

Optimal capital accumulation, energy cost and the nature of technological progress^α

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September 2001

Abstract

This paper derives the optimal pace of capital accumulation at the firm level and the corresponding investment dynamics in the presence of an energy-saving technological progress. Energy and capital are complementary. When technical progress is disembodied, the firm invests once at the first period and never invests again. The optimal capital stock is a decreasing function of the energy price. When technical progress is embodied, the optimal scrapping time of capital goods is constant and investment is periodic. The optimal effective capital stock is shown to be lower than the optimal capital stock under disembodied technical change. A striking outcome of the paper is that under embodiment, the optimal effective capital stock is an increasing function of the energy cost, in contrast to the disembodiment case.

Keywords: Investment theory, Embodied technological progress, Energy, Investment dynamics

Journal of Economic Literature: E22, E32, O40, C63.

^αThe authors acknowledge the support of the Belgian research programmes "Poles d'Attraction inter-universitaires" PAI P4/01, and "Action de Recherches Concertée" 99/04-235.

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1. Introduction

A recent and very promising trend in macroeconomic research concentrates on the empirical assessment and theoretical analysis of embodied technological progress. This goes from worthwhile accounting exercises revealing the importance of embodiment in the growth performances of some national economies (among them, Greenwood, Hercowitz and Krusell, 1997) to much more theoretical contributions depicting the specific patterns of optimal capital accumulation under embodiment (for example, Benhabib and Rustichini, 1991, and Boucekkine, Germain and Licandro, 1997). Some computable general equilibrium models have also been built along the way as an attempt to replicate some important empirical regularities (as in Cooley, Greenwood and Yorukoglu, 1997).

This paper adopts a much simpler approach compared with the above-mentioned contributions. In particular, we use a representative firm framework in order to draw some simple and useful lessons on how and why the embodied nature of technological progress should be accounted for at the microeconomic level. To this end, we conduct a detailed comparison between the outcomes of a benchmark firm model with disembodied technological progress and the corresponding model under embodiment. The embodiment characteristic is met through a vintage capital structure in line with the canonical model of Solow et al. (1966). In addition to capital and labor, production involves energy expenditures. Vintage capital models with energy as an input have been intensively used in the late seventies by some well-known US economists confronted with the productivity slowdown puzzle (see for example, Shoven and Slepian, 1978, and Baily, 1981).

In a very famous paper, Baily argued that the productivity slowdown might be due to a reduction in the utilization rate of capital, namely in the decrease of the effective stock of capital, in contrast to the traditional interpretation in terms of technological progress. The keywords, said Baily, are embodied technological change, obsolescence and the energy cost. The rise in the energy cost following the first oil shock caused a massive capital obsolescence and a subsequent decline in capital services. Following Baily, "Energy-inefficient vintages of capital will be utilized less intensively and scrapped earlier following a rise in energy prices". Robert Gordon (1981), after recognizing that Baily's hypothesis is indeed highly attractive, pointed at the difficulty of its empirical validation in the macroeconomy (as measuring the utilization rate is rather hard for certain sectors, like the nonfarm non-manufacturing sectors) and reported that in any case, it does not seem to be supported at all by the evidence available from certain energy-consuming industries like the airline industry.

Our contribution is based on a vintage capital technology allowing for an endogenous determination of the scrapping time of old capital goods, in contrast to the vintage capital models considered by Baily in which only exogenous obsolescence rules are studied. Our approach is likely to produce different economic mechanisms. Indeed, we show that in

our model with complementary capital and energy, a rise in energy price generates an increase in the effective capital stock, in contrast to the disembodied case. Such an effect is generated through the endogenous scrapping rule. An increase in the energy price level decreases the scrapping age, as predicted by Baily, but the resulting lower scrapping time tends to increase the optimal effective capital stock for our optimal scrapping condition to hold.

Our paper also provides a very simple study of investment dynamics depending on the nature of technological progress. As far as investment dynamics at the firm level are concerned, Doms and Dunne (1994) have shown that investment is lumpy and occurs infrequently. This strikingly departs from the standard neoclassical model with convex adjustment costs of investment. Relaxing the assumption of such adjustment costs is possible when considering imperfect competition in order to bound the size of the firm. Nevertheless this alternative model does not generate an investment dynamics more consistent with the data. Considering uncertainty and irreversible investment may help to explain periods with no investment (Cf. Pindyck, 1988 or Abel and Eberly, 1994) but it is not enough to generate discontinuities in the capital stock evolution.

Embodiment is the alternative story as we will show in this paper. This idea has been previously explored in optimal growth models, as we mention in the beginning of this introduction. Embodiment implies obsolescence and the latter involves replacement. Replacement cycles (or echoes) may arise at equilibrium under some relatively stringent conditions (see Boucekkine, Germain and Licandro, 1997, for example). However, investment lumpiness is much more a microeconomic property than a phenomenon truly observed on aggregate data. Hence, a probably more natural way to tackle the problem of investment dynamics is to restrain the analysis to the firm level. Partial equilibrium vintage capital models have already been considered by Terborgh (1961) and Smith (1949). While these papers assume a constant optimal lifetime for the machines, Malcomson (1975) and especially Van Hilten (1991) have proven that the optimal lifetime is in fact constant. Nevertheless, they first did not turn to the analysis of the investment dynamics. Second, they only considered a linear technology. This paper proposes a partial equilibrium vintage capital model under imperfect competition in which the firm produces using labor, capital and energy, with energy and capital being complementary while substitution is allowed between capital and labor. In such a framework, optimal investment is periodic, as in the optimal growth vintage capital models considered by Boucekkine, Germain and Licandro (1997), but in sharp contrast to the latter models which typically use linear production functions, we are able to define an optimal value for the effective capital stock due to our substitutability assumption between capital and labor. The periodicity of investment paths will thus come from very different channels. While this periodicity property comes from the constancy of labor supply in the equilibrium condition of the labor market in the above mentioned general equilibrium model, it comes from the constancy of the optimal

capital stock in our firm problem.

Another valuable contribution of this paper is that it allows to bring out quite easily some useful lessons about the implications of the nature of technological progress on optimal capital accumulation and investment dynamics. Explicit comparative exercises between the embodiment and the disembodiment cases will be conducted to this end along the way. The rest of the paper is organized as follows. The next section analyzes the properties of the benchmark model with disembodied technical progress. The third section is devoted to study the counter-part model with embodied technical progress. The optimal scrapping rule is first derived; then, the determinants of the optimal effective capital stock are studied in details with a reference to Baily's work and a thorough comparison with the benchmark case. The replacement echoes in investment dynamics are finally shown to be optimal under embodiment, and robust to departures from a reference parametric case. Section 4 concludes.

2. Optimal capital stock and investment dynamics under disembodied technological progress

As a benchmark, we first consider that technical progress is purely disembodied. We consider a standard monopolistic competition economy (Cf. Dixit and Stiglitz, 1997 or the production side of Boucekine et al., 1996 for a vintage capital growth model) in which the firm has to solve the following problem :

$$\max_0^Z \int_0^1 [P(t)Q(t) - P_e(t)E(t) - w(t)L(t) - k(t)I(t)] e^{i^* t} dt$$

subject to :

$$P(t) = bQ(t)^{\mu} \quad \text{with } \mu < 1 \quad (2.1)$$

$$Q(t) = AK(t)^{\alpha} L(t)^{1-\alpha} \quad (2.2)$$

$$dK(t) = I(t)dt \quad (2.3)$$

$$P_e(t) = \bar{P}_e e^{\gamma t} \quad (2.4)$$

$$E(t) = K(t)e^{i^* t} \quad (2.5)$$

$$w(t) = \bar{w} e^{\beta t} \quad (2.6)$$

$$I(t) \text{ known for } t < 0$$

$P(t)$ is the market price of the good produced by the firm, $Q(t)$ is the production, the demand price elasticity is $(\mu - 1)$, $K(t)$ is capital, $L(t)$ is labour $E(t)$ stands for the energy use and $I(t)$ is investment ; $w(t)$ is the wage rate, $P_e(t)$ is energy price and $k(t)$ is the purchase cost of capital ; r is the discount rate, γ is the energy price rate of growth

and $\theta > 0$ represents the rate of energy-saving technical progress. Moreover, we assume¹ $\theta < r$ and $\theta < r$.

The Cobb-Douglas production function exhibits constant returns to scale but there exists operating costs whose size depends on the energy requirement of the capital : to any capital use $K(t)$ corresponds a given energy requirement $K(t) e^{\theta t}$. Such a complementarity is assumed first in order to be consistent with the results of several studies showing that capital and energy are complements (see for instance Hudson and Jorgenson, 1974 or Berndt and Wood, 1975) and second, for technical reasons since it allows to analytically solve the model.

Technical progress is assumed to make machines becoming less energy-consuming over time. In the disembodied case, the capital goods become more and more energy saving over time whatever their age. This is a rather unrealistic assumption which will be relaxed in the next section. We assume that labour may be adjusted immediately and without any cost and this standard problem reduces to the following conditions for optimal inputs use :

$$L^{\pi}(t) = \frac{A^{1-\mu} b (1-\alpha)(1-\mu)^{\frac{1}{1-\alpha(1-\mu)}}}{\bar{w}} K(t)^{\frac{-(1-\mu)}{1-\alpha(1-\mu)}} \quad (2.7)$$

$$K^{D^{\pi}}(t) = \frac{B}{(rk(t) - \dot{k}(t)) + \bar{P} e^{(\theta - r)t}} \quad (2.8)$$

with $B = A^{(1-\mu)b \frac{1}{1-\alpha(1-\mu)}} [1-\alpha(1-\mu)] [(1-\alpha)(1-\mu)]^{\frac{(1-\alpha)(1-\mu)}{1-\alpha(1-\mu)}} \bar{w}^{\frac{(1-\alpha)(1-\mu)}{1-\alpha(1-\mu)}}$, and $B = [-(1-\mu)] = [1-\alpha(1-\mu)]$. Note that $0 < B < 1$.

The corresponding optimal investment may be written:

$$I^{\pi}(t) = \frac{B}{1-\alpha} (1-\theta) \bar{P} e^{(\theta - r)t} (rk(t) - \dot{k}(t)) \bar{P} e^{(\theta - r)t} \frac{1}{1-\alpha}$$

Assuming that the user cost of capital is constant and positive² : $(rk(t) - \dot{k}(t)) = \pi$; note that it implies the cost $k(t)$ to grow at a rate r . Without loss of generality, we also assume that the real cost of labor is constant: $w(t) = \bar{w}$. Under these simplifying assumptions, we are not only able to bring out analytical results along this paper, we

¹If $\theta > r$, the firm would have an incentive to infinitely get into debt to buy an infinite amount of energy.

² $\theta < r$ is a standard assumption in the exogenous growth literature since it allows to have a bounded objective function.

³Such an assumption will be needed for technical reasons when we will consider embodied technical progress in the next section. Since we would like to compare in a rigorous way the outcomes of the latter case with those of the disembodied model of the current section, we introduce this simplification here.

can also concentrate our discussion around the two variables repeatedly invoked in the introduction, technological progress and the energy cost. Indeed, the dynamics of our model do depend on the values of the rate of technical progress and of the energy price trend :

² If $\sigma = 1$, then $I^*(t) = 0$ and $K^{D^*}(t)$ is constant : investment occurs once at the beginning of the program and never happens again. The behavior of the optimal capital stock with respect to the model parameters is such that :

$$\begin{aligned} \frac{\partial K^{D^*}}{\partial \bar{P}e} &< 0 \\ \frac{\partial K^{D^*}}{\partial \bar{u}c} &< 0 \\ \frac{\partial K^{D^*}}{\partial \bar{w}} &< 0 \end{aligned}$$

An increase in the energy price level decreases the optimal capital stock. This is due to the fact that the firm should invest until the marginal productivity of the capital equals the sum of the user cost of capital and the operating cost $\bar{P}e$. Note that such a result is not inconsistent with the interpretation proposed by Baily (1981) of the productivity slowdown observed in the 70's, namely that the lower growth rate of total factor productivity may well be attributed to a drop in the (optimal) capital stock as energy gets more expensive. However, no obsolescence scheme is so far involved in the story, and the results come from a direct operation cost effect.

The remaining comparative statics exercises are completely standard. The user cost of capital and the real cost of labor negatively affect the optimal capital stock since a higher $\bar{u}c$ would require a higher marginal productivity of capital and a higher \bar{w} would reduce the marginal productivity of capital.

² If $\sigma < 1$, then $I^*(t) < 0$ and $K^{D^*}(t)$ is decreasing with time. Moreover :

$$\lim_{t \rightarrow +\infty} K^{D^*}(t) = 0 \text{ and } \lim_{t \rightarrow +\infty} I^*(t) = 0$$

² If $\sigma > 1$, then $I^*(t) > 0$ and $K^{D^*}(t)$ is increasing with time. Moreover,

$$\lim_{t \rightarrow +\infty} K^{D^*}(t) = \frac{\bar{B} \cdot \bar{B}^{-1/\sigma}}{\bar{u}c} \text{ which is constant and } \lim_{t \rightarrow +\infty} I^*(t) = 0$$

Note the asymmetry of the results successively obtained for the cases $\sigma < 1$ and $\sigma > 1$: The optimal capital stock is produced once its marginal productivity is equal to the sum of the user cost and the operating cost. If $\sigma < 1$ the operating cost increases indefinitely which leads to an optimal capital stock tending to zero. In the opposite cases, namely if $\sigma > 1$, this operating cost vanishes over time but the user cost is constant, and so the total cost of holding capital does not vanish. As a consequence, the optimal capital stock tends to a strictly positive constant.

Overall, the firm problem with disembodied technical progress and complementarity between capital and energy generates some very useful benchmark (and mostly expected) results concerning the optimal capital stock properties and the induced investment dynamics. Regarding the latter aspect, this model is particularly insufficient -no investment or an investment smoothly going to zero during time- which is far away from the evidence collected by Doms and Dunne on investment patterns at the firm level. In this respect the same model with embodied technological progress will perform much better as we will see in the next section.

3. Optimal capital stock and investment dynamics under embodied technological progress

We now consider that the technical progress is embodied in the new capital goods acquired by the firm. The firm's problem becomes:

$$\max_0^{\infty} \int_0^{\infty} [P(t)Q(t) - Pe(t) - E(t) - w(t)L(t) - k(t)I(t)] e^{i^* t} dt \quad (3.1)$$

subject to constraints taking embodiment into account :

$$P(t) = bQ(t)^{\mu} \quad \text{with } \mu < 1 \quad (3.2)$$

$$Q(t) = \int_{t-T(t)}^t AK(z)^{\alpha} L(z)^{1-\alpha} dz \quad (3.3)$$

$$K(t) = \int_{t-T(t)}^t I(z) dz \quad (3.4)$$

$$Pe(t) = \overline{P} e^{1^* t} \quad \text{with } 1^* < r \quad (3.5)$$

$$E(t) = \int_{t-T(t)}^t I(z) e^{i^* z} dz \quad \text{with } i^* < r \quad (3.6)$$

$$w(t) = \overline{w} \quad (3.7)$$

The unique additional variable with respect to the benchmark model is $T(t)$ which denotes the age of the oldest machine still in use at t or scrapping age. Also the capital variable is now effective capital, since only active machines are taken into account in the definition of the capital stock. Note that only the new machines incorporate the latest technological advances, i.e. are more energy-saving than the machines acquired in the

past. Such an assumption is consistent with Terborgh (1961) and Smith (1949) set-ups in which it is hypothesized that the operation cost of a machine is a decreasing function of its vintage³. However, the rate of technical progress ρ enters linearly into their operation costs functions while it is exponential in our model.

It is not hard to see that the optimal labour use as a function of the amount of capital remains the same as in the previous section. The vintage structure does matter in capital accumulation decisions, investment and scrapping. By using the same definitions for B and β as in the previous section, and by noting $J(t) = T(t + J(t))$ the lifetime of a machine of vintage t^4 , the problem may be transformed (see appendix 1) into a more tractable one and it then leads to the following first order conditions :

$$\int_t^{J(t)+t} B^\beta [K(\zeta)]^{\beta-1} \bar{P} e^{(\rho-\delta)\zeta} e^{-r(\zeta-t)} d\zeta = k(t) \quad (3.8)$$

$$\beta B [K(t)]^{\beta-1} = \bar{P} e^{-\rho[t+T(t)]+\delta t} \quad (3.9)$$

Equation (3.8) gives the optimal investment rule according to which the firm should invest at time t until the discounted marginal productivity during the whole lifetime of the capital acquired in t exactly compensates for both its discounted operation cost and its marginal purchase cost in t . Equation (3.9) is the scrapping condition: It states that a machine should be scrapped as soon as its marginal productivity (which is the same for any machine whatever its age) no longer covers its operating cost (which rises with its age).

Since the condition (3.8) must hold for any t , so must its derivative with respect to t :

$$\beta B [K(t)]^{\beta-1} \bar{P} e^{(\rho-\delta)t} + \int_t^{J(t)+t} r \beta B [K(\zeta)]^{\beta-1} (\rho-\delta) \bar{P} e^{(\rho-\delta)\zeta} e^{-r(\zeta-t)} d\zeta = \dot{k}(t)$$

Using equation (3.9) and then equation (3.8), we obtain :

$$\beta B [K(t)]^{\beta-1} \bar{P} e^{(\rho-\delta)t} + \frac{\rho \bar{P} e^{(\rho-\delta)t}}{1-\rho} e^{(1-\rho)J(t)} \beta B [K(t)]^{\beta-1} = \dot{k}(t) + rk(t)$$

$$\beta B [K(t)]^{\beta-1} \bar{P} e^{(\rho-\delta)t} = \dot{k}(t) + rk(t) \frac{e^{(\rho-\delta)t}}{\bar{P}} \quad (3.10)$$

Using the first order condition (3.9), one may deduce a characterization of the optimal capital stock as a function of the optimal scrapping age :

$$K^{E^*}(t) = \frac{\beta B}{\bar{P} e} e^{\rho[t+T^*(t)]} e^{-\delta t} e^{-\frac{1}{1-\rho}} \quad (3.11)$$

³On the contrary, Brems (1967) assumes a constant operation cost.

⁴We are assuming perfect foresight.

The optimal scrapping age, and then the optimal capital stock and the optimal investment dynamics may be determined by going further into the model resolution. Note at the minute that the energy price trend ρ and the technological progress trend σ have opposite effects on the optimal lifetime of machines. Indeed, from (3.8), one can immediately see that a rise in ρ (Resp. σ) reduces (Resp. increases) the lifetime value $J(t)$ since it results in a diminishing (Resp. augmenting) operating cost and since the unit cost of capital, $k(t)$, the right-hand side of equation (3.8) is unaffected. We will concentrate on the "balanced" case $\rho = \sigma$ to illustrate our arguments, specially because it is the unique parametric case which allows for an analytical characterization of the short-run dynamics. The "unbalanced" model $\rho < \sigma$ is also explored to support in a way the robustness of our results in the balanced case.

3.1. Technical progress, energy price and optimal stock of capital

To go further into the resolution of the model, we consider the case in which $\rho = \sigma$ as announced just above. We first derive the optimal scrapping rule.

3.1.1. Optimal scrapping

If $\rho = \sigma$, the rate of technical progress is equal to the energy price rate of growth. $J^s(t)$ and $T^s(t)$ are then determined by the system :

$$T^s(t) = f(J^s(t)) = \frac{1}{\rho} \ln \left(1 + \frac{\sigma}{\rho} r k(t) \right) \left[\frac{1}{P e} + \frac{\rho}{\sigma} \frac{h}{r} e^{(\rho - \sigma) J^s(t)} \right] \quad (3.12)$$

$$J^s(t) = T^s(t + J^s(t)) \quad (3.13)$$

where (3.12) may be derived from (3.10).

As in the previous section, we assume that the user cost of capital is constant and positive : $\sigma r k(t) \dot{k}(t) = \pi c$. In fact Van Hilten (1991) has shown that such a condition has to be satisfied to allow the use of a fixed-point argument, which is crucial in the analytical characterization of the equilibrium dynamics in the embodiment case.⁵ It can be easily shown that function $f(J^s(t))$ is strictly increasing and concave, with $f(0) > 0$ and that $f(J^s(t))$ admits a finite limit when its argument goes to infinity (see appendix 2), thus it admits a unique strictly positive fixed-point. The fixed-point argument of Van Hilten (1991) follows: The forward-looking system (3.12)-(3.13) has a unique strictly positive solution, which is precisely the fixed-point of function $f(\cdot)$. Therefore the Terborgh-Smith result $T^s(t) = J^s(t) = T$ is also reproduced in our case with T given by:

$$e^{\rho T} = \frac{\sigma}{\rho} \frac{r}{1} e^{\rho T} \left[\frac{\bar{A}}{r} + \frac{\pi c}{P e} \right] \quad (3.14)$$

⁵Terborgh (1961) and Smith (1949) assume that the price of capital is constant.

Appendix 2 also gives the proof of the following proposition :

Proposition 1 : The optimal scrapping age $T^*(t)$ as well as the optimal lifetime of the machine $J^*(t)$ are such that : $T^*(t) = J^*(t) = T$ $\forall t \geq 0$, with T being the fixed-point of the function $f(\cdot)$.

Some results concerning the behavior of the optimal scrapping age with respect to the model parameters may be derived from its implicit expression:

$$\frac{\partial T}{\partial \bar{P}e} = -i \frac{\bar{u}c}{\bar{P}e^2 [e^{\rho T} (1 - e^{-i r T})]} < 0;$$

$$\frac{\partial T}{\partial \bar{u}c} = \frac{1}{\bar{P}e [e^{\rho T} (1 - e^{-i r T})]} > 0;$$

As suggested by Baily (1981), the higher the energy price level, the sooner a machine has to be scrapped. Moreover, the higher the user cost of this machine, the longer a machine has to be kept in order to be profitable. Nevertheless, both the rate of technical progress ρ and the interest rate affect the optimal scrapping age in an ambiguous way. This is a standard characteristic of the vintage capital models (Cf. Boucekkine et al., 1998). In our model, the ambiguity of the comparative statics with respect to these two parameters is absolutely clear. Indeed, since we are solving the balanced case $\rho = 1$ and as these two trends have opposite effects on optimal scrapping, the comparative statics with respect to ρ should be ambiguous. As for the interest rate, an increase in r will rise the unit cost of capital $k(t)$, inducing a lower desired stock of capital $K(t)$ and a smaller discounting factor of the profits stemming from the use of a particular machine. It is clear from (3.8) that the resulting overall effect on the optimal lifetime is completely ambiguous. Therefore, to summarize:

Proposition 2 : In the balanced case $\rho = 1$, the optimal scrapping age is such that $T = T(\bar{u}c; r; \bar{P}e; \rho)$. It decreases with the energy price level and increases with respect to the user cost of capital. The effect on optimal scrapping of a change in the interest rate or in the rate of technical progress is ambiguous.

3.1.2. Technical progress and optimal stock of capital

The optimal capital stock (given by (3.11)) becomes :

$$K^{E^*}(t) = \frac{\bar{B}}{\bar{P}e} e^{i \rho T} \frac{1}{1 - e^{-i r T}} = K^{E^*} \quad (3.15)$$

Recall the results obtained in the disembodied technical progress model in this same balanced case $\rho = 1$. The optimal capital stock is constant whatever is the nature of

technological progress. However, its size does depend on the latter characteristic. Indeed, when technical progress is embodied, the firms are likely to acquire more new machines but also to scrap old machines. These two effects work in opposite directions. Nevertheless, it can be shown (see appendix 3) that the second effect, applying through the endogenous scrapping rule, always prevails, so that the optimal capital stock is lower when technical progress is embodied. This leads to the following proposition :

Proposition 3 : (i) The optimal stock of capital, as the optimal scrapping time, remains constant over time: $K^{E^*}(t) = K^{E^*} \quad \forall t \geq 0$.

(ii) The optimal capital stock is lower in the embodied case: $K^{E^*} < K^{D^*}$.

As argued in the introduction section, such results depart to a large extent from those established for general equilibrium growth models (see Boucek, Germain and Licandro, 1997, Caballero and Hammour, 1996, or Aghion and Howitt, 1994). In our set-up, as the production function is strictly concave with respect to (effective) capital, it is possible to define an optimal value for the stock of capital in contrast to the general equilibrium models mentioned above which typically use linear technologies. This has some concrete implications in terms of short term dynamics as we will see later with more details. We will discuss before the relationship between the energy price level and optimal capital accumulation in line with Baily's reasoning.

3.1.3. Energy price level and optimal stock of capital

The behavior of the optimal capital stock with respect to the parameters of the model is as follows :

$$\begin{aligned} \frac{\partial K^{E^*}}{\partial T} &< 0 & (3.16) \\ \frac{\partial K^{E^*}}{\partial \bar{P}_e} &= \frac{\partial K^{E^*}(T; \bar{P}_e)}{\partial \bar{P}_e} + \frac{\partial K^{E^*}(T; \bar{P}_e)}{\partial T} \frac{\partial T}{\partial \bar{P}_e} > 0 \\ \frac{\partial K^{E^*}}{\partial \tau} &= i \frac{\partial T}{\partial \tau} < 0 \\ \frac{\partial K^{E^*}}{\partial W} &= \frac{\partial K^{E^*}}{\partial B} < 0 \end{aligned}$$

Two main results are worth pointing out :

(i) As in Baily's reasoning, we might think of a simple direct effect between the scrapping age and the optimal stock of capital: The longer machines are kept, the larger the optimal capital stock is. However, equation (3.16) shows that there exists in fact a negative relationship between K^{E^*} and a given scrapping age T . The underlying mechanism

is the following. The higher the age of the operated machines, the bigger the operation cost associated with those machines, and thus the higher the marginal productivity required for all machines whatever their age, by the optimality condition (3.9). This in turn explains the smaller optimal capital stock given our decreasing returns assumption with respect to capital. Therefore, Baily's interpretation of the productivity slowdown does not hold in our framework since an increase in the energy price eventually leads to more capital.

(ii) As far as $\frac{\partial K^{E^a}}{\partial \bar{P}_e}$ is concerned there exists a direct effect (for a given optimal scrapping age, a higher initial energy price leads to a lower optimal capital stock) and an indirect effect (the optimal scrapping age decreases with \bar{P}_e thus leading to a higher optimal capital stock). In our model, the indirect effect prevails. Note that in the disembodied capital case, only the direct effect exists and thus, \bar{P}_e affects the optimal capital stock in opposite ways depending on the nature of the technical progress.

There are two major departures with respect to Baily's setting, which help explaining the registered difference in outcomes. In Baily's framework, obsolescence is simply modeled through a decreasing effective output (at a given constant rate) as capital ages. First of all, scrapping is endogenous in our framework and thus, ...nite scrapping time is optimal. Second, in Baily's set-up, embodied technological progress makes capital goods less productive over time while in our model, technological progress is primarily energy saving. This makes a crucial difference and explains to a large extent the obtained opposite results. Obviously, embodied technological progress may work in both directions, but as far as the energy-saving characteristic is accounted for, the implications of a more costly energy on optimal capital accumulation are complex. The empirical evidence put forward by Gordon (1981) to question Baily's simple conclusions makes clear that this feature is not merely a theoretical outcome.

Finally note that the user cost of capital only affects the optimal capital stock through the optimal scrapping age (Cf. Proposition 2 for the effect of these parameters on T). Also observe that the wage rate negatively affects the optimal capital stock which in turn reduces the optimal labor use (see equation (2.7)). The proposition below sums up the main comparative statics properties of the optimal capital stock :

Proposition 4 : The optimal capital stock is such that $K^{E^a} = K^{E^a}(\underline{w}; r; \bar{P}_e; \bar{w}; \circ)$

(i) The optimal capital stock increases with the energy price level while the relationship is reversed for a disembodied technical progress.

(ii) The optimal capital stock decreases with the wage and the user cost of capital.

3.2. Investment dynamics, energy cost and technical progress

We turn now to investment dynamics at the interior solution of the firm's optimization problem⁶. Assume that $T(t) = T$, for all $t \geq 0$, and thus that the firm can start from $t = 0$ forever with its optimal capital stock K^{E^a} . Investment patterns can be deduced from equation (3.4): As the optimal capital stock and scrapping time are constant, differentiation with respect to time of the latter equation implies that investment dynamics are periodic of period T :

Proposition 5 : At the interior solution of the firm's optimization problem, the investment dynamics exhibit replacement echoes: $I(t) = I(t - T)$.

The dynamics depicted in the proposition above are analogous to those pointed out by Boucekkine, Germain and Licandro (1997) for general equilibrium growth models. Assuming that the interior solution is implementable from $t = 0$, endogenous investment cycles arise, reproducing the past behaviour of this variable. The firm chooses the optimal values for scrapping and the capital stock using forward-looking criteria, but investment reproduces its past profile forever once the optimal replacement policy can be implemented. There is however a big difference with respect to the general equilibrium models mentioned along this text. While the dynamics of investment in these models come from the specific labor market requirements, here the periodicity property of investment comes from the constancy of the optimal (effective) capital stock, which derives itself from the constancy of the optimal scrapping time. Indeed, for Leontief technologies with vintage capital à la Solow et al. (1966), labor demand is given by $\int_{t-T(t)}^t I(z) e^{i^\circ z} dz$ with i° the rate of labor-augmenting technological progress. If labor supply is constant, the clearing condition in the labor market looks very similar to our equation (3.4) once the scrapping time and the stock of capital are set equal to their optimal constant values. Differentiation with respect to time of both equations yields the same periodicity outcome. Thus, while the periodic investment paths are obtained thanks to the constancy of labor supply in the general equilibrium model, they are obtained in the firm problem because the optimal effective capital stock is constant.

Compared with the disembodied technical progress case where investment occurs at most once at the beginning of the program, we have a further propagation mechanism induced by endogenous scrapping giving rise to replacement cycles. Taking account of the embodied nature of the technical progress allows for an investment dynamics characterization markedly more consistent with the observation. In particular, the obtained periodicity property implies discontinuous investment patterns if investment is not con-

⁶We omit here the case where the interior solution is not implementable from $t = 0$. In such a case, a finite time adjustment period typically takes place, after which the interior solution holds forever. This purely technical point is tackled in Boucekkine, Germain and Licandro (1997), for example, but it is not necessary here to make the point.

stant before the interior solution is reached: Investment will “jump” at the beginning of each cycle, a property that fits much better the observation compared to the disembodied technological progress case.

3.3. Robustness of echoes dynamics under embodiment

If the technical progress grows faster or slower than the energy price, results may only be obtained when time goes to infinity. We consider here the case where $\sigma > 1$, the other unbalanced case delivering trivial and uninteresting results.⁷ Using (3.10) and since $\lim_{t \rightarrow \infty} e^{(\sigma-1)t} t! \rightarrow \infty$ and $\lim_{t \rightarrow \infty} e^{(1-r)J(t)}$ is finite (because $1 < r$ and $1 < \sigma$), the optimal scrapping condition may be written:

$$\lim_{t \rightarrow \infty} T(t) = \lim_{t \rightarrow \infty} \frac{1}{\sigma} \ln e^{(\sigma-1)t} = \lim_{t \rightarrow \infty} (1 - \frac{1}{\sigma})t! \rightarrow \infty :$$

Using equations (3.3) and (3.11) we may also obtain the optimal capital stock when time goes to infinity:

$$\lim_{t \rightarrow \infty} K^{E^a}(t) = \frac{\theta B}{rk(t)j \dot{k}(t)} \frac{1}{\sigma} = K^{E^a^0}$$

which is constant if the user cost of capital is constant ($rk(t)j \dot{k}(t) = \bar{u}$), which may again be assumed. It might seem surprising that when technical progress grows faster than energy price, the model generates a constant capital stock at the limit. Things look clearer when rewriting the first order condition as follows :

$$\theta B [K(t)]^{\theta-1} = \underbrace{\bar{p} e^{(1-\sigma)t}}_{MEC} e^{\sigma T(t)}$$

with MEC being the net marginal energy cost of a machine bought at t while the term $e^{\sigma T(t)}$ alters this marginal cost to account for the fact that the energy cost gets bigger as active capital ages. MEC tends to zero as times goes to infinity since $\sigma > 1$ but $e^{\sigma T(t)}$ increases over time as scrapping rises and tends to infinity. Indeed, the latter effect offsets the former as it may be immediately inferred from the expression of $\lim_{t \rightarrow \infty} T(t)$ given above. Therefore the marginal cost of the effective capital stock is constant at the limit, and so is the limit capital stock.

We now turn to the investment dynamics. At first, $I^a(t)$ has to satisfy

$$\lim_{t \rightarrow \infty} \int_{t_j T(t)}^{Z_t} I(z) dz = K^{E^a^0} \quad (3.17)$$

⁷It is not hard to prove that when $\sigma < 1$, both the optimal scrapping time and the optimal capital stock tend to zero.

Assume that $I(t)$ is continuous.⁸ Since $I(t) \geq 0$ and $T(t)$ is equivalent to $(1 - \frac{1}{\sigma})t$ with $1 < \sigma$, the relationship (3.17) is only possible if $\lim_{t \rightarrow +\infty} I^*(t) = 0$. However, it is possible to detect a kind of echo mechanism at work in the short run even in this case. Indeed, by time differentiation of the definition $\int_{t-T(t)}^t I(z) dz = K^{*0}(t)$, with $K^{*0}(t)$ being optimal in t , one gets:

$$I^*(t) = (1 - \frac{1}{\sigma}) \frac{dT(t)}{dt} I^*(t - T(t)) + \frac{dK^{*0}(t)}{dt}.$$

It follows that contemporaneous investment is equal to the sum of a “destruction” term, $(1 - \frac{1}{\sigma}) \frac{dT(t)}{dt} I^*(t - T(t))$, and the variation over time of the desired capital stock. The destruction term includes the amount of capital driven out the firm plus the variation of the scrapping time. This destruction term is most likely to induce short-term fluctuations, exactly as the corresponding destruction term, namely $I^*(t - T)$, works in the balanced case $\sigma = 1$. Especially if the scrapping time $T(t)$ evolves smoothly over time, as its long-run behaviour suggests, the echo mechanism will be the most important determinant of the short run dynamics. Again this is not the case in the disembodied technological progress counterpart model as one can check for the unbalanced case $\sigma > 1$: The two models share the same long-run desired capital stock (as $T(t)$ tends to infinity in the embodied case) but there is no short-term destruction term when technical progress is disembodied, and hence no corresponding echo fluctuations. In the embodied case, replacement echoes are likely to strongly affect investment dynamics in the short term, although they should vanish in the long run.

4. Conclusion

In this paper, we have proposed a vintage capital model in a partial equilibrium framework in which energy and capital are complements, and the returns to (effective) capital are decreasing. We study two versions of the model, without and with embodied technical progress. Several lessons can be brought out from our analysis.

First this paper can be considered as a contribution to the vintage capital models literature. Indeed, it deals with optimal capital accumulation in a vintage capital partial equilibrium framework with a concave technology while the recent literature has focused on general equilibrium set-ups with linear preferences and technologies. As a consequence, we are able to define an optimal (effective) capital stock, and then to establish the periodicity of the investment paths at the interior solution of the firm’s problem, a feature that

⁸except eventually at a countable set of points, the kind of patterns we may generate in the balanced case. Note that this kind of functions is perfectly manageable with Riemann integrals, and the usual theorems, notably the Newton-Leibniz formula, still apply in this case.

typically comes from the labor market specifications in the general equilibrium related models.

Second, this paper provides a simple theoretical set-up to analyze the interaction between the energy cost, the scrapping time and optimal capital accumulation. In particular, it allows to assess the usual interpretations of the productivity slowdown based on the energy cost. We show that in contrast to Baily's argument, a rise in the energy price may well increase the optimal capital stock if scrapping is endogenous and if technical progress is embodied and energy-saving. If one has to account for more characteristics of the embodied technological progress (i.e., not only the energy-saving property), the result would be much more ambiguous, and in any case the relationship between the energy cost and capital accumulation would be definitely much more complex than what is reported in the traditional productivity slowdown literature.

Thirdly, the paper compares rigorously optimal capital accumulation patterns depending on the nature of technological progress. It is shown that under embodiment, optimal investment is periodic in a balanced case and that this property is likely to be robust to departures from this reference case. These investment cycles are driven by the so-called echo principle, and it is not hard to show that this mechanism is consistent with an investment occurring by bursts as the data suggests. In contrast, when technological progress is disembodied, investment occurs once at the beginning of the program and never again. Nevertheless, this paper exploits only one hint to reconcile the observed investment dynamics with the one generated by models, namely embodiment. Another aspect to exploit is the irreversibility of investment under uncertain environments. This latter approach allows to explain periods with no investment but not the lumpiness of investment. Nevertheless, introducing uncertainty in a vintage capital model, and allowing for re-using previously scrapped machines in the case of good realizations of the uncertain variable seems first to be a more realistic modeling and second to have the ability to generate significantly different investment patterns. Note that models of irreversible investment under uncertainty have largely been developed in partial equilibrium frameworks, analogous to the one adopted in this paper. Thus, this paper may also be viewed as a first step towards the introduction of an embodied technical progress in models of irreversible investment under uncertainty.

5. References

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Appendix 1 : First order conditions associated with program (3.1)

The program (3.1) may be rewritten :

$$\begin{aligned}
 & \int_{t_1}^{t_2} dt \left(\int_{z_i T(t)}^{z_i} B_{\#} I(z) dz - Pe(z) \int_{z_i T(t)}^{z_i} I(z) e^{i \circ z} dz - k(z) I(z) e^{i r z} dz \right) \\
 & \max_{T(t); I(t)} \int_{t_0}^{t_1} dt \left(\int_{z_i T(t)}^{z_i} B_{\#} I(z) dz - Pe(z) \int_{z_i T(t)}^{z_i} I(z) e^{i \circ z} dz - k(z) I(z) e^{i r z} dz \right) \\
 & + \int_{t_1}^{t_2} dt \left(\int_{z_i T(t)}^{z_i} B_{\#} I(z) dz - Pe(z) \int_{z_i T(t)}^{z_i} I(z) e^{i \circ z} dz - k(z) I(z) e^{i r(z_i J(t) - t_i dt)} dz \right) \\
 & + \int_{t_2}^{t_2+dt} dt \left(\int_{z_i T(t)}^{z_i} B_{\#} I(z) dz - Pe(z) \int_{z_i T(t)}^{z_i} I(z) e^{i \circ z} dz - k(z) I(z) e^{i r(z_i J(t) - t_i dt)} dz \right) \\
 = & \max_{T(t); I(t)} \int_{t_0}^{t_2} dt \left(\int_{z_i T(t)}^{z_i} B_{\#} I(z) dz - Pe(z) \int_{z_i T(t)}^{z_i} I(z) e^{i \circ z} dz - k(z) I(z) e^{i r(z_i J(t) - t_i dt)} dz \right)
 \end{aligned}$$

since the first and third integrals do not involve any control variable. The first order conditions are then :

$$k(t) = \int_{z_i T(t)}^{z_i} B_{\#} I(z) dz - Pe(t) e^{i \circ t} = \int_{z_i T(t)}^{z_i} I(z) e^{i r(z_i J(t) - t_i dt)} dz$$

and

$$\int_{z_i T(t)}^{z_i} B_{\#} I(z) dz = Pe(t) e^{i \circ [t_i T(t)]}$$

from which (3.8) and (3.9) in the text may easily be deduced.

Appendix 2 : Proof of proposition 1

First, we show that $f(J(t))$ is strictly increasing and concave :

$$\begin{aligned}
 \frac{\partial f(J(t))}{\partial J(t)} &= \frac{e^{(\circ_i r)J(t)}}{1 + \frac{uc}{Pe} + \frac{\circ}{i r} [e^{(\circ_i r)J(t)} - 1]} > 0 \text{ since } \circ < r \\
 \frac{\partial^2 f(J(t))}{\partial J(t)^2} &= \frac{(\circ_i r) e^{(\circ_i r)J(t)} - \frac{uc}{Pe} - \frac{\circ}{i r} e^{(\circ_i r)J(t)}}{1 + \frac{uc}{Pe} + \frac{\circ}{i r} [e^{(\circ_i r)J(t)} - 1]^2} e^{(\circ_i r)J(t)} < 0
 \end{aligned}$$

Second, using the expression of $f(J(t))$, it can be shown that $\underline{I} \cdot T(t) \cdot \bar{T}$, 8t. Building sequences $x_{n+1} = f(x_n)$ and $y_{n+1} = f(y_n)$ respectively starting at $x_0 = \underline{I}$ and $y_0 = \bar{T}$, it can be shown that both sequences are monotonic and that $y_1 < y_0$, with $y_1 = f(y_0) = f(\bar{T})$ while $x_0 < x_1$ with $x_1 = f(x_0) = f(\underline{I})$ which implies that both of them converge to the fixed-point T .

Appendix 3 : Proof of $K^{E^a} < K^{D^a}$

First we, using both the expression (3.15) and (2.8) which respectively give K^{E^a} and K^{D^a} , it can be shown that

$$K^{E^a} > K^{D^a}, \quad e^{i^* T} > \frac{\bar{P}e}{\bar{P}e + \bar{u}c} \quad (5.1)$$

Second, the implicit expression for the optimal scrapping age provides some restriction for T :

Since it has been assumed that $r > 0$, we also have $e^{i^* T} < e^{i^* T}$. Using equation (3.14), we then have the following inequality :

$$\frac{0}{0} \frac{i^* r}{1} > e^{i^* T} \left[\frac{\bar{A}}{r} + \frac{\bar{u}c}{\bar{P}e} \right] < e^{i^* T}$$

$$, \quad e^{i^* T} < \frac{\bar{P}e}{\bar{P}e + \bar{u}c}$$

which contradicts equation (5.1). We therefore deduce that we always have $K^{E^a} < K^{D^a}$.