Modeling Aggregate Behavior and Fluctuations in Economics

Stochastic Views of Interacting Agents

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# CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preface</td>
<td>xiii</td>
</tr>
<tr>
<td><strong>1 Overviews</strong></td>
<td>1</td>
</tr>
<tr>
<td>1.1 Our Objectives and Approaches</td>
<td>1</td>
</tr>
<tr>
<td>1.2 Partial List of Applications</td>
<td>2</td>
</tr>
<tr>
<td>1.3 States: Vectors of Fractions of Types and Partition Vectors</td>
<td>3</td>
</tr>
<tr>
<td>1.3.1 Vectors of Fractions</td>
<td>4</td>
</tr>
<tr>
<td>1.3.2 Partition Vectors</td>
<td>5</td>
</tr>
<tr>
<td>1.4 Jump Markov Processes</td>
<td>6</td>
</tr>
<tr>
<td>1.5 The Master Equation</td>
<td>7</td>
</tr>
<tr>
<td>1.6 Decomposable Random Combinatorial Structures</td>
<td>8</td>
</tr>
<tr>
<td>1.7 Sizes and Limit Behavior of Large Fractions</td>
<td>8</td>
</tr>
<tr>
<td><strong>2 Setting Up Dynamic Models</strong></td>
<td>9</td>
</tr>
<tr>
<td>2.1 Two Kinds of State Vectors</td>
<td>10</td>
</tr>
<tr>
<td>2.2 Empirical Distributions</td>
<td>11</td>
</tr>
<tr>
<td>2.3 Exchangeable Random Sequences</td>
<td>12</td>
</tr>
<tr>
<td>2.4 Partition Exchangeability</td>
<td>13</td>
</tr>
<tr>
<td>2.5 Transition Rates</td>
<td>16</td>
</tr>
<tr>
<td>2.6 Detailed-Balance Conditions and Stationary Distributions</td>
<td>17</td>
</tr>
<tr>
<td><strong>3 The Master Equation</strong></td>
<td>19</td>
</tr>
<tr>
<td>3.1 Continuous-Time Dynamics</td>
<td>19</td>
</tr>
<tr>
<td>3.2 Power-Series Expansion</td>
<td>23</td>
</tr>
<tr>
<td>3.3 Aggregate Dynamics and Fokker–Planck Equation</td>
<td>25</td>
</tr>
<tr>
<td>3.4 Discrete-Time Dynamics</td>
<td>25</td>
</tr>
<tr>
<td><strong>4 Introductory Simple and Simplified Models</strong></td>
<td>27</td>
</tr>
<tr>
<td>4.1 A Two-Sector Model of Fluctuations</td>
<td>27</td>
</tr>
</tbody>
</table>
Contents

4.2 Closed Binary Choice Models 30
  4.2.1 A Pólya Distribution Model 31
4.3 Open Binary Models 32
  4.3.1 Examples 35
4.4 Two Logistic Process Models 35
  4.4.1 Model 1: The Aggregate Dynamics and Associated Fluctuations 35
  4.4.2 Model 2: Nonlinear Exit Rate 37
  4.4.3 A Nonstationary Pólya Model 38
4.5 An Example: A Deterministic Analysis of Nonlinear Effects May Mislead! 40

5 Aggregate Dynamics and Fluctuations of Simple Models 41
  5.1 Dynamics of Binary Choice Models 41
  5.2 Dynamics for the Aggregate Variable 43
  5.3 Potentials 45
  5.4 Critical Points and Hazard Function 47
  5.5 Multiplicity – An Aspect of Random Combinatorial Features 49

6 Evaluating Alternatives 52
  6.1 Representation of Relative Merits of Alternatives 53
  6.2 Value Functions 54
  6.3 Extreme Distributions and Gibbs Distributions 57
    6.3.1 Type I: Extreme Distribution 58
  6.4 Approximate Evaluations of Value Functions with a Large Number of Alternatives 60
  6.5 Case of Small Entry and Exit Probabilities: An Example 60
  6.6 Approximate Evaluation of Sums of a Large Number of Terms 61
  6.7 Approximations of Error Functions 62
    6.7.1 Generalization 64
    6.7.2 Example 65

7 Solving Nonstationary Master Equations 66
  7.1 Example: Open Models with Two Types of Agents 66
    7.1.1 Equilibrium Distribution 67
    7.1.2 Probability-Generating-Function Method 67
    7.1.3 Cumulant Generating Functions 68
  7.2 Example: A Birth–Death-with-Immigration Process 69
    7.2.1 Stationary Probability Distribution 70
    7.2.2 Generating Function 70
Contents

7.2.3 Time-Inhomogeneous Transition Rates 73
7.2.4 The Cumulant-Generating-Function 74
7.3 Models for Market Shares by Imitation or Innovation 75
   7.3.1 Deterministic Innovation Process 76
   7.3.2 Deterministic Imitation Process 77
   7.3.3 A Joint Deterministic Process 78
   7.3.4 A Stochastic Dynamic Model 79
7.4 A Stochastic Model with Innovators and Imitators 80
   7.4.1 Case of a Finite Total Number of Firms 83
7.5 Symmetric Interactions 84
   7.5.1 Stationary State Distribution 84
   7.5.2 Nonstationary Distributions 84
8 Growth and Fluctuations 85
   8.1 Two Simple Models for the Emergence of New Goods 87
      8.1.1 Poisson Growth Model 87
      8.1.2 An Urn Model for Growth 88
   8.2 Disappearance of Goods from Markets 90
      8.2.1 Model 91
      8.2.2 Stability Analysis 92
   8.3 Shares of Dated Final Goods Among Households 93
      8.3.1 Model 94
   8.4 Deterministic Share Dynamics 95
   8.5 Stochastic Business-Cycle Model 96
   8.6 A New Model of Fluctuations and Growth: Case with Underutilized Factor of Production 99
      8.6.1 The Model 100
      8.6.2 Transition-Rate Specifications 101
      8.6.3 Holding Times 102
      8.6.4 Aggregate Outputs and Demands 103
      8.6.5 Equilibrium Sizes of the Sectors (Excess Demand Conditions) 104
      8.6.6 Behavior Out of Equilibrium: Two-Sector Model 105
      8.6.7 Stationary Probability Distribution: The Two-Sector Model 107
      8.6.8 Emergence of New Sectors 110
      8.6.9 Simulation Runs for Multi-Sector Model 111
      8.6.10 Discussion 112
   8.7 Langevin-Equation Approach 117
      8.7.1 Stationary Density Function 119
      8.7.2 The Exponential Distribution of the Growth Rates of Firms 119
Contents

8.8 Time-Dependent Density and Heat Equation 121
8.9 Size Distribution for Old and New Goods 122
   8.9.1 Diffusion-Equation Approximation 122
   8.9.2 Lines of Product Developments and Inventions 123

9 A New Look at the Diamond Search Model 127
   9.1 Model 129
   9.2 Transition Rates 129
   9.3 Aggregate Dynamics: Dynamics for the Mean of the Fraction 130
   9.4 Dynamics for the Fluctuations 131
   9.5 Value Functions 132
      9.5.1 Expected-Value Functions 133
   9.6 Multiple Equilibria and Cycles: An Example 134
      9.6.1 Asymmetrical Cycles 136
         9.6.1.1 Approximate Analysis 136
         9.6.1.2 Example 137
   9.7 Equilibrium Selection 138
   9.8 Possible Extensions of the Model 139

10 Interaction Patterns and Cluster Size Distributions 141
   10.1 Clustering Processes 141
   10.2 Three Classes of Transition Rates 144
      10.2.1 Selections 144
      10.2.2 Multisets 146
         10.2.2.1 Capacity-Limited Processes 150
      10.2.3 Assemblies 150
         10.2.3.1 Internal Configurations of Assemblies 151
   10.3 Transition-Rate Specifications in a Partition Vector 153
   10.4 Logarithmic Series Distribution 153
      10.4.1 Frequency Spectrum of the Logarithmic Series Distribution 156
   10.5 Dynamics of Clustering Processes 157
      10.5.1 Examples of Clustering-Process Distributions 157
      10.5.2 Example: Ewens Sampling Formula 162
      10.5.3 Dynamics of Partition Patterns: Example 164
   10.6 Large Clusters 165
      10.6.1 Expected Value of the Largest Cluster Size 166
      10.6.2 Joint Probability Density for the Largest \( \tau \) Fractions 169
   10.7 Moment Calculations 171
   10.8 Frequency Spectrum 172
      10.8.1 Definition 173
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>10.8.2 Herfindahl Index of Concentration</td>
<td>173</td>
</tr>
<tr>
<td>10.8.3 A Heuristic Derivation</td>
<td>174</td>
</tr>
<tr>
<td>10.8.4 Recursion Relations</td>
<td>176</td>
</tr>
<tr>
<td>10.8.5 Examples of Applications</td>
<td>177</td>
</tr>
<tr>
<td>10.8.6 Discrete Frequency Spectrum</td>
<td>177</td>
</tr>
<tr>
<td>10.9 Parameter Estimation</td>
<td>178</td>
</tr>
<tr>
<td><strong>11 Share Market with Two Dominant Groups of Traders</strong></td>
<td>180</td>
</tr>
<tr>
<td>11.1 Transition Rates</td>
<td>181</td>
</tr>
<tr>
<td>11.2 Ewens Distribution</td>
<td>183</td>
</tr>
<tr>
<td>11.2.1 The Number of Clusters and Value of $\theta$</td>
<td>184</td>
</tr>
<tr>
<td>11.2.2 Expected Values of the Fractions</td>
<td>185</td>
</tr>
<tr>
<td>11.2.3 The Largest Two Shares</td>
<td>186</td>
</tr>
<tr>
<td>11.3 Market Volatility</td>
<td>187</td>
</tr>
<tr>
<td>11.4 Behavior of Market Excess Demand</td>
<td>188</td>
</tr>
<tr>
<td>11.4.1 Conditions for Zero Excess Demand</td>
<td>188</td>
</tr>
<tr>
<td>11.4.2 Volatility of the Market Excess Demand</td>
<td>189</td>
</tr>
<tr>
<td>11.4.3 Approximate Dynamics for Price Differences and Power Law</td>
<td>190</td>
</tr>
<tr>
<td>11.4.3.1 Simulation Experiments</td>
<td>192</td>
</tr>
<tr>
<td><strong>Appendix</strong></td>
<td>195</td>
</tr>
<tr>
<td>A.1 Deriving Generating Functions via Characteristic Curves</td>
<td>195</td>
</tr>
<tr>
<td>A.2 Urn Models and Associated Markov Chains</td>
<td>197</td>
</tr>
<tr>
<td>A.2.1 Pólya's Urn</td>
<td>197</td>
</tr>
<tr>
<td>A.2.2 Hoppe's Urn</td>
<td>197</td>
</tr>
<tr>
<td>A.2.3 Markov Chain Associated with the Urn</td>
<td>199</td>
</tr>
<tr>
<td>A.3 Conditional Probabilities for Entries, Exits, and Changes of Type</td>
<td>200</td>
</tr>
<tr>
<td>A.3.1 Transition Probabilities</td>
<td>200</td>
</tr>
<tr>
<td>A.3.2 Transition Rates</td>
<td>202</td>
</tr>
<tr>
<td>A.4 Holding Times and Skeletal Markov Chains</td>
<td>202</td>
</tr>
<tr>
<td>A.4.1 Sojourn-Time Models</td>
<td>205</td>
</tr>
<tr>
<td>A.5 Stirling Numbers</td>
<td>206</td>
</tr>
<tr>
<td>A.5.1 Introduction</td>
<td>206</td>
</tr>
<tr>
<td>A.5.2 Recursions</td>
<td>207</td>
</tr>
<tr>
<td>A.5.3 Relations with Combinatorics</td>
<td>209</td>
</tr>
<tr>
<td>A.5.4 Explicit Expressions and Asymptotic Relations</td>
<td>210</td>
</tr>
<tr>
<td>A.5.5 Asymptotics</td>
<td>212</td>
</tr>
<tr>
<td>A.6 Order Statistics</td>
<td>213</td>
</tr>
<tr>
<td>A.7 Poisson Random Variables and the Ewens Sampling Formula</td>
<td>214</td>
</tr>
</tbody>
</table>
Contents

A.7.1 Approximations by Poisson Random Variables 214
A.7.2 Conditional Poisson Random Variables 216
A.8 Exchangeable Random Partitions 219
A.8.1 Exchangeable Random Sequences 219
A.8.2 Partition Exchangeability 221
A.9 Random Partitions and Permutations 224
A.9.1 Permutations 224
A.9.2 Random Partitions 225
A.9.3 Noninterference of Partitions 228
A.9.4 Consistency 229
A.10 Dirichlet Distributions 229
A.10.1 Beta Distribution 229
A.10.2 Dirichlet Distribution 230
A.10.3 Marginal Dirichlet Distributions 232
A.10.4 Poisson–Dirichlet Distribution 232
A.10.5 Size-Biased Sampling 233
A.11 Residual Allocation Models 234
A.12 GEM and Size-Biased Distributions 235
A.13 Stochastic Difference Equations 240
A.14 Random Growth Processes 242
A.15 Diffusion Approximation to Growth Processes 243

References 245

Index 253
CHAPTER 1

Overviews

1.1 Our objectives and approaches

This book is about modeling a large collection of interacting agents, and examining aggregate (deterministic) dynamics and associated stochastic fluctuations.

There are two aspects or components in carrying out these objectives: dynamics, and random combinatorial analysis. The former is more or less self-explanatory and familiar to economists, although some of the techniques that are presented in this book may be new to them. The latter involves some facts or results that are rather new in economics, such as obtaining statistical distributions for cluster sizes of agents by types. More will be said on types later.

We regard economic processes as jump Markov processes, that is, continuous-time Markov processes with at most countable state spaces, and analyze formations of subgroups or clusters of agents by types. Jump Markov processes allow us to model group sentiments or pressure, such as fashion, fads, bandwagon effects, and the like. A cluster is formed by agents who use the same choices or decisions. Agents are thus identified with the rules they use at that point in time. Agents generally change their minds — that is, types — over time. This aspect is captured by specifying a set of transition rates in the jump Markov processes. Distributions of cluster sizes matter, because a few of the larger clusters, if and when formed, approximately determine the market excess demands for whatever goods are in the markets. There are some new approaches to firm size distributions as well.

Dynamics are represented by the master equations (the backward Chapman–Kolmogorov equations) for the joint probability distributions of suitably defined states of the collection of agents. The solutions of the master equations give us stationary or equilibrium behavior of the model and some fluctuations about them, obtained by solving the associated Fokker–Planck equations. Nonstationary solutions give us information on the time profiles of interactions, and how industries or sectors of economies mature or grow with time. These solutions may require some approximations, such as expansion of the master equations in
some inverse powers of a parameter that represents the size of the model. In dis-
cussing multiple equilibria, we introduce a new equilibrium selection criterion,
and consider distributions of the sizes of the associated basins of attractions in
some random mapping contexts.

To fulfill our objectives, we use concepts such as partition vectors as state
vectors, which arise in examining patterns formed by partitions of agents by
types; Stirling numbers of the first and second kind, which have roots in combi-
natorial analysis; and distributions such as the Poisson–Dirichlet distributions
and the multivariate Ewens distribution. All of these are unfamiliar to tradition-
ally trained economists and graduate students of economics. We therefore
present these as well as some others, as needs arise, to advance and support our
modeling tasks and views proposed in this book.

Our approach is finitary. We start with a finite number of agents, each of
whom is assumed to have a choice set – a set of at most countably many decision
rules or behavioral rules. We define a demographic profile of agents composed
of fractions of agents of the same type, with a finite number of total agents.
We may let the number of agents go to infinity later, but we do not start with
fractions of uncountably many agents arranged in a unit interval, for example
(a typical starting point of some models in the economic literature). Our
finitary approach is more work, but we reap a greater harvest of results. We may obtain
more information on the natures of fluctuations, and more insight into dynamics,
which get lost in the conventional approach.

Here is our approach in a nutshell. We start with a collection of a large, but
finite, number of microeconomic agents in some economic context. We first
specify a set of transition rates in some state space to model agent interactions
stochastically. Agents may be households, firms, or countries, depending on the
context of the models. Unlike examples in textbooks in probability, chemistry,
or ecology, the reader will recognize that our transition rates are endogenously
determined by considerations of value-function maximization associated with
evaluations of alternative choices that confront agents.

Then we analyze the master equations that incorporate specified transition
rates. Their size effects may be important in approximate analysis of the master
equations. Stationary or nonstationary solutions of the master equations are
then examined to draw their economic implications.

In models that focus on the decomposable random combinatorial aspects,
distributions of a few of the largest order statistics of the cluster size distributions
are examined to examine their economic consequences.

1.2 Partial list of applications

A number of models, mostly elementary or simple, are presented in Chap-
ters 4 through 11 to illustrate the methods and potential usefulness of the
proposed approaches. Some more elaborate models are found in parts of
1.3 States: Vectors of fractions of types and partition vectors

Chapters 8 through 11, with some additional supporting material for them in Chapter 10.

One of the important consequences of our efforts is the derivation of aggregate, or emergent, or evolutionary patterns of behavior of large collections of agents. We deduce macroeconomic or sectoral properties or behavior of the microeconomic agents, starting from probabilistic descriptions of individual agents. Thus, we go part way from the microeconomic specifications of models to macroeconomic models, a level of models called mesoscopic by van Kampen (1992). By mesoscopic, we mean that we can deduce (nearly) deterministic average behavior and associated fluctuations. For example, we may think of building sectoral models composed of a large number of firms as mesoscopic models. Several or many such mesoscopic models may then be connected, or aggregated, as macroeconomic models.

We examine with fresh and different views processes for diffusion of new ideas or practices among firms in an industry, due to innovation, changing economic and social environments, disturbances, or the appearance and spread of new products among firms of an industrial sector, such as new manufacturing processes, new inventions, new employment policies, and technical improvements. We also examine a well-known model in the search literature, due to Diamond (1982), from our finitary perspectives in Chapter 9. In taking a new look at the Diamond model, we show a new probabilistic equilibrium selection criterion. In evaluating the Kiyotaki–Wright model (Kiyotaki and Wright 1993), which has similar dynamic structure to the Diamond model, we provide more dynamic analysis, and respecify their model so that money traders hold several units of money. Here, we show how partition vectors may be applied.

There are obviously many new results we can obtain in the area of industrial organization, such as entry and exit problems, changing market shares (Herfindahl index), or distributions of firm sizes or growth-rate distributions.

We also present, in Chapter 11, a simplified account of power laws that govern distributions of large price differences or returns in prices of some financial assets, and explanations of volatility switchings observed in financial time series, by examining conditions under which two large subgroups of agents with two opposing strategies form such that they largely determine the market excess demands for some financial assets.

1.3 States: Vectors of fractions of types and partition vectors

Levels of detail in describing behavior of a large collection of agents of several (or countably many) types dictate our choice of state variables.

Models are depicted in terms of configurations, namely patterns, or states, in more technical terms, and how they or some functions of them evolve with time. If we start our modeling task by specifying how sets of interacting agents behave at the level of microeconomics, then we may next inquire how some
4 Overviews

subsets or subgroups of microeconomic agents behave by attempting to describe their behavior in terms of less detailed state variables. These more aggregated state variables, or variables averaged over some larger subsets of agents than the original configurations, refer to model behavior at the aggregated, or more macroeconomic, levels of description. We use rather less detailed, or less probabilistic, specifications of states. Indeed, one of the insights we gain after many model-building exercises is that some of the very detailed microeconomic description found in some of the economic literature disappears, or matters less, as we describe agent behaviors averaged over larger sets of microeconomic configurations.

At the highest level of aggregation we have macroeconomic models in terms of macroeconomic variables. At a less aggregated level, we may have sectoral models described in terms of sectoral variables, which are less aggregated than the macroeconomic variables, but are more aggregated than microeconomic variables.\(^1\) Stochastic description in terms of macroeconomic variables imply deterministic laws and the fluctuations about them (van Kampen 1992, p. 57).

We seek to link models for collections of microeconomic agents, whose behavior are described or stated by microeconomic specifications, with the aggregate or global behavior, which corresponds to mesoscopic or macroeconomic description.

1.3.1 Vectors of fractions

In this book, we use discrete states and models with finite or at most countable state spaces. This choice of state spaces is based on the way we describe microeconomic models and the details with which we describe behavior of agents – or, more pertinently, the decisions or choices they make, or the way we aggregate or incorporate microeconomic agents into macroeconomic models.

An example may help to clarify what we have in mind. At this preliminary stage of our explanation, let us suppose that agents have binary choices, or there are two types of agents, if we associate types with choices. The binary choices may be to participate or not in some joint projects, or to buy or not to buy some commodity or stocks at this point in time, etc. The nature of choices varies from model to model and from context to context. Here, we merely illustrate abstractly the ways states may be introduced. The two choices may be labeled or represented by 1 and 0, say. Then the state of \(n\) agents could be \(s = (s_1, s_2, \ldots, s_n)\), where \(s_i = 1\) or \(s_i = 0\), \(i = 1, 2, \ldots, n\).

\(^1\) To refer to variables at these intermediate levels we borrow a term from van Kampen (1992, p. 185) and call them mesoscopic variables for mesoscopic models. According to him, a mesoscopic quantity is a functional of the probability distribution (of states). He distinguishes mesoscopic variable from macro-variables.
1.3 States: Vectors of fractions of types and partition vectors

This vector gives us a complete picture of who has chosen what. Thus, with regard to the information on the choice patterns by \( n \) agents, we don’t need, nor can we have, more detail than that provided by this state vector. This is the microeconomic state at a point in time. We may then proceed to incorporate mechanisms or interaction patterns that determine how they may revise their choices over time, by specifying reward or cost structures and particulars on externalities among agents.

In some cases, we may decide not to model the collection of agents with that much detail. For example, identities of agents who have chosen 1 may not be relevant to our objectives of constructing models. We may care merely about the fraction of agents with choice 1, for example. Then, \( \sum s_i / n \) is the information we need. Then we may proceed to specify how this demographic or fractional compositional information of agents evolves with time. At this level of completeness of describing the collection of a set of agents, the vector \((n_1, n_2)\), where \( n_i \) is the number of agents with choice \( i = 1, 2 \), is a state vector. So is the vector made of fractions of each type of agents. This vector is related to the notion of empirical distribution in statistics. If the total number of agents is fixed, then the scalar variable \( n_1 \) or \( f_1 = n_1 / (n_1 + n_2) \) serves as the state variable.

With \( K \) choices or types, where \( K \) is larger than 2, detailed information on the choice pattern is provided by the vector \( s \), where \( s_i \) now takes on one of \( K \) possible values, and choice patterns may be represented by the vector of demographic fractions, or by a vector \( n = (n_1, n_2, \ldots, n_K) \), where \( n_j \) is the total number of agents making the \( j \)th choice.

1.3.2 Partition vectors

This choice of state vector may look natural. There is, however, another possibility. To understand this, let us borrow the language of the occupancy problem in probability, and think of \( K \) unmarked or indistinguishable boxes into which agents with the same choices (identical-looking balls) are placed. Let \( a_i \) be the number of boxes with \( i \) agents in them. With \( n \) agents distributed into \( K \) boxes, we have \( \sum_{j=1}^{n} j a_j = n \), and \( \sum_{j=1}^{n} a_j := K_n \leq K \). The first equation counts the number of agents, and the second the number of occupied boxes.

The vector with these \( a_s \) as components is a state vector for some purposes. In dealing with demographic distributions such as the number of firms in various size classes, the numbers of employees, the amount of sales per month, and so on, we are not interested in the identities of firms but in the number of firms each size class, as in the histogram representations of the numbers of firms of given characteristics or categories.

In some applications, we are faced with the problem of describing sets of partitions of agents of the type called exchangeable random partitions by
6  

Overviews

Kingman (1978a,b). The notion of partition vectors, in Zabell (1992), is just the right notion for discussing models in which some types of agents play a dominant role in determining market demands. This notion is discussed in detail in Chapter 3, and applied in Chapter 11 among many places.

We have briefly mentioned two alternative choices for state vectors. One of them is in terms of fractions of agents of each type or category. Instead of this more obvious choice of state variables, Watterson (1976) has proposed another way of describing states, which is less detailed than the one above using $n$. A level of disaggregation, or a way of describing the delabeled composition of a population of agents, is proposed that is suitable in circumstances in which new types of agents appear continually and there is no theoretical upper limit to the number of possible types. This is the so-called sampling-of-species problem in statistics (see Zabell 1993). The state of a population is described by the (unordered) set of type frequencies, i.e., fractions or proportions of different types, without stating which frequency belongs to which type. In the context of economic modeling, this way of description does not require model builders to know in advance how many or what types of agents are in the population. It is merely necessary to recognize that there are $k$ distinct types in his sample of size $n$, and that there are $a_j$ types with $j$ agents or representatives in the sample. Compositions of samples and populations at this level are given by vectors $a$ and $b$ with components $a_j$ and $b_j$, respectively, such that

$$\sum_{j=1}^{n} ja_j = n, \quad \sum_{j=1}^{n} a_j = k,$$

and

$$\sum_{j=1}^{n} jb_j = n, \quad \sum_{j=1}^{n} b_j = K$$

in the population, where $N$ is the number of agents in the population, and $K$ the number of distinct types, categories, or choices in the population, both being possibly infinite.

1.4  Jump Markov processes

By associating types with the decisions or choices, we may think of groups in which each agent has several alternative decisions to choose from. Agents may change their types when types are associated with their decisions, actions, or choices. In open models, agents of various types may, in addition, enter or leave the group or collection. These changes of fractions may occur at any time, not
1.5 The master equation

necessarily at the equally spaced discrete points of discrete dynamics. They are therefore modeled by continuous-time (jump) Markov processes with finite or countable state spaces. See Norris (1997).

Among Markov processes we use those with a finite or at most countable states, and time running continuously. They are called jump or pure jump Markov processes in the probability literature.

1.5 The master equation

Once states have been assigned to a collection of economic agents, their behavior over time is specified by the dynamics for the joint probabilities of the states. Dynamics are set up by taking account of the probability fluxes into and out of a specified state over a small interval of time. We use the backward Chapman–Kolmogorov equation to do this accounting. We adopt the shorter name that is used in the physics and ecology literature and call the dynamic equation the master equation. This is an appropriate name because everything of importance we need to know about the dynamic behavior can be deduced from this equation. In particular we derive the dynamics for aggregate variables, which we call the aggregate dynamics (roughly corresponding to macroeconomic dynamics) and the dynamics for the fluctuations of state variables about the mean, or aggregate, values. The latter is called the Fokker–Planck equation.

It should be emphasized that the master equation describes the time evolution of the probability distribution of states, not the time evolution of the states themselves. This distinction may seem unimportant to the reader, but it is a crucial one and helps to avoid some technical difficulties. For example, in a model with two types of agents of a fixed total number, the fraction of one type of agents is often used as the state. The master equation describes how the probability for the fraction of one type evolves with time, not the time evolution of the fraction itself. The latter may exhibit some abnormal behavior at the extreme values of zero and one, but the probability distribution cannot.

When the master equations admit stationary solutions, as some models in this book do, we can deduce much from those distributions. Some nonstationary distributions may be obtained by the method of probability generating functions, or information on moments derived from cumulant generating functions. These are discussed in Chapters 3 and 4.

In general, we use Taylor series expansion in inverse powers of some measure of the model size, such as the number of agents in the model. We can show that in the limit of an infinite number of agents we recover traditional macroeconomic results. This is illustrated by reworking the well-known Diamond (1982) model in our framework in Chapter 9.
Overviews

1.6 Decomposable random combinatorial structures
How do agents cluster or form subgroups in a market? What are the distributions of fractions on (high-dimensional) simplexes? These questions essentially have to do with random combinatorial structures such as random partitions. We borrow from Watterson (1976), Watterson and Guess (1977), and, more recently, Arratia (1992) and others to deal with the questions of multiplicities of microeconomic states compatible with a set of observations of (macroeconomic or mesoscopic) variables. In the second longest chapter of this book, Chapter 10, we connect three types of transition rates with three types of distributions, and discuss dynamics of clusters. Some of the results are then applied in Chapter 11, in which the two largest groups are on the opposite sides of the market and their excess demands drive the price dynamics of the shares.

1.7 Sizes and limit behavior of large fractions
We use order statistics of the fractions in some of the later chapters of this book. These have a well-defined limit distribution, called the Poisson–Dirichlet distribution, as the number of agents goes to infinity. The probability density of the first few of the fractions is later used in our discussion of approximations of market excess demands by a few dominant fractions in Chapters 10 and 11.