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CAPITAL ACCUMULATION GAMES
OF INFINITE DURATION

by

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1. Introduction

The main purpose of this paper is to investigate a class of games in which each player accumulates some form of capital. The payoff of each player depends on his own capital and the capital stocks of his rivals. Changes in stock, however, are not instantaneous. The firm can invest in the capital stock and it deteriorates at a certain constant proportional rate. Each player thus chooses a path of investment and thus an induced path of capital accumulation so as to maximize his total discounted profits.

The first issue in such a game is the problem of existence of paths which form a Nash solution, i.e., given the paths of the rivals, the firm's strategy is the best response for these paths.

When the existence issue is solved, the main issue is whether such markers have a stationary equilibrium and whether the market will converge to the stationary point. It is straightforward to show that even if a stationary equilibrium path exists, in the finite horizon case the market will not converge to the equilibrium point. Thus the issue of convergence necessitates introducing infinite horizons. In order to clarify the economic situations of our games, the following are examples that fall into our general class.

Example 1: Durable Good Production:

Consider a market for a durable good. The rental price $p$ is a function of the total stock in the market. Firm $i$ can change its stock of durables, $Q_i(t)$, by producing $x(t)$ units at time $t$ and its stock depreciates at a constant rate of $\delta$. Thus its equation is $\dot{Q}_i = x_i - \delta Q_i$. Its revenues at time $t$ are given by $p(Q_1 + Q_2)Q_i$ and its cost of production is $C_i(x)$. 
Example 2: Advertising and Goodwill:

Consider a market in which the firms accumulate goodwill $G_t$ according to the Nerlove-Arrow equation $G_t = a_t - \delta G_t$, where $a_t$ is the advertising investment and $\delta$ is the depreciation due to forgetting and other reasons. Sales of firm $i$ will be some concave function of its relative market share. Price will be determined by a Cournot type solution. Thus the revenues of firm $i$ is given by $r_i(G_i, [G_j])$ for some concave function $f_i$. This example is dealt with separately by the authors (1982).

This work is an extension of two separate lines of research: capital accumulation and differential games.

The capital accumulation literature began with the seminal paper of Nerlove and Arrow (1962) where they defined the capital accumulation equation which is used here. Arrow (1964, 1968) has generalized his original findings by considering two extensions: the first considers a general decay which is not necessarily exponential, and the second considered a non-stationary economic environment. Gould (1970), by considering the model of Nerlove-Arrow with strictly convex cost has found that for any initial value of the stock of capital, there exists an initial investment such that the induced capital path converges to a stationary point.

At the same time a whole stream of related research began investigating the stability properties of capital accumulation growth models. In particular, the interest was in finding conditions under which a capital growth system would converge to a particular stationary point regardless of the initial conditions. Such a system was defined as having the global asymptotic stability property. See for example the special issue of JET (February, 1976) and in particular Cass and Shell, and Brock and Scheinkman. The common type of condition that relates these works is that more than strict
convexity (concavity) is needed.\footnote{1}

We are interested in extending the issue posed by Gould. His type of stability can be denoted by \textit{conditional stability} which is weaker than global stability since the path converges just for a particular initial condition of investment. In our game, global stability is ruled out since it can be shown that the game does not even possess local stability. We do, however, investigate the issue of conditional local and global stability.

In terms of differential games, we choose to formulate an open loop solution although it has known limitations; see Spence (1979) or Kylsand (1977). The closed loop solutions, however, are known to exist only with severe limitations on the structure and duration of the game, for example, Reinganum (1982).

For open loop differential games, Scalzo (1976) first proved existence for any finite duration. Proofs of existence prior to this were known only for "small" duration. Scalzo's work has been extended by Wilson (1977) and Williams (1980) to games with incomplete information and by Scalzo and Williams (1976) to games with nonlinear state equations. All three extensions dealt with the finite horizon case.

Thus, in terms of contribution to differential games we first provide a simpler proof for a setting similar to Scalzo. Then we extend this result by proving existence to the infinite horizon case. Third, because of our method of proof we are able to show the convergence to a stationary equilibrium regardless of the initial stocks of capital.

2. Formulation

We consider a game $G$ with two players where the payoff for each player is its total discounted profits. Instantaneous profits depend on the firm's own capital stock as well as the capital stocks of its rivals. Capital stock $K_t$
accumulates according to the Nerlove–Arrow capital accumulation equation

\[ \dot{K}_i = I_i - \delta K_i, \quad K_i(0) = K_{i0}, \quad i = 1, 2. \]

Where \( I_i \) is the investment in the capital stock \( K_i \) of firm \( i \), \( \delta \) is the depreciation constant. The planning horizon is denoted by \( T \).

In order to define a game we have to specify the strategy spaces \( S_1, S_2 \) and the payoffs.

Player \( i \)’s strategy is assumed to belong to the following set:

\[ S_i = \{ I_i(t) : [0,T] \rightarrow [0,\bar{I}_i] \mid I_i(t) \text{ is piecewise continuous on } [0,T] \} \]

where \( \bar{I}_i \) is given in assumption 1.

The payoff for firm \( i \) is defined by

\[ J_i = \int_0^T e^{-rt}[\Pi_i(K_{1i}, K_{2i}) - C_i(I_i)] \, dt \]

where \( r \) is the discount rate, \( T \) might be finite or infinite, and \( C_i(I_i) \) is the cost of investing \( I_i \) units.

**Assumption 1.** The control \( I_i(t) \) takes its value in a compact set \( [0,\bar{I}_i] \). For example, if the cost \( C_i(I_i) \) is convex and satisfies that \( \lim_{I_i \downarrow 0} C_i(I_i) = +\infty \), \( \bar{I}_i \) will induce a control function satisfying assumption 1.

The instantaneous profit function \( \Pi_i(K_{1i}, K_{2i}) \) and cost function \( C_i(I_i) \) satisfy

**Assumption 2:** \( \Pi_i(K_{1i}, K_{2i}) \in C^2 \), is increasing and strictly concave function of \( K_{1i} \), decreasing in \( K_{2i} \) (for \( i \neq j, i, j = 1,2 \), \( C_i(I_i) \in C^2 \), increasing and
strictly convex.

It can be checked that the two examples given earlier can satisfy assumption 2 (with respect to the revenue function). In example 2 note that the revenue function will be increasing and concave in $C_i$ if $f$ is increasing and concave in its argument; see Perlmutter (1982). Note that the condition

$$\lim_{t \to \infty} C_i(t_j) = 1$$

as $t \to \infty$ implies that $C_i(t_j)$ is more convex than $1/t$.

We consider an open loop differential game, i.e., the problem of player 1 is to maximize $(j_1)$ subject to his capital constraint given in (1), given $K_j(t)$ for $j \neq 1$.

Define the game $G(K_{10}, K_{20}, T)$ as the game with strategy spaces $S_1$, payoff functions as in (2), time horizon $T$, and at $t=0$, the game starts at the initial stocks of $K_i(0) = K_{i0}$ ($i=1,2$) and satisfies assumptions 1 and 2.

Finally, let $K_0 = (K_{10}, K_{20})$.

A Nash Equilibrium for the game $G(K_0, T)$ (for $T \in [0, \infty)$) is a pair of functions $l_1^*(t)$, $l_2^*(t)$ such that $l_i^*(t)$ maximizes (2) subject to (1) given $l_j^*(t)$ ($i \neq j$).

A Stationary Nash Equilibrium for $G(K_0, T)$ is a pair of values $(l_1^*, k_1^*)$, $(l_2^*, k_2^*)$ such that $l_i^* = \delta_i k_i^*$ and the pair $(l_1^*, l_2^*)$ is a Nash equilibrium for the game $u(K_1, K_2, \cdot, \cdot)$.

We shall call a stationary equilibrium point $(K_1^*, K_2^*)$ conditionally locally stable if there exists a two dimensional manifold $S$, containing $(K_1^*, K_2^*, l_1^*, l_2^*)$ such that for every $(K_1, K_2, l_1, l_2) \in S$ the solution of the game $G$ which starts at $(K_1, K_2, l_1, l_2)$ converges to the stationary equilibrium point.

We shall call a stationary equilibrium point $(K_1^*, K_2^*)$ conditionally globally stable if there exists a two dimensional manifold $S$, containing $(K_1^*, K_2^*, l_1^*, l_2^*)$ such that for every initial conditions $K_{10}, K_{20}$ there exists a pair of initial investment $l_{10}, l_{20}$ such that $(K_{10}, K_{20}, l_{10}, l_{20}) \in S$ and the
solution of the game $G(K_{10}, K_{20}, \omega)$ converges to the stationary equilibrium point $(K^*_1, K^*_2)$.

3. Finite Time Horizon

In this section we consider the game $G(K_{10}, K_{20}, T)$ for finite time horizon $T$.

We prove that for any $K_0$, and any $T$, there exists a path $(I_1(t), I_2(t))$, such that this pair of functions is a Nash equilibrium for the game $G$.

Define the following family of functions

$$B_{L_1}([0, T]) = \{ f \in C([0, T]) | 0 < f(t) < \frac{\tilde{I}_1}{L_1} \}$$

for all $t \in [0, T]$ and $|f(t) - f(s)| < \frac{\tilde{I}_1}{L_1} |t - s|$.

where $C([0, T])$ is the family of continuous, bounded function on $[0, T]$. Thus the family $B_{L_1}$ is bounded by a common bound and is equi-Lipschitz, i.e., all the functions of the family share the same Lipschitz constant.

Lemma 3.1: $B_{L_1}([0, T])$ is a convex, compact subset of $C([0, T])$.

Proof: We make use of Arzelà-Ascoli theorem (see Dunford and Schwartz, ch. 4) that states that if $M$ is compact then a set in $C(M)$ is conditionally compact if and only if it is bounded and equicontinuous.

Let $M = [0, T]$ and let $C(M)$ be $B_{L_1}$. Since equi-Lipschitz implies equi-continuity of $B_{L_1}$, Arzelà-Ascoli theorem can be applied and so $B_{L_1}$ is conditionally compact for $i=1, 2$.

Furthermore, by applying the triangle inequality it is clear that $B_{L_1}$ is closed since a converging sequence of equi-Lipschitz functions converges to a Lipschitz function with the same constant. Convexity can be shown in the same...
For each strategy $I_1(t) \in S_1$ define the induced capital path as $K_1(t)$ which is the solution of equation (1). Assumption (1) guarantees that $I_1(t)$ is bounded by $\tilde{I}_1$. Equation (1) guarantees that $K_1(t)$ is continuous and bounded by $\bar{K}_1 = \tilde{I}_1/\delta_1$ and that its Lipschitz coefficient is $\tilde{I}_1$. Thus every induced capital path $K_1(t)$ is a member of $B_{\bar{K}_1}([0,T])$. For every $K_2(t) \in B_{\bar{K}_1}([0,T])$ consider the problem of maximizing (2) subject to (1) as a regular control problem for player 1. Under assumptions 1 and 2 (which guarantee sufficiency) there exists a unique $\tilde{I}_1(t)$ that solves this control problem (see, for example, Lee and Markov, ch. 4 (1987) for finite time horizon and Baum (1976) for the infinite case). Clearly $\tilde{I}_1$ induces a unique path of $\bar{K}_1 \in B_{\bar{K}_1}([0,T])$.

Assumption 3: $\delta_1^2 = \partial \gamma_1 \partial K_1$ is bounded, i.e., $|\delta_1| < L$ for some $L > 0$.

Lemma 3.2: Consider a function $\phi_1: B_{\bar{K}_1}([0,T]) \rightarrow B_{\bar{K}_1}([0,T])$ such that $\phi_1(K_1(t)) = \bar{K}_1(t)$. Under assumptions 1, 2, and 3, the functions are continuous with respect to the supremum metric $\|f - g\| = \sup_t |f(t) - g(t)|$.

Proof: Consider the maximization problems for firm 1 in which the stock of player 2 is given by $K_2(t)$. The problem can be solved by using standard control theory.

Define the current value Hamiltonian to be

$$H_1 = \pi_1(K_1, K_2) - C_1(I_1) + \lambda_1 \theta_1 - \lambda_1 \delta_1 K_1$$

Under assumptions 1 and 2 the necessary conditions for optimality are sufficient as well since the Hamiltonian is concave in $K_1$ and $I_1$. The necessary conditions are
(3) \[ \lambda_1 - \lambda_1 = -\partial H_1/\partial K_1 = -\partial H_1/\partial K_1 + \lambda_1 \delta_1 \]

(4) \[ \partial H_1/\partial t^1 = 0 = -C_1^1(1_1) - \lambda_1 \]

Solving equation (3) for \( \lambda_1 \), (4) for \( L_1(t) \), substituting into (1) and solving for \( L_1(t) \) yields

(5) \[ L_1(t) = \xi + \int_0^t e^{-\delta_1(t-s)} (C_1^1)^{-1} \int_s^t \pi_1^1(L_1(t), L_2(t)) e^{-(r*\delta_1)(t-s)} \, ds \, dt \]

where \( \xi = K_{10} \).

We need to show that given a converging sequence \( K^n_2(t) \rightarrow K^n_2(t) \), the corresponding sequence \( K^n_1(t) = \phi_t(K^n_2(t)) \) satisfies \( K^n_1(t) + K^n_1(t) \) where \( \phi_t(\xi) = \phi_t(K^n_2(t)) \).

Assume a contrario that \( K^n_1(t) \) does not tend to \( K^n_1(t) \). Without loss of generality (taking subsequence if necessary), we can assume that \( K^n_1(t) \rightarrow J(t) \) but \( J(t) \neq K^n_1(t) \). From the fact that \( B_L \) is equi-lipschitz, it follows that the convergence of \( K^n_1 \) is uniform and thus this and the continuity of \( C_1^1 \) and \( \pi_1^1 \) imply that \( J(t) \) satisfies

\[ J(t) = \xi + \int_0^t e^{-\delta_1(t-s)} (C_1^1)^{-1} \int_s^t \pi_1^1(J(t), K^n_2(t)) e^{-(r*\delta_1)(t-s)} \, ds \, dt \]

Since the solution of (5) is unique, it follows that \( J(t) = K^n_1(t) \). The fact that every converging sequence of \( K^n_1 \) converges to \( K^n_1 \) implies that \( K^n_1 \) tends to \( K_1 \).

Note that the functions \( \phi_t \) are not reaction functions since they are not defined on the strategy space but rather on the state path space. If firm 2
chooses a path of investment $l_i(t)$ which induces a path of capital $K_i(t)$ then the optimal response of firm $i$ will be to choose a path of investment such that the induced path of capital is $\theta_i(K_i(t))$.

Theorem 1: The differential game $G(K_{10}, K_{20}, T)$ associated with equation (1) and (2), and satisfies assumptions 1, 2, and 3 has a Nash equilibrium solution for any initial conditions $K_{10}$ and $K_{20}$.

Proof: Define the function $\psi$ from $B_{11} \times B_{12}$ into itself as follows: For every $x \in B_{11}$, $y \in B_{12}$ let

\[
\psi(x, y) = \langle \phi_1(y), \phi_2(x) \rangle
\]

We make use of the Schauder-Tychonoff theorem which states that if $A$ is a compact convex subset of a locally convex linear topological space then every continuous mapping from $A$ into itself has a fixed point.

Since $C([0, T])$ is a Banach space, from Lemma 2, $B_{11} \times B_{12}$ is a compact convex subset of a locally convex space, from Lemma 1 the function $\psi$ is a continuous mapping and thus $\psi$ has a fixed point. This fixed point is a Nash equilibrium solution for the game $G(K_{10}, T)$.

Q.E.D.

The economic interpretation of Theorem 1 is that for every initial conditions $K_{10}$ and $K_{20}$, there exists a pair of strategies $(l^*_1(t), l^*_2(t))$ such that: first, $l^*_i(t)$ is the best response for $l^*_j(t)$ and second, the induced capital paths $K^*_i(t)$ start at $K_{10}$, for $i=1,2$. 
Infinite Time Horizon

In this section we prove the existence of a Nash solution to the game $G(K_{10}, K_{20}, \omega)$ for every $K_{10}$ and $K_{20}$. Replication of the finite time horizon proof is not possible. To see this note that we have defined a family of Lipschitz functions $B_{L_4}([0,T])$. Then we defined mappings $\phi_4$ which, we were able to show, were continuous. Using this continuity and the compactness of $B_{L_4}([0,T])$ we were able to make use of the Tychonov theorem. In the infinite case, $B_{L_4}([0,\omega])$ is not compact. We therefore modify $B_{L_4}$ in a way to achieve compactness.

Define the following family of functions

$$\mathcal{U}_{L_4}([0,\omega]) = \{ f \in C([0,\omega]) | f = e^{-\tau T_4} g \text{ and } g \in B_{L_4}([0,\omega]) \}$$

where $C([0,\omega])$ is the family of continuous, bounded functions on $[0,\omega]$.

Lemma 4.1: $\mathcal{U}_{L_4}([0,\omega])$ is a convex, compact subset of $C([0,\omega])$.

Proof: We make an extension of the Arzela-Ascoli theorem which states the following.

Let $M$ be an arbitrary topological space and $A$ a bounded subset of $C(M)$.

Then $A$ is conditionally compact if and only if for every $\varepsilon > 0$ there is a finite collection $E = [E_1, \ldots, E_n]$ of sets with union $M$ and points $m_i \in E_i$ $i=1,\ldots,n$ such that for $i=1,\ldots,n$, $\sup_{m \in A} \sup_{E_i \in E} |f(m_i) - f(m)| < \varepsilon$ (see Dunford and Schwartz, chapter 4.)

From the definition of $B_{L_4}([0,T])$ (see Section 3) it is evident that due to the fact that $B_{L_4}$ is equi-Lipschitz, for every finite $T$ there exists a collection $E$ as required. Since the functions in $B_{L_4}([0,\omega])$ are bounded by $E_4$, for every given $\varepsilon > 0$, let $T$ be such that $e^{-T T_4} E_4 < \varepsilon$. For this $T$ define
the collection \(E^i\) as \(\{E_1, \ldots, E_n, E_{n+1}\}\) where \(E_{n+1} = \{\emptyset, \star\}\). It is clear that, for \(i = 1, \ldots, n\), and \(e_i \in E_1\),

\[
\sup_{f \in \mathcal{F}_i} \sup_{m \in \mathcal{E}_i} |f(m_i) - f(m)| < \varepsilon
\]

and thus \(\mathcal{G}_i\) is conditionally compact. It is cumbersome but straightforward to check that \(\mathcal{G}_i\) is closed and thus it is compact.

Define a function \(\phi_i : B_{L_i}(\{\emptyset, \star\}) \times B_{L_i}(\{\emptyset, \star\})\) as the best induced capital path of player \(i\) for a given capital path of \(j\) as in section 3. Define a function \(\theta_i : \mathcal{G}_{L_i} \times \mathcal{G}_{L_i}\) such that for every \(f \in \mathcal{G}_{L_j}\)

\[
\theta_i(f) = e^{-rt_i}(\rho^i_f)
\]

The function \(\theta_i\) is well defined since by definition of \(\mathcal{G}_{L_j}\), \(e^{-rt_i} \in B_{L_i}\). In order to prove its continuity we need the following definition and lemma.

**Definition**: Let \(x_n, x_0 \in B_{L_i}(\{\emptyset, \star\})\). \(x_n \sim x_0\) iff for every finite \(T\)

\[
\sup_{t \in T} |x_n(t) - x_0(t)| = 0 \quad \text{as} \quad n \to \infty.
\]

**Lemma 4.2**: \(e^{-rt_n} \sim e^{-rt_0}\) iff \(x_n \sim x_0\)

**Proof**: Clearly if \(e^{-rt_n} \sim e^{-rt_0}\) then for every finite \(T\)

\[
\sup_{t \in T} |e^{-rt_n} x_n(t) - e^{-rt_0} x_0(t)| = 0 \quad \text{and thus} \quad \sup_{t \in T} |x_n(t) - x_0(t)| = 0 \quad \text{as} \quad n \to \infty.
\]

Conversely, \(x_n\) are bounded for every given \(\varepsilon > 0\), there is \(T_1\) sufficiently large such that \(\sup_{t \in T_1} |e^{-rt_n} x_n(t) - e^{-rt_0} x_0(t)| < \varepsilon/2\). For sufficiently large \(n\)

\[
\sup_{t \in T_1} |e^{-rt_n} x_n(t) - e^{-rt_0} x_0(t)| < \varepsilon/2.
\]

Therefore for every \(\varepsilon > 0\), there is \(T_1\) and sufficiently large \(N\) such that for every \(n \geq N\)

\[
\sup_{t \in T_1} |e^{-rt_n} x_n(t) - e^{-rt_0} x_0(t)| < \varepsilon
\]
Assumption 4: $p_{ij}^{13}$ is bounded, i.e., $\tau_{ij}^{13} < L_i$ for some $L_i > 0$ and $c_i^{11}$ is bounded from below, i.e., $c_i^{11} > c_i$ for some $c_i > 0$.

Lemma 4.3 Under assumptions 1, 2, 3, and 4 the functions $\theta_i$ as defined in (7) are continuous with respect to the metric $\|f - g\| = \sup_{t \in [0, T]} \|f(t) - g(t)\|$.

Proof: Using Lemma 4.2 we need to show that given a converging sequence $K_0^n \rightarrow K_0^m$, the corresponding sequence $K_0^n = e^{-t\theta_1(a^{-1}K_0^n)}$ satisfies $K_0^n \rightarrow K_0^m$, where $K_0^n = e^{-t\theta_1(a^{-1}K_0^n)}$.

Without loss of generality, taking subsequences if necessary, we can assume that $K_0^n \rightarrow J$. We wish to show that $J = K_0^m$.

The solution of $K_0^m(t)$ following the procedure outlined in Lemma 2 is:

$$K_0^m(t) = \zeta + \int_0^t e^{-\int_0^{\tau} \pi_1(\tau) d\tau} \left( \int_0^t \pi_1(\tau, K_0^n(\tau)) e^{-(\tau + \theta_1(\tau))} d\tau \right) ds$$

Step 1: Observe the following expressions:

$$\int_0^t e^{-\int_0^{\tau} \pi_1(\tau, K_0^n(\tau)) d\tau} e^{-(\tau + \theta_1(\tau))} d\tau ds$$

For $\tau$ given $t$, the difference between (10) and (10a) tends to zero as $n \rightarrow \infty$.

This is true since, by assumption 4, $((C_1)^{-1})_j$ and $\pi_1^2$ are bounded and so as $n \rightarrow \infty$,

$$\int_0^\infty |\pi_1(\tau, K_0^n(\tau)) e^{-(\tau + \theta_1(\tau))} d\tau = 0$$

Step 2: Define the following expressions:
5. Stationary Equilibrium and Its Properties

In this section, we show the existence of a stationary equilibrium, discuss the concept of a Nash equilibrium manifold, and investigate the properties of the stationary equilibrium. Proposition 5.1 (existence). Under the assumptions 1 and 2, there exists a

\[ J = 0 \]

The difference between (11) and (12) tends to zero as \( n \to \infty \). This is true since \( K \) is a function of \( t \) and by assumption 4, \( \| K \|_2 \) and \( \| \phi \|_2 \) are bounded. Since (12) is identically zero, for a given \( t \), by definition of \( \phi \), it follows that expression (11) tends to zero when \( n \to \infty \).

Theorem 2. The differential game \((E, U, \phi, \gamma)\) satisfying assumptions 3 and 4 has a Nash equilibrium solution for any initial condition \( K_0 \) and \( K_2 \), since the solution of (9) is unique, it follows that \[ J = 0 \].

Proof: The proof follows the proof of Theorem 1, where Proposition 4.1 and 4.3 replace Proposition 3.1 and 3.2 respectively.

Q.E.D.
stationary Nash equilibrium point \((K_1^*, K_2^*)\).

Proof: Consider the maximization problem for firm 1 in which the stock \(K_j\) of firm \(j\) is constant, i.e., \(K_j(t) = \bar{K}_j\). This problem can be solved using standard control theory, as follows.

The necessary conditions are

\[
\begin{align*}
\dot{\lambda}_1 - \bar{\pi}_1 &= -\dot{\lambda}_1 K_1 = -\varphi_1 / \partial K_1 = -\varphi_1 / K_1 + \lambda_1 \delta_1 \\
\dot{K}_1 &= 0 = -C_1 (\text{I}_1) + \lambda_1
\end{align*}
\]

Differentiating equation (13) with respect to time, and substituting \(\lambda_1\) and \(\lambda_2\) from (12) and (13) yields the following equation

\[
C_1 \dot{I}_1 = (r + \delta_1) K_1 - \pi_1 (K_1, \bar{K}_j)
\]

where \(\pi_1\) denotes \(\dot{\varphi}_1 / \partial K_1\).

The solution to equations (14) and (1) can be depicted on the \((K_1, I_1)\) phase diagram. It is straightforward to check that the phase diagram is as in Figure 1.

Lemma 5.1: There exists a unique intersection point between \(\bar{K}_1 = 0\) and \(\dot{I}_1 = 0\), and this intersection is a saddle point.

Proof: The proof is straightforward. See, for example, Gould (1970).

It follows that given \(K_j(t) = \bar{K}_j\) for any initial point \(K_i(0)\) there exists a unique optimal path for firm \(i\) which converges to \(\bar{K}_i\). \(\bar{K}_i\) is thus the stationary optimal stock for firm \(i\) given \(K_j(t) = \bar{K}_j\).

The point at which both equations (1) and (14) vanish yield an implicit
equation for \( \tilde{K}_j \) as a function of \( \tilde{K}_j \). This equation is given by

\[
(\tau + \delta \nu \lambda' \delta K_i)(\delta K_i) = \alpha_i^i(K_i, K_j)
\]

Figure 1 depicts a case in which \( K_j > \tilde{K}_j \) and \( \tau_{12}^{12} = \delta^2 \nu_{1} / \delta K_1 \delta K_2 > 0 \), or the case where both inequalities are reversed.

Assumption 1 and equation (1) guarantee that \( K_i(t) \) is bounded from above by \( \tilde{K}_i = \bar{K}_i / \delta_i \).

Define a function \( \phi_i: [0, \bar{K}_i] \rightarrow [0, \tilde{K}_i] \) (for \( i \neq j, i, j = 1, 2 \)) such that

\[
\phi_i(\tilde{K}_i) = \tilde{K}_i
\]

where \( \tilde{K}_i \) is the solution of equation (15). Thus \( \phi_i \) assigns for each constant level of \( \tilde{K}_j \) the stationary solution of firm \( i \). The continuity of \( \phi_i \) implies the continuity of the functions \( \phi_i \). Define a function \( \psi \) from \([0, \bar{K}_1] \times [0, \bar{K}_2] \) to itself such that

\[
\psi(K_1, K_2) = (\phi_1(K_2), \phi_2(K_1))
\]

\( \psi \) is a continuous function from a compact convex set into itself, thus using Brouwer fixed point theorem there exist \( K_1^*, K_2^* \) such that

\[
(K_1^*, K_2^*) = \psi(K_1^*, K_2^*) = (\phi_1(K_2^*), \phi_2(K_1^*))
\]

Thus \( K^* = (K_1^*, K_2^*) \) satisfies the condition for a stationary Nash equilibrium point for the game \( C \).

Q.E.D.
\( \dot{K}_1 = 0 \) is given by \( I_1 = \delta \dot{K}_1 \)

\( \dot{I}_1 = 0 \) is given by \((r + \epsilon) C'(I_1) > \eta_1 (K_1, \bar{K}_j)\)
Note that $\phi$ is not a best response or "reaction function." $\phi$ is not defined on the strategy space but rather on the state space. If firm 1 is at $K_1$ for the rest of the game, only then the best strategy for player 2 is to converge to $\phi_1(K_1)$.

Let $\pi_i^j$ denote $\partial^2 \pi / \partial K_i \partial K_j$. The following assumption, in addition to assumptions 1 and 2, are sufficient for uniqueness of the stationary equilibrium.

**Assumption 5:** $\pi_i(K_1, K_2)$ satisfy the following inequality for all $K_1$ and $K_2$:

$$\pi_1 \pi_2 > \pi_1 \pi_2^{22}$$

and $\pi_i^{22} > 0$ for $i=1, 2$ and all $K_1$ and $K_2$. Note that in the symmetric case when $\pi_1 = \pi_2 = \pi$, the assumption is a concavity assumption on $\pi$.

**Proposition 5.2 (uniqueness):** Under assumptions 1, 2, and 5 the stationary equilibrium point is unique.

**Proof:** Since $\pi_i^{22} < 0$, the sign of $\phi$ is the same as the sign of $\pi_i^{22}$. If $\pi_i^{22}$ and $\pi_i^{12}$ have opposite signs, the equilibrium point whose existence is guaranteed by proposition 2 is necessarily unique.

If $\pi_i^{12} > 0$ for $i=1, 2$, then it is sufficient to prove that at any equilibrium point $(\phi_i^{11})' > \phi_i^{12}$. Since $\phi$ is the solution of (15), this last condition is equivalent to the following condition:

$$(\delta_1(r + \delta_1)C_{11} - \pi_1^{11})(\delta_2(r + \delta_2)C_{22} - \pi_2^{22}) > \pi_1^{12} \pi_2^{12}$$

If, however, $\pi_i^{12} < 0$ for $i=1, 2$, then it suffices to show that $(\phi_i^{11})' < \phi_i^{12}$. As before, this is equivalent to condition (18). Since assumption 3 holds, then
necessary (18) holds and the equilibrium point is unique.

It should be noted that when $\delta_1 = \delta_2 = 0$, assumption (5) is necessary as well as sufficient.

**Proposition 5.3 (conditional local stability):** Under assumption 1, 2, and 4 the stationary equilibrium point is conditionally locally stable.

**Proof:** What we need to show is that the Jacobian matrix of the following system has two positive and two negative (real parts of the) eigenvalues at the equilibrium point.

\begin{align}
(19) & \quad \dot{x}_1 = I_1 - \delta_1 x_1 \\
(19a) & \quad \dot{x}_2 = I_2 - \delta_2 x_2 \\
(19b) & \quad C_1 x_1 = (r + \delta_1) x_1 - \pi_1(x_1 x_2) \\
(19c) & \quad C_2 x_2 = (r + \delta_2) x_2 - \pi_2(x_1 x_2)
\end{align}

If $\Delta$ is an eigenvalue, it is straightforward to check that $\Delta$ has to satisfy the following condition:

\begin{equation}
(20) \quad f(\Delta) = \pi_{12}^1 \pi_{21}^2 C_1 C_2
\end{equation}

Where $f(\Delta) = f_1(\Delta)f_2(\Delta)$ where $f_i(\Delta)$ is given by:

\begin{equation}
(21) \quad f_i(\Delta) = (r + \delta_i - \Delta)(\delta_i + \Delta) - \pi_{ii}^i \pi_{ii}^i C_i
\end{equation}

It is clear that $\lim_{\Delta \to -\infty} f_i(\Delta) = -\infty$ and thus $\lim_{\Delta \to \infty} f(\Delta) = -\infty$. In addition $\lim_{\Delta \to \infty} f(\Delta)$
achieves a local maximum at $\Delta = \pm \sqrt{2}$, and the equation $f_4(\Delta) = 0$ has two real roots, one positive and one negative. $f(\Delta)$ has one maximum at positive $\Delta$ and two minima, one at positive $\Delta$ and another negative. A necessary and sufficient condition for equation (20) to have two positive and two negative roots is that $f(0) > \frac{12}{7} C_1 C_2$. This condition is exactly equation (18) which holds if assumption 5 is valid.

From a well-known theorem of differential equations there exists a two-dimensional manifold $S$ such that the solution of equation (i) and (14) starting on the manifold, converges to the equilibrium point. See, for example, Godfrey and Levinson (1955, Chapter 13). Q.E.D.

Define the set of $K(S)$ as the following projection of $S$, i.e.,

$$K(S) = \{K \in \{0, \bar{K}_1\} \times [0, \bar{K}_2]\}$$

There exists $I = (I_1, I_2)$ such that $(K,I) \in S$.

We now have the following corollary: For every initial condition $K_0 \in K(S)$, the game $G(K_0, K)$ has a solution which converges to the stationary equilibrium point. To see this, note that by definition of $K(S)$, for $K_0$ there exists a pair $I_0 = (I_1(0), I_2(0))$ such that $(K_0, I_0) \in S$ and therefore there exists a unique path which starts at $(K_0, I_0)$ and ends at $(K, I)$. Since along this path conditions (i) and (14) are satisfied for $i=1,2$ we only have to show that the transversality conditions are satisfied. It will then follow that $I_j(t)$ is the best response for $I_j(t)$ since assumptions 1 and 2 guarantee the sufficiency of the necessary conditions.

The transversality condition for control problems with infinite horizons that were proven by Michel (1982) are that the discounted Hamiltonian vanishes as $t$ approaches infinity. This is satisfied in our case since the instantaneous profit function is bounded and at the stationary equilibrium
Thus the manifold \( \mathcal{S} \) can be described as a Nash equilibrium manifold since for any initial condition \( K_0 \) in its projection there exist \( I_0 \) such that there exists a Nash solution to the game that lies on the manifold and converges to a steady state.

In the next section, we investigate the spanning range of the manifold (or its continuation).

6. Characterization and Convergence of the Nash Solution

In this section we investigate the properties of the Nash solution. In particular we examine its convergence and monotonicity properties.

The analysis involves phase diagrams where the boundaries are nonstationary. For the pioneering work on this subject see Kamien and Schwartz (1977). For further work on this subject see Miller (1983).

Consider Figure 1 which depicts the \((K_i, I_i)\) phase diagram. Define the movement of \( \dot{I}_i = 0 \) from \( \dot{K}_j \) to \( \dot{K}_j \) as "up." Whether the \( \dot{I}_i = 0 \) boundary moves up or its reverse (down) depends on the cross partial derivative of the revenue function, and on the sign of \( K_j \).

Lemma 6.1: Consider paths of \( K_1(t) \) and \( K_2(t) \) which are a Nash solution for the game \( G(K_{10}, K_{20}, \mu) \). The extremal points of \( K_1(\cdot) \) and \( K_2(\cdot) \), which are achieved at any finite time, interlace.

Proof: What we have to show is that between any two zeros of \( \dot{K}_1 \) there exists one zero of \( \dot{K}_j \). The proof will be done for \( \dot{K}_1 > 0 \). The proof for \( \dot{K}_1 < 0 \) is the same, mutatis mutandis. Consider Figure 2 on which the path is in region 2. For the path to cross over the \( \dot{K}_1 = 0 \) line, it first has to be in region 3 because no cross over is possible from region 2 to 1. Thus the \( \dot{K}_1 = 0 \) line is
moving "down," and is catching up with the path. Once it crosses it, the path enters region 3 and it can cross, so at the crossing time there is a zero of \( K_1 \). We have to show that before it can have another zero, \( K_1 \) has to change sign. The path can now be depicted in Figure 3.

The path cannot cross over to region 4, and therefore the \( t_i = 0 \) boundary, which has moved down has to change its direction, catch up with the path so that the path will again be in region 1 and the intersection will take place. The boundary \( t_i = 0 \) is given by

\[(\tau + \delta_i)C_i(t) = \tau_i^e(K_1^e, K_1^e)\]

It can change direction only if \( K_1 \) changes sign, which is what we set out to prove.

**Lemma 2.2:** Consider the game \( G(K_1^e, K_2^e) \) satisfying assumptions 3, 4, and 5 and the function \( \phi_i \) as defined in section 4. If \( \lim_{t \to \infty} K_1(t) = K_1^e \) and \( \lim_{t \to \infty} K_2(t) = K_2^e \) then \( \lim_{t \to \infty} K_1(t) = K_1^e \) where \( (K_1^e, K_2^e) \) is the unique stationary equilibrium point.

**Proof:** What we have to show is that if one player converges to the stationary equilibrium point then the induced capital path of the best response of the second player will converge as well.

If \( K_1(t) \) converges monotonically, then according to Lemma 6.1 the induced capital path of player 1 is either monotonic or single-peaked. By standard arguments (see, for example, [1]) the path \( K_1 \) does not tend to zero or to infinity. Thus it converges to a stationary equilibrium point. Its uniqueness guarantees that \( \phi_i(t) \) will converge to \( K_1^e \). If \( K_1(t) \) does not
converge nonmonotonically, the frequency of the extremal points of \( K_1(t) \) is bounded since \( K_1 \) is Lipschitz. Lemma 6.1 implies that the frequency of the extremal points of \( K_1(t) \) is bounded as well. Since \( K_1(t) \) converge to \( K_1^* \), the amplitude of its cycles, i.e., the value of each extremal point, tends to zero as time tends to infinity. From Figure 3 it is clear that the variation in \( K_1(t) \) is smaller than the variation of the \( I_1 = 0 \) boundary (observe that necessarily \( K_1' < K_1^* \) and the reverse will be true in the next extremal point of \( K_1 \)).

Assumption 5 guarantees that the amplitude of \( K_1(t) \) tends to zero so does the amplitude of the \( I_1 = 0 \) boundary and therefore the amplitude of \( K_1(t) \) tends to zero as well. The uniqueness of the stationary point guarantees that \( K_1(t) \) tends to \( K_1^* \).

**Theorem 3.** The differential game \( G(K_{10}, K_{20}, \omega) \) satisfying assumptions 3, 4, and 5, has a Nash equilibrium solution that converges to the stationary equilibrium point for every initial condition \( K_{10} \) and \( K_{20} \).

**Proof:** Let

\[
B_{Li}^* = \{ f \in B_{Li}([0, \infty)) \mid \lim_{t \to \infty} f(t) = K_1^* \}
\]

Lemma 6.2 assures us that the range of the function \( K_1 \) is \( B_{Li}^* \). In the same fashion we can define \( B_{Li}^* \) (as in section 4). It can be verified that \( B_{Li}^* \) is conditionally compact (since it is a subset of a conditionally compact set) is closed and convex. Thus we can make use of the Schauder-Tychonov fixed point theorem.

Q.E.D.

The existence of the stationary manifold \( S \) guarantees that the only convergence to \( K_1^* \) and \( K_2^* \) is through the manifold. Thus a corollary of theorem
3 is that if $z'$ is the continuation of $S$ on the $(k_1, k_2)$ plane, $S'$ spans the entire $(k_1, k_2)$ plane. We thus have the following corollary.

**Corollary:** The stationary equilibrium point $(k_1^*, k_2^*)$ is conditionally globally stable.
NOTES

1. A function \( f \) is more convex than \( g \) if \( f - g \) is convex. The functions that are needed in these cases are functions which are more convex than quadratic function.

2. Since \( \lambda(T) = 0 - C'(\lambda(T)) \), it follows that \( \lambda(T) = 0 \) and thus \( \lambda(T) < 0 \).

3. We are thankful to Dov Samet for pointing out this method of proof to us.
REFERENCES


