partial V(A, R)}{\partial A} , \quad V_R \equiv \frac{\partial V(A, R)}{\partial R} , \quad \text{and}$$

$$\Delta V(A, R) \equiv \lim_{\Delta A \rightarrow 0} E\left[\frac{V(A, R - \Delta R) - V(A, R)}{-\Delta A}\right] ,$$

that is, ΔV is the "expected rate" of improvement in V induced by additions to stockpiles R resulting from exploration at a unit rate (holding A constant). For example, under the Poisson distributional assumption, $\Delta V(A, R) = \beta[V(A, R + 1) - V(A, R)]$, where β is the parameter of the Poisson distribution.

Simplifying, we have the Bellman equation:

$$(1.4) \quad \rho V \Delta t \approx \text{Max}_{c_t, \Delta A_t} \{ u(c_t) \Delta t - V_R c_t \Delta t + [-\Delta V + P + V_A] \Delta A_t \} .$$

From the first order conditions for optimality in (1.4) we have

$$(1.5) \quad c^* = C(V_R) \equiv u'^{-1}(V_R) ,$$

where u'^{-1} is the functional inverse of u' , well defined since u is strictly concave. Furthermore,

$$(1.6) \quad \Delta A^* = 0 \quad \text{if} \quad \Delta V - P - V_A < 0 ,$$

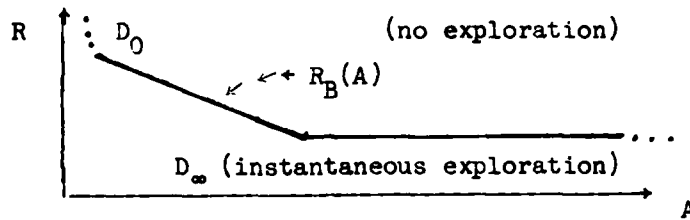
and otherwise:

$$(1.7) \quad \Delta A^* = \sup \{ \Delta A < 0 : \Delta V(A + \Delta A, R + \Delta R) - P - V_A(A + \Delta A, R + \Delta R) < 0 ; \\ \text{or } A_t + \Delta A = 0 \} .$$

The recipe (1.6)-(1.7) for ΔA^* obviously needs some interpretation. The exploration policy A is apparently "bang-bang." If the marginal expected return to exploring, $\Delta V - P - V_A$, is negative, zero exploration is optimal (1.6). Otherwise, land should be explored instantaneously "until" either the random amount of resources extracted, ΔR in (1.7), is sufficient to push the marginal return on exploration below zero, or until the remaining land is exhausted. Note that ΔA_t^* is thus a random "probing variable." Instantaneous control for this problem is not merely a case of "infinite exploration rate," but also involves sequential decisions and realizations of random discoveries all at a single point of time! (See Section 2.)

Assuming all of the above can be made rigorous, the state space $\{(A,R) \in \mathbb{R}_+^2\}$ can be divided into two regions, no exploration and instantaneous exploration, as illustrated in Figure 1.1.

Figure 1.1 Control Regions in the State Space



In region D_0 (no exploration) we can eliminate the last term of the Bellman equation (1.4) since $\Delta A = 0$ and divide through by Δt , obtaining the following differential equation for V after substituting from (1.5):

$$(1.8) \quad \rho V(A,R) = u[C(V_R)] - V_R C(V_R) \quad , \quad (A,R) \in D_0 \quad .$$

Equation (1.8) is actually a first order differential equation for V as a function of R , of the form:

$$(1.9) \quad V(A,R) = W(R + R_E(A)) \quad ,$$

where $R_E(A)$ is a constant representing the "resource equivalent" of the remaining unexplored land A . For the case $u(c) = \ln(c)$, $W(\cdot)$ has the solution

$$(1.10) \quad W(x) = \frac{1}{\rho} [\ln(\rho x) - 1] \quad ,$$

which implies, using (1.5),

$$(1.11) \quad C^* (A,R) = \rho[R + R_E(A)] \quad .$$

Similar solutions are available for the case of power utilities and, in general,

$$(1.12) \quad c^* (A,R) = \frac{-\rho V_R}{V_{RR}} \quad ,$$

which is the classical Hotelling [1931] result in the deterministic case ($A = R_E(A) = 0$).

Turning to the instantaneous exploration region D_∞ , we can divide the Bellman equation (1.4) through by ΔA , eliminating terms in Δt since "instantaneous" of course means $\Delta t / \Delta A = 0$. This leaves the inequality, using (1.6)-(1.7),

$$(1.13) \quad \Delta V - P - V_A > 0 \quad (A,R) \in D_\infty \quad .$$

Derzko and Sethi [1981] give a common sense argument that (1.13) must in fact hold with equality in D_∞ , while H-C-K give a more formal argument based on the transition probability governing movement in D_∞ .

Thus the equation

$$(1.14) \quad \Delta V(A,R) - P - V_A(A,R) = 0 \quad (A,R) \in D_\infty$$

along with the (1.8) and the obvious boundary conditions constitute the information available to determine a solution for $V(A,R)$. The key elements of the solution are the two functions: $R_B(A)$, the boundary curve separating D_0 from D_∞ ; and $R_E(A)$, the "resource equivalents" function.

The papers by H-C-K and Derzko and Sethi [1981] both contain numerical approximations for $R_E(\cdot)$. Their results are similar although obtained by quite different routes. H-C-K also produced numerical approximations for $R_E(\cdot)$ and extended the price dynamics analysis of Arrow and Chang [1978].

Sundaresan [1983] includes a survey of research in optimal extraction of nonrenewable resources under uncertainty.

2. The Control Clock

Before proceeding to a diffusion formulation of Arrow's model, it is important to place the basic model on a rigorous foundation by formalizing the notion of instantaneous control suggested in Section 1.

It is inherent in Arrow's model that, during exploration, decisions of whether or not to continue exploring may be made successively at a single point of time. This is a much stronger interpretation of "instantaneous control" than has usually been considered (e.g. Harrison and Taksar [1982]). Here one may explore a certain area of land, re-evaluate the situation based on new discovery information, and perhaps continue exploring, all at the same point of time. It is implicit that there are two "clocks" running, one describing the passage of "real" time, the other tracking the running down of unexplored land. During instantaneous exploration the first clock is not running, while the second records the using up of unexplored land and generates information about the increments of the discoveries proceeds, N^A . For a well defined control problem, however, the control policy should be formally

adapted to some information structure^{1/} $\mathcal{F} = \{F_\tau, \tau > 0\}$ where, roughly speaking, F_τ describes the information known at "time τ " on some "control clock." A convenient way to set up the control clock is to let "control time" be the sum of real time and cumulative land explored. Accordingly, we relate $t(\tau)$, (real time at τ on the control clock), and $L(\tau) \equiv A_0 - A(\tau)$ (land explored) by:

$$(2.1) \quad L(\tau) = \int_0^\tau \lambda_s ds > 0$$

$$(2.2) \quad t(\tau) = \int_0^\tau (1 - \lambda_s) ds > 0$$

so that

$$(2.3) \quad \tau = L(\tau) + t(\tau) > 0 ,$$

where $\lambda_\tau \in [0,1]$ is the "exploration intensity" (a control process). When $\lambda_\tau = 1$, real time is standing still (2.2) while exploration takes place at full intensity (instantaneously in real time). When $\lambda_\tau = 0$ no exploration is occurring. Finally $\lambda_\tau \in [0,1]$ implies that real time and exploration are running simultaneously.

With this control clock, $\lambda(\tau)$, $A(\tau)$, $t(\tau)$, $R(\tau)$, and $c(t(\tau))$ can all be formally modeled as stochastic processes adapted to some exogenous information structure. If the notion that exploration can actually occur instantaneously is rejected, the exploration control λ can be restricted to a compact subinterval of $[0,1]$.

It is a difficult task indeed to formalize the analysis in Section 1 (and in the earlier papers) without a device similar to this time

change. For example, it was assumed throughout the derivation of the Bellman equation that ΔA_t is "very small," whereas the actual policy involves considerable jumps in certain regions of the state space.

3. A Diffusion Formulation of Arrow's Model

In this section we reformulate Arrow's model using a diffusion idealization of the discoveries process N^A . Although this does not improve on the Poisson distributional assumption by yielding an analytical solution (as one might have hoped), it does promote a somewhat clearer understanding of certain points. It also establishes the robustness of certain of Arrow and Chang's [1978] original results under quite different probabilistic assumptions.

As a preliminary, let $B = (B_\tau; \tau > 0; \Omega, F, P)$ denote a Standard Brownian Motion on the probability space (Ω, F, P) .

We begin by suggesting that the exploration activity requires stochastic inputs $I = (I_\tau; \tau > 0)$ of the resource itself, where I_τ is the amount of the resource required to explore the first L_τ units of land area. The stochastic process $O = (O_\tau; \tau > 0)$ similarly describes gross discoveries (output) of the resource.

If the input and output processes I and O have i.i.d. increments over each successive section of land of fixed area, then a natural idealization of the net discoveries process $N \equiv O - I$ is the controlled diffusion process:

$$(3.1) \quad N_\tau^\lambda = \int_0^\tau \lambda_s [\mu ds + \sigma dB_s]$$

for some positive constants μ and σ . See Harrison [1981] for the arguments leading to this idealization of a production process.

From (3.1) we see that N^λ has drift $\lambda_\tau \mu$ and "instantaneous variance" $\lambda_\tau^2 \sigma^2$ which depend on the exploration control λ . In effect, λ "speeds up" or "slows down" the (μ, σ) Brownian motion discoveries process which would result if exploration were carried out at a uniform rate.

The control problem (1.1)-(1.2)-(1.3) is unchanged, but can now be set up in "control time," using (2.1) and (2.2), as:

Find $V: \mathbb{R}^2 \rightarrow \mathbb{R}$ and non-anticipating controls λ_τ and $c_\tau \equiv c(t(\tau))$ satisfying

$$(3.2) \quad V(A, R) = \text{Max}_{\lambda, c} E_{AR}^{\lambda, c} \left\{ \int_0^\infty e^{-\rho t(\tau)} [u(c_\tau)(1 - \lambda_\tau) - \rho A_\tau] d\tau \right\}$$

where

$$(3.3) \quad dt(\tau) = (1 - \lambda_\tau) d\tau, \quad t(0) = 0, \quad \lambda_\tau \in [0, 1]$$

$$(3.4) \quad dR_\tau = dN_\tau^\lambda - c_\tau(1 - \lambda_\tau) d\tau, \quad R_\tau \geq 0$$

$$(3.5) \quad dN_\tau^\lambda = \lambda_\tau \mu d\tau + \lambda_\tau \sigma dR_\tau,$$

$$(3.6) \quad dA_\tau = -\lambda_\tau d\tau, \quad A_\tau \geq 0.$$

To guarantee that the above integrals are well-defined (with V permitted to take the value $-\infty$), we assume that $c \in [0, \bar{c}]$ for some (large) constant \bar{c} . The conditions on u given in Section 1 then place an upper bound on $u(c_\tau)$.

We will proceed on the basis that a solution to (3.2) exists with

$$V_R, V_A, \text{ and } V_{RR} \equiv \frac{\partial^2 V}{\partial R^2}(A,R)$$

existing and bounded (at least for $A > 0, R > 0$). Using Ito's lemma, the infinitesimal generator $L^{\lambda c}$ corresponding to the transition semigroup for the controlled process N^λ yields (using (3.4), (3.5) and (3.6)):

$$(3.7) \quad L^{\lambda c} V(A,R) = -\lambda V_A + V_R [\mu\lambda - c(1-\lambda)] + \lambda^2 \frac{\sigma^2}{2} V_{RR}.$$

Then applying the strong Markov property of B and relation (3.3), we derive the Bellman equation from (3.2):

$$(3.8) \quad V = \text{Max}_{\lambda c} \{ [1 - \rho(1-\lambda)]V + u(c)(1-\lambda) - P\lambda + L^{\lambda c} V \}$$

subject to: $c > 0, \lambda \in [0,1]$.

(See, for example, Fleming and Rishel [1975] Chapter VI for details.)

Note that with the advantages of a "control clock" and the continuity of diffusion processes, the derivation of the Bellman equation is quick and without approximation.

Since $u(\cdot)$ is strictly concave it is easy to deduce from (3.2) that $V_{RR} < 0$. We can then define

$$(3.9) \quad \hat{\lambda}(A,R) \equiv \frac{-1}{V_{RR} \sigma^2} [\rho V - u(c(V_R)) - P - V_A + V_R (\mu + c(V_R))] .$$

The first order necessary conditions for optimality in (3.8) then generate the following solution for $\lambda^*(A,R)$ and $c^*(A,R)$, the optimal exploration and consumption controls:

$$\begin{aligned} \hat{\lambda}(A,R) > 1 &\Rightarrow \lambda^*(A,R) = 1; c^*(A,R) \text{ arbitrary} \\ (3.10) \quad 0 < \hat{\lambda}(A,R) < 1 &\Rightarrow \lambda^*(A,R) = \hat{\lambda}(A,R); c^*(A,R) = C(V_R) \\ \hat{\lambda}(A,R) \leq 0 &\Rightarrow \lambda^*(A,R) = 0; c^*(A,R) = C(V_R) \end{aligned}$$

Combining (3.7), (3.8), and (3.10) and simplifying, we have the final form of the Bellman equation:

$$(3.11) \quad (1 - \lambda^*)[-c^*V_R - \rho V + u(c^*)] + \lambda^*(\mu V_R - V_A - P) + \lambda^{*2} \frac{\sigma^2}{2} V_{RR} = 0 \quad .$$

Note that (3.11) is a partial differential equation for V which must hold throughout the state space. Just as in Section 1, however, we can simplify the Bellman equation by dividing up the state-space, this time into the three regions:

$$\begin{aligned} D_0 &= \{(A,R) \in \mathbb{R}_+^2: \hat{\lambda}(A,R) \leq 0\} \quad (\text{consumption only}) \\ D_1 &= \{(A,R) \in \mathbb{R}_+^2: \hat{\lambda}(A,R) \in (0,1)\} \quad (\text{simultaneous consumption} \\ &\quad \text{and exploration}) \\ D_\bullet &= \{(A,R) \in \mathbb{R}_+^2: \hat{\lambda}(A,R) > 1\} \quad (\text{instantaneous exploration}) \end{aligned}$$

The intermediate region D_1 , where exploration and consumption occur simultaneously and continuously, is also feasible for the formulation in Section 1, but can be rejected there as sub-optimal from the pure discontinuity of N^A . In the diffusion case, however, we see from

(3.9) that D_1 is null only if there is a solution $\hat{V}(A,R)$ for the Bellman equation (3.11) satisfying:

$$(3.12) \quad \rho \hat{V} = u(\hat{V}_R) - P - \hat{V}_A + \hat{V}_R(\mu + C(\hat{V}_R)) = 0$$

with

$$\lambda^*(A,R) = \hat{\lambda}(A,R) = 0$$

and

$$c^*(A,R) = C(\hat{V}_R) .$$

In the case of logarithmic utility, $u(c) = \ln(c)$, the following specification for \hat{V} satisfies (3.11) and, if $P = 0$, (3.12):

$$\hat{V}(A,R) = \frac{1}{\rho} \ln(\rho(R + \mu A)) + \frac{P - 1}{\rho} .$$

We feel this to be somewhat of a quirk, however, related to the very special properties of logarithmic utility ($C(V_R)V_R = 1$). In general the solution is enriched by situations in which it is optimal to consume and explore simultaneously.

In D_0 , the "consume only" region, the same ODE (1.9) found in Section 1 is obtained from the Bellman equation (3.11) for $\lambda^* = 0$. That is, it is again optimal to consume in D_0 according to the "Hotelling rule" (1.12) until the reduction in stocks induces further exploration.

Finally in D_{∞} , where $\lambda^* = 1$, we obtain from (3.11)

$$(3.14) \quad \mu V_R + \frac{\sigma^2}{2} V_{RR} - V_A - P = 0 .$$

Note that (3.14) is the direct analogue of (1.14), which was obtained by a much more tortuous route.

In fact (3.14) and (1.14) can be shown to be formally equivalent by applying Ito's lemma to the definition of ΔV in (1.3).

In the diffusion case (3.14) has an interesting interpretation as the Kolmogorov Backward equation governing the transition density of V inside D_{∞} . Define the stopping time

$$T = \inf \{ \tau > 0 : (A_{\tau}, R_{\tau}) \notin D_{\infty} \}$$

and consider the stopped process $V(A_{\tau \wedge T}, R_{\tau \wedge T})$. Since $\lambda \equiv 1$ in D_{∞} , R moves in D_{∞} simply as a (μ, σ^2) Brownian motion, and $dA_{\tau} \equiv d\tau$ from (2.1). For any stopping time $s < T$, by Bellman's Principle of Optimality we have, for $(A, R) \in D_{\infty}$

$$(3.15) \quad \begin{aligned} V(A, R) &= E[V(A_s, R_s) - P(A_s - A_{\tau}) | A_{\tau} = A, R_{\tau} = R] \\ &= E[V(A - s + \tau, R_s) - P(s - \tau) | R_{\tau} = R] . \end{aligned}$$

In particular, for $s = T$, (3.15) says that the current value of V at a point in D_{∞} is the expected value of V at the exit point (A_{τ}, R_{τ}) , less the expected exploration cost to "get out," $E[P(T - \tau)]$.

Now define $Y(s, \tau, R)$ by equating it with the right-hand side of (3.15). Then (3.14) is formally the backward equation for $Y(s, \tau, R)$, since R_{τ} is a (μ, σ^2) Brownian motion in D_{∞} . Thus, since

$Y(\tau, \tau, R) = V(A, R)$ for $(A, R) \in D_{\infty}$, (3.14) is the partial differential equation giving the transition density of V , treating land as "time."

4. Mapping from Control Time Back to Real Time

In the last section we characterized the optimal controls λ^* and c^* as feedback policies on the current state variables, unexplored land (A) and stockpiles of the resource (R). Given the simple relationship (2.1) between "real time" and "control time," it is simple to map these policies, which apply in control time, back into real time.

Since the consumption policy $c_{\tau} \equiv c(t(\tau))$ was formulated in real time to begin with, we have the solution

$$(4.1) \quad c^*(t) = C(V_R(A_t, R_t)) \quad ,$$

which holds everywhere (since the consumption policy is irrelevant in D_{∞}).

The exploration policy must be characterized separately in each of the regions from (3.6) and (3.10). In D_{∞} , it is impossible to express the policy in real time except to say that it is optimal to explore "instantaneously" to the boundary of D_{∞} . In some of the previously cited studies it has been overlooked that this may entail exploration of all remaining land without ever reaching the boundary curve $R_B(\cdot)$ illustrated in Figure 1. In the case of diffusion discoveries, it may even occur that instantaneous exploration will exhaust all stocks R before the remaining land is all explored. Of course the probability of such an occurrence will be small given reasonable choices for μ and σ .

In D_0 , by definition, the optimal exploration policy A^* is

$$(4.2) \quad \dot{A}^*(t) \equiv \frac{dA^*(t)}{dt} = 0 \quad .$$

Finally, in the intermediate region we have

$$(4.3) \quad \dot{A}^*(t) = \frac{-\hat{\lambda}(A_t, R_t)}{1 - \hat{\lambda}(A_t, R_t)} \quad ,$$

where $\hat{\lambda}$ is the function defined in (3.9).

Footnotes

- 1/ Formally, we should preface these remarks by a statement that (Ω, \mathcal{F}, P) is a probability space describing uncertainty in Arrow's model. Then \mathcal{F} is a filtration, a right-continuous increasing family of sub-tribes of \mathcal{F} , with $\mathcal{F} = \bigcup_{\tau \geq 0} \mathcal{F}_\tau$. See, for example Meyer [1967], p. 65.

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213	"Measuring Quality and Regulation," by Michael Spence	216	"Approval of Public Loans Under Limited Information," by Peter J. Hammond
214	"A Note on the Budget Constraint in a Model of Borrowing," by Joseph E. Stiglitz	217	"On the Rate of Convergence of the Core," by Robert J. Aumann
216	"Incentives, Risk, and Information: Notes Towards a Theory of Simultaneous Equations of Alternative Production Sequences," by J. W. Anderson	218	"On the Existence of Equilibria for Aggregate Demand Functions: The Case of a Single Index," by Lawrence J. Lan
218	"Approximate Expansions of the Distributions of Estimates in Simultaneous Equations of Alternative Production Sequences," by J. W. Anderson	220	"A Note on Dual Index Numbers," by Lawrence J. Lan
220	"Estimation of Linear Functional Relationships: Approximate Distributions and Connections with Simultaneous Equations of Linear Functional Relationships," by J. W. Anderson	222	"Linear Regression with Both Temporally Aggregated and Temporally Disaggregated Data," by Cheng Hsiao
222	"Monopolies and the Rate of Extraction of Exhaustible Resources," by Joseph E. Stiglitz	224	"The Existence of Equilibrium Equilibria, Continuity and Mixed Strategies," by Partha Dasgupta and Eyal Sheshinski
224	"Implications of Competitive Inequality in Normal Linear Regression," by J. W. Anderson and John B. Taylor	226	"A Complete Class Theorem for the Control Problem and Further Results on Admissibility and Inadmissibility," by Asad Zaman
226	"Some Observations on Least Squares Estimates in Normal Linear Regression," by J. W. Anderson and John B. Taylor	228	"Measure-Based Values of Market Games," by Sripati Hart
228	"On the Existence of Differential Information Structures: An Application to Trade Policy," by Partha Dasgupta and J. E. Stiglitz	230	"A Representation Theorem for Preference for Flexibility," by David M. Kepp
230	"The Influence of Efficiency Effects of Taxes on Income Distribution," by John B. Taylor	232	"The Existence of Efficient and Income Compatible Equilibria with Public Goods," by Theodore Groves and John C. Ledyard
232	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	234	"Efficient Collective Choice with Compensation," by Theodore Groves
234	"On the Existence of Efficiency Effects of Taxes on Income Distribution," by John B. Taylor	236	"On the Impossibility of Informationally Efficient Markets," by Sanford J. Grossman and Joseph E. Stiglitz
236	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	238	
238	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	240	
240	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	242	
242	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	244	
244	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	246	
246	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	248	
248	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	250	
250	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	252	
252	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	254	
254	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	256	
256	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	258	
258	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	260	
260	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	262	
262	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	264	
264	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	266	
266	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	268	
268	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	270	
270	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	272	
272	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	274	
274	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	276	
276	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	278	
278	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	280	
280	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	282	
282	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	284	
284	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	286	
286	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	288	
288	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	290	
290	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	292	
292	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	294	
294	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	296	
296	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	298	
298	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	300	
300	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	302	
302	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	304	
304	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	306	
306	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	308	
308	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	310	
310	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	312	
312	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	314	
314	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	316	
316	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	318	
318	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	320	
320	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	322	
322	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	324	
324	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	326	
326	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	328	
328	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	330	
330	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	332	
332	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	334	
334	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	336	
336	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	338	
338	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	340	
340	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	342	
342	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	344	
344	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	346	
346	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	348	
348	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	350	
350	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	352	
352	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	354	
354	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	356	
356	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	358	
358	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	360	
360	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	362	
362	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	364	
364	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	366	
366	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	368	
368	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	370	
370	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	372	
372	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	374	
374	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	376	
376	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	378	
378	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	380	
380	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	382	
382	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	384	
384	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	386	
386	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	388	
388	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	390	
390	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	392	
392	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	394	
394	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	396	
396	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	398	
398	"On the Existence of a Unique Likelihood Estimate of a Slope Coefficient," by J. W. Anderson	400	

REPORTS IN THIS SERIES

221. A Generalization of the Box-Cox Maximum Likelihood Estimator and the Naïve Two-Stage Least Squares Estimator," by Takechi Anemiyama and James J. Powell
222. "Comparison of the Densities of the FLS and LIML Estimators for Simultaneous Equations," by J. W. Anderson, Naoto Kunitomo, and Takarashi Sawa
223. "Admissibility of the Ridge Procedure Corresponding to the Uniform Prior Distribution for the Control Problem in Four Dimensions but Not in Five," by Charles Stein and Avshalom Zouari
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249. "A Curious Property in the Style of Fulfilled Expectations Equilibrium," by William Novshek and Hugh Sonnenschein
250. "Law of Large Numbers for Random Sets and Allocation Processes," by Avi Arstein and Sergiu Hart
251. "Risk Perception in Psychology and Economics," by Kenneth J. Arrow
252. "Shapken Predictions for Antisegregatory Models," by Taku Yamamoto
253. "Prediction, Reputation, and Entry Deterrence," by Paul Milgrom and John Roberts
254. "Social and Private Production Objectives in the Sequence Economy," by David Starrett
255. "Recursive Rational Choice," by Alain Lewis
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273. "Asymptotic Bias of the Least Squares Estimator for Multivariate Autoregressive Models," by T. Yamamoto and S. Kunitomo
274. "The Asymptotic Normality of Two-Stage Least Absolute Deviations Estimators," by J. Powell
275. "Rational Cooperation in the Limited Repeated Prisoner's Dilemma," by D. Kreps, P. Milgrom, J. Roberts, and R. Wilson
276. "A Generalization of the Box-Cox Maximum Likelihood Estimator and the Naïve Two-Stage Least Squares Estimator," by Takechi Anemiyama and James J. Powell
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Reports in this Series

376. "Necessary and Sufficient Conditions for Single-Peakedness Along a Linearly Ordered Set of Policy Alternatives" by P.J. Coughlin and M.J. Hinich.
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416. "Diffusion Approximation in Arrow's Model of Exhaustable Resources" by Darrell Duffie and Michael Taksar.

84