<table>
<thead>
<tr>
<th>Title</th>
<th>DYNAMIC UTILITY MAXIMIZATION, WEALTH EFFECT AND DERIVATION OF THE CONSUMPTION FUNCTION: FURTHER CONSIDERED</th>
</tr>
</thead>
<tbody>
<tr>
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</tbody>
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**Note:** The table contains all the necessary details from the document. The table structure is preserved, and the text is formatted to match the original document layout.
In a previous paper [1] I have analyzed a dynamic model of the household, in which the rational behavior of the consumer over time is formulated as a problem of the calculus of variations. That is, one should choose a saving plan so as to maximize a particular class of the utility integral

\[(1) \quad J[c, b] = \int_0^\infty [u(c) + v(b)] e^{-\beta t} dt\]

subject to the budget equation

\[(2) \quad Db = w + ib - c, \quad \text{or} \quad i \int_0^\infty ce^{-it} dt = ib_0 + \int_0^\infty we^{-it} dt.\]

The notation is restated below.

- \(c\) = real consumption
- \(b\) = real balance of the financial asset
- \(w\) = real wage rate
- \(i\) = real rate of interest
- \(\beta\) = rate of discount

The term \(v(b)\) in (1) leads to the wealth effect. Under the assumption that the subjective rate of discount \(\beta\) is greater than the real rate of interest \(i\) we
have confirmed that there exists a unique optimal trajectory starting from a given initial value of the asset holdings $b_0$. Furthermore we have focused attention on the case where there exists a long-run stationary point having the saddle point property. The optimal saving plan depends upon $w$, $i$ and $\beta$. So that, in general, the saving function is written as

$$ (3) \quad Db = f(w, i, \beta). $$

In this note we shall contemplate specifying the form of $f(*)$ by using the idea of "flexible accelerator" applied to the theory of investment by Lucas[3]. This approach will generate a saving function of a stock adjustment pattern. In what follows the stationary value of wealth, $b^*$, is regarded as the desired level of wealth. And $c^*$ is the corresponding value of consumption to $b^*$. That is,

$$ (4) \quad c^* = w + ib^*. $$

The dynamic motion of the system is described by the differential equations

$$ (2) \quad Db = w + ib - c, $$

$$ (5) \quad Dc = (\beta - i)u'(c) - v'(b), $$

$$ u''(c) $$

(2) is the performance equation and (5) is the Euler equation. Expanding this system about the stationary solution $(b^*, c^*)$, we obtain the approximate linear system
(6) \( \text{Db} = i(b-b*)-(c-c*) \)

(7) \( \text{Dc} = -\frac{v''(b*)}{u''(c*)}(b-b*) + (\beta-i)(c-c*) \),

or

\[
\begin{bmatrix}
  i & -v''/u'' \\
  -1 & \beta-i
\end{bmatrix}
\]

\[
[\text{Db} \text{ Dc}] = [b \ c] + [-ib*+c* \frac{v''}{u''}b*-(\beta-i)c*].
\]

First, we solve the homogeneous part of the system

(9) \( \text{Dy} = yA \),

where \( y = [b \ c] \), \( \text{Dy} = [\text{Db} \text{ Dc}] \) and

\[
A = \begin{bmatrix}
  i & -v''/u'' \\
  -1 & \beta-i
\end{bmatrix}
\]

Let the eigenvalues of \( A \) be \( \alpha_1 \) and \( \alpha_2 \). That is,

\[
\alpha_1 = \frac{1}{2}[\beta - [\beta^2 - 4(i(\beta-i) - v''/u'')]^{1/2}],
\]

\[
\alpha_2 = \frac{1}{2}[\beta + [\beta^2 - 4(i(\beta-i) - v''/u'')]^{1/2}].
\]

It is assumed that
(10) \( i(\beta - i) - v''/u'' < 0 \).

This assumption seems plausible, since \( i(\beta - i) \) is negligible. Then \( \alpha_1 < 0 \) and \( \alpha_2 > 0 \). Moreover let

\[
B = \begin{bmatrix} x_{11} & x_{12} \\ x_{21} & x_{22} \end{bmatrix},
\]

where \([x_{11} \ x_{12}]\) is an eigenvector corresponding to \( \alpha_1 \) and \([x_{21} \ x_{22}]\) is an eigenvector corresponding to \( \alpha_2 \).

Now define new variables

(11) \( z = [z_1 \ z_2] = yB^{-1} \).

Differentiating (11) yields

(12) \( Dz = DyB^{-1} \).

Multiplying both sides of (9) on the right by \( B^{-1} \) yields

(13) \( DyB^{-1} = yAB^{-1} \).

Substituting (12) into the left side and substituting \( y = zB \) (obtained from (11)) into the right side yield

(14) \( Dz = zBAB^{-1} \).

Here, \( BAB^{-1} \) can be written in the Jordan canonical form.
(15) $BAB^{-1} = \begin{bmatrix} a_1 & 0 \\ 0 & a_2 \end{bmatrix}$.

Thus, (14) reduces to

(16) $[Dz_1 \ Dz_2] = [z_1 \ z_2] \begin{bmatrix} a_1 & 0 \\ 0 & a_2 \end{bmatrix}$.

Solving (16) gives

(17) $[z_1 \ z_2] = [R_1 e^{a_1 t} \ R_2 e^{a_2 t}]$, where $R_1$ and $R_2$ are constants. Hence,

(18) $[b \ c] = [R_1 e^{a_1 t} \ R_2 e^{a_2 t}] \begin{bmatrix} x_{11} & x_{12} \\ x_{21} & x_{22} \end{bmatrix}$.

That is,

(19) $b = R_1 x_{11} e^{a_1 t} + R_2 x_{21} e^{a_2 t}$,

(20) $c = R_1 x_{12} e^{a_1 t} + R_2 x_{22} e^{a_2 t}$.

The particular solutions, $b^*$ and $c^*$, of the original
non-homogeneous equations added to (19) and (20) respectively make

\( b = R_1 x_{11} e^{a_1 t} + R_2 x_{21} e^{a_2 t} + b^* \),

\( c = R_1 x_{12} e^{a_1 t} + R_2 x_{22} e^{a_2 t} + c^* \).

From the initial conditions

\( R_1 = \frac{x_{22} (b_0 - b^*) - x_{21} (c_0 - c^*)}{x_{11} x_{22} - x_{12} x_{21}} \),

\( R_2 = \frac{-x_{12} (b_0 - b^*) + x_{11} (c_0 - c^*)}{x_{11} x_{22} - x_{12} x_{21}} \).

In (21) we shall employ a stable solution

\( b = R_1 x_{11} e^{a_1 t} + b^* \).

Differentiating (25) we have

\( \dot{b} = R_1 x_{11} a_1 e^{a_1 t} \)

\( = -a_1 (b^* - b) \).

(26) implies that the larger the difference between the actual wealth \( b \) and the desired one \( b^* \), the larger will be the current saving \( \dot{b} \). The actual wealth \( b \) approaches the stationary level \( b^* \) as time \( t \) goes to infinity. In the stationary state the propensity to save becomes zero. (26) is very akin to the "capital
stock adjustment principle" in the theory of investment. The larger the desired level of wealth, the larger will be the current level of saving. On the other hand, given desired wealth $b^*$ the larger the actual wealth, the smaller will be the current level of saving. That is,

$$(27) \frac{\partial Db}{\partial b} = a_1 < 0.$$  

Of course this means the "wealth effect".

NOTES

1) $u(0)=0$, $u(\infty)=\infty$; $u'>0$, $u''<0$; $u'(0)=\infty$, $u'(\infty)=0$. $v(b)$ also satisfies these conditions.


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REFERENCES

