

Federico, Salvatore; Ferrari, Giorgio; Schuhmann, Patrick

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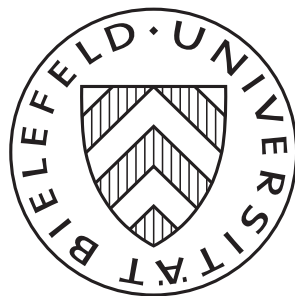
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A Model for the Optimal Management of Inflation

Salvatore Federico, Giorgio Ferrari and Patrick Schuhmann



A MODEL FOR THE OPTIMAL MANAGEMENT OF INFLATION

SALVATORE FEDERICO, GIORGIO FERRARI, AND PATRICK SCHUHMAN

ABSTRACT. Consider a central bank that can adjust the inflation rate by increasing and decreasing the level of the key interest rate. Each intervention gives rise to proportional costs, and the central bank faces also a running penalty, e.g., due to misaligned levels of inflation and interest rate. We model the resulting minimization problem as a Markovian degenerate two-dimensional bounded-variation stochastic control problem. Its characteristic is that the mean-reversion level of the diffusive inflation rate is an affine function of the purely controlled interest rate's current value. By relying on a combination of techniques from viscosity theory and free-boundary analysis, we provide the structure of the value function and we show that it satisfies a second-order smooth-fit principle. Such a regularity is then exploited in order to determine a system of functional equations solved by the two monotone curves that split the control problem's state space in three connected regions.

Keywords: singular stochastic control; Dynkin game; viscosity solution; free boundary; smooth-fit; inflation rate; interest rate.

MSC2010 subject classification: 93E20, 91A55, 49L25, 49J40, 91B64.

1. INTRODUCTION

Inflation and interest rates are linked fundamental macroeconomic quantities. In general, as interest rates are reduced, more people are able to borrow more money, consumers have more money to spend, and, as a consequence, economy grows and inflation raises. On the other hand, if interest rates are increased, consumers are more inclined to save since the returns from savings are higher. Hence, the economy slows and inflation decreases. Central banks main aims are to maintain maximum employment and stable inflation. For example, the monetary policies of the European Central Bank and of the U.S. Federal Reserve (Fed) are planned for inflation rates of below, but close to, 2% over the medium term. Some inflation is good since it helps to avoid that prices sink during times of slow growth, while a deflation (i.e. negative inflation) is dangerous because induces a delay in the purchases, with a possible negative spiral for the economy. It is a recent news (September 6, 2019) that the Bank of Russia Board of Directors decided to cut the key rate to 7.00% per annum in order to dam the “continuing inflation slowdown”. Also, in July 2019, the Fed decided to lower its key short-term interest rate “in light of the implications of global developments for the economic outlook as well as muted inflation pressures”. In fact, for the first half of 2019 inflation has remained below the Fed's annual 2% target.

In this paper, we propose a continuous-time stochastic model for the optimal management of the inflation. A central bank can adjust the level of inflation by acting on the key interest rate. We assume that the inflation has diffusive dynamics of Ornstein-Uhlenbeck type, with mean-reversion level that is an affine decreasing function of the current level of the key interest rate. The latter follows a purely controlled dynamics whose level can be increased and decreased. Since central banks wish to guarantee stable interest rates, they are usually reluctant to make large changes in the rate. We model this fact by assuming that each intervention on the key interest rate is costly, and that, in particular, central bank's actions give rise to proportional costs with marginal constant costs. The central bank also faces a running cost due, e.g., to misaligned levels of inflation and interest rates. In our formulation, the resulting central bank's

cost-minimization problem takes the form of a Markovian degenerate, two-dimensional *singular stochastic control problem with controls of bounded variation* over an infinite time-horizon (see, e.g., [2], [23], [33] as early contributions on singular stochastic control problems). It is Markovian and two-dimensional since the state-variable is a Markov process and consists of the current levels of inflation, X_t , and of the key interest rate, R_t ; it is degenerate since the dynamics of the interest rate does not have any diffusive component; finally, it is a bounded-variation stochastic control problem since we interpret the cumulative amounts of increase/decrease of the key interest rate as the central bank's control variables.

The coupling between the dynamics of the inflation and key interest rates makes the problem quite intricate. Our analysis is mainly devoted to the value function and the geometry of the problem's state space, being the main contribution of our work the determination of the structure of the control problem's value function V and the study of its regularity. More in detail: (i) we show that the state space is split into three connected regions by two monotone curves (free boundaries); (ii) we provide the expression of the value function in each of those regions; (iii) we prove that V is continuously differentiable, and admits second order derivative V_{xr} which is continuous in the whole space (second-order smooth-fit). This latter regularity allows us to obtain a system of functional equations that are necessarily solved by the free boundaries. Further properties of the latter are also determined.

In order to perform our analysis we do not rely on the so-called “guess-and-verify” approach, usually employed in the study of two-dimensional degenerate singular stochastic control problems (see, e.g., [1], [15], [16], and [26]). Indeed, given the dependency of the (uncontrolled) inflation rate dynamics on the current value of the (controlled) interest rate, such an approach seems not to be viable. Instead, here we follow a direct study of the control problem's value function. First of all, by exploiting the convexity of the value function, we show that $V \in W_{\text{loc}}^{2,\infty}(\mathbb{R}^2; \mathbb{R})$; i.e., by Sobolev's embedding, it is continuously differentiable and admits second order (weak) derivatives that are locally bounded on \mathbb{R}^2 . Then, through a suitable (and not immediate) approximation procedure needed to accommodate our degenerate setting, we can employ a result of [12] and show that the derivative V_r is the value function of a related stopping game (Dynkin game). The main characteristic of such a game is that its functional involves the derivative V_x of the control problem's value function in the form of a running cost; the presence of this term is due to the coupling between the two components of the control problem's state space (see also [12]). The fact that V_r identifies with the value of a Dynkin game, together with the convexity of V , allows us to obtain preliminary information about the geometry of the state space of our problem. We show that there exist two monotone boundaries that delineate the regions where V_r equates (up to a sign) the marginal costs of increasing and decreasing the key interest rate, K_1 and K_2 , respectively (action regions). We then move on by studying the Hamilton-Jacobi-Bellman (HJB) equation associated to V . This takes the form of an ordinary differential equation with the gradient constraint $-K_1 \leq V_r \leq K_2$ (variational inequality), and we prove that V solves it in the viscosity sense. Such a result paves the way to the determination of the structure of the value function; indeed, V is shown to be a classical solution to the HJB equation in the region between the two boundaries (inaction region), and therefore it is given there in terms of the linear combination of the two strictly increasing and decreasing eigenvectors of the infinitesimal generator of the Ornstein-Uhlenbeck process. The structure of V in the two action regions is then obtained by exploiting the continuity of V and the gradient constraint.

The regularity of V is further improved by proving that the second-order mixed derivative, V_{xr} , is continuous (second-order smooth fit). This proof exploits the fact that V is a viscosity solution to the HJB, as well as the preliminary properties of the free boundaries, and can be obtained by suitably adjusting to our setting the arguments of the proof of Proposition 5.3 in [20]. The structure of V and the second-order smooth fit property have a number of notable implications. They allow to provide the asymptotic behavior of the free boundaries and, in

the relevant case of a separable running cost function, to obtain their strict monotonicity, and therefore the continuity of their inverses g_1 and g_2 . These latter curves are then shown to necessarily satisfy a nonlinear system of functional equations which, in the case of decoupled dynamics of inflation and interest rates, coincides with that of Proposition 5.5 in [20]. However, in contrast to the lengthy analytical approach followed in [20], our way of obtaining the equations for g_1 and g_2 is fully probabilistic as it employs the local-time-space calculus of [27] and properties of one-dimensional regular diffusions (see [6]). Unfortunately, the highly complex structure of the equations for g_1 and g_2 makes a statement about the uniqueness of their solution far from being trivial, and we leave the study of this relevant issue for future research.

In a final section of this paper, we show that an optimal control is given in terms of the solution (if it exists) to a suitable Skorokhod reflection problem at the boundary of the inaction region. Existence of multi-dimensional reflected diffusions is per se an interesting and not trivial question, that is linked to the regularity of the reflection boundary and direction of reflection. We do not investigate in detail such a problem, but we discuss conditions on the free boundaries ensuring the existence of a two-dimensional process (X^*, R^*) that is reflected at the boundary of the inaction region. In particular, global Lipschitz-regularity of the free boundaries would make the job.

The closest papers to ours are [12] and [20]. In fact, from a mathematical point of view, our model can be seen in between that of [12] (see also [11] for a finite-horizon version) and that of [20] (see also [26]). On the one hand, we propose a degenerate version of the fully two-dimensional bounded-variation stochastic control of [12]; on the other hand, the problem of [20] can be obtained from ours when the dynamics of inflation X and interest rates R decouple. It is exactly the degeneracy of our state process that makes the determination of the structure of the value function possible in our problem, and it is the coupling between X and R that makes our analysis much more involved than that in [20]. To the best of our knowledge, the only other paper dealing with a two-dimensional degenerate singular stochastic control problem where the dynamics of the two components of the state process are coupled is [18]. There it is considered a dividend and investment problem for a cash constrained firm, and both a viscosity solution approach and a verification technique is employed to get qualitative properties of the value function. It is important to notice that, differently to ours, the problem in [18] is not convex, thus making it hard to prove any regularity of the value function further than its continuity.

The rest of this paper is organized as follows. In Section 2 we set up the problem and provide preliminary properties of the value function. The related Dynkin game is obtained in Section 3, where we also show preliminary properties of the free boundaries. Section 4 gives the structure of the control problem's value function, while the second-order smooth-fit property is proved in Section 5. Such a regularity is then used in Section 6 for the proof of further properties of the free boundaries and the determination of the system of equations solved by the latter (cf. Subsection 6.2). Section 7 discusses the structure of the optimal control. Finally, Appendix A provides the proof of the main theorem of Section 3.

1.1. Notation. In the rest of this paper, we adopt the following notation and functional spaces. We will use $|\cdot|$ for the Euclidean norm on any finite-dimensional space, without indicating the dimension each time for simplicity of exposition.

Given a smooth function $h : \mathbb{R} \rightarrow \mathbb{R}$, we shall write h' , h'' , etc. to denote its derivatives. If the function h admits k continuous derivatives, $k \geq 1$, we shall write $h \in C^k(\mathbb{R}; \mathbb{R})$, while $h \in C(\mathbb{R}; \mathbb{R})$ if such a function is only continuous.

For a smooth function $h : \mathbb{R}^2 \rightarrow \mathbb{R}$, we denote by h_x , h_r , h_{xx} , h_{rr} , etc. its partial derivatives. Given $k, j \in \mathbb{N}$, we let $C^{k,j}(\mathbb{R}^2; \mathbb{R})$ be the class of functions $h : \mathbb{R}^2 \rightarrow \mathbb{R}$ which are k -times continuously differentiable with respect to the first variable and h -times continuously differentiable with respect to the second variable. If $k = j$, we shall simply write $C^k(\mathbb{R}^2; \mathbb{R})$. Moreover,

for an open domain $\mathcal{O} \subseteq \mathbb{R}^d$, $d \in \{1, 2\}$, we shall work with the space $C_{\text{loc}}^{k, \text{Lip}}(\mathcal{O}; \mathbb{R})$, $k \geq 1$, which consists of all the functions $h : \mathcal{O} \rightarrow \mathbb{R}$ that are k times continuously differentiable, with locally-Lipschitz k th-derivative(s).

Also, for $p \geq 1$ we shall denote by $L^p(\mathcal{O}; \mathbb{R})$ (resp. $L_{\text{loc}}^p(\mathcal{O}; \mathbb{R})$) the space of real-valued functions $h : \mathcal{O} \rightarrow \mathbb{R}$ such that $|h|^p$ is integrable with respect to the Lebesgue measure on \mathcal{O} (resp. locally integrable on \mathcal{O}). Finally, for $k \geq 1$, we shall make use of the space $W^{k, p}(\mathcal{O}; \mathbb{R})$ (resp. $W_{\text{loc}}^{k, p}(\mathcal{O}; \mathbb{R})$), which is the space of all the functions $h : \mathcal{O} \rightarrow \mathbb{R}$ that admit k th-order weak derivative(s) in $L^p(\mathcal{O}; \mathbb{R})$ (resp. $L_{\text{loc}}^p(\mathcal{O}; \mathbb{R})$).

2. PROBLEM FORMULATION AND PRELIMINARY RESULTS

2.1. Problem formulation. Let $(\Omega, \mathcal{F}, \mathbb{F} := (\mathcal{F}_t)_{t \geq 0}, \mathbf{P})$ be a complete filtered probability space rich enough to accommodate an \mathbb{F} -Brownian motion $W := (W_t)_{t \geq 0}$. We assume that the filtration \mathbb{F} satisfies the usual conditions.

Introducing the (nonempty) set

$$(2.1) \quad \mathcal{A} := \{ \xi : \Omega \times \mathbb{R}_+ \rightarrow \mathbb{R} : \mathbb{F}\text{-adapted and such that } t \mapsto \xi_t \text{ is a.s.} \\ \text{c\`adl\`ag and (locally) of finite variation} \},$$

for any $\xi \in \mathcal{A}$ we denote by ξ^+ and ξ^- the two nondecreasing \mathbb{F} -adapted c\`adl\`ag processes providing the minimal decomposition of ξ ; i.e. $\xi = \xi^+ - \xi^-$ and the (random) Borel-measures induced on $[0, \infty)$ by ξ^+ and ξ^- have disjoint supports. In the following we set $\xi_0^\pm = 0$ a.s. for any $\xi \in \mathcal{A}$.

Picking $\xi \in \mathcal{A}$, we then consider the purely controlled dynamics

$$(2.2) \quad R_t^{r, \xi} = r + \xi_t^+ - \xi_t^-, \quad t \geq 0, \quad R_0^{r, \xi} = r \in \mathbb{R},$$

giving the evolution of the key interest rate. Here, ξ_t^+ (resp. ξ_t^-) represents the cumulative increase (resp. decrease) of the key interest rate made by the central bank up to time $t \geq 0$. Notice that we do not restrict to cumulative actions of the central bank that, as functions of time, are absolutely continuous with respect to the Lebesgue measure. In fact, also lump sum and singular interventions are allowed.

The central bank acts on the level of the key interest rate in order to adjust the long-term mean of the inflation, which we assume to have a mean-reverting dynamics. In particular, for any given $\xi \in \mathcal{A}$, the inflation rate evolves as

$$(2.3) \quad \begin{cases} dX_t^{x, r, \xi} = \theta \left(\mu + b \left(\bar{r} - R_t^{r, \xi} \right) - X_t^{x, r, \xi} \right) dt + \eta dW_t, & t > 0, \\ X_0^{x, r, \xi} = x \in \mathbb{R}, \end{cases}$$

where $\eta > 0$ is the inflation's volatility and $\theta > 0$ is the speed of mean reversion. Defining, for some $\mu \in \mathbb{R}, \bar{r} \in \mathbb{R}$,

$$\bar{\mu}(r) := \mu + b(\bar{r} - r)$$

as the key interest rate-dependent equilibrium (or long-term mean) of the inflation, the unique strong solution to (2.3) can be obtained by the well known method of variation of constants and is given by

$$(2.4) \quad X_t^{x, r, \xi} = xe^{-\theta t} + \theta e^{-\theta t} \int_0^t e^{\theta s} \bar{\mu}(R_s^{r, \xi}) ds + \eta e^{-\theta t} \int_0^t e^{\theta s} dW_s, \quad \forall \xi \in \mathcal{A}, t \geq 0.$$

Notice that when $b = 0$, the central bank's actions do not affect the inflation's dynamics, which in such a case evolves as an Ornstein-Uhlenbeck process with mean-reversion level μ .

The central bank faces a running cost depending on the current levels of inflation and key interest rate. Such a cost might be thought of as a penalization for having any misalignment of those macroeconomic quantities from exogenously given reference levels; for example, the

monetary policy of the European Central Bank is planned for inflation rates of below, but close to, 2% over the medium term. However, it is also well known that central banks wish to guarantee stable interest rates, and are therefore reluctant to make large changes in the rate. We model this fact by assuming that each intervention on the key interest rate is costly, and that, in particular, central bank's actions give rise to proportional costs with marginal constant costs $K_1 > 0$, when increasing, and $K_2 > 0$, when decreasing. The central bank is then faced with the problem of choosing a monetary policy $\xi \in \mathcal{A}$ such that, for any $(x, r) \in \mathbb{R}^2$, the cost functional

$$(2.5) \quad \mathcal{J}(x, r; \xi) := \mathbb{E} \left[\int_0^\infty e^{-\rho t} f(X_t^{x,r;\xi}, R_t^{r;\xi}) dt + \int_0^\infty e^{-\rho t} K_1 d\xi_t^+ + \int_0^\infty e^{-\rho t} K_2 d\xi_t^- \right]$$

is minimized; that is, it aims at solving

$$(2.6) \quad V(x, r) := \inf_{\xi \in \mathcal{A}} \mathcal{J}(x, r; \xi), \quad (x, r) \in \mathbb{R}^2.$$

In (2.5), the parameter $\rho > 0$ is a measure of the time-preferences of the central bank's governor, while the running cost function $f : \mathbb{R}^2 \rightarrow \mathbb{R}^+$ satisfies the following standing assumption.

Assumption 2.1. *There exists $p > 1$, and $C_0, C_1, C_2 > 0$ such that the following hold true:*

- (i) $0 \leq f(z) \leq C_0(1 + |z|)^p$, for every $z = (x, r) \in \mathbb{R}^2$;
- (ii) for every $z = (x, r), z' = (x', r') \in \mathbb{R}^2$,

$$|f(z) - f(z')| \leq C_1(1 + |z| + |z'|)^{p-1}|z - z'|;$$

- (iii) for every $z = (x, r), z' = (x', r') \in \mathbb{R}^2$ and $\lambda \in (0, 1)$,

$$0 \leq \lambda f(z) + (1 - \lambda)f(z') - f(\lambda z + (1 - \lambda)z') \leq C_2\lambda(1 - \lambda)(1 + |z| + |z'|)^{(p-2)^+}|z - z'|^2;$$

in particular, f is convex and locally semiconcave, and, by Corollary 3.3.8 in [10], it belongs to $C_{loc}^{1,Lip}(\mathbb{R}^2; \mathbb{R}) = W_{loc}^{2,\infty}(\mathbb{R}^2; \mathbb{R})$;

- (iv) $x \mapsto f_r(x, r)$ is nonincreasing for any $r \in \mathbb{R}$.

Remark 2.2. *A function f satisfying Assumption 2.1 is, for example,*

$$f(x, r) = \alpha(x - \tilde{x})^2 + \beta(r - \tilde{r})^2, \quad (x, r) \in \mathbb{R}^2,$$

for some constant target levels $\tilde{x} \in \mathbb{R}$ and $\tilde{r} \in \mathbb{R}$ of inflation and key interest rate, and for some constants $\alpha, \beta \geq 0$.

Remark 2.3. *Our modeling choice of considering a (possibly) unbounded key interest rate (cf. (2.2)) is made for mathematical simplicity. Indeed, introducing exogenous bounds on the level of R , the dynamic programming equation (see (4.4) below) associated to problem (2.6) would be complemented by boundary conditions leading to a more complex analysis. We leave the case of bounded R for future research.*

Also we do not consider fixed costs associated to the central bank's actions, that would lead to a two-dimensional stochastic impulse control problem (see, e.g., [5]). For this class of optimal control problems we are not aware of any work providing the structure of the value function and of the state space in multi-dimensional settings with coupled dynamics as ours (2.2) and (2.3).

2.2. Preliminary Properties of the Value Function. We now provide some preliminary properties of the value function. Their proof is classical, but those properties will play an important role in our subsequent analysis. We notice that the linear structure of the state equations yields

$$(2.7) \quad X_t^{x,r;\xi} - X_t^{\hat{x},\hat{r};\xi} = (x - \hat{x})e^{-\theta t} + b(\hat{r} - r)(1 - e^{-\theta t}), \quad \forall (x, r), (\hat{x}, \hat{r}) \in \mathbb{R}^2, \forall \xi \in \mathcal{A}, \forall t \geq 0.$$

Proposition 2.4. *Let Assumption 2.1 hold and let $p > 1$ be the constant appearing in such assumption. There exist constants $\hat{C}_0, \hat{C}_1, \hat{C}_2 > 0$ such that the following hold:*

- (i) $0 \leq V(z) \leq \hat{C}_0(1 + |x|^p) + (-K_1 \min\{r, 0\} \wedge K_2 \max\{r, 0\})$ for every $z = (x, r) \in \mathbb{R}^2$;
- (ii) there exists $\hat{C}_1 > 0$ such that, for every $z = (x, r), z' = (x', r') \in \mathbb{R}^2$,

$$|V(z) - V(z')| \leq \hat{C}_1(1 + |z| + |z'|)^{p-1}|z - z'|;$$

- (iii) for every $z = (x, r), z' = (x', r') \in \mathbb{R}^2$ and $\lambda \in (0, 1)$,

$$0 \leq \lambda V(z) + (1 - \lambda)V(z') - V(\lambda z + (1 - \lambda)z') \leq \hat{C}_2 \lambda(1 - \lambda)(1 + |z| + |z'|)^{(p-2)^+}|z - z'|^2;$$

in particular, V is convex and locally semiconcave, and, by Corollary 3.3.8 in [10], it belongs to $C_{loc}^{1,Lip}(\mathbb{R}^2; \mathbb{R}) = W_{loc}^{2,\infty}(\mathbb{R}^2; \mathbb{R})$.

Proof. Due to (2.7), the properties of f required in (ii) and (iii) of Assumption 2.1 are straightly inherited by V (see, e.g., the proof of Theorem 1 of [14], that can easily adapted to our infinite time-horizon setting).

We prove (i), which requires a slightly finer argument. Let $z = (x, r) \in \mathbb{R}^2$ and assume $r \geq 0$. Consider then the admissible control $\bar{\xi}$ such that $\bar{\xi}_t^+ = 0$ and $\bar{\xi}_t^- = r$ for all $t \geq 0$ a.s. We then have

$$\mathcal{J}(x, r; \bar{\xi}) \leq \mathbb{E} \left[\int_0^\infty e^{-rt} f \left(x e^{-\theta t} + \theta e^{-\theta t} \int_0^t e^{\theta s} \bar{\mu}(0) ds + \eta e^{-\theta t} \int_0^t e^{\theta s} dW_{s,0} \right) dt \right] + K_2 \max\{r, 0\}.$$

Symmetrically, if $r \leq 0$, pick the admissible $\hat{\xi}$ such that $\hat{\xi}_t^+ = -r$ and $\hat{\xi}_t^- = 0$ for all $t \geq 0$ a.s. and obtain

$$\mathcal{J}(x, r; \hat{\xi}) \leq \mathbb{E} \left[\int_0^\infty e^{-rt} f \left(x e^{-\theta t} + \theta e^{-\theta t} \int_0^t e^{\theta s} \bar{\mu}(0) ds + \eta e^{-\theta t} \int_0^t e^{\theta s} dW_{s,0} \right) dt \right] - K_1 \min\{r, 0\}.$$

Then, since $V(x, r) \leq \mathcal{J}(x, r; \bar{\xi}) \wedge \mathcal{J}(x, r; \hat{\xi})$, the claim follows by Assumption 2.1-(i), (2.7) and standard estimates. \square

3. A RELATED DYNKIN GAME

In this section we derive the Dynkin game (a zero-sum game of optimal stopping) associated to Problem (2.6). In order to simplify the notation, in the following we write $X^{x,r}$, instead of $X^{x,r,0}$, to identify the solution to (2.3) for $\xi \equiv 0$.

Denote by \mathcal{T} the set of all \mathbb{F} -stopping times. For $(\sigma, \tau) \in \mathcal{T} \times \mathcal{T}$, and $(x, r) \in \mathbb{R}^2$, consider the stopping functional

$$\begin{aligned} \Psi(\sigma, \tau; x, r) := & \mathbb{E} \left[\int_0^{\tau \wedge \sigma} e^{-\rho t} \left(-\theta b V_x(X_t^{x,r}, r) + f_r(X_t^{x,r}, r) \right) dt \right. \\ & \left. - e^{-\rho \tau} K_1 \mathbb{1}_{\{\tau < \sigma\}} + e^{-\rho \sigma} K_2 \mathbb{1}_{\{\tau > \sigma\}} \right], \end{aligned} \quad (3.1)$$

where V_x is the partial derivative of V with respect to x (which exists continuously by Proposition 2.4).

Consider now two agents (players), playing against each other and having the possibility to end the game by choosing a stopping time: Player 1 chooses a stopping time σ , while Player 2 a stopping time τ . If Player 1 stops the game before Player 2, she pays $e^{-\rho \sigma} K_2$ to Player 2. If Player 2 stops first, then she pays $e^{-\rho \tau} K_1$ to Player 1. As long as the game is running, Player 1 keeps paying Player 2 at the rate $-\theta b V_x(X_t^{x,r}, R_t^r) + f_r(X_t^{x,r}, R_t^r)$. Clearly, Player 1 aims at minimizing functional (3.1), while Player 2 at maximizing it. For any $(x, r) \in \mathbb{R}^2$, define now

$$\underline{u}(x, r) := \sup_{\tau \in \mathcal{T}} \inf_{\sigma \in \mathcal{T}} \Psi(\sigma, \tau; x, r), \quad \bar{u}(x, r) := \inf_{\sigma \in \mathcal{T}} \sup_{\tau \in \mathcal{T}} \Psi(\sigma, \tau; x, r) \quad (3.2)$$

as the lower- and upper-values of the game. Clearly, $\underline{u} \leq \bar{u}$. We say that the game has a value if $\underline{u} = \bar{u} =: u$; in such a case,

$$u(x, r) = \inf_{\sigma \in \mathcal{T}} \sup_{\tau \in \mathcal{T}} \Psi(\sigma, \tau; x, r) = \sup_{\tau \in \mathcal{T}} \inf_{\sigma \in \mathcal{T}} \Psi(\sigma, \tau; x, r).$$

Moreover, given $(x, r) \in \mathbb{R}^2$, a pair $(\sigma_*, \tau_*) := (\sigma_*(x, r), \tau_*(x, r))$ is called a *saddle-point* of the game if

$$(3.3) \quad \Psi(\sigma_*, \tau; x, r) \leq \Psi(\sigma_*, \tau_*; x, r) \leq \Psi(\sigma, \tau_*; x, r)$$

for all stopping times $\sigma, \tau \in \mathcal{T}$.

We then have the following theorem, whose proof follows from Theorems 3.11 and 3.13 in [12], through a suitable (and not immediate) approximation procedure needed to accommodate our degenerate setting. Details are postponed to Appendix A.

Theorem 3.1. *Let $(x, r) \in \mathbb{R}^2$. Then the game has a value given by*

$$(3.4) \quad V_r(x, r) = \inf_{\sigma \in \mathcal{T}} \sup_{\tau \in \mathcal{T}} \Psi(\sigma, \tau; x, r) = \sup_{\tau \in \mathcal{T}} \inf_{\sigma \in \mathcal{T}} \Psi(\sigma, \tau; x, r),$$

and the couple of \mathbb{F} -stopping times $(\tau_*(x, r), \sigma_*(x, r)) := (\tau_*, \sigma_*)$ such that

$$(3.5) \quad \sigma_* := \inf \{t \geq 0 : V_r(X_t^{x,r}, r) \geq K_2\}, \quad \tau_* := \inf \{t \geq 0 : V_r(X_t^{x,r}, r) \leq -K_1\}$$

(with the usual convention $\inf \emptyset = +\infty$) form a saddle-point; that is,

$$\forall \tau \in \mathcal{T} \quad \Psi(\sigma^*, \tau; x, r) \leq V_r(x, r) = \Psi(\sigma^*, \tau^*; x, r) \leq \Psi(\sigma, \tau^*; x, r) \quad \forall \sigma \in \mathcal{T}.$$

As it is discussed also at p. 1196 of [11], the Dynkin game introduced above can be thought of as the game between two different components in the board of the central bank: the one which aims at choosing when to pursue monetary stability by increasing the key interest rate, and the one which instead wishes to optimally time a decrease of the key interest rate in order to stimulate the economy.

From (3.4) it readily follows that $-K_1 \leq V_r(x, r) \leq K_2$ for any $(x, r) \in \mathbb{R}^2$. Hence, defining

$$(3.6) \quad \begin{cases} \mathcal{I} := \{(x, r) \in \mathbb{R}^2 : V_r(x, r) = -K_1\}, \\ \mathcal{C} := \{(x, r) \in \mathbb{R}^2 : -K_1 < V_r(x, r) < K_2\}, \\ \mathcal{D} := \{(x, r) \in \mathbb{R}^2 : V_r(x, r) = K_2\}, \end{cases}$$

we have that those regions provide a partition of \mathbb{R}^2 .

By continuity of V_r (cf. Proposition 2.4), \mathcal{C} is an open set, while \mathcal{I} and \mathcal{D} are closed sets. Moreover, convexity of V provides the representation

$$\mathcal{C} = \{(x, r) : b_1(x) < r < b_2(x)\},$$

$$\mathcal{I} = \{(x, r) : r \leq b_1(x)\}, \quad \mathcal{D} = \{(x, r) : r \geq b_2(x)\},$$

where the functions $b_1 : \mathbb{R} \rightarrow \bar{\mathbb{R}}$ and $b_2 : \mathbb{R} \rightarrow \bar{\mathbb{R}}$ are defined as

$$(3.7) \quad b_1(x) := \inf\{r \in \mathbb{R} \mid V_r(x, r) > -K_1\} = \sup\{r \in \mathbb{R} \mid V_r(x, r) = -K_1\}, \quad x \in \mathbb{R},$$

$$(3.8) \quad b_2(x) := \sup\{r \in \mathbb{R} \mid V_r(x, r) < K_2\} = \inf\{r \in \mathbb{R} \mid V_r(x, r) = K_2\}, \quad x \in \mathbb{R},$$

(with the usual conventions $\inf \emptyset = \infty$, $\inf \mathbb{R} = -\infty$, $\sup \emptyset = -\infty$, $\sup \mathbb{R} = \infty$).

Lemma 3.2. $V_r(\cdot, r)$ is nonincreasing for all $r \in \mathbb{R}$.

Proof. Since $x \mapsto V_x(x, r)$ is nondecreasing for any $r \in \mathbb{R}$ by convexity of V (cf. Proposition 2.4) and $x \mapsto f_r(x, r)$ is nonincreasing by Assumption 2.1-(iv), we have that $\Psi(\sigma, \tau; \cdot, r)$ is nonincreasing for every $r \in \mathbb{R}$ and $\sigma, \tau \in \mathcal{T}$. Then the claim follows by (3.4). \square

The monotonicity of V_r proved above, together with its continuity, allows to obtain preliminary properties of b_1 and b_2 .

Proposition 3.3. *The following hold:*

- (i) $b_1 : \mathbb{R} \rightarrow \mathbb{R} \cup \{-\infty\}$, $b_2 : \mathbb{R} \rightarrow \mathbb{R} \cup \{\infty\}$;
- (ii) b_1 and b_2 are nondecreasing;
- (iii) $b_1(x) < b_2(x)$ for all $x \in \mathbb{R}$;
- (iv) b_1 is right-continuous and b_2 is left-continuous.

Proof. We prove each item separately.

Proof of (i). We argue by contradiction and we assume that there exists $x_o \in \mathbb{R}$ such that $b_1(x_o) = \infty$. Then, we have that $V_r(x_o, r) = -K_1$ for all $r \in \mathbb{R}$ and therefore

$$V(x_o, r + r') = V(x_o, r) - K_1 r'$$

for all $r, r' \in \mathbb{R}$. Using now the fact that V is nonnegative, and that $V(x_o, r) \leq \mathcal{J}(x_o, r; 0) < \infty$ by Proposition 2.4, one obtains

$$K_1 r' \leq V(x_o, r) \leq \mathcal{J}(x_o, r; 0) < \infty \quad \forall r, r' \in \mathbb{R}.$$

Since the right-hand side of the latter is independent of r' and bounded, we obtain a contradiction by picking r' sufficiently large. A similar argument applies to show that b_2 takes values in $\mathbb{R} \cup \{\infty\}$.

Proof of (ii). The claimed monotonicity of b_1 and b_2 easily follows by Lemma 3.2.

Proof of (iii). The fact that $b_1(x) < b_2(x)$ for any $x \in \mathbb{R}$ is due to the convexity of V with respect to r and to the fact that $V_r(x, \cdot)$ is continuous for any $x \in \mathbb{R}$.

Proof of (iv). We prove the claim relative to b_1 , as the one relative to b_2 can be proved analogously. Let $\varepsilon > 0$. Then for $x \in \mathbb{R}$ we have $b_1(x) \leq b_1(x + \varepsilon)$, by (ii) above. Hence, also $b_1(x) \leq \lim_{\varepsilon \downarrow 0} b_1(x + \varepsilon) =: b_1(x+)$, where the last limit exists due to monotonicity of b_1 . However, the sequence $(x + \varepsilon, b_1(x + \varepsilon))_{\varepsilon > 0} \subset \mathcal{I}$, and, because \mathcal{I} is closed, we therefore obtain in the limit $(x, b_1(x+)) \in \mathcal{I}$. It thus follows $b_1(x) \geq b_1(x+)$ by (3.7), and the right-continuity of b_1 is then proved. \square

Let us now define

$$(3.9) \quad \bar{b}_1 := \sup_{x \in \mathbb{R}} b_1(x), \quad \underline{b}_1 := \inf_{x \in \mathbb{R}} b_1(x), \quad \bar{b}_2 := \sup_{x \in \mathbb{R}} b_2(x), \quad \underline{b}_2 := \inf_{x \in \mathbb{R}} b_2(x),$$

together with the pseudo-inverses of b_1 and b_2 by

$$(3.10) \quad g_1(r) := \inf\{x \in \mathbb{R} : b_1(x) \geq r\}, \quad g_2(r) := \sup\{x \in \mathbb{R} : b_2(x) \leq r\},$$

with the conventions $\inf \emptyset = \infty$ and $\sup \emptyset = -\infty$.

Proposition 3.4. *The following holds:*

- (i) $g_1(r) = \sup\{x \in \mathbb{R} : V_r(x, r) > -K_1\}$, $g_2(r) = \inf\{x \in \mathbb{R} : V_r(x, r) < K_2\}$;
- (ii) the functions g_1, g_2 are nondecreasing and $g_1 \geq g_2$;
- (iii) If $\bar{b}_2 < \infty$, then $g_2(r) = \infty$ for all $r \geq \bar{b}_2$ and if $\underline{b}_1 > -\infty$, then $g_1(r) = -\infty$ for all $r \leq \underline{b}_1$.

Proof. Claim (i) follows by definition, while (ii) is due to Proposition 3.3-(ii). To show (iii), assume $\bar{b}_2 < \infty$ and suppose, by contradiction, that $\lim_{r \rightarrow \infty} g_2(r) = \bar{g} < \infty$. Then, one has $b_2(x) = \infty$ for all $x \in (\bar{g}, \infty)$, and this clearly contradicts $\bar{b}_2 < \infty$. The statement relative to g_1 can be proved analogously. \square

4. THE STRUCTURE OF THE VALUE FUNCTION

In the previous section we have derived a representation of the derivative V_r of the value function defined in (2.6), and we have shown how the state space can be split in three regions, separated by nondecreasing curves. In this section, we exploit these results and we determine the structure of the value function V .

For any given and fixed $r \in \mathbb{R}$, denote by \mathcal{L}^r the infinitesimal generator associated to the uncontrolled process $X^{x,r,0}$. Acting on $\alpha \in C^2(\mathbb{R}; \mathbb{R})$ it yields

$$(\mathcal{L}^r \alpha)(x) := \frac{\eta^2}{2} \alpha''(x) + \theta(\mu + b(\bar{r} - r) - x) \alpha'(x), \quad x \in \mathbb{R}.$$

Recall that $\bar{\mu}(r) := \mu + b(\bar{r} - r)$. For frequent future use, it is worth noticing that any solution to the second-order ordinary differential equation (ODE)

$$(\mathcal{L}^r \alpha)(x) - \rho \alpha(x) = 0, \quad x \in \mathbb{R},$$

can be written as

$$\alpha(x) = A(r) \psi(x - \bar{\mu}(r)) + B(r) \varphi(x - \bar{\mu}(r)), \quad x \in \mathbb{R},$$

where the strictly positive functions ψ and φ are the strictly increasing and decreasing fundamental solutions to the ODE

$$(4.1) \quad \frac{\eta^2}{2} \zeta''(x) - \theta x \zeta'(x) - \rho \zeta(x) = 0, \quad x \in \mathbb{R}.$$

The functions ψ and φ are given by (see page 280 in [22], among others)

$$(4.2) \quad \psi(x) = e^{\frac{\theta x^2}{2\eta^2}} D_{-\frac{\rho}{\theta}} \left(-\frac{x}{\eta} \sqrt{2\theta} \right) \quad \text{and} \quad \varphi(x) = e^{\frac{\theta x^2}{2\eta^2}} D_{-\frac{\rho}{\theta}} \left(\frac{x}{\eta} \sqrt{2\theta} \right),$$

where

$$(4.3) \quad D_\beta(x) := \frac{e^{-\frac{x^2}{4}}}{\Gamma(-\beta)} \int_0^\infty t^{-\beta-1} e^{-\frac{t^2}{2} - xt} dt, \quad \beta < 0,$$

is the Cylinder function of order β and $\Gamma(\cdot)$ is the Euler's Gamma function (see, e.g., Chapter VIII in [3]). Moreover, ψ and φ are strictly convex.

By the dynamic programming principle, we expect that V identifies with a suitable solution to the following variational inequality

$$(4.4) \quad \max \left\{ -v_r(x, r) - K_1, v_r(x, r) - K_2, [(\rho - \mathcal{L}^r)v(\cdot, r)](x) - f(x, r) \right\} = 0, \quad (x, r) \in \mathbb{R}^2.$$

By assuming that an optimal control exists, the latter can be derived by noticing that in the optimal control problem (2.6) only three actions are possible at initial time (and, hence, at any time given the underlying Markovian framework): (i) do not intervene on the key interest rate for a small amount of time, and then continue optimally; (ii) immediately adjust the interest rate via a lump sum decrease having marginal cost K_2 , and then continue optimally; (iii) immediately adjust the interest rate via a lump sum increase having marginal cost K_1 , and then continue optimally. Then, by supposing that V is smooth enough, an application of Itô's formula and a standard limiting procedure involving the mean-value theorem leads to (4.4) (we refer to [26] for details in a related setting).

We now show that V is a viscosity solution to (4.4). Later, this will enable us to determine the structure of V (see Theorem 4.5 below) and then to upgrade its regularity (cf. Theorem 5.1) in order to derive necessary optimality conditions for the boundaries splitting the state space (cf. Theorem 6.5).

Definition 4.1.

- (i) A function $v \in C^0(\mathbb{R}^2; \mathbb{R})$ is called a viscosity subsolution to (4.4) if, for every $(x, r) \in \mathbb{R}^2$ and every $\alpha \in C^{2,1}(\mathbb{R}^2; \mathbb{R})$ such that $v - \alpha$ attains a local maximum at (x, r) , it holds

$$\max \left\{ -\alpha_r(x, r) - K_1, \alpha_r(x, r) - K_2, \rho\alpha(x, r) - [\mathcal{L}^r \alpha(\cdot, r)](x) - f(x, r) \right\} \leq 0.$$

- (ii) A function $v \in C^0(\mathbb{R}^2; \mathbb{R})$ is called a viscosity supersolution to (4.4) if, for every $(x, r) \in \mathbb{R}^2$ and every $\alpha \in C^{2,1}(\mathbb{R}^2; \mathbb{R})$ such that $v - \alpha$ attains a local minimum at (x, r) , it holds

$$\max \left\{ -\alpha_r(x, r) - K_1, \alpha_r(x, r) - K_2, \rho\alpha(x, r) - [\mathcal{L}^r \alpha(\cdot, r)](x) - f(x, r) \right\} \geq 0.$$

- (iii) A function $v \in C^0(\mathbb{R}^2; \mathbb{R})$ is called a viscosity solution to (4.4) if it is both a viscosity subsolution and supersolution.

Following the arguments developed in Theorem 5.1 in Section VIII.5 of [21], one can show the following result.

Proposition 4.2. *The value function V is a viscosity solution to (4.4).*

Remark 4.3. *Clearly, due to Lemma 5.4 in Chapter 4 of [34], a viscosity solution which lies in the class $W_{loc}^{2,\infty}(\mathbb{R}^2; \mathbb{R})$ (as our value function does; cf. Proposition 2.4-(iii)) is also a strong solution (in the sense, e.g., of [8]; see the same reference also for relations between these notions of solutions); i.e., it solves (4.4) in the pointwise sense almost everywhere.*

Our choice of using the concept of viscosity solution is motivated by the fact that we will deal afterwards (see Proposition 4.4 and Theorem 5.1 below) with the variational inequality (4.4) on sets of null Lebesgue measure (regular lines). Indeed, the concept of viscosity solution still provides information on what happens on those sets, as the viscosity property holds for all (and not merely for a.e.) points of the state space \mathbb{R}^2 .

For future frequent use, notice that the function

$$(4.5) \quad \widehat{V}(x, r) := \mathbb{E} \left[\int_0^\infty e^{-\rho t} f(X_t^{x,r}, r) dt \right], \quad (x, r) \in \mathbb{R}^2,$$

is finite and that, for any $r \in \mathbb{R}$, by Feynman-Kac's theorem it identifies with a classical particular solution to the inhomogeneous linear ODE

$$(4.6) \quad [(\mathcal{L}^r - \rho)q(\cdot, r)](x) + f(x, r) = 0, \quad x \in \mathbb{R}.$$

Moreover, \widehat{V} is continuously differentiable with respect to r , given the assumed regularity of f_x and f_r .

Recall the regions \mathcal{C} , \mathcal{I} and \mathcal{D} from (3.6), and that $V_r = -K_1$ on \mathcal{I} , while $V_r = K_2$ on \mathcal{D} . The next proposition provides the structure of V inside \mathcal{C} .

Proposition 4.4. *Recall (3.9) and let $r_o \in (\underline{b}_1, \bar{b}_2)$.*

- (i) *The function $V(\cdot, r_o)$ is a viscosity solution to*

$$(4.7) \quad \rho\alpha(x, r_o) - [\mathcal{L}^{r_o} \alpha(\cdot, r_o)](x) - f(x, r_o) = 0, \quad x \in (g_2(r_o), g_1(r_o)).$$

- (ii) *$V(\cdot, r_o) \in C_{loc}^{3,Lip}((g_2(r_o), g_1(r_o)); \mathbb{R})$.*

- (iii) *There exist constants $A(r_o)$ and $B(r_o)$ such that for all $x \in (g_2(r_o), g_1(r_o))$*

$$V(x, r_o) = A(r_o)\psi(x - \bar{\mu}(r_o)) + B(r_o)\varphi(x - \bar{\mu}(r_o)) + \widehat{V}(x, r_o),$$

where the functions ψ and φ are the fundamental strictly increasing and decreasing solutions to (4.1) and \widehat{V} is as in (4.5).

Proof. We prove each item separately.

Proof of (i). We show the subsolution property; that is, we prove that for any $x_o \in (g_2(r_o), g_1(r_o))$ and $\alpha \in C^2((g_2(r_o), g_1(r_o)); \mathbb{R})$ such that $V(\cdot, r_o) - \alpha$ attains a local maximum at x_o it holds that

$$\rho\alpha(x_o, r_o) - [\mathcal{L}^{r_o}\alpha(\cdot, r_o)](x_o) - f(x_o, r_o) \leq 0.$$

First of all, we claim that

$$(V_r(x_o, r_o), \alpha'(x_o), \alpha''(x_o)) \in D_x^{2,1,+}V(x_o, r_o),$$

where $D_x^{2,1,+}V(x_o, r_o)$ is the superdifferential of V at (x_o, r_o) of first order with respect to r and of second order with respect to x (see Section 5 in Chapter 4 of [34]). This means that we have to show that

$$(4.8) \quad \limsup_{(x,r) \rightarrow (x_o, r_o)} \frac{V(x, r) - V(x_o, r_o) - V_r(x_o, r_o)(r - r_o) - \alpha'(x_o)(x - x_o) - \frac{1}{2}\alpha''(x_o)(x - x_o)^2}{|r - r_o| + |x - x_o|^2} \leq 0.$$

In order to prove (4.8), notice first that $V(x_o, \cdot)$ is continuously differentiable, and therefore

$$(4.9) \quad \lim_{r \rightarrow r_o} \frac{V(x, r) - V(x, r_o) - V_r(x_o, r_o)(r - r_o)}{|r - r_o|} = 0 \quad \text{uniformly in } x \in (x_o - 1, x_o + 1).$$

Using now Lemma 5.4 in [34], we have that

$$(\alpha'(x_o), \alpha''(x_o)) \in D_x^{2,+}V(x_o, r_o),$$

where $D_x^{2,+}V(x_o, r_o)$ denotes the superdifferential of $V(\cdot, r_o)$ at x_o of second order (with respect to x); i.e.

$$(4.10) \quad \limsup_{x \rightarrow x_o} \frac{V(x, r_o) - V(x_o, r_o) - \alpha'(x_o)(x - x_o) - \frac{1}{2}\alpha''(x_o)(x - x_o)^2}{|x - x_o|^2} \leq 0.$$

Adding and subtracting $V(x, r_o)$ in the numerator of (4.8), and using (4.9) and (4.10), we obtain (4.8).

Using again Lemma 5.4 in [34], we can then construct a function $\hat{\alpha} \in C^{2,1}(\mathbb{R}^2; \mathbb{R})$ such that $V - \hat{\alpha}$ attains a local maximum in (x_o, r_o) and

$$(4.11) \quad (\hat{\alpha}_r(x_o, r_o), \hat{\alpha}_x(x_o, r_o), \hat{\alpha}_{xx}(x_o, r_o)) = (V_r(x_o, r_o), \alpha'(x_o), \alpha''(x_o)).$$

Since $(x_o, r_o) \in \mathcal{C}$ we know that $-K_1 < V_r(x_o, r_o) < K_2$, and because V is a viscosity solution to (4.4), we obtain by (4.11) that

$$\rho\alpha(x_o, r_o) - [\mathcal{L}^{r_o}\alpha(\cdot, r_o)](x_o) - f(x_o, r_o) \leq 0,$$

thus completing the proof of the subsolution property. The supersolution property can be shown in an analogous way and the proof is therefore omitted.

Proof of (ii). Let $a, b \in \mathbb{R}$ be such that $(a, r_o), (b, r_o) \in \mathcal{C}$ and $a < b$. Introduce the Dirichlet boundary value problem

$$(4.12) \quad \begin{cases} (\mathcal{L}^{r_o} - \rho)q(x) + f(x, r_o) = 0, & x \in (a, b), \\ q(a, r_o) = V(a, r_o), & q(b, r_o) = V(b, r_o). \end{cases}$$

Since $f(\cdot, r_o) \in C_{loc}^{1,Lip}((g_2(r_o), g_1(r_o)); \mathbb{R})$, by assumption, and $V(\cdot, r_o) \in C([a, b]; \mathbb{R})$, by classical results problem (4.12) admits a unique classical solution $\hat{q} \in C^0([a, b]; \mathbb{R}) \cap C_{loc}^{3,Lip}((a, b); \mathbb{R})$. The latter is also a viscosity solution, and by (i) above and standard uniqueness results for viscosity

solutions of linear equations it must coincide with $V(\cdot, r_o)$. Hence, we have that $V(\cdot, r_o) \in C_{loc}^{3,Lip}((g_2(r_o), g_1(r_o)); \mathbb{R})$ and $V(\cdot, r_o)$ is a classical solution to

$$[(\mathcal{L}^{r_o} - \rho)V(\cdot, r_o)](x) + f(x, r_o) = 0, \quad x \in (g_2(r_o), g_1(r_o)),$$

given the arbitrariness of (a, b) and the fact that \mathcal{C} is open.

Proof of (iii). Since any solution to the homogeneous linear ODE $(\mathcal{L}^{r_o} - \rho)q = 0$ is given by a linear combination of its increasing fundamental solution ψ and decreasing fundamental solution φ , we conclude by (ii) and the superposition principle. \square

With the previous results at hand, we are now able to provide the structure of the value function V .

Theorem 4.5. *Define the sets*

$$(4.13) \quad \mathcal{O}_1 := \{x \in \mathbb{R} : b_1(x) > -\infty\} \quad \mathcal{O}_2 := \{x \in \mathbb{R} : b_2(x) < \infty\}.$$

There exist functions

$$A, B \in W_{loc}^{2,\infty}((\underline{b}_1, \bar{b}_2); \mathbb{R}) = C_{loc}^{1,Lip}((\underline{b}_1, \bar{b}_2); \mathbb{R}), \quad z_{1,2} : \mathcal{O}_{1,2} \rightarrow \mathbb{R}$$

such that the value function defined in (2.6) can be written as

$$(4.14) \quad V(x, r) = \begin{cases} A(r)\psi(x - \bar{\mu}(r)) + B(r)\varphi(x - \bar{\mu}(r)) + \widehat{V}(x, r) & \text{on } \bar{\mathcal{C}}, \\ z_1(x) - K_1 r & \text{on } \mathcal{I}, \\ z_2(x) + K_2 r & \text{on } \mathcal{D}, \end{cases}$$

where $\bar{\mathcal{C}}$ denotes the closure of \mathcal{C} ,

$$(4.15) \quad z_1(x) := V(x, b_1(x)) + K_1 b_1(x), \quad x \in \mathcal{O}_1$$

and

$$(4.16) \quad z_2(x) := V(x, b_2(x)) - K_2 b_2(x), \quad x \in \mathcal{O}_2.$$

Proof. We start by deriving the structure of V within \mathcal{C} . Using Lemma 4.4, we already know the existence of functions $A, B : (\underline{b}_1, \bar{b}_2) \rightarrow \mathbb{R}$ such that

$$(4.17) \quad V(x, r) = A(r)\psi(x - \bar{\mu}(r)) + B(r)\varphi(x - \bar{\mu}(r)) + \widehat{V}(x, r), \quad (x, r) \in \mathcal{C}.$$

Take now $r_o \in (\underline{b}_1, \bar{b}_2)$. Since \mathcal{C} is open, by Proposition 3.3, we can find x and \tilde{x} , $x \neq \tilde{x}$, such that $(x, r), (\tilde{x}, r) \in \mathcal{C}$ for any given $r \in (r_o - \varepsilon, r_o + \varepsilon)$, for a suitably small $\varepsilon > 0$. Now, by evaluating (4.17) at the points (x, r) and (\tilde{x}, r) , we obtain a linear algebraic system that we can solve with respect to $A(r)$ and $B(r)$ so to obtain

$$(4.18) \quad A(r) = \frac{(V(x, r) - \widehat{V}(x, r))\varphi(\tilde{x} - \bar{\mu}(r)) - (V(\tilde{x}, r) - \widehat{V}(\tilde{x}, r))\varphi(x - \bar{\mu}(r))}{\psi(x - \bar{\mu}(r))\varphi(\tilde{x} - \bar{\mu}(r)) - \psi(\tilde{x} - \bar{\mu}(r))\varphi(x - \bar{\mu}(r))},$$

$$(4.19) \quad B(r) = \frac{(V(\tilde{x}, r) - \widehat{V}(\tilde{x}, r))\psi(x - \bar{\mu}(r)) - (V(x, r) - \widehat{V}(x, r))\psi(\tilde{x} - \bar{\mu}(r))}{\psi(x - \bar{\mu}(r))\varphi(\tilde{x} - \bar{\mu}(r)) - \psi(\tilde{x} - \bar{\mu}(r))\varphi(x - \bar{\mu}(r))}.$$

Note that the denominator does not vanish due to the strict monotonicity of ψ and φ , and to the fact that $x \neq \tilde{x}$. Since r_o was arbitrary and V_r and \widehat{V}_r are continuous with respect to r , we therefore obtain that A and B belong to $W_{loc}^{2,\infty}((\underline{b}_1, \bar{b}_2); \mathbb{R}) = C_{loc}^{1,Lip}((\underline{b}_1, \bar{b}_2); \mathbb{R})$. The structure of V in the closure of \mathcal{C} , denoted by $\bar{\mathcal{C}}$, is then obtained by Proposition 4.4 and by recalling that V is continuous on \mathbb{R}^2 and that A , B , and \widehat{V} are also continuous.

Given the definition of z_1 and z_2 , the structure of V inside the regions \mathcal{I} and \mathcal{D} follow by (3.6) and the continuity of V . \square

Remark 4.6. Notice that in the case when \underline{b}_1 (resp. \bar{b}_2) is finite we have from (4.18) and (4.19) that A and B actually belong to $W^{2,\infty}$ up to \underline{b}_1 (resp. \bar{b}_2).

5. A SECOND-ORDER SMOOTH-FIT PRINCIPLE

This section is devoted to the proof of a second order smooth-fit principle for the value function V . Precisely, we are going to show in Proposition 5.1 that the function V_{xr} is jointly continuous on \mathbb{R}^2 . The proof of such a property closely follows the arguments of Proposition 5.3 in [20]; however, we provide a complete proof here in order to have a self-consistent result and also to correct a few small mistakes/typos contained in the aforementioned reference. Notice that

$$V_{rx}(x, r) = 0 \quad \forall (x_o, r_o) \in \mathbb{R}^2 \setminus \bar{\mathcal{C}}.$$

According to that, the main result of this section establishes a smooth-fit principle for the mixed derivative.

Theorem 5.1. *It holds*

$$(5.1) \quad \lim_{\substack{(x,r) \rightarrow (x_o, r_o) \\ (x,r) \in \mathcal{C}}} V_{rx}(x, r) = 0 \quad \forall (x_o, r_o) \in \partial \mathcal{C}.$$

Proof. We prove (5.1) only at $\partial^1 \mathcal{C} := \{(x, r) \in \mathbb{R}^2 : V_r(x, r) = -K_1\}$, and we distinguish two different cases for $(x_o, r_o) \in \partial^1 \mathcal{C}$.

Case (a). Assume that $r_o = b_1(x_o)$. Define the function

$$(5.2) \quad \bar{V}(x, r) := A(r)\psi(x - \bar{\mu}(r)) + B(r)\varphi(x - \bar{\mu}(r)) + \hat{V}(x, r), \quad (x, r) \in \mathbb{R}^2,$$

where A, B are the functions of Theorem 4.5. Then, one clearly has that $\bar{V} \in C^{2,1}(\mathbb{R}^2; \mathbb{R})$. Moreover, the mixed derivative \bar{V}_{rx} exists and is continuous. Since $\bar{V} = V$ in $\bar{\mathcal{C}}$, by Lemma 3.2 we conclude that $\bar{V}_{rx} \leq 0$ in \mathcal{C} . Then by continuity of \bar{V}_{rx} , in order to show (5.1) we have only to exclude that

$$(5.3) \quad \bar{V}_{rx}(x_o, r_o) < 0,$$

Assume, by contradiction, (5.3). Due to the continuity of \bar{V} , we can then find an $\varepsilon > 0$ such that

$$(5.4) \quad \bar{V}_{rx}(x, r) \leq -\varepsilon \quad \forall (x, r) \in N_{x_o, r_o},$$

where N_{x_o, r_o} is a suitable neighborhood of the point $(x_o, r_o) \in \partial^1 \mathcal{C}$. Notice now that $\bar{V}_r(x_o, r_o) = V_r(x_o, r_o) = -K_1$, because $(x_o, r_o) \in \partial^1 \mathcal{C}$, and $\bar{V} = V$ in $N_{x_o, r_o} \cap \bar{\mathcal{C}}$. Then, using (5.3), we can apply the implicit function theorem to $\bar{V}_r(x, r) + K_1$, getting the existence of a continuous function $\bar{g}_1 : (r_o - \delta, r_o + \delta) \rightarrow \mathbb{R}$, for a suitable $\delta > 0$, such that $\bar{V}_r(r, \bar{g}_1(r)) = -K_1$ in $(r_o - \delta, r_o + \delta)$. Moreover, taking into account the regularity of A, B , we have that $\bar{g}_1 \in W^{1,\infty}(r_o - \delta, r_o + \delta)$ as

$$\bar{g}'_1(r) = -\frac{\bar{V}_{rr}(r, \bar{g}_1(r))}{\bar{V}_{rx}(r, \bar{g}_1(r))} \quad \text{a.e. in } (r_o - \delta, r_o + \delta).$$

Hence, by (5.4) and the fact that $A, B \in W^{2,\infty}_{\text{loc}}((\underline{b}_1, \bar{b}_2); \mathbb{R})$ (see also Remark 4.6 for the case $r_o = \underline{b}_1$), there exists $M_\varepsilon > 0$ such that

$$(5.5) \quad |\bar{g}_1(r) - \bar{g}_1(s)| \leq M_\varepsilon |r - s| \quad \forall r, s \in (r_o - \delta, r_o + \delta).$$

Furthermore, recalling the definition of g_1 in (3.10), \bar{g}_1 and g_1 coincide in $(r_o - \delta, r_o + \delta)$. Therefore, g_1 is continuous in $(r_o - \delta, r_o + \delta)$, and this fact immediately implies that b_1 - which is nondecreasing by Proposition 3.3 - is actually strictly increasing in a neighborhood $(x_o - \vartheta, x_o + \vartheta)$, for a suitable $\vartheta > 0$. Hence, $g_1 = b_1^{-1}$ over $b_1((x_o - \vartheta, x_o + \vartheta))$, and from (5.5) we find

$$(5.6) \quad M_\varepsilon |b_1(x) - b_1(y)| \geq |\bar{g}_1(b_1(x)) - \bar{g}_1(b_1(y))| = |x - y|, \quad \forall x, y \in (r_o - \delta, r_o + \delta).$$

Recalling again that b_1 is strictly increasing in $b_1((x_o - \vartheta, x_o + \vartheta))$, hence differentiable a.e. overthere, from (5.6), we obtain

$$(5.7) \quad \exists b_1'(x) \geq \frac{1}{M_\varepsilon} \quad \forall x \in \mathcal{Y},$$

where \mathcal{Y} is a dense set (actually of full Lebesgue measure) in $[x_o, x_o + \vartheta]$.

Consider now the function $[x_o, x_o + \vartheta] \ni x \mapsto V(x, r_o) \in \mathbb{R}_+$. Since b_1 is strictly increasing, we have that the set $K := \{(x, r_o) : x \in [x_o, x_o + \vartheta]\} \subset \mathcal{I}$, and therefore by Theorem 4.5 that

$$(5.8) \quad V(x, r_o) = -K_1 r_o + z_1(x) \quad \forall x \in [x_o, x_o + \vartheta].$$

Furthermore, defining the function

$$[x_o, x_o + \vartheta] \rightarrow \mathbb{R}, \quad x \mapsto z_1(x) = V(x, b_1(x)) + K_1 b_1(x) = \bar{V}(x, b_1(x)) + K_1 b_1(x),$$

and applying the chain rule we get that

$$(5.9) \quad \exists z_1'(x) = \bar{V}_x(x, b_1(x)) + \bar{V}_r(x, b_1(x))b_1'(x) + K_1 b_1'(x), \quad \forall x \in \mathcal{Y}.$$

Since by definition of b_1 we have that $\bar{V}_r(x, b_1(x)) = V_r(x, b_1(x)) = -K_1$, we obtain from (5.9)

$$z_1'(x) = \bar{V}_x(x, b_1(x)), \quad \forall x \in \mathcal{Y}.$$

Using this result together with (5.8) we obtain existence of $V_x(x, r_o)$ for all $x \in \mathcal{Y}$ and moreover

$$(5.10) \quad V_x(x, r_o) = z_1'(x) = \bar{V}_x(x, b_1(x)) \quad \forall x \in \mathcal{Y}.$$

Using again the chain rule in (5.10) we obtain existence of $V_{xx}(x, r_o)$ for all $x \in \mathcal{Y}$ and

$$(5.11) \quad V_{xx}(x, r_o) = z_1''(x) = \bar{V}_{xx}(x, b_1(x)) + \bar{V}_{xr}(x, b_1(x))b_1'(x) \quad \forall x \in \mathcal{Y}.$$

Combining (5.11) with (5.7) and (5.4) one obtains

$$(5.12) \quad V_{xx}(x, r_o) \leq \bar{V}_{xx}(x, b_1(x)) - \frac{\varepsilon}{M_\varepsilon} \quad \forall x \in \mathcal{Y}.$$

Using now that V is a viscosity solution to (4.4) (in particular a subsolution) by Proposition 4.2, that V_{xx} exists for all points $x \in \mathcal{Y}$, and (5.10) and (5.12), we obtain that

$$(5.13) \quad \begin{aligned} f(x, r_o) &\geq \rho V(x, r_o) - \theta(\mu + b(\bar{r} - r_o) - x)V_x(x, r_o) - \frac{1}{2}\eta^2 V_{xx}(x, r_o) \\ &\geq \rho V(x, r_o) - \theta(\mu + b(\bar{r} - r_o) - x)\bar{V}_x(x, b_1(x)) - \frac{1}{2}\eta^2 (\bar{V}_{xx}(x, b_1(x)) - \frac{\varepsilon}{M_\varepsilon}) \end{aligned}$$

for all $x \in \mathcal{Y}$. Since \mathcal{Y} is dense in $[x_o, x_o + \vartheta]$, we can take a sequence $(x^n)_{n \in \mathbb{N}} \subset \mathcal{Y}$ such that $x^n \downarrow x_o$. Evaluating (5.13) at $x = x^n$, taking limits as $n \uparrow \infty$, using the right-continuity of b_1 , the fact that $r_o = b_1(x_o)$, and the fact that $\bar{V} \in C^{1,2}(\mathbb{R}^2; \mathbb{R})$, we obtain

$$(5.14) \quad f(x_o, r_o) \geq \rho \bar{V}(x_o, r_o) - \theta(\mu + b(\bar{r} - r_o) - x_o)\bar{V}_x(x_o, r_o) - \frac{1}{2}\eta^2 (\bar{V}_{xx}(x_o, r_o) - \frac{\varepsilon}{M_\varepsilon}).$$

On the other hand, since $\rho \bar{V}(x, r) - [\mathcal{L}^r \bar{V}(\cdot, r)](x) = \rho V(x, r) - [\mathcal{L}^r V(\cdot, r)](x) = f(x, r)$ for all $(x, r) \in \mathcal{C}$, using that $\bar{V} \in C^{1,2}(\mathbb{R}^2; \mathbb{R})$ and $(x_o, r_o) \in \bar{\mathcal{C}}$, we obtain by continuity of \bar{V} that

$$(5.15) \quad f(x_o, r_o) = \rho \bar{V}(x_o, r_o) - \theta(\mu + b(\bar{r} - r_o) - x_o)\bar{V}_x(x_o, r_o) - \frac{1}{2}\eta^2 \bar{V}_{xx}(x_o, r_o).$$

Combining now (5.15) and (5.14) leads to $\frac{\varepsilon}{M_\varepsilon} \leq 0$. This gives the desired contradiction.

Case (b). Assume now that $x_o = g_1(r_o)$ and $r_o < b_1(x_o)$, with $b_1(x_o) < \infty$ due to Proposition 3.3-(i). Notice that such a case occurs if the function b_1 has a jump at x_o . Defining the segment $\Gamma := \{(r, x_o) : r \in [r_o, b_1(x_o)]\}$, it follows that $\Gamma \subset \partial^1 \mathcal{C}$. Moreover, letting again \bar{V} as in (5.2), we have that $\bar{V}_r = V_r = -K_1$ in Γ , so that

$$(5.16) \quad -K_1 - \bar{V}_r(x, r) = \bar{V}_r(x_o, r) - \bar{V}_r(x, r) = \int_x^{x_o} \bar{V}_{rx}(u, r) du, \quad \forall r \in [r_o, b_1(x_o)], \quad \forall x \leq x_o.$$

Using now that A', B' are locally Lipschitz by Theorem 4.5, we can take the derivative with respect to r in (5.16) (in the Sobolev sense) and we obtain

$$-\bar{V}_{rr}(x, r) = \int_x^{x_o} \bar{V}_{rxx}(u, r) du \quad \text{for a.e. } r \in [r_o, b_1(x_o)], \quad x \leq x_o.$$

The convexity of V and the fact that $\bar{V} = V$ in $\bar{\mathcal{C}}$, yields $\bar{V}_{rr} \geq 0$ (again in the Sobolev sense) and therefore

$$0 \geq \int_x^{x_o} \bar{V}_{rxx}(u, r) du \quad \text{for a.e. } r \in [r_o, b_1(x_o)], \quad x \leq x_o.$$

Dividing now both sides by $(x_o - x)$, letting $x \rightarrow x_o$, and invoking the mean value theorem one has

$$0 \geq \bar{V}_{rxx}(x_o, r) \quad \text{for a.e. } r \in [r_o, b_1(x_o)], \quad x \leq x_o.$$

This implies that \bar{V}_{rx} is nonincreasing with respect to $r \in [r_o, b_1(x_o)]$.

If we now assume, as in Case (a) above, that $\bar{V}_{rx}(x_o, r_o) < 0$, then we must also have $\bar{V}_{rx}(x_o, b_1(x_o)) < 0$. We are therefore left with the assumption employed in the contradiction scheme of Case (a), and we can thus apply again the rationale of that case to obtain a contradiction. This completes the proof. \square

6. A SYSTEM OF EQUATIONS FOR THE FREE BOUNDARIES

In this section we move on by proving further properties of the free boundaries and determining a system of functional equations for them.

6.1. Further Properties of the Free Boundaries. We start by studying the limiting behavior of the free boundaries and some natural bounds.

Proposition 6.1. (i) *Suppose that $\lim_{x \rightarrow \pm\infty} f_x(x, r) = \pm\infty$ for any $r \in \mathbb{R}$. Then*

$$\bar{b}_1 = \lim_{x \uparrow \infty} b_1(x) = \infty, \quad \underline{b}_2 = \lim_{x \downarrow -\infty} b_2(x) = -\infty;$$

hence $\underline{b}_1 = -\infty$ and $\bar{b}_2 = \infty$.

(ii) *Define*

$$\zeta_1(r) := \inf\{x \in \mathbb{R} : \theta b V_x(x, r) - f_r(x, r) - \rho K_1 \geq 0\}, \quad r \in \mathbb{R},$$

$$\zeta_2(r) := \sup\{x \in \mathbb{R} : \theta b V_x(x, r) - f_r(x, r) + \rho K_2 \leq 0\}, \quad r \in \mathbb{R}.$$

Then, for any $r \in \mathbb{R}$, we have

$$g_1(r) \geq \zeta_1(r) \geq \zeta_2(r) \geq g_2(r).$$

Proof. We prove the two claims separately.

Proof of (i). Here we show that $\lim_{x \uparrow \infty} b_1(x) = \infty$. The fact that $\lim_{x \downarrow -\infty} b_2(x) = -\infty$ can be proved by similar arguments. We argue by contradiction assuming $\bar{b}_1 := \lim_{x \uparrow \infty} b_1(x) < \infty$. Take $r_o > \bar{b}_1$, so that $\tau^*(x, r_o) = \infty$ for all $x \in \mathbb{R}$. Then, take $x_o > g_2(r_o)$ such that $(x_o, r_o) \in \mathcal{C}$. Clearly, every $x > x_o$ belongs to \mathcal{C} , and therefore, by the representation (4.14), we obtain that it must be $A(r_o) = 0$; indeed, otherwise, by taking limits as $x \rightarrow \infty$ and using (4.2), we would contradict Proposition 2.4. Moreover, since $\varphi'(x) \rightarrow 0$ when $x \rightarrow \infty$ (cf. (4.2)), we then have by dominated convergence

$$(6.1) \quad \lim_{x \rightarrow \infty} V_x(x, r_o) = \lim_{x \rightarrow \infty} \widehat{V}_x(x, r_o) = \mathbb{E} \left[\int_0^\infty e^{-(\rho+\theta)t} f_x(X_t^{x, r_o}, r_o) dt \right] = \infty.$$

Now, setting

$$\hat{\sigma}_x := \inf\{t \geq 0 : X_t^{x, r_o} \leq x_o\},$$

for $x > x_o$, we have by monotonicity of $f_r(\cdot, r)$

$$(6.2) \quad \begin{aligned} -K_1 < V_r(x, r_o) &= \inf_{\sigma \in \mathcal{T}} \mathbb{E} \left[\int_0^\sigma e^{-\rho t} \left(-b\theta V_x(X_t^{x, r_o}, r_o) + f_r(X_t^{x, r_o}, r_o) \right) dt + e^{-\rho \sigma} K_2 \right] \\ &\leq \mathbb{E} \left[\int_0^{\hat{\sigma}_x} e^{-\rho t} \left(-b\theta V_x(X_t^{x, r_o}, r_o) + f_r(x_o, r_o) \right) dt + K_2 \right]. \end{aligned}$$

The latter implies

$$(6.3) \quad K_1 + K_2 + \frac{|f_r(x_o, r_o)|}{\rho} \geq b\theta \mathbb{E} \left[\int_0^{\hat{\sigma}_x} e^{-\rho t} V_x(X_t^{x_o, r_o}, r_o) dt \right].$$

Notice that one has $\hat{\sigma}_x \rightarrow \infty$ P-a.s. as $x \rightarrow \infty$, since ∞ is a natural boundary for the Ornstein-Uhlenbeck process. Hence, by dominated convergence we get a contradiction from (6.1) and (6.3). Finally, the fact that $\bar{b}_2 = \infty$ follows by noticing that $b_2(x) \geq b_1(x)$ for any $x \in \mathbb{R}$ (cf. Proposition 3.3-(iii)).

Proof of (ii). Fix $r \in \mathbb{R}$. Recall that $V_r(\cdot, r) \in C(\mathbb{R}; \mathbb{R})$ by Proposition 2.4, $V_{rx}(\cdot, r) \in C(\mathbb{R}; \mathbb{R})$ by Theorem 5.1, and $V_{rxx}(\cdot, r) \in L_{\text{loc}}^\infty(\mathbb{R}; \mathbb{R})$ by direct calculations on the representation of V given in Theorem 4.5. Also, it is readily verified from (3.4) that $-K_1 \leq V_r(\cdot, r) \leq K_2$ on \mathbb{R}^2 . Then, the semiharmonic characterization of [28] (see equations (2.27)–(2.29) therein, suitably adjusted to take care of the integral term appearing in (3.4)), together with the above regularity of $V_r(\cdot, r)$, allow to obtain by standard means that $(V_r(\cdot, r), g_1(r), g_2(r))$ solves

$$(6.4) \quad \begin{cases} (\mathcal{L}^r - \rho)V_r(x, r) = \theta b V_x(x, r) - f_r(x, r) & \text{on } g_2(r) < x < g_1(r), \\ (\mathcal{L}^r - \rho)V_r(x, r) \geq \theta b V_x(x, r) - f_r(x, r) & \text{on a.e. } x < g_1(r), \\ (\mathcal{L}^r - \rho)V_r(x, r) \leq \theta b V_x(x, r) - f_r(x, r) & \text{on a.e. } x > g_2(r), \\ -K_1 \leq V_r(x, r) \leq K_2 & x \in \mathbb{R}, \\ V_r(g_1(r), r) = -K_1 \quad \text{and} \quad V_r(g_2(r), r) = K_2, \\ V_{rx}(g_1(r), r) = 0 \quad \text{and} \quad V_{rx}(g_2(r), r) = 0. \end{cases}$$

In particular, we have that $V_r(x, r) = -K_2$ for any $x < g_2(r)$, and therefore from the second equation in (6.4) we obtain

$$-\rho K_2 \geq \theta b V_x(x, r) - f_r(x, r) := \Lambda(x, r), \quad \forall x < g_2(r).$$

Since the mapping $x \mapsto \Lambda(x, r)$ is nondecreasing for any given $r \in \mathbb{R}$ by the convexity of V and the assumption on f_r (cf. Assumption 2.1), we obtain that

$$g_2(r) \leq \zeta_2(r) = \sup\{x \in \mathbb{R} : \theta b V_x(x, r) - f_r(x, r) + \rho K_2 \leq 0\}.$$

An analogous reasoning also shows that

$$g_1(r) \geq \zeta_1(r) = \inf\{x \in \mathbb{R} : \theta b V_x(x, r) - f_r(x, r) - \rho K_1 \geq 0\}.$$

Moreover, for any $r \in \mathbb{R}$,

$$\begin{aligned} \zeta_1(r) &= \inf\{x \in \mathbb{R} : \theta b V_x(x, r) - f_r(x, r) - \rho(K_1 + K_2) + \rho K_2 \geq 0\} \\ &\geq \inf\{x \in \mathbb{R} : \theta b V_x(x, r) - f_r(x, r) + \rho K_2 \geq 0\} \\ &= \sup\{x \in \mathbb{R} : \theta b V_x(x, r) - f_r(x, r) + \rho K_2 \leq 0\} = \zeta_2(r). \end{aligned}$$

□

The next result readily follows from Proposition 6.1-(i).

Corollary 6.2. *Suppose that $\lim_{x \rightarrow \pm\infty} f_x(x, r) = \pm\infty$ for any $r \in \mathbb{R}$. Then $g_1(r)$ and $g_2(r)$ as in (3.10) are finite for any $r \in \mathbb{R}$.*

Proposition 6.3. *Let f be strictly convex with respect to x for all $r \in \mathbb{R}$ and such that $f_{rx} = 0$. Then the boundaries b_1 and b_2 are strictly increasing.*

Proof. We prove the claim only for b_1 , since analogous arguments apply to prove it for b_2 . By Theorem 4.5, we can differentiate the first line of (4.14) with respect to r and get by Proposition 4.4(i) that V_r solves inside \mathcal{C} the equation

$$(6.5) \quad \frac{1}{2}\eta^2 V_{rxx}(x, r) + \theta(\mu + b(\bar{r} - r) - x)V_{rx}(x, r) - \rho V_r(x, r) - \theta b V_x(x, r) + \beta(r) = 0,$$

where $\beta(r) := f_r(\cdot, r)$, the latter depending only on r by assumption. By continuity, (6.5) also holds on $\partial^1 \mathcal{C} = \{V_r = -K_1\}$, and we therefore obtain

$$(6.6) \quad \rho K_1 + \beta(r) = \theta b V_x(x, r), \quad \forall (x, r) \in \partial^1 \mathcal{C}.$$

Suppose now, by contradiction, that the boundary b_1 is constant on $(x_o, x_o + \varepsilon)$, for some $x_o \in \mathbb{R}$ and some $\varepsilon > 0$. Setting $r_o := b_1(x_o)$, we then obtain from (6.6) that

$$\rho K_1 + \beta(r_o) = \theta b V_x(x, r_o), \quad \forall x \in (x_o, x_o + \varepsilon).$$

This means that $V_x(\cdot, r)$ is constant on $(x_o, x_o + \varepsilon)$, and therefore that $V(r_o, \cdot)$ is an affine function of x therein. However, by continuity, we know that V solves (4.7) also on $(x_o, x_o + \varepsilon)$, and therefore we have

$$(6.7) \quad \theta(\mu + b(\bar{r} - r_o) - x) \left[\frac{\rho K_1}{\theta b} + \frac{\beta(r_o)}{\theta b} \right] - \rho V(x, r_o) + f(x, r_o) = 0, \quad \forall x \in (x_o, x_o + \varepsilon).$$

Since now $V(\cdot, r_o)$ is affine, whereas f is strictly convex, we reach a contradiction. \square

Notice that the conditions on f of Proposition 6.3 (and of the following corollary) are satisfied, e.g., by the relevant quadratic cost function of Remark 2.2.

Corollary 6.4. *Let f be strictly convex with respect to x for all $r \in \mathbb{R}$ and such that $f_{rx} = 0$. Then the boundaries g_1 and g_2 defined through (3.10) are continuous.*

6.2. A System of Equations for the Free Boundaries and the Coefficients A and B .

Before proving the main result of this section (i.e. Theorem 6.5 below), we need to introduce some of the characteristics of the process $X^{x,r}$. Recall that $\bar{\mu}(r) := \mu + b(\bar{r} - r)$, $r \in \mathbb{R}$. Then, for an arbitrary $x_o \in \mathbb{R}$, and for any given and fixed $r \in \mathbb{R}$, the scale function density of the process $X^{x,r}$ is defined as

$$(6.8) \quad S'(x; r) := \exp \left\{ - \int_{x_o}^x \frac{2\theta(\bar{\mu}(r) - y)}{\eta^2} dy \right\}, \quad x \in \mathbb{R},$$

while the density of the speed measure is

$$(6.9) \quad m'(x; r) := \frac{2}{\eta^2 S'(x; r)}, \quad x \in \mathbb{R}.$$

For later use we also denote by p the transition density of $X^{x,r}$ with respect to the speed measure; then, letting $A \mapsto P_t(x, A; r)$, $A \in \mathcal{B}(\mathbb{R})$, $t > 0$ and $r \in \mathbb{R}$, be the probability of starting at time 0 from level $x \in \mathbb{R}$ and reaching the set $A \in \mathcal{B}(\mathbb{R})$ in t units of time, we have (cf., e.g., p. 13 in [6])

$$P_t(x, A; r) = \int_A p(t, x, y; r) m'(y; r) dy.$$

The density p can be taken positive, jointly continuous in all variables and symmetric (i.e. $p(t, x, y; r) = p(t, y, x; r)$). Furthermore, our analysis will involve the Green function G that, for given and fixed $r \in \mathbb{R}$, is defined as (see again [6], p. 19)

$$(6.10) \quad G(x, y; r) := \int_0^\infty e^{-\rho t} p(t, x, y; r) dt = \begin{cases} w^{-1} \psi(x - \bar{\mu}(r)) \varphi(y - \bar{\mu}(r)) & \text{for } x \leq y, \\ w^{-1} \psi(y - \bar{\mu}(r)) \varphi(x - \bar{\mu}(r)) & \text{for } x \geq y, \end{cases}$$

where w denotes the Wronskian between ψ and φ (normalized by S').

Theorem 6.5. *Define $H(x, r) := -\theta bV_x(x, r) + f_r(x, r)$, $(x, r) \in \mathbb{R}^2$. The free boundaries g_1 and g_2 as in (3.10), and the coefficients $A, B \in W_{loc}^{2;\infty}(\mathbb{R}; \mathbb{R})$ solve the following system of functional and ordinary differential equations*

$$(6.11) \quad 0 = \int_{g_2(r)}^{g_1(r)} \psi(y - \bar{\mu}(r))H(y, r)m'(y; r) \, dy + K_1 \frac{\psi'(g_1(r) - \bar{\mu}(r))}{S'(g_1(r); r)} + K_2 \frac{\psi'(g_2(r) - \bar{\mu}(r))}{S'(g_2(r); r)},$$

$$(6.12) \quad 0 = \int_{g_2(r)}^{g_1(r)} \psi(y - \bar{\mu}(r))H(y, r)m'(y; r) \, dy + K_1 \frac{\varphi'(g_1(r) - \bar{\mu}(r))}{S'(g_1(r); r)} + K_2 \frac{\varphi'(g_2(r) - \bar{\mu}(r))}{S'(g_2(r); r)},$$

and

$$(6.13) \quad \begin{aligned} 0 &= A'(r)\psi'(g_1(r) - \bar{\mu}(r)) + bA(r)\psi''(g_1(r) - \bar{\mu}(r)) \\ &\quad + B'(r)\varphi'(g_1(r) - \bar{\mu}(r)) + B(r)\varphi''(g_1(r) - \bar{\mu}(r)) + \widehat{V}_{rx}(g_1(r), r), \end{aligned}$$

$$(6.14) \quad \begin{aligned} 0 &= A'(r)\psi'(g_2(r) - \bar{\mu}(r)) + bA(r)\psi''(g_2(r) - \bar{\mu}(r)) \\ &\quad + B'(r)\varphi'(g_2(r) - \bar{\mu}(r)) + B(r)\varphi''(g_2(r) - \bar{\mu}(r)) + \widehat{V}_{xr}(g_2(r), r). \end{aligned}$$

Proof. Fix $(x, r) \in \mathbb{R}^2$, and, for $n \in \mathbb{N}$, set $\tau_n := \inf\{t \geq 0 : |X_t^{x,r}| \geq n\}$, $n \in \mathbb{N}$. Propositions 2.4 and 5.1 guarantee that V_r and V_{rx} are continuous functions on \mathbb{R}^2 . Moreover, direct calculations on (4.14) yield that $V_{rxx} \in L_{loc}^\infty(\mathbb{R}^2)$, upon recalling that $A, B \in W_{loc}^{2,\infty}(\mathbb{R}; \mathbb{R})$. Such a regularity of V_r allows us to apply the local time-space calculus of [27] to the process $(e^{-\rho s}V_r(X_s^{x,r}, r))_{s \geq 0}$ on the time interval $[0, \tau_n]$, take expectations (so that the term involving the stochastic integral vanishes) and obtain

$$(6.15) \quad \begin{aligned} \mathbb{E} \left[e^{-\rho \tau_n} V_r(X_{\tau_n}^{x,r}, r) \right] &= V_r(x, r) + \mathbb{E} \left[\int_0^{\tau_n} e^{-\rho s} [(\mathcal{L}^r - \rho)V_r(\cdot, r)](X_s^{x,r}) \mathbf{1}_{\{X_s^{x,r} \neq g_1(r)\}} \mathbf{1}_{\{X_s^{x,r} \neq g_2(r)\}} \, ds \right] \\ &= V_r(x, r) + \mathbb{E} \left[\int_0^{\tau_n} e^{-\rho s} (\theta bV_x(X_s^{x,r}, r) - f_r(X_s^{x,r}, r)) \mathbf{1}_{\{g_2(r) < X_s^{x,r} < g_1(r)\}} \, ds \right] \\ &\quad + \mathbb{E} \left[\int_0^{\tau_n} \rho K_1 e^{-\rho s} \mathbf{1}_{\{X_s^{x,r} > g_1(r)\}} \, ds - \int_0^{\tau_n} \rho K_2 e^{-\rho s} \mathbf{1}_{\{X_s^{x,r} < g_2(r)\}} \, ds \right]. \end{aligned}$$

Notice now that $\mathbb{P}(X_s^{x,r} = g_1(r)) = \mathbb{P}(X_s^{x,r} = g_2(r)) = 0$, $s > 0$, for any $(x, r) \in \mathbb{R}^2$ so that we can write from (6.15) that

$$(6.16) \quad \begin{aligned} V_r(x, r) &= \mathbb{E} \left[e^{-\rho \tau_n} V_r(X_{\tau_n}^{x,r}, r) \right] - \mathbb{E} \left[\int_0^{\tau_n} e^{-\rho s} (\theta bV_x(X_s^{x,r}, r) - f_r(X_s^{x,r}, r)) \mathbf{1}_{\{(X_s^{x,r}, r) \in \mathcal{C}\}} \, ds \right] \\ &\quad - \mathbb{E} \left[\int_0^{\tau_n} \rho K_1 e^{-\rho s} \mathbf{1}_{\{(X_s^{x,r}, r) \in \mathcal{I}\}} \, ds + \int_0^{\tau_n} \rho K_2 e^{-\rho s} \mathbf{1}_{\{(X_s^{x,r}, r) \in \mathcal{D}\}} \, ds \right]. \end{aligned}$$

We now aim at taking limits as $n \uparrow \infty$ in the right-hand side of the latter. To this end notice that $\tau_n \uparrow \infty$ a.s. when $n \uparrow \infty$, and therefore $\lim_{n \uparrow \infty} \mathbb{E}[e^{-\rho \tau_n} V_r(X_{\tau_n}^{x,r}, r)] = 0$ since $V_r \in [-K_1, K_2]$. Also, recalling (2.4), Proposition 2.4-(ii), and using standard estimates based on Burkholder-Davis-Gundy's inequality, one has

$$\mathbb{E} \left[\int_0^\infty e^{-\rho s} (\theta b|V_x(X_s^{x,r}, r)| + |f_r(X_s^{x,r}, r)|) \, ds \right] < +\infty.$$

Hence, thanks to the previous observations we can take limits as $n \uparrow \infty$, invoke the dominated convergence theorem, and obtain from (6.16) that

$$\begin{aligned}
V_r(x, r) &= \mathbb{E} \left[\int_0^\infty e^{-\rho s} H(X_s, r) \mathbf{1}_{\{(X_s^{x,r}, r) \in \mathcal{C}\}} ds \right] \\
&\quad - \mathbb{E} \left[\int_0^\infty \rho K_1 e^{-\rho s} \mathbf{1}_{\{(X_s^{x,r}, r) \in \mathcal{I}\}} ds \right] + \mathbb{E} \left[\int_0^\infty \rho K_2 e^{-\rho s} \mathbf{1}_{\{(X_s^{x,r}, r) \in \mathcal{D}\}} ds \right] \\
(6.17) \quad &=: I_1(x, r) - I_2(x, r) + I_3(x, r).
\end{aligned}$$

With the help of the Green function (6.10) and Fubini's theorem, we can now rewrite each I_i , $i = 1, 2, 3$, so to find

$$\begin{aligned}
I_1(x; r) &= \mathbb{E} \left[\int_0^\infty e^{-\rho s} H(X_s, r) \mathbf{1}_{\{g_2(r) < X_s^{x,r} < g_1(r)\}} ds \right] \\
&= \int_0^\infty e^{-\rho s} \left(\int_{-\infty}^\infty H(y, r) \mathbf{1}_{\{g_2(r) < y < g_1(r)\}} p(s, x, y; r) m'(y; r) dy \right) ds \\
(6.18) \quad &= \int_{-\infty}^\infty G(x, y; r) H(y, r) \mathbf{1}_{\{g_2(r) < y < g_1(r)\}} m'(y; r) dy \\
&= \frac{1}{w} \varphi(x - \bar{\mu}(r)) \int_{-\infty}^x \psi(y - \bar{\mu}(r)) H(y, r) \mathbf{1}_{\{g_2(r) < y < g_1(r)\}} m'(y; r) dy \\
&\quad + \frac{1}{w} \psi(x - \bar{\mu}(r)) \int_x^\infty \varphi(y - \bar{\mu}(r)) H(y, r) \mathbf{1}_{\{g_2(r) < y < g_1(r)\}} m'(y; r) dy,
\end{aligned}$$

$$\begin{aligned}
I_2(x; r) &= \mathbb{E} \left[\int_0^\infty \rho K_1 e^{-\rho s} \mathbf{1}_{\{(X_s, r) \in \mathcal{I}\}} ds \right] \\
&= \rho K_1 \int_0^\infty e^{-\rho s} \left(\int_{-\infty}^\infty p(s, x, y; r) \mathbf{1}_{\{y \geq g_1(r)\}} m'(y; r) dy \right) ds \\
(6.19) \quad &= \rho K_1 \int_{-\infty}^\infty G(x, y; r) \mathbf{1}_{\{y \geq g_1(r)\}} m'(y; r) dy \\
&= \frac{1}{w} \rho K_1 \varphi(x - \bar{\mu}(r)) \int_{-\infty}^x \psi(y - \bar{\mu}(r)) \mathbf{1}_{\{y \geq g_1(r)\}} m'(y; r) dy \\
&\quad + \frac{1}{w} \rho K_1 \psi(x - \bar{\mu}(r)) \int_x^\infty \varphi(y - \bar{\mu}(r)) \mathbf{1}_{\{y \geq g_1(r)\}} m'(y; r) dy,
\end{aligned}$$

and, similarly,

$$\begin{aligned}
I_3(x; r) &= \mathbb{E} \left[\int_0^\infty \rho K_2 e^{-\rho s} \mathbf{1}_{\{(X_s, r) \in \mathcal{D}\}} ds \right] \\
(6.20) \quad &= \frac{1}{w} \rho K_2 \varphi(x - \bar{\mu}(r)) \int_{-\infty}^x \psi(y - \bar{\mu}(r)) \mathbf{1}_{\{y \leq g_2(r)\}} m'(y; r) dy \\
&\quad + \frac{1}{w} \rho K_2 \psi(x - \bar{\mu}(r)) \int_x^\infty \varphi(y - \bar{\mu}(r)) \mathbf{1}_{\{y \leq g_2(r)\}} m'(y; r) dy.
\end{aligned}$$

Now, by plugging (6.18), (6.19), and (6.20) into (6.17), and then by imposing that $V_r(g_1(r), r) = -K_1$ and $V_r(g_2(r), r) = K_2$, we obtain the two equations

$$-K_1 = \frac{1}{w} \varphi(g_1(r) - \bar{\mu}(r)) \int_{g_2(r)}^{g_1(r)} \psi(y - \bar{\mu}(r)) H(y, r) m'(y) dy - I_2(g_1(r); r) + I_3(g_1(r); r)$$

and

$$K_2 = \frac{1}{w} \psi(g_2(r) - \bar{\mu}(r)) \int_{g_2(r)}^{g_1(r)} \varphi(y - \bar{\mu}(r)) H(y, r) m'(y) dy - I_2(g_2(r); r) + I_3(g_2(r); r).$$

Finally, rearranging terms and using the fact that (cf. Chapter II in [6])

$$\frac{\psi'(\cdot - \bar{\mu}(r))}{S'(\cdot; r)} = \rho \int_{-\infty}^{\cdot} \psi(y - \bar{\mu}(r)) m'(y; r) dy$$

and

$$\frac{\varphi'(\cdot - \bar{\mu}(r))}{S'(\cdot; r)} = -\rho \int_{\cdot}^{\infty} \varphi(y - \bar{\mu}(r)) m'(y; r) dy,$$

yield (6.11) and (6.12).

Notice that (6.11) and (6.12) involve the coefficients $A(r)$ and $B(r)$ through the function H since $V_x(x, r) = A(r)\psi'(x - \bar{\mu}(r)) + B(r)\varphi'(x - \bar{\mu}(r)) + \widehat{V}_x(x, r)$, for any $g_2(r) < x < g_1(r)$, by (4.14). In order to obtain equations for A and B , we use (4.14) together with the second-order smooth-fit principle $V_{rx}(g_1(r), r) = V_{rx}(g_2(r), r) = 0$, and we find that, given the boundary functions g_1 and g_2 , A and B solve the system of ODEs (6.13) and (6.14). \square

Notice that equations (6.11) and (6.12) are consistent with those obtained in Proposition 5.5 of [20]; in particular, one obtains, as a special case, those in Proposition 5.5 of [20] by taking $b = 0$ in ours (6.11) and (6.12). However, the nature of our equations is different. While the equations in [20] are algebraic, ours (6.11) and (6.12) are functional. Indeed, from (6.13) and (6.14) we see that A and B depend on the whole boundaries g_1 and g_2 (and not only on the points $g_1(r)$ and $g_2(r)$, for a fixed $r \in \mathbb{R}$), so that, once those coefficients are substituted into the expression for V_x , they give rise to a functional nature of (6.11) and (6.12).

It is also worth noticing that (6.11) and (6.12) are obtained via simple and handy probabilistic means, in contrast to the lengthy analytic ones followed in [20]. We believe that this different approach has also a methodological value. Indeed, if we would have tried to derive equations for the free boundaries imposing the continuity of V_r and V_{rx} at the points $(g_1(r), r)$ and $(g_2(r), r)$, $r \in \mathbb{R}$, we would have ended up with a system of complex and unhandy (algebraic and differential) equations from which it would have been difficult to observe their consistency with Proposition 5.5 of [20].

In Theorem 6.5 we provide equations for the free boundaries g_1 and g_2 and for the coefficients A , and B , but we do not prove uniqueness of the solution to (6.11), (6.12), (6.13) and (6.14). We admit that we do not know how to establish such a uniqueness claim. Also, even if we would have uniqueness (given g_1 and g_2) of the solution to the system of ODEs (6.13) and (6.14), the complexity of functional equations (6.11) and (6.12) is such that a proof of the uniqueness of their solution seems far to being trivial. A study of this point thus deserves a separate careful analysis that we leave for future research.

7. ON THE OPTIMAL CONTROL

Existence of an optimal control for problem (2.6) can be shown relying on (a suitable version of) Komlós' theorem, by following arguments similar to those employed in the proof of Proposition 3.4 in [20] (see also Theorem 3.3 in [24]). In fact, one also has uniqueness of the optimal control if the running cost function is strictly convex. In this section we investigate the structure of the optimal control by relating it to the solution to a Skorokhod reflection problem at $\partial\mathcal{C}$. We then discuss conditions under which such a reflection problem admits a solution.

Problem 7.1. *Let $(x, r) \in \bar{\mathcal{C}}$ be given and fixed. Find a process $\widehat{\xi} \in \mathcal{A}$ such that $\widehat{\xi}_{0-} = 0$ a.s. and, letting $(\widehat{X}_t^{x,r}, \widehat{R}_t^r)_{t \geq 0} := (X_t^{x,r;\widehat{\xi}}, R_t^{r;\widehat{\xi}})_{t \geq 0}$ and denoting by $(\widehat{\xi}_t^+, \widehat{\xi}_t^-)_{t \geq 0}$ its minimal decomposition,*

we have

$$(7.1) \quad (\widehat{X}_t^{x,r}, \widehat{R}_t^r) \in \bar{\mathcal{C}} \quad \text{for all } t \geq 0, \quad \mathbb{P} - \text{a.s.}$$

and

$$(7.2) \quad \widehat{\xi}_t^+ = \int_{(0,t]} \mathbb{1}_{\{\widehat{X}_s^{x,r}, \widehat{R}_s^r \in \mathcal{I}\}} d\widehat{\xi}_s^+, \quad \widehat{\xi}_t^- = \int_{(0,t]} \mathbb{1}_{\{\widehat{X}_s^{x,r}, \widehat{R}_s^r \in \mathcal{D}\}} d\widehat{\xi}_s^-.$$

The next theorem shows that a solution to Problem 7.1 (if it does exist) provides an optimal control.

Theorem 7.2. *Let $(x, r) \in \mathbb{R}^2$ and suppose that a solution $\widehat{\xi} = \widehat{\xi}^+ - \widehat{\xi}^-$ to Problem 7.1 exists. Define the process $\xi^* := \xi_t^{*,+} - \xi_t^{*,-}$, $t \geq 0$, where*

$$(7.3) \quad \xi_t^{*,+} := \widehat{\xi}_t^+ + (x - g_1(r))^+, \quad \xi_t^{*,-} := \widehat{\xi}_t^- + (g_2(r) - x)^+, \quad \text{for all } t \geq 0,$$

and with $\xi_{0-}^* = 0$ a.s. Then ξ^* is optimal for problem (2.6). Moreover, if f is strictly convex, it is the unique optimal control.

Proof. Being the process ξ^* clearly admissible, it is enough to show that

$$(7.4) \quad V(x, r) \geq \mathbb{E} \left[\int_0^\infty e^{-\rho t} f(X_t^{x,r,\xi^*}, R_t^{r,\xi^*}) dt + \int_0^\infty e^{-\rho t} K_1 d\xi_t^{*,+} + \int_0^\infty e^{-\rho t} K_2 d\xi_t^{*,-} \right].$$

To accomplish that, let $(K_n)_{n \in \mathbb{N}}$ be an increasing sequence of compact subsets such that $\bigcup_{n \in \mathbb{N}} K_n = \mathbb{R}^2$, and for any given $n \geq 1$, define the bounded stopping time $\tau_n := \inf\{t \geq 0 : (X_t^{x,r,\xi^*}, R_t^{r,\xi^*}) \notin K_n\} \wedge n$. We already know by Theorem 4.5 that $V \in C^{2,1}(\bar{\mathcal{C}}; \mathbb{R})$; moreover, by construction, the process ξ^* is that $(X_t^{x,r,\xi^*}, R_t^{r,\xi^*}) \in \bar{\mathcal{C}}$ for all $t \geq 0$ a.s. Hence, we can apply Itô's formula on the (stochastic) time interval $[0, \tau_n]$ to the process $(e^{-\rho t} V(X_t^{x,r,\xi^*}, R_t^{r,\xi^*}))_{t \geq 0}$, take expectations, and obtain (upon noticing that the expectation of the resulting stochastic integral vanishes due to the continuity of V_x)

$$(7.5) \quad \begin{aligned} V(x, r) &= \mathbb{E} \left[e^{-\rho \tau_n} V(X_{\tau_n}^{x,r,\xi^*}, R_{\tau_n}^{r,\xi^*}) \right] - \mathbb{E} \left[\int_0^{\tau_n} e^{-\rho t} [(\mathcal{L}^r - \rho)V(\cdot, R_t^{r,\xi^*})](X_t^{x,r,\xi^*}) dt \right] \\ &\quad - \mathbb{E} \left[\int_0^{\tau_n} e^{-\rho t} V_r(X_t^{x,r,\xi^*}, R_t^{r,\xi^*}) d\xi_t^{*,c} \right] \\ &\quad - \mathbb{E} \left[\sum_{0 \leq t \leq \tau_n} e^{-\rho t} \left(V(X_t^{x,r,\xi^*}, R_t^{r,\xi^*}) - V(X_t^{x,r,\xi^*}, R_{t-}^{r,\xi^*}) \right) \right]. \end{aligned}$$

Here $\xi^{*,c}$ denotes the continuous part of ξ^* . Notice now that

$$[(\mathcal{L}^r - \rho)V(\cdot, R_t^{r,\xi^*})](X_t^{x,r,\xi^*}) = -f(X_t^{x,r,\xi^*}, R_t^{r,\xi^*})$$

due to Proposition 4.4-(i) and the fact that $V \in C^{2,1}(\bar{\mathcal{C}}; \mathbb{R})$ by Theorem 4.5. Therefore,

$$(7.6) \quad \mathbb{E} \left[\int_0^{\tau_n} e^{-\rho t} [(\mathcal{L}^r - \rho)V(\cdot, R_t^{r,\xi^*})](X_t^{x,r,\xi^*}) dt \right] = -\mathbb{E} \left[\int_0^{\tau_n} e^{-\rho t} f(X_t^{x,r,\xi^*}, R_t^{r,\xi^*}) dt \right].$$

Letting $\Delta \xi_t^{*,\pm} := \xi_t^{*,\pm} - \xi_{t-}^{*,\pm}$, $t \geq 0$, notice now that

$$(7.7) \quad \begin{aligned} V(X_t^{x,r,\xi^*}, R_t^{r,\xi^*}) - V(X_t^{x,r,\xi^*}, R_{t-}^{r,\xi^*}) &= \mathbb{1}_{\{\Delta \xi_t^{*,+} > 0\}} \int_0^{\Delta \xi_t^{*,+}} V_r(X_t^{x,r,\xi^*}, R_{t-}^{r,\xi^*} + u) du \\ &\quad - \mathbb{1}_{\{\Delta \xi_t^{*,-} > 0\}} \int_0^{\Delta \xi_t^{*,-}} V_r(X_t^{x,r,\xi^*}, R_{t-}^{r,\xi^*} - u) du. \end{aligned}$$

Since the support of the (random) measure induced on \mathbb{R}_+ by $\xi^{*,+}$ is \mathcal{I} , and that of (random) the measure induced on \mathbb{R}_+ by $\xi^{*,-}$ is \mathcal{D} , and $V_r = -K_1$ on \mathcal{I} and $V_r = K_2$ on \mathcal{D} , we therefore conclude by using (7.7) that

$$(7.8) \quad \begin{aligned} & \mathbb{E} \left[\int_0^{\tau_n} e^{-\rho t} V_r(X_t^{x,r,\xi^*}, R_t^{r,\xi^*}) d\xi_t^{*,c} + \sum_{0 \leq t \leq \tau_n} e^{-\rho t} \left(V(X_t^{x,r,\xi^*}, R_t^{r,\xi^*}) - V(X_t^{x,r,\xi^*}, R_t^{r,\xi^*}) \right) \right] \\ &= -\mathbb{E} \left[\int_0^{\tau_n} e^{-\rho t} \left(K_1 d\xi_t^{*,+} + K_2 d\xi_t^{*,-} \right) \right]. \end{aligned}$$

Then using (7.6) and (7.8) in (7.5), we obtain

$$(7.9) \quad V(x, r) \geq \mathbb{E} \left[\int_0^{\tau_n} e^{-\rho t} f(X_t^{x,r,\xi^*}, R_t^{r,\xi^*}) dt + \int_0^{\tau_n} e^{-\rho t} K_1 d\xi_t^{*,+} + \int_0^{\tau_n} e^{-\rho t} K_2 d\xi_t^{*,-} \right],$$

where the nonnegativity of V has also been employed. Taking now limits as $n \uparrow \infty$ in the right-hand side of the latter, and invoking the monotone convergence theorem (due to nonnegativity of f and of K_1 and K_2) we obtain (7.4).

Finally, uniqueness of the optimal control can be shown thanks to the strict convexity of f by arguing as in the proof of Proposition 3.4 in the Appendix A of [20]. \square

A key question is now: does a solution to Problem 7.1 exists?

Existence of a solution to Problem 7.1 is per se an interesting and not trivial question. It is well known that in multi-dimensional settings the possibility of constructing a reflected diffusion at the boundary of a given domain strongly depends on the smoothness of the reflection boundary itself; sufficient conditions can be found in the early papers [19] and [25]. Unfortunately, our information on the boundary of the inaction region $\partial\mathcal{C}$ do not suffice to apply the results of the aforementioned works. In particular, even in the case in which g_1 and g_2 are continuous (equivalently, b_1 and b_2 are strictly increasing; see Proposition 6.3 and Corollary 6.4), we are not able to exclude horizontal segments of the free boundaries g_1 and g_2 (cf. Case (1) and Case (2) in [19]). An alternative and more constructive way of obtaining a solution to Problem 7.1 might be the one followed in [12], where the needed reflected diffusion is constructed by means of a Girsanov's transformation of probability measures and a pathwise uniqueness result (see Section 5 in [12]). However, such an approach would work if we could show that the free boundaries b_1 and b_2 are globally Lipschitz-continuous, a property that is assumed in [12]. In fact, in such a case, following the arguments of Section 5 in [12] or Section 4.3 in [20], one could construct pathwise the solution to Problem 7.1 when $b = 0$ in the dynamics for the inflation rate X (this corresponds to having decoupled dynamics for X and R), and then introduce back the linear term $-\theta b R$ via a Girsanov's transformation. The Lipschitz property of the free boundaries would indeed guarantee that the exponential process needed for the change of measure is an exponential martingale, and that there exists a weak solution to Problem 7.1. A (strong) solution could then be obtained via a pathwise uniqueness claim whose proof uses, once more, the global Lipschitz-continuity of the free boundaries (see Remark 5.2 in [12]).

It is worth noticing that in certain obstacle problems in \mathbb{R}^d , $d \geq 1$, the Lipschitz property is the preliminary regularity needed to upgrade - via a bootstrapping procedure and suitable technical conditions - the regularity of the free boundary to $C^{1,\alpha}$ -regularity, for some $\alpha \in (0, 1)$, and eventually to C^∞ -regularity (see [9] and [29], among others, for details; see also [17] for Lipschitz-regularity results related optimal stopping boundaries). In multi-dimensional singular stochastic control problems, Lipschitz regularity of the free boundary has been obtained, e.g., in a series of early papers by Soner and Shreve ([30], [31], and [32]), via fine PDE techniques, and in the more recent [7], via more probabilistic arguments. In all those works the control process is monotone and the state process is a linearly controlled Brownian motion. Obtaining global

Lipschitz-continuity of the free boundaries for the two-dimensional degenerate bounded-variation control problem (2.6) is a non trivial task that we leave for future research.

APPENDIX A. PROOF OF THEOREM 3.1

We want to suitably employ the results of Theorems 3.11 and 3.13 of [12]. However, in contrast to the fully diffusive setting of [12], in our model the key interest rate is purely controlled so that the two-dimensional process (X, R) is degenerate. The idea of the proof is then to perturb the dynamics of the key interest rate R (cf. (2.2)) by adding a Brownian motion $B := (B_t)_{t \geq 0}$ with volatility coefficient $\delta > 0$ so to be able to apply Theorems 3.11 and 3.13 of [12]. The claims of Theorem 3.1 (in particular (3.4)) will then follow by an opportune limit procedure as $\delta \downarrow 0$.

Let W be as in Section 2, and suppose that $(\Omega, \mathcal{F}, \mathbb{F}, \mathbb{P})$ is rich enough to accommodate also a second Brownian motion $B := (B_t)_{t \geq 0}$, independent of W . Then, given $(x, r) \in \mathbb{R}^2$, $\delta > 0$, and $\xi \in \mathcal{A}$ (cf. (2.1)), we denote by $(X_t^{\xi; \delta}, R_t^{\xi; \delta}) := (X_t^{\xi; \delta}, R_t^{\xi; \delta})_{t \geq 0}$ the unique strong solution to

$$(A.1) \quad \begin{pmatrix} dR_t \\ dX_t \end{pmatrix} = \left[\begin{pmatrix} 0 \\ \theta\mu + \theta b\bar{r} \end{pmatrix} + \begin{pmatrix} 0 & 0 \\ -\theta b & -\theta \end{pmatrix} \begin{pmatrix} R_t \\ X_t \end{pmatrix} \right] dt + \begin{pmatrix} \delta & 0 \\ 0 & \eta \end{pmatrix} \begin{pmatrix} dB_t \\ dW_t \end{pmatrix} + \begin{pmatrix} 1 \\ 0 \end{pmatrix} d\xi_t.$$

with initial data $X_{0-} = x$ and $R_{0-} = r$. In order to simplify the notation, in the the first of this proof we will not stress the dependency on (x, r) of the subsequent involved processes. In the case $\xi \equiv 0$, we simply write $(X^\delta, R^\delta) := (X_t^{0; \delta}, R_t^{0; \delta})_{t \geq 0}$.

Notice that (A.1) can be easily obtained from equation (2.2) of [12] by taking $c = 1$, by suitably defining the matrices b and σ therein, and by setting $x_1 = r$ and $x_2 = x$. Then we define the perturbed optimal control problem

$$(A.2) \quad V^\delta(x, r) := \inf_{\xi \in \mathcal{A}} \mathbb{E} \left[\int_0^\infty e^{-\rho t} f(X_t^{\xi; \delta}, R_t^{\xi; \delta}) dt + K_1 \int_0^\infty e^{-\rho t} d\xi_t^+ + K_2 \int_0^\infty e^{-\rho t} d\xi_t^- \right].$$

By estimates as those leading to Proposition 2.4 it can be shown that there exist constants $\tilde{C}_0, \tilde{C}_1, \tilde{C}_2$ (which are independent of δ , for all δ sufficiently small) such that for any $\lambda \in (0, 1)$, any $z := (x, r) \in \mathbb{R}^2$ and $z' := (x', r') \in \mathbb{R}^2$, we have

- (i) $0 \leq V^\delta(z) \leq \tilde{C}_0(1 + |z|)^p$,
- (ii) $|V^\delta(z) - V^\delta(z')| \leq \tilde{C}_1(1 + |z| + |z'|)^{p-1}|z - z'|$,
- (iii) $0 \leq \lambda V^\delta(z) + (1 - \lambda)V^\delta(z') - V^\delta(\lambda z + (1 - \lambda)z') \leq \tilde{C}_2\lambda(1 - \lambda)(1 + |z| + |z'|)^{(p-2)^+}|z - z'|^2$,

where $p > 1$ is the same of Assumption 2.1. Hence V^δ is convex, $V^\delta \in W_{\text{loc}}^{2, \infty}(\mathbb{R}^2; \mathbb{R})$. In particular, there exists a version of $V^\delta \in C_{\text{loc}}^{1, \text{Lip}}(\mathbb{R}^2; \mathbb{R})$.

Let $(X_t^\xi, R_t^\xi)_{t \geq 0} := (X_t^{\xi; 0}, R_t^{\xi; 0})_{t \geq 0}$. By (2.2), (2.4), and (A.1) one easily finds for $p \in [1, \infty)$

$$\mathbb{E}[|(X_t^{\xi; \delta}, R_t^{\xi; \delta}) - (X_t^\xi, R_t^\xi)|^p] \leq C_t \delta^p, \quad \forall \xi \in \mathcal{A} \text{ and } t \geq 0,$$

for some C_t that is at most of polynomial growth with respect to t . Using now the latter and Assumption 2.1-(ii), it can be shown that $V^\delta(x, r) \rightarrow V(x, r)$ as $\delta \downarrow 0$ for each $(x, r) \in \mathbb{R}^2$. Let $\mathcal{B}_N := \{z \in \mathbb{R}^2 : |z| < N\}$, for some $N > 0$. Since items (i)-(iii) above imply that $V^\delta \in W^{2, p}(\mathcal{B}_N)$ for any $p > 2$ and $W^{2, p}(\mathcal{B}_N)$ is reflexive, there exists a sequence $\delta_n \downarrow 0$ as $n \uparrow \infty$ such that V^{δ_n} converges weakly in $W^{2, p}(\mathcal{B}_N)$. Because $V^{\delta_n} \rightarrow V$ pointwise and weak limits are unique, we have that $V^{\delta_n} \rightarrow V$ weakly in $W^{2, p}(\mathcal{B}_N)$. Since the embedding $W^{2, p}(\mathcal{B}_N) \hookrightarrow C^1(\mathcal{B}_N)$ is compact for $p > 2$ (2 being the dimension of our space), it follows that

$$(A.3) \quad V^{\delta_n} \rightarrow V \text{ locally uniformly in } \mathbb{R}^2,$$

$$(A.4) \quad V_x^{\delta_n} \rightarrow V_x \text{ locally uniformly in } \mathbb{R}^2,$$

and

$$(A.5) \quad V_r^{\delta_n} \rightarrow V_r \text{ locally uniformly in } \mathbb{R}^2.$$

Moreover, by Theorem 3.11 in [12] (easily adjusted to take care of our general convex function f satisfying Assumption 2.1) we have that V_r^δ is the unique (given V_x^δ) solution to the pointwise variational inequality:

$$(A.6) \quad \begin{cases} V_r^\delta \in W_{\text{loc}}^{2,q}(\mathbb{R}^2), \quad \forall q \geq 2, & -K_1 \leq V_r^\delta \leq K_2 \quad \text{a.e. in } \mathbb{R}^2, \\ (\mathcal{L}^r - \rho)V_r^\delta \leq \theta b V_x^\delta - f_r(x, r) & \text{a.e. in } \mathcal{I}^\delta, \\ (\mathcal{L}^r - \rho)V_r^\delta \geq \theta b V_x^\delta - f_r(x, r) & \text{a.e. in } \mathcal{D}^\delta, \\ (\mathcal{L}^r - \rho)V_r^\delta = \theta b V_x^\delta - f_r(x, r) & \text{a.e. in } \mathcal{C}^\delta, \end{cases}$$

where we have set

$$\mathcal{I}^\delta := \left\{ (x, r) \in \mathbb{R}^2 : V_r^\delta(x, r) = -K_1 \right\}, \quad \mathcal{D}^\delta := \left\{ (x, r) \in \mathbb{R}^2 : V_r^\delta(x, r) = K_2 \right\},$$

and

$$\mathcal{C}^\delta := \left\{ (x, r) \in \mathbb{R}^2 : -K_1 < V_r^\delta(x, r) < K_2 \right\}.$$

Define

$$(A.7) \quad \tau^{*,\delta} := \inf\{t \geq 0 : V_r^\delta(X_t^\delta, R_t^\delta) \leq -K_1\},$$

$$(A.8) \quad \sigma^{*,\delta} := \inf\{t \geq 0 : V_r^\delta(X_t^\delta, R_t^\delta) \geq K_2\},$$

$$(A.9) \quad \tau^* := \inf\{t \geq 0 : V_r(X_t, r) \leq -K_1\},$$

$$(A.10) \quad \sigma^* := \inf\{t \geq 0 : V_r(X_t, r) \geq K_2\},$$

as well as, for a given $M > 0$,

$$(A.11) \quad \tau_M^\delta := \inf\{t \geq 0 : |X_t^\delta| + |R_t^\delta| \geq M\},$$

$$(A.12) \quad \tau_M := \inf\{t \geq 0 : |X_t| + |r| \geq M\}.$$

Now, by (A.6) we know that for each $\delta > 0$ given and fixed, V_r^δ is regular enough to apply a weak version of Itô's lemma (see, e.g., Theorem 8.5 at p. 185 of [4]) so that for any stopping time ζ and some fixed $T > 0$ one obtains

$$(A.13) \quad \begin{aligned} V_r^\delta(x, r) = & \mathbb{E} \left[- \int_0^{\tau_M^\delta \wedge \tau_M \wedge \zeta \wedge T} e^{-\rho s} (\mathcal{L}^r - \rho) V_r^\delta(X_s^\delta, R_s^\delta) ds \right. \\ & \left. + e^{-\rho(\tau_M^\delta \wedge \tau_M \wedge \zeta \wedge T)} V_r^\delta \left(X_{\tau_M^\delta \wedge \tau_M \wedge \zeta \wedge T}^\delta, R_{\tau_M^\delta \wedge \tau_M \wedge \zeta \wedge T}^\delta \right) \right]. \end{aligned}$$

Given an \mathbb{F} -stopping time τ , set $\zeta := \sigma^{*,\delta} \wedge \sigma^* \wedge \tau$ in (A.13), and use that V^δ solves a.e. the variational inequality (A.6) to find

$$(A.14) \quad \begin{aligned} V_r^\delta(x, r) & \geq \mathbb{E} \left[\int_0^{\tau_M^\delta \wedge \tau_M \wedge \sigma^{*,\delta} \wedge \sigma^* \wedge \tau \wedge T} e^{-\rho s} (-\theta b V_x^\delta(X_s^\delta, R_s^\delta) + f_r(X_s^\delta, R_s^\delta)) ds \right. \\ & \left. + e^{-\rho(\tau_M^\delta \wedge \tau_M \wedge \sigma^{*,\delta} \wedge \sigma^* \wedge \tau \wedge T)} V_r^\delta \left(X_{\tau_M^\delta \wedge \tau_M \wedge \sigma^{*,\delta} \wedge \sigma^* \wedge \tau \wedge T}^\delta, R_{\tau_M^\delta \wedge \tau_M \wedge \sigma^{*,\delta} \wedge \sigma^* \wedge \tau \wedge T}^\delta \right) \right] \\ & \geq \mathbb{E} \left[\int_0^{\tau_M^\delta \wedge \tau_M \wedge \sigma^{*,\delta} \wedge \sigma^* \wedge \tau \wedge T} e^{-\rho s} (-\theta b V_x^\delta(X_s^\delta, R_s^\delta) + f_r(X_s^\delta, R_s^\delta)) ds \right. \\ & + \mathbb{1}_{\{\sigma^{*,\delta} < \tau_M^\delta \wedge \tau_M \wedge \sigma^* \wedge \tau \wedge T\}} e^{-\rho \sigma^{*,\delta}} K_2 - \mathbb{1}_{\{\tau < \tau_M^\delta \wedge \tau_M \wedge \sigma^{*,\delta} \wedge \sigma^* \wedge T\}} e^{-\rho \tau} K_1 \\ & \left. + \mathbb{1}_{\{\tau_M^\delta \wedge \tau_M \wedge \sigma^* \wedge T < \sigma^{*,\delta} \wedge \tau\}} e^{-\rho(\tau_M^\delta \wedge \tau_M \wedge \sigma^* \wedge T)} V_r^\delta \left(X_{\tau_M^\delta \wedge \tau_M \wedge \sigma^* \wedge T}^\delta, R_{\tau_M^\delta \wedge \tau_M \wedge \sigma^* \wedge T}^\delta \right) \right]. \end{aligned}$$

Recalling (A.1), thanks to the estimates (i)-(iii) above, the uniform convergence of $V_r^{\delta_n}$ to V_r (cf. (A.5)), and the fact that there exists $C_T > 0$ such that $\mathbb{E}[\sup_{0 \leq s \leq T} |(X_t^{\delta_n}, R_t^{\delta_n}) - (X_t, r)|^q] \leq C_T \delta_n^q$, with $X_t := X_t^{0;0}$ and $\infty > q \geq 1$, it can be shown that (see Theorem 3.7 in Section 3 of Chapter 3 of Chapter [4] – in particular p. 322 – and especially Lemma 4.17 in [13] for a detailed proof in a related but different setting) $\tau_M^{\delta_n} \wedge \tau_M \wedge \sigma^{*,\delta_n} \wedge \sigma^* \wedge \tau \wedge T \rightarrow \tau_M \wedge \sigma^* \wedge \tau \wedge T$ as $n \uparrow \infty$, P-a.s. Therefore, taking limits in (A.14) with $\delta = \delta_n$ as $n \uparrow \infty$, using the latter convergence of stopping times and (A.3)-(A.4), one finds

$$V_r(x, r) \geq \mathbb{E} \left[\int_0^{\sigma^* \wedge \tau_M \wedge \tau \wedge T} e^{-\rho s} (-\theta b V_x(X_s, r) - f_r(X_s, r)) ds + e^{-\rho \sigma^*} K_2 \mathbb{1}_{\{\sigma^* < \tau_M \wedge \tau \wedge T\}} - e^{-\rho \tau} K_1 \mathbb{1}_{\{\tau < \sigma^* \wedge \tau_M \wedge T\}} + e^{-\rho(\tau_M \wedge T)} V_r(X_{\tau_M \wedge T}, r) \mathbb{1}_{\{\tau_M \wedge \sigma^* \wedge T < \sigma^* \wedge \tau\}} \right].$$

Letting now $M \uparrow \infty$ and $T \uparrow \infty$ and invoking the dominated convergence theorem we obtain (A.15)

$$V_r(x, r) \geq \mathbb{E} \left[\int_0^{\sigma^* \wedge \tau} e^{-\rho s} (-\theta b V_x(X_s, r) - f_r(X_s, r)) ds + e^{-\rho \sigma^*} K_2 \mathbb{1}_{\{\sigma^* < \tau\}} - e^{-\rho \tau} K_1 \mathbb{1}_{\{\tau < \sigma^*\}} \right],$$

for any \mathbb{F} -stopping time τ .

Analogously, picking $\zeta = \tau^{*,\delta_n} \wedge \tau^* \wedge \sigma$, for any \mathbb{F} -stopping time σ , in (A.13), and taking limits as $n \uparrow \infty$, and then as $M \uparrow \infty$ and $T \uparrow \infty$, yield

$$(A.16) \quad V_r(x, r) \leq \mathbb{E} \left[\int_0^{\sigma \wedge \tau^*} e^{-\rho s} (-\theta b V_x(X_s, r) - f_r(X_s, r)) ds + e^{-\rho \sigma} K_2 \mathbb{1}_{\{\sigma < \tau^*\}} - e^{-\rho \tau^*} K_1 \mathbb{1}_{\{\tau^* < \sigma\}} \right].$$

Finally, the choice $\zeta = \tau^{*,\delta_n} \wedge \tau^* \wedge \sigma^{*,\delta_n} \wedge \sigma^*$ leads (after taking limits) to

$$(A.17) \quad V_r(x, r) = \mathbb{E} \left[\int_0^{\sigma^* \wedge \tau^*} e^{-\rho s} (-\theta b V_x(X_s, r) - f_r(X_s, r)) ds + e^{-\rho \sigma^*} K_2 \mathbb{1}_{\{\sigma^* < \tau^*\}} - e^{-\rho \tau^*} K_1 \mathbb{1}_{\{\tau^* < \sigma^*\}} \right].$$

Combining (A.15), (A.16), and (A.17) completes the proof.

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S. FEDERICO: DIPARTIMENTO DI ECONOMIA POLITICA E STATISTICA, UNIVERSITÀ DI SIENA, PIAZZA SAN FRANCESCO 7/8, 53100, SIENA ITALY

Email address: salvatore.federico@unisi.it

G. FERRARI: CENTER FOR MATHEMATICAL ECONOMICS (IMW), BIELEFELD UNIVERSITY, UNIVERSITÄTSSTRASSE 25, 33615, BIELEFELD, GERMANY

Email address: giorgio.ferrari@uni-bielefeld.de

P. SCHUHMANN: CENTER FOR MATHEMATICAL ECONOMICS (IMW), BIELEFELD UNIVERSITY, UNIVERSITÄTSSTRASSE 25, 33615, BIELEFELD, GERMANY

Email address: patrick.schuhmann@uni-bielefeld.de