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Article

Jump-diffusion Models for Valuing the Future: Discounting under Extreme Situations

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Abstract: We develop the process of discounting when underlying rates follow a jump-diffusion process, that is, when, in addition of diffusive behavior, rates suffer a series of finite discontinuities located at random Poissonian times. Jump amplitudes are also random and governed by an arbitrary density. Such a model may describe the economic evolution specially when extreme situations occur (pandemics, global wars, etc.). When between jumps the dynamical evolution is governed by an Ornstein-Uhlenbeck diffusion process, we obtain exact and explicit expressions for the discount function and the long-run discount rate and show that the presence of discontinuities may drastically reduce the discount rate, a fact that has significant consequences for environmental planning. We also discuss as a specific example the case when rates are described by the continous time random walk.

Keywords: stochastic processes; finance; climate; discount function; environmental econonomics; Poissonian jumps; Ornstein-Uhlenbeck process; interest rates; asymptotics

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1. Introduction

The importance of discounting, particularly in the long run, does not exclusively refer to finance but to many aspects of global economy. This is the case of long-term environmental planning which is certainly acute in climate action. In essence, an environmental problem that costs X to fix at a time t is worth an investment of $\exp(-rt)X$ today, where r is the interest rate. This simple analysis assumes that interest rates remain constant between today and the distant future t, which may be decades ahead. The rate r thus becomes a key magnitude to decide whether it is more beneficial to take action today with a significant investment or whether the discount gives negligible value to today's investment.

No wonder that the estimation of the discount rate has enormous consequences and has been the object of intense work and controversy since long. While, for instance, Nicholas Stern –in a highly influential report on climate change commissioned by the UK government [6]– uses a discounting rate of 1.4%, William Nordhaus [7] argues for a discount rate of 4% and at other times [8] has even advocated rates as high as 6%. Both estimates constitute a completely different point of view on how to address climate change and other catastrophic events. Indeed, while Stern's estimate would imply immediate spending, Nordhaus's figures indicate that immediate and strong action would be unnecessary. In a 100 year horizon, Stern's rate implies a present value of 25 % (that is, the future is worth 25 % as much as the present) while Nordhaus's rates imply present values of 2 % or even 0, 3 %. The choice of discount rate is, therefore, one of the biggest factors influencing the debate on the urgency of the response to climate change.

For environmental problems normative approaches to choosing discount rates are based on ethical grounds [9,10] and assumptions about economic growth. They also depend on arguments involving the maximization of utility functions that are chosen for mathematical convenience [11]. Economists present a variety of reasons for discounting, including impatience, economic growth and declining marginal utility; all of them included in the Ramsey formula [12], which forms the basis for traditional approaches to discounting [13]. However, rates r are uncertain and follow a random dynamics. It is therefore not

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realistic to represent discounting by deterministic functions of time such as decreasing exponentials with fixed rates and some kind of average over all interest rate paths must be taken. This problem is particularly severe for environmental problems, where in questions such as global warming one must consider costs and benefits for long time horizons. It also indeed occurs in finance where it has long been recognized that interest rates must be modeled as random processes [14–17].

A practical economist engaged in the environmental debate might try to use as discount rate the average of historical interest rates which occurred in the last 200 years (which is 2.7 % in stable countries [1,5]), or take the average of Wall Street forward looking models which price bonds of maturity as long as 30 years. However, we have shown [4] that, due to historical fluctuations of short real interest rates, the appropriate rate is considerably below these averages. As a result, any proper analysis must take into account fluctuations in the real interest rate (obtained by subtracting nominal rates from inflation) which are fundamentally due to fluctuations in economic growth [18–22].

The function $r(t)$ can, in principle, be any random process. The simplest and most common hypothesis consists in assuming that rates are described by a Markovian process with continuous sample paths. In other words, real rates $r(t)$ are modeled as diffusion processes. Throughout this paper we will assume the so-called "Local Expectation Hypothesis" in which there is no market price of risk (investors are assumed to be risk neutral) and rates are based on the data generating measure [23–25].

We have recently analyzed these issues by considering three of the most popular stochastic models for the dynamics of interest rates [2]: Ornstein-Uhlenbeck [26], Feller [27], and lognormal [28] processes, which are also very relevant in statistical physics. However, we are interested in real rates (recall, nominal rates corrected by inflation)[1] which can be negative even during prolonged periods of time [1,4]. The Ornstein-Uhlenbeck (OU) model is the only one that allows for negative rates. Moreover its asymptotic expression for discount has an exponential decay with a long-run rate r_∞ that differs from historical average interest rates by being substantially smaller, zero or eventually negative [1–5].

We will go here one step further and assume that, in addition to diffusive and continuous behavior, the sample paths of real rates $r(t)$ also exhibit discontinuities. That is, we will model rates by a jump-diffusion process. During the last fifty years jump-diffusion models have been extensively used not only in many branches of statistical mechanics and condensed matter physics [29] but also in economics and finance [30]. Thus the economic evolution is known to occasionally have sudden bursts that hardly adjust to continuous diffusion-like evolution. The fact that these discontinuities do not occur frequently sustains in a great measure the use of diffusion models for the economic evolution. However, many empirical observations of economic time series tend to show the appearance of many outliers in which changes of great magnitude occur during small intervals of time, in opposition to the basic diffusive hypothesis for which changes during short intervals of time are only by small amounts.

One very recent example is provided by the Covid-19 pandemics where prices dropped worldwide approximately 40% in less than 3 weeks. Pandemics episodes are rather recurrent, thus during the 20th century there have been reported several pandemic incidents from the Spanish flu of 1918 to the Hong-Kong flu in 1968 or AIDS starting in 1981. Several similar episodes are reported during the 19th century (cholera, etc.). One could approximately quantify the appearance of 3 to 5 of such episodes per century. Other "nightmare scenarios" [31,32] of environmental disasters would include climate change, biotechnology, asteroid impacts, runaway computer systems, and nuclear proliferation among others (see Refs. [33,34] for a thorough discussion).

The main objectives of this work are to provide a general framework and to elucidate the effect on the long-run discount –and, hence, on how we should value the future– of

[1] That is, $r(t) = n(t) - i(t)$, where $n(t)$ are nominal rates (usually positive, but not always) and computed from government bonds and $i(t)$ is the rate of inflation constructed out of consumer price indexes.

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discontinuities which reflect the existence of high-risk events. For the sake of completeness, we consider not only sudden negative bursts but also positive bursts as the two show distinctive behaviors.

2. Materials and Methods

2.1. Main definitions

Suppose that $r(t)$ is a random process representing the dynamical evolution of real rates. If we define the cumulative process

$$x(t) = \int_{t_0}^{t} r(t')dt', \tag{1}$$

the *discount function* is then defined as

$$D(t) = \mathbb{E}\left[e^{-x(t)}\right], \tag{2}$$

where the average is taken over all possible realizations of $r(t)$.

Closely related to the discount function $D(t)$ it is the (average) *discount rate* defined as

$$d(t) = -\frac{\ln D(t)}{t}, \tag{3}$$

so that the discount function can be written in the standard exponential form $D(t) = \exp(-td(t))$. Moreover, in terms of $d(t)$, we can define the *long-run discount rate*, r_∞, as the asymptotic value of the discount rate $d(t) \to r_\infty$ as $t \to \infty$. That is,

$$r_\infty = -\lim_{t\to\infty} \frac{\ln(D(t))}{t}. \tag{4}$$

When introducing specific stochastic models, it then becomes particularly useful to consider the bidimensional process $\big(x(t), r(t)\big)$ and denote by $p(x, r, t|x_0, r_0, t_0)$ the probability density function (PDF) of such process (sometimes referred to as the data generating measure). This PDF is defined as

$$p(x, r, t|x_0, r_0, t_0)dxdr = \text{Prob}\{x \le x(t) < x + dx, r \le r(t) < r + dr|x(t_0) = x_0, r(t_0) = r_0\},$$

and the discount function defined as the average (2) can therefore be written as

$$D(t) = \int_{-\infty}^{\infty} dr \int_{-\infty}^{\infty} e^{-x} p(x, r, t|x_0, r_0, t_0)dx. \tag{5}$$

The joint characteristic function of the bidimensional process $(x(t), r(t))$ is defined as the Fourier transform of the joint PDF:

$$\tilde{p}(\omega_1, \omega_2, t|x_0, r_0, t_0) = \int_{-\infty}^{\infty} e^{-i\omega_1 x}dx \int_{-\infty}^{\infty} e^{-i\omega_2 r} p(x, r, t|x_0, r_0, t_0)dr. \tag{6}$$

Once we know the joint characteristic function obtaining discount is straightforward. Comparison of Eqs. (5) and (6) shows that

$$D(t) = \tilde{p}\big(\omega_1 = -i, \omega_2 = 0, t|x_0, r_0, t_0\big), \tag{7}$$

and obtaining the discount function is equivalent to knowing the joint characteristic function of the bidimensional return process.

2.2. Diffusion process in the presence of random jumps

The process $r(t)$ can be any random process, although the simplest and most usual assumption consists in modeling $r(t)$ as a diffusion process, that is, a Markovian process with

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continuous sample paths. We here take the further step of assuming that $r(t)$ is a compound process which combines an ordinary diffusion with random jumps. The diffusion process trajectory thus exhibits discontinuities at random instants of time. Discontinuities will be here assumed to be finite. The resulting bidimensional process $(x(t), r(t))$ is described by the following pair of stochastic differential equations (all stochastic differential equations are interpreted in the sense of Itô)

$$\begin{aligned} \frac{dx}{dt} &= r \\ \frac{dr}{dt} &= f(r) + g(r)\xi(t) + n(t), \end{aligned} \tag{8}$$

where $f(r)$ and $g(r)$ are given functions (the drift and noise intensity, respectively), $\xi(t)$ is a zero-mean Gaussian white noise ($\xi(t)dt = dW(t)$ where $W(t)$ is the standard Wiener process with unit variance), and $n(t)$ is a white shot noise. The white shot noise can be written as [35,36]

$$n(t) = \sum_j \gamma_j \delta(t - t_j), \tag{9}$$

where γ_j and t_j ($j = 1, 2, 3 \ldots$) are independent and identically distributed random variables. The random quantities γ_i characterize the size of jumps and are described by a given PDF which we denote by $h(u)$. For simplicity, the size of these discontinuities are taken to be identically distributed and independent of each other as well as independent of the instants of time at which they occur. We further assume that these random times form a Poisson set of events. In such a case the time interval τ between two consecutive jumps $\{t_j, t_{j+1}\}$ is governed by the PDF [37]

$$\psi(\tau) = \lambda e^{-\lambda\tau}, \tag{10}$$

where $\lambda > 0$ is the rate of the Poisson process and λ^{-1} is the average time interval between two consecutive jumps.

To obtain the discount we need to look at the joint PDF $p(x, r, t|x_0, r_0, t_0)$ of the bidimensional process $(x(t), r(t))$. It is however convenient to first consider the jump PDF characterizing the discontinuities of the return process. This density is defined as [29]

$$W(x, r|x_0, r_0) = \lim_{\Delta t \to 0} \left[\frac{1}{\Delta t} p(x, r, t_0 + \Delta t|x_0, r_0, t_0) \right],$$

A standard reasoning –based on the Chapman-Kolmogorov equation and detailed in Gardiner's monograph [29] (see also [37]) shows that the PDF of the bidimensional jump-diffusion process defined in (8) obeys the integro-differential equation

$$\begin{aligned} \frac{\partial p}{\partial t} = & - r\frac{\partial p}{\partial x} - \frac{\partial}{\partial r}[f(r)p] + \frac{1}{2}\frac{\partial^2}{\partial r^2}[g^2(r)p] \\ & + \int_{-\infty}^{\infty} dy \int_{-\infty}^{\infty} [W(x, r|y, \rho)p(y, \rho, t|x_0, r_0, t_0) - W(y, \rho|x, r)p(x, r, t|x_0, r_0, t_0)] d\rho, \end{aligned} \tag{11}$$

with the initial condition

$$p(x, r, t_0|x_0, r_0, t_0) = \delta(x - x_0)\delta(r - r_0). \tag{12}$$

The assumptions made above about discontinuities allow us to obtain a a more explicit expression for both the transition density W and the integro-differential equation (11). Let us recall that the magnitude of the discontinuities, expressed by the random variables γ_i, is independent of the times t_i where jumps occur. We see from the model expressed by Eq. (8) that the instantaneous jumps only affect $r(t)$ but not $x(t)$. These considerations along with

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the Poisson character of jump times allow us to take as transition density the following expression [37]

$$W(x,r|x_0,r_0) = \lambda\delta(x-x_0)h(r-r_0). \tag{13}$$

Substituting this simpler expression for W into Eq. (11) and taking into account the homogeneity of both x and t (which amounts to take $x_0 = 0$ and $t_0 = 0$) as well as the normalization condition on the PDF $h(u)$,

$$\int_{-\infty}^{\infty} h(u)du = 1,$$

we see that the integro-differential equation for $p(x,r,t|r_0)$, Eq. (11) reads

$$\begin{aligned}\frac{\partial p}{\partial t} = -r\frac{\partial p}{\partial x} &- \frac{\partial}{\partial r}[f(r)p] + \frac{1}{2}\frac{\partial^2}{\partial r^2}[g^2(r)p] \\ &- \lambda p(x,r,t|r_0) + \lambda\int_{-\infty}^{\infty} h(r-\rho)p(x,\rho,t|r_0)d\rho,\end{aligned} \tag{14}$$

and the initial condition is

$$p(x,r,0|r_0) = \delta(x)\delta(r-r_0). \tag{15}$$

Equation (14) is the most general formulation of the discount problem of time-homogeneous diffusion with independent and Poissonian random jumps. In order to proceed further we need to further specify a particular diffusion process for the continuous part of the return.

The Ornstein-Uhlenbeck process and Poissonian jumps

In the modeling of financial interest rates, the Ornstein-Uhlenbeck (OU) diffusion process was proposed by Oldrich Vasicek during the late nineteen seventies [14]. The model allows for both positive and negative rates and is, therefore, suitable for describing the so-called real interest rates. We have extensively used this process in the study of long-run discounting [1,2,4,5]. For the OU process, the drift is linear and the noise intensity constant:

$$f(r) = -\alpha(r-m), \qquad g(r) = k. \tag{16}$$

The parameter m (usually referred to as "normal level") is the mean value to which the process reverts in the long run, $\alpha > 0$ is the strength of the reversion to the mean and $k > 0$ is the amplitude of the fluctuations. In the stationary regime when $t \gg \alpha^{-1}$ rates are explicitly given by [2]

$$r(t) = m + k\int_{-\infty}^{t} e^{-\alpha(t-t')}\xi(t')dt',$$

where $\xi(t)$ is the Gaussian white noise defined above. We thus easily see that the normal level m is the stationary mean value of the return, while the stationary autocorrelation function $C(\tau)$ is given by [2]

$$C(\tau) = \left(\frac{k^2}{2\alpha}\right)e^{-\alpha\tau}$$

showing that α^{-1} is the autocorrelation time and $\sigma^2 = k^2/2\alpha$ is the variance. For this continuous model we have been able to obtain a closed expression for the discount function $D(t)$ which in the long run, as $t \to \infty$ (cf. Eq. (4)), reads [?]

$$D(t) \simeq e^{-r_\infty t}, \qquad r_\infty = m - k^2/2\alpha^2. \tag{17}$$

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Let us now assume that the rate process $r(t)$ is governed by an OU process with random discontinuities described by Poissonian jumps. The integro-differential equation for the joint PDF $p(x,r,t|r_0)$ will be given by (cf. Eqs. (14) and (16))

$$\begin{aligned}\frac{\partial p}{\partial t} &= -r\frac{\partial p}{\partial x} + \alpha\frac{\partial}{\partial r}[(r-m)p] + \frac{1}{2}k^2\frac{\partial^2 p}{\partial r^2}\\ &- \lambda p(x,r,t|r_0) + \lambda\int_{-\infty}^{\infty} h(r-\rho)p(x,\rho,t|r_0)d\rho, \end{aligned} \tag{18}$$

with the initial condition

$$p(x,r,0|r_0) = \delta(x)\delta(r-r_0). \tag{19}$$

Fourier transforming Eqs. (18) and (19) results in a much simpler problem for the characteristic function,

$$\frac{\partial\tilde{p}}{\partial t} = (\omega_1 - \alpha\omega_2)\frac{\partial\tilde{p}}{\partial\omega_2} - \left[\lambda - \lambda\tilde{h}(\omega_2) + i\alpha m\omega_2 + \frac{k^2}{2}\omega_2^2\right]\tilde{p}, \tag{20}$$

where $\tilde{p} = \tilde{p}(\omega_1,\omega_2,t|r_0)$ is the joint Fourier transform defined in Eq. (6) and

$$\tilde{h}(\omega_2) = \int_{-\infty}^{\infty} e^{-i\omega_2 u}h(u)du \tag{21}$$

is the characteristic function of the jump PDF $h(u)$. The initial condition is now given by

$$\tilde{p}(\omega_1,\omega_2,0|r_0) = e^{-i\omega_2 r_0}. \tag{22}$$

Equation (20) is a partial differential equation of first order whose solution can be obtained by the method of characteristics [38]. In the Appendix A we show that the exact solution to the initial-value problem (20) and (22) is given by

$$\tilde{p}(\omega_1,\omega_2,t|r_0) = \exp\Big\{-\lambda\big[t+\phi(\omega_1,\omega_2,t)\big] - A(t)\omega_2^2 - B(\omega_1,t)\omega_2 - C(\omega_1,t)\Big\}, \tag{23}$$

where

$$\phi(\omega_1,\omega_2,t) = \int_{\omega_2}^{\chi(\omega_1,\omega_2,t)}\frac{\tilde{h}(\theta)}{\alpha\theta-\omega_1}d\theta, \qquad \chi(\omega_1,\omega_2,t) = \frac{\omega_1}{\alpha}(1-e^{-\alpha t}) + \omega_2 e^{-\alpha t}, \tag{24}$$

$$A(t) = \frac{k^2}{4\alpha}\left(1-e^{-2\alpha t}\right), \tag{25}$$

$$B(\omega_1,t) = ir_0e^{-\alpha t} + im\left(1-e^{-\alpha t}\right) + \frac{k^2\omega_1}{2\alpha^2}\left(1-2e^{-\alpha t}+e^{-2\alpha t}\right), \tag{26}$$

and

$$\begin{aligned}C(\omega_1,t) &= i\omega_1 r_0\frac{1}{\alpha}(1-e^{-\alpha t}) + im\omega_1\left[t-\frac{1}{\alpha}(1-e^{-\alpha t})\right]\\ &+\frac{k^2\omega_1^2}{2\alpha^3}\left[\alpha t - 2(1-e^{-\alpha t}) + \frac{1}{2}\left(1-e^{-2\alpha t}\right)\right]. \end{aligned} \tag{27}$$

Looking at Eq. (23) we see that when there are no discontinuities (*i.e.*, $\lambda = 0$) the PDF (23) reduces to a Gaussian density as we had obtained in previous works [2]. Denoting this density by $p^{(0)}$ and setting $\lambda = 0$ in Eq. (23) we get

$$\tilde{p}^{(0)}(\omega_1,\omega_2,t|r_0) = \exp\Big\{-\Big[A(t)\omega_2^2 + B(\omega_1,t)\omega_2 + C(\omega_1,t)\Big]\Big\}. \tag{28}$$

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We can thus write Eq. (23) as

$$\tilde{p}(\omega_1,\omega_2,t|r_0) = \tilde{p}^{(0)}(\omega_1,\omega_2,t|r_0)\exp\Big\{-\lambda\left[t+\phi(\omega_1,\omega_2,t)\right]\Big\}. \tag{29}$$

Let us finally recall that knowing the joint PDF of the two-dimensional process $(x(t), r(t))$, the distribution of the return $r(t)$ is given by the marginal density,

$$p(r,t|r_0) = \int_{-\infty}^{\infty} p(x,r,t|r_0)dx,$$

and the characteristic function of return, $\tilde{p}(\omega_2,t|r_0)$, is simply obtained by setting $\omega_1 = 0$ in the joint characteristic function. From Eqs. (23)–(27) we get

$$\tilde{p}(\omega_2,t|r_0) = \exp\bigg\{-\frac{k^2}{4\alpha}\left(1-e^{-2\alpha t}\right)\omega_2^2 - i\left[r_0e^{-\alpha t}+m\left(1-e^{-\alpha t}\right)\right]\omega_2 \\ -\lambda\left[t+\frac{1}{\alpha}\int_{\omega_2}^{\omega_2 e^{-\alpha t}}\frac{\tilde{h}(\theta)}{\theta}d\theta\right]\bigg\}. \tag{30}$$

In terms of the characteristic function $\tilde{p}(\omega_2,t|r_0)$ the moments of the return, $\langle r^n(t)\rangle$ are given by the derivatives $i^n\tilde{p}^{(n)}(\omega_2 = 0,t|r_0)$ $(n = 1,2,\ldots)$. Thus, for example, the variance of the return, that is the volatility, is given by

$$\sigma^2(t) = \frac{1}{2\alpha}\left(k^2+\lambda\mu\right)\left(1-e^{-2\alpha t}\right), \tag{31}$$

where μ is the second moment of the jump density, $\mu = -\tilde{h}''(0)$. In the long-range $(t\to\infty)$ the volatility reaches the stationary value

$$\sigma^2_{\text{stat}} = \frac{1}{2\alpha}\left(k^2+\lambda\mu\right). \tag{32}$$

3. Results

We know that in terms of the characteristic function of the bidimensional process $(x(t), r(t))$ the discount function $D(t)$ is given by (cf. Eq. (7))

$$D(t) = \tilde{p}(\omega_1 = -i, \omega_2 = 0, t|r_0).$$

Then from Eq. (29) we see that

$$D(t) = D^{(0)}(t)e^{-\lambda[t+\phi(t)]}, \tag{33}$$

where $D^{(0)}(t)$ is the discount function for the continuous process in the absence of jumps and $\phi(t) \equiv \phi(-i,t)$. The explicit form of these quantities is respectively given by (cf. Eqs. (27) and (24))

$$D^{(0)}(t) = \exp\bigg\{-\frac{r_0}{\alpha}\left(1-e^{-\alpha t}\right) - m\left[t-\frac{1}{\alpha}\left(1-e^{-\alpha t}\right)\right] \\ +\frac{k^2}{2\alpha^3}\left[\alpha t - 2\left(1-e^{-\alpha t}\right)+\frac{1}{2}\left(1-e^{-2\alpha t}\right)\right]\bigg\}, \tag{34}$$

and

$$\phi(t) = \frac{1}{\alpha}\int_0^{-i(1-e^{-\alpha t})/\alpha}\frac{\tilde{h}(\theta)}{\theta+i/\alpha}d\theta = -\frac{1}{\alpha}\int_0^{(1-e^{-\alpha t})/\alpha}\frac{\tilde{h}(-i\xi)}{1/\alpha-\xi}d\xi. \tag{35}$$

Equation (33) constitutes the main result of this work and expresses the discount function of the jump-diffusion process in terms of the discount function $D^{(0)}(t)$ of the continuous OU process and the function $\phi(t)$ related to discontinuities.

3.1. Asymptotic discount function

We next analyze the asymptotic behavior as $t \to \infty$ of the discount function (33). Firstly from Eq. (34) we easily see that

$$D^{(0)}(t) \simeq \exp\left\{-\left(m - \frac{k^2}{2\alpha^2}\right)t\right\} \qquad (t \to \infty). \tag{36}$$

On the other hand, in order to get the asymptotic behavior of $\phi(t)$ we expand the jump characteristic function $\tilde{h}(\theta)$ around the value $\theta = -i/\alpha$,

$$\tilde{h}(\theta) = \tilde{h}(-i/\alpha) + \sum_{n=1}^{\infty} \frac{1}{n!}\tilde{h}^{(n)}(-i/\alpha)(\theta + i/\alpha)^n,$$

and plugging it into Eq. (35) we have

$$\phi(t) = \frac{1}{\alpha}\tilde{h}(i/\alpha)\int_0^{-i(1-e^{-\alpha t})/\alpha} \frac{d\theta}{\theta + i/\alpha} + \frac{1}{\alpha}\sum_{n=1}^{\infty}\frac{1}{n!}\tilde{h}^{(n)}(-i/\alpha)\int_0^{-i(1-e^{-\alpha t})/\alpha}(\theta + i/\alpha)^{n-1}d\theta.$$

But

$$\int_0^{-i(1-e^{-\alpha t})/\alpha} \frac{d\theta}{\theta + i/\alpha} = -\alpha t,$$

while

$$\int_0^{-i(1-e^{-\alpha t})/\alpha}(\theta + i/\alpha)^{n-1}d\theta = -\frac{(i/\alpha)^n}{n}\left(1 - e^{-n\alpha t}\right).$$

Thus

$$\phi(t) = -\tilde{h}(-i/\alpha)t - \frac{1}{\alpha}\sum_{n=1}^{\infty}\frac{(i/\alpha)^n}{n}\frac{\tilde{h}^{(n)}(-i/\alpha)}{n!}\left(1 - e^{-n\alpha t}\right), \tag{37}$$

and in the long-time limit we have

$$\phi(t) \simeq -\tilde{h}(-i/\alpha)t - \frac{1}{\alpha}\sum_{n=1}^{\infty}\frac{(i/\alpha)^n}{n}\frac{\tilde{h}^{(n)}(-i/\alpha)}{n!}.$$

Let us note that if the sum on the right hand side of this expression is convergent and $\tilde{h}(-i/\alpha)$ is finite we then have

$$\phi(t) \simeq -\tilde{h}(-i/\alpha)t, \qquad (t \to \infty). \tag{38}$$

Substituting Eqs. (36) and (38) into Eq. (33) yields

$$D(t) \simeq \exp\left\{-\left(m - k^2/2\alpha^2 + \lambda\left[1 - \tilde{h}(-i/\alpha)\right]\right)t\right\}, \qquad (t \to \infty). \tag{39}$$

The asymptotic discount function can thus be written as

$$D(t) \simeq e^{-r_\infty t}, \qquad (t \to \infty), \tag{40}$$

where the long-run discount rate defined in Eq. (4) reads

$$r_\infty = r_\infty^{(0)} + \lambda\left[1 - \tilde{h}(-i/\alpha)\right], \tag{41}$$

and

$$r_\infty^{(0)} = m - \frac{k^2}{2\alpha^2}, \tag{42}$$

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is the long-run discount rate in the absence of jumps [2]. From Eq. (41) we see that discontinuities will reduce the long-run discount rate as long as

$$r_\infty < r_\infty^{(0)} \qquad \Leftrightarrow \qquad \tilde{h}(-i/\alpha) > 1. \tag{43}$$

Let us remark that all expressions involving the long-run rate are meaningful as long as $\tilde{h}(-i/\alpha)$ exists. We will, however, see below some cases in which $\tilde{h}(-i/\alpha)$ is infinite and r_∞ is meaningless.

Bounded and symmetric jump density

We next develop condition (43) when the jump density $h(u)$ is bounded and symmetric around $u = 0$. In other words, when sudden ups and downs of $r(t)$ are finite and equally likely. From the definition of $\tilde{h}(\theta)$,

$$\tilde{h}(\theta) = \int_{-\infty}^{\infty} h(u)e^{-iu\theta}du, \tag{44}$$

and bearing in mind the symmetry of $h(u)$ around $u = 0$ (implying that $h(u) = h(-u)$) we may write

$$\tilde{h}(-i/\alpha) = \int_{-\infty}^{\infty} h(u)e^{-u/\alpha}du = \int_0^{\infty} h(u)\left[e^{-u/\alpha} + e^{u/\alpha}\right]du, \tag{45}$$

that is,

$$\tilde{h}(-i/\alpha) = 2\int_0^{\infty} h(u)\cosh(u/\alpha)du. \tag{46}$$

Since $\cosh(u/\alpha) > 1$ and recalling that the normalization and symmetry of $h(u)$ imply $\int_0^\infty h(u)du = 1/2$, we have

$$\tilde{h}(-i/\alpha) > 2\int_0^{\infty} h(u)du = 1,$$

hence $\tilde{h}(-i/\alpha) > 1$ and condition (43) holds. Therefore, *for finite and symmetric jumps where ups and downs in return are equally likely discontinuities always reduce the long-run discount rate.* Let us recall that this conclusion remains valid as long as the integral in (46) is finite.

It is also possible to write an explicit expression of the long-run discount rate in terms of the jump PDF $h(u)$ instead of the expression given by Eq. (41) which gives r_∞ in terms of the characteristic function $\tilde{h}(-i/\alpha)$. Indeed, taking into account Eq. (46) and recalling the normalization of $h(u)$, we write

$$\begin{aligned}1 - \tilde{h}(-i/\alpha) = 1 - 2\int_0^{\infty} h(u)\cosh(u/\alpha)du &= 2\int_0^{\infty} h(u)[1 - \cosh(u/\alpha)]du \\ &= -\int_0^{\infty} h(u)\sinh^2(u/2\alpha)du\end{aligned}$$

and substituting this result into Eq. (41) we obtain

$$r_\infty = r_\infty^{(0)} - \lambda\int_0^{\infty} h(u)\sinh^2(u/2\alpha)du, \tag{47}$$

clearly showing that $r_\infty < r_\infty^{(0)}$ for symmetrical jumps. See also the final part of Appendix B for an alternative approach. Appendix B is however fundamentally focussed in providing the discount rate when the jump distribution is asymmetric, that is, when sudden ups and downs are not equally likely.

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3.2. Some specific jump distributions

We now study two particular examples of the jump distribution $h(u)$. For these examples we obtain the long-run discount rate and elucidate the meaning of condition (43) assuring that discontinuities reduce the long-run rate.

3.2.1. Fixed jump amplitudes

Let us first assume that the amplitudes of the discontinuities consist of a series of N fixed values, $\gamma_1, \ldots, \gamma_N$ ($N = 1, 2, 3, \ldots$). If these values are equally likely, the jump distribution function is

$$h(u) = \frac{1}{N}\sum_{j=1}^{N}\delta(u-\gamma_j) \qquad \Rightarrow \qquad \tilde{h}(\theta) = \frac{1}{N}\sum_{j=1}^{N} e^{-i\theta\gamma_j}. \tag{48}$$

In this case the function $\phi(t)$ defined in (35) can be written as

$$\phi(t) = -\frac{1}{\alpha N}\sum_{j=1}^{N}\int_0^{(1-e^{-\alpha t})/\alpha}\frac{e^{-\gamma_j\xi}}{1/\alpha-\xi}d\xi = \frac{1}{\alpha N}\sum_{j=1}^{N}e^{-\gamma_j/\alpha}\int_{1/\alpha}^{e^{-\alpha t}/\alpha}\frac{e^{\gamma_j\eta}}{\eta}d\eta$$
$$= \frac{1}{\alpha N}\sum_{j=1}^{N}e^{-\gamma_j/\alpha}\left[Ei\left(\gamma_i e^{-\alpha t}/\alpha\right) - Ei(\gamma_i/\alpha)\right], \tag{49}$$

where $Ei(\cdot)$ is the Exponential integral defined as [39]

$$Ei(x) = \int_{-\infty}^{x}\frac{e^{\eta}}{\eta}d\eta.$$

Expanding the integrand we get:

$$\int\frac{e^{\eta}}{\eta}d\eta = \ln\eta + \sum_{n=1}^{\infty}\frac{\eta^n}{nn!}.$$

Hence

$$\int_{1/\alpha}^{e^{-\alpha t}/\alpha}\frac{e^{\gamma_j\eta}}{\eta}d\eta = -\alpha t - \sum_{n=1}^{\infty}\frac{(\gamma_j/\alpha)^n}{nn!}\left(1-e^{-n\alpha t}\right),$$

and

$$\phi(t) = -\left(\frac{1}{N}\sum_{j=1}^{N}e^{-\gamma_j/\alpha}\right)t - \frac{1}{\alpha N}\sum_{j=1}^{N}e^{-\gamma_j/\alpha}\psi_j(t), \tag{50}$$

where

$$\psi_j(t) \equiv \sum_{n=1}^{\infty}\frac{(\gamma_j/\alpha)^n}{nn!}\left(1-e^{-n\alpha t}\right). \tag{51}$$

The discount function $D(t)$, given in Eq. (33), now reads

$$D(t) = D^{(0)}(t)\exp\left\{-\lambda t\left[1-\frac{1}{N}\sum_{j=1}^{N}e^{-\gamma_j/\alpha}\right] + \frac{\lambda}{\alpha N}\sum_{j=1}^{N}e^{-\gamma_j/\alpha}\psi_j(t)\right\} \tag{52}$$

with the jump-free discount $D^{(0)}(t)$ given by Eq. (34).

Figure 1 shows the effect on the average discount rate $d(t)$, defined in (3), of the presence of jumps with the simplest possible case when there is only one jump amplitude $\gamma < 0$ ($N = 1$). In this case the average discount rate reads (cf. Eqs. (52) and (49))

$$d(t) = -\frac{\ln D^{(0)}(t)}{t} + \lambda\left\{1 + \frac{\exp(-\gamma/\alpha)}{\alpha t}\left[Ei\left(\gamma e^{-\alpha t}/\alpha\right) - Ei(\gamma/\alpha)\right]\right\}. \tag{53}$$

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In Fig. 1 we assume a jump frequency $\lambda = 0.02$ 1/year (1 jump every 50 years) and show how the discount $d(t)$ changes as a function of time when considering no jumps and negative jumps of size $|\gamma|/\alpha = 0.25$ and 0.5, where α is the reversion to the mean of the OU process (cf. Eq. (16)). When considering the case of United States of America [4], it can be shown that small changes in $\gamma < 0$ parameter can lead to very sensitive effects to the discount rate lowering the rate to values close to 1% and lower, even if jumps size are small or very small.

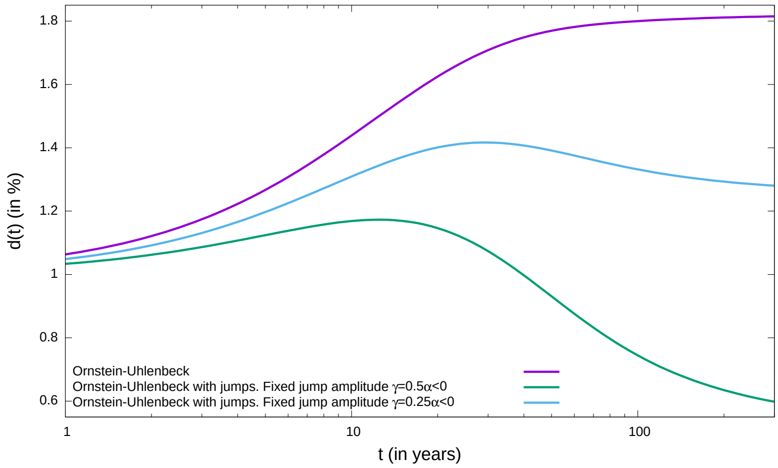

Figure 1. The discount rate (53) (in %) as a function of time (in years). We present the effects of the addition of jumps to the Ornstein-Uhlenbeck process by modifying the scaled jump size $|\gamma|/\alpha$<0. Jumps frequency λ is 1/50 years. General parameters for the Ornstein-Uhlenbeck process are those estimated by Ref. [4] for the case of United States of America whose estimated parameters are $\hat{m} = 0.0319$ year^{-1}, $\hat{\alpha} = 0.0603$ year^{-1}, $\hat{k^2} = 10.03 \times 10^{-5}$ year^{-3}.

In the long-run as $t \to \infty$ we see from (50) and (51) that

$$\phi(t) \simeq -\left(\frac{1}{N}\sum_{j=1}^{N} e^{-\gamma_j/\alpha}\right) t \qquad (t \to \infty),$$

and the discount function can be approximated by Eq. (40):

$$D(t) \simeq e^{-r_\infty t}, \qquad (t \to \infty),$$

where the long-run discount rate given in Eq. (41) now reads

$$r_\infty = r_\infty^{(0)} + \lambda\left[1 - \frac{1}{N}\sum_{j=1}^{N} e^{-\gamma_j/\alpha}\right] \tag{54}$$

and $r_\infty^{(0)}$ is the jump-free discount rate, Eq. (42). Let us also note that $r_\infty < r_\infty^{(0)}$ if

$$\frac{1}{N}\sum_{j=1}^{N} e^{-\gamma_j/\alpha} > 1. \tag{55}$$

The simplest case, when all jumps have the same amplitude, $\gamma_j = \gamma$, reads (cf. Eq. (54))

$$r_\infty = r_\infty^{(0)} + \lambda\left[1 - e^{-\gamma/\alpha}\right]. \tag{56}$$

In this case, if there is a sudden decrease in return ($\gamma < 0$) then $r_\infty < r_\infty^{(0)}$. Otherwise, an increase of return ($\gamma > 0$) implies the increase of the long-run discount ratio, $r_\infty > r_\infty^{(0)}$. These results are consistent with condition (43). Figure 2 shows how r_∞ change as a function

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of the scaled dimensionless jump length magnitude $|\gamma|/\alpha$ where α is the reversion to the mean of the OU process (cf. Eq. (16)). Figure 2 shows the opposite effects in the long run discount function for positive and negative jumps when $r_\infty^{(0)} = 1.81\%$, which corresponds to the lon-run discount rate estimated in Ref. [4] with United States of America (USA) real interest rate ratio datasets. For positive jumps $\gamma > 0$, the long-run rate in the case of USA can increase up to 3% with jump amplitudes of size 5% taking place once every 50 years. For negative jumps $\gamma < 0$, the long-run discount rates can become negative for jumps amplitudes of only 4%. These results confirm the high sensitivity of the long-run discount rate r_∞ when considering jumps.

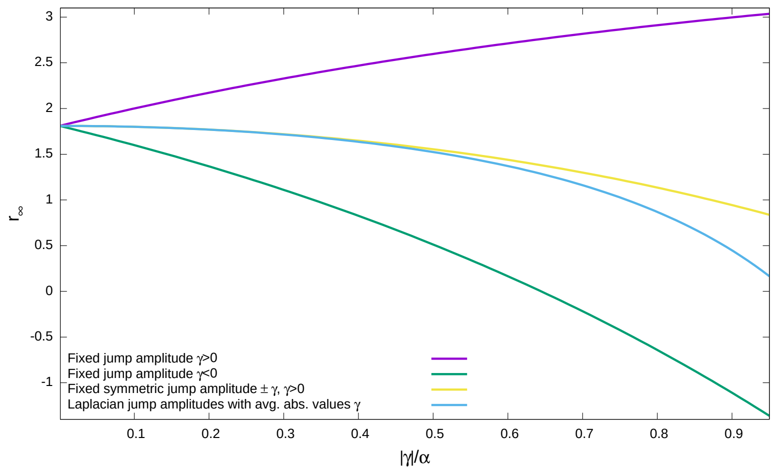

Figure 2. The long-run discount rate r_∞ as a function of the the scaled jump size ($|\gamma|/\alpha$) for jumps with fixed and bounded amplitudes ($\gamma > 0$ and $\gamma < 0$, cf. Eq. (56)), with two fixed and bounded symmetric jumps $\pm\gamma$ (cf. Eq. (57)) and for Laplacian jumps with average absolute value equals to γ (cf. Eq. (67)). In all cases, jumps frequency λ is 1/50 years and $r_\infty^{(0)} = 1.81\%$.

Another particular case consists in assuming that discontinuities have only two possible amplitudes which are equal but of opposite sign, that is, $\gamma_1 = \gamma$ and $\gamma_2 = -\gamma$. Now (cf. (48))

$$\tilde{h}(\theta) = \cosh(\gamma\theta/\alpha)$$

and the long-run discount rate (41) is

$$r_\infty = r_\infty^{(0)} + \lambda[1 - \cosh(\gamma/\alpha)]. \tag{57}$$

Note that since $\cosh(\gamma/\alpha) > 1$ for all values of γ/α then $r_\infty < r_\infty^{(0)}$. In this example in which return suddenly decreases or increases equally likely by a fixed quantity, discontinuities always reduce the long-run rate, as we have already proved in a previous section. Figure 2 shows that this decrease can be quite sensitive even when jumps amplitudes are relatively small (r_∞ can already be negative when jumps size are of the order of 5% when considering USA datasets).

3.2.2. Laplacian jump amplitudes

As a second example we suppose that jump amplitudes are not fixed but distributed according to the Laplace ("tent shape") density:

$$h(u) = \frac{1}{\sqrt{2}\gamma} e^{-\sqrt{2}|u|/\gamma}, \tag{58}$$

($\gamma > 0$). In this model increasing and decreasing jumps are equally likely with zero average discontinuity, $\langle \Delta r \rangle = 0$, and $\sigma = \sqrt{\langle \Delta r^2 \rangle} = \gamma$. Thus the parameter γ represents the average of absolute values of the amplitude of discontinuities. Bearing in mind that Eq.

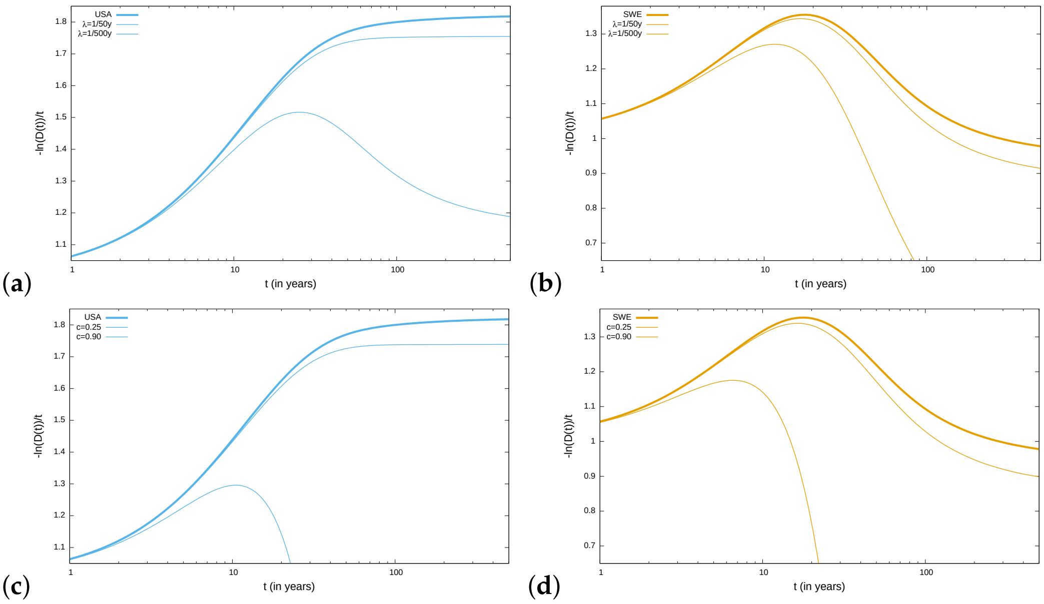

Figure 3. Discount function for Laplacian jump amplitudes with $c < 1$ (cf. Eqs. (64) and (65)) as a function of time (in years) and for different jumps time frequency λ. We take the Ornstein-Unlebeck parameters estimated somewherelse with initial interest rate $r_0 = 1\%$ [4] with United States of America (USA) and Sweden (SWE) dates which are considered to be stable countries. **a** and **(b)**: we explore the effect of increasing jumps time frequency (thiner lines, $1/\lambda$={500 and 50 years}) while fixing jumps amplitude ($c = 0.5$, cf. Eq. (63)). The pannel figures **(a)** and **(b)** show that the higher the frequency the lower the discount function curve. The pannel figuures **(c)** and **(d)** explore the effect of increasing jumps amplitude (thiner lines, c={0.2, 0.9}) while fixing jumps frequency ($1/\lambda$=50 years). The higher the c (jump size), the lower the discount. The case of the United States of America (USA) whose Ornstein-Uhlenbeck estimated parameters are $\hat{m} = 0.0319$ year^{-1}, $\hat{\alpha} = 0.0603$ year^{-1}, $\hat{k^2} = 10.03 \times 10^{-5}$ year^{-3}. The case of Sweden (SWE) whose Ornstein-Uhlenbeck estimated parameters are $\hat{m} = 0.0279$ year^{-1}, $\hat{\alpha} = 0.0676$ year^{-1}, $\hat{k^2} = 16.9 \times 10^{-5}$ year^{-3}.

(58) represents a symmetric distribution around $u = 0$ we see that the Fourier transform of $h(u)$ can be written as

$$\tilde{h}(\theta) = \frac{2}{\gamma\sqrt{2}} \int_0^\infty e^{-u\sqrt{2}/\gamma} \cos(\theta u) du. \tag{59}$$

When $\theta \in \mathbb{R}$ is real direct integration [39] yields

$$\tilde{h}(\theta) = \frac{1}{1 + \gamma^2\theta^2/2}. \tag{60}$$

Suppose, however, that $\theta = i\xi$ ($\xi \in \mathbb{R}$) is an imaginary number, in such a case since $\cos i\theta = \cosh \xi$ the integral in Eq. (59) diverges when $|\xi| \geq \sqrt{2}/\gamma$. We thus have

$$\tilde{h}(i\xi) = \begin{cases} \frac{1}{1-\gamma^2\xi^2/2}, & |\xi| < \sqrt{2}/\gamma, \\ \infty & |\xi| \geq \sqrt{2}/\gamma. \end{cases} \tag{61}$$

For the special case $\xi = -1/\alpha$ we have

$$\tilde{h}(-i/\alpha) = \begin{cases} 1/(1-c^2), & c < 1, \\ \infty, & c \geq 1, \end{cases} \tag{62}$$

where

$$c \equiv \frac{\gamma}{\alpha\sqrt{2}} \tag{63}$$

is a dimensionless parameter which combines the average absolute jump γ and the strength α of the reversion to the mean of the OU process.

Recall that in terms of the jump-free discount the discount function is given by (cf. Eq. (33))

$$D(t) = D^{(0)}(t) e^{-\lambda[t+\phi(t)]}. \tag{64}$$

where $D^{(0)}(t)$ and $\phi(t)$ are respectively given by Eqs. (34) and (35). In the Appendix C we show that for the Laplace density (58) the form and behavior of the discount function depends on the value of the parameter c defined in Eq. (63). We have three cases:

1. When $c < 1$ (i.e., $\gamma < \alpha\sqrt{2}$) we prove in the Appendix C that the function $\phi(t)$ is given by

$$\phi(t) = -\frac{t}{1-c^2} - \frac{1}{2\alpha}\left[\frac{1}{1-c}\ln\left(1 - c(1-e^{-\alpha t})\right) + \frac{1}{1+c}\ln\left(1 + c(1-e^{-\alpha t})\right)\right]. \tag{65}$$

In this case the discount function is finite and follows from Eq. (64) after substituting Eq. (65). Figure 3 illustrate this result considering the OU parameters estimated in Ref. [4] while considering different jumps frequencies λ and diffent jumps amplitude in terms of c. For large values of t we have

$$\phi(t) \simeq -\frac{t}{1-c^2}, \qquad (t \to \infty).$$

Since $D^{(0)}(t) \simeq e^{-r_\infty^{(0)} t}$ as $t \to \infty$ (cf. Eqs. (36) and (42)) we finally obtain

$$D(t) \simeq \exp\left\{-\left[r_\infty^{(0)} - \lambda c^2/(1-c^2)\right]t\right\}, \qquad (t \to \infty), \tag{66}$$

and the expression for the long-run rate reads

$$r_\infty = r_\infty^{(0)} - \frac{\lambda c^2}{1-c^2} < r_\infty^{(0)}, \qquad (c < 1), \tag{67}$$

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with $r_\infty^{(0)}$ given in Eq. (42). In this model discontinuities reduce the long-run discount rate if $c < 1$, which implies that r_∞ is finite. That is, when $\gamma < \alpha\sqrt{2}$ and the average of the absolute value of discontinuities is smaller than the strength of the reversion to the mean represented by $\alpha\sqrt{2}$. The behavior of the lon-run discount rate r_∞ for Laplacian jumps can be compared to fixed and bounded jumps amplitude case provided in Subsection 3.2.1. As shown in Figure 2, the behavior is qualitatively similar to the case of two symmetric jumps. The differences among both examples become relevant when $c \to 1^-$, being the curve consistent with the critical behavior described in Eq. (62).

2. When $c > 1$ (i.e., $\gamma > \alpha\sqrt{2}$) we prove in the Appendix C that discount becomes infinite for times greater than a critical time,

$$D(t) = \infty, \qquad (t \geq t^*), \tag{68}$$

where

$$t^* = -\frac{1}{\alpha}\ln\left(1 - \frac{1}{c}\right), \tag{69}$$

while for $t < t^*$ the discount function is given as in case (i) above (even though now it has no sense asking for the asymptotic behavior of discount as $t \to \infty$). Figure 4 shows the sensitivity of the critical time with respect to jumps amplitude. We there show that critical time t^* can become shorter than a year or be strongly reduced as c increases.

3. For the threshold case $c = 1$ (i.e., $\gamma = \alpha\sqrt{2}$) the discount function grows exponentially. Thus in the Appendix C we show that

$$D(t) \simeq \exp\left\{\frac{\lambda}{2\alpha}e^{\alpha t}\right\}, \qquad (t \to \infty). \tag{70}$$

Note that this behavior is not contradictory with our previous results since, as $r_\infty^{(0)} > 0$ and

$$1 < \frac{2\alpha^2}{\gamma^2} < 1 + \frac{\lambda}{r_\infty^{(0)}},$$

r_∞ becomes negative, and discount turns into an increasing function for t large enough.

From this case, we conclude that if jump amplitudes are on average smaller than the restoring force toward the normal level ($\gamma < \alpha\sqrt{2}$) jumps reduce the long-run discount rate. However, when jump amplitudes are larger ($\gamma > \alpha\sqrt{2}$) the discount function becomes infinite at a finite time.

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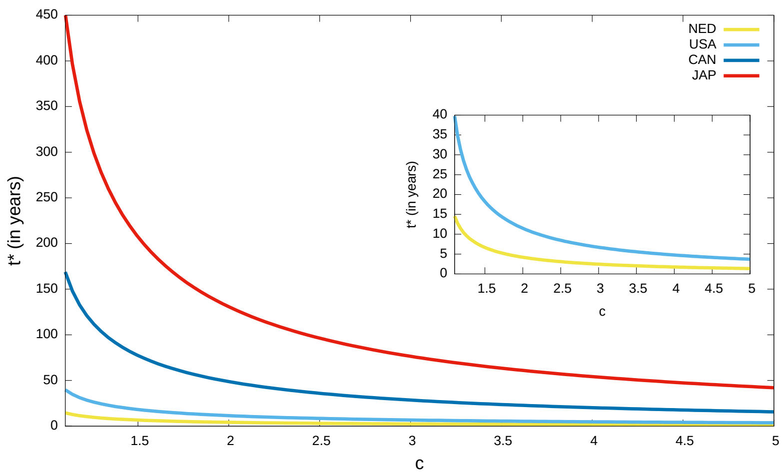

Figure 4. Critical time as a function of the Laplacian jumps amplitude $c = \gamma/(\sqrt{2}\hat{\alpha}) > 1$ (cf. Eq. (69)) and for serveral values of $\hat{\alpha}$ attributed to different countries. We take the Ornstein-Unlebeck $\hat{\alpha}$ parameter estimated somewherelse [4]: $1/(6.068$ years$)$ for Netherlands (NED), $1/(16.58$ years$)$ for United States of America (USA), $1/(70.42$ years$)$ for Canada (CAN) and $1/(188.7$ years$)$ for Japan (JAP). The inset shows in further detail the cases with shorter critical times.

3.3. Discount in the continuous time random walk formalism

Up to this point we have dealt with a rate process described by a diffusion process in which there are superimposed finite discontinuities. At one extreme of the model we find continuous diffusion processes with no discontinuities which have been developed in our previous works [1,2,4]. At the other extreme we find a purely discontinuous process where the return starting at some initial value keeps this value during a random interval of time and makes a sudden jump with a random amplitude to a new value, keeps the new value another random time interval, makes another jump and so on. This is precisely the Continuous Time Random Walk (CTRW) with countless applications in many branches of natural sciences, engineering and economics and social sciences [40,41]. Let us observe that if waiting times between jumps are Poissonian with rate λ and independent of the jump amplitudes, then the PDF of the bidimensional process $(x(t), r(t))$ –which we denote by $p_0(x, r, t|r_0)$– is described by the integro-differential equation (14) with $f(r) = g(r) = 0$

$$\frac{\partial p_0}{\partial t} = -r\frac{\partial p_0}{\partial x} - \lambda p_0(x, r, t|r_0) + \lambda \int_{-\infty}^{\infty} h(r-\rho) p_0(x, \rho, t|r_0) d\rho, \tag{71}$$

with the initial condition

$$p_0(x, r, 0|r_0) = \delta(x)\delta(r - r_0). \tag{72}$$

By Fourier transforming this problem we easily obtain the expression for the characteristic function $\tilde{p}(\omega_1, \omega_2, t|r_0)$. It reads [2]

$$\tilde{p}_0(\omega_1, \omega_2, t|r_0) = \exp\left\{-i(\omega_1 t + \omega_2)r_0 - \lambda\left[t - \frac{1}{\omega_1}\int_{\omega_2}^{\omega_1 t+\omega_2} \tilde{h}(\theta)d\theta\right]\right\}. \tag{73}$$

The marginal distribution of the return, $\tilde{p}_0(\omega_2, t|r_0)$, is obtained from (73) after setting $\omega_1 = 0$:

$$\tilde{p}_0(\omega_2, t|r_0) = \exp\{-i\omega_2 r_0 - \lambda t[1 - \tilde{h}(\omega_2)]\}, \tag{74}$$

and the return variance reads $\sigma_0^2(t) = \lambda\mu t$, where $\mu = -\tilde{h}''(0)$ is the jump second moment.

[2] This solution can be also obtained from Eq. (23) with the values $\alpha = 0$ and $k = 0$.

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The discount function is obtained by setting $\omega_1 = -i$ and $\omega_2 = 0$ in the joint characteristic function (73). For the CTRW model this yields

$$D_0(t) = \exp\{-r_0 t - \lambda[t + \phi_0(t)]\}, \tag{75}$$

where

$$\phi_0(t) = \frac{1}{i}\int_0^{-it} \tilde{h}(\theta)d\theta = -\int_0^t \tilde{h}(-i\xi)d\xi. \tag{76}$$

Equation (75) is the expression of the discount function when rates are modeled by a Markovian CTRW with a general jump density $h(u)$.

In the special case of Laplacian jumps $\tilde{h}(-i\xi)$ (cf. Eq. (61))

$$\tilde{h}(i\xi) = \begin{cases} \frac{1}{1-\gamma^2\xi^2/2}, & |\xi| < \sqrt{2}/\gamma, \\ \infty & |\xi| \geq \sqrt{2}/\gamma. \end{cases} \tag{77}$$

For times such that $t < \sqrt{2}/\gamma$ we see from Eq. (76) that $\xi < t < \sqrt{2}/\gamma$, hence

$$\phi_0(t) = -\int_0^t \frac{d\xi}{1-\gamma^2\xi^2/2} = \frac{1}{\gamma}\Big[-\ln\Big(1-\gamma t/\sqrt{2}\Big) + \ln\Big(1+\gamma t/\sqrt{2}\Big)\Big].$$

In this case the discount function reads

$$D_0(t) = \left(\frac{1+\gamma t/\sqrt{2}}{1-\gamma t/\sqrt{2}}\right)^{\lambda/\gamma} e^{-(r_0+\lambda)t}, \qquad (t < \sqrt{2}/\gamma). \tag{78}$$

On the other hand, if $t > \sqrt{2}/\gamma$ we can write

$$\phi_0(t) = -\left[\int_0^{\sqrt{2}/\gamma} \tilde{h}(-i\xi)d\xi + \int_{\sqrt{2}/\gamma}^t \tilde{h}(-i\xi)d\xi\right].$$

But due to Eq. (77) the second integral is infinite, hence $\phi_0(t) = -\infty$ and

$$D_0(t) = \infty, \qquad (t > \sqrt{2}/\gamma). \tag{79}$$

Therefore, for the CTRW model with Laplacian jumps the discount function becomes infinite in the finite time $t^* = \sqrt{2}/\gamma$.

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Table 1. Summary of the results proved in Section 3. The Ornstein-Uhlenbeck diffusion process already shows that the presence of noise ($k \neq 0$) reduce long-run discount rate $r_\infty^{(0)}$. The inclusion of Poissonian jumps with specific scenarios leads to several discount functions $D(t)$ and several long-run discount rate r_∞.

Model	Discount
Main definitions	Discount function:
$dx/dt = r$	$D(t) = \mathbb{E}\left[\exp\left(-\int_0^t r(t')dt'\right)\right]$
$dr/dt = f(r) + g(t)\xi(t) + n(t)$	Discount rate: $\ln D(t)/t$
	Long-run discount rate:
	$r_\infty = \lim_{t\to\infty} \ln D(t)/t$
Ornstein-Uhlenbeck (OU)	
$dr/dt = -\alpha(r-m)dt + k\xi(t)$	$r_\infty^{(0)} = m - k^2/(2\alpha^2)$
OU and Poissonian jumps	
$dr/dt = -\alpha(r-m)dt + k\xi(t) + n(t)$	
$n(t) = \sum_j \gamma_j \delta(t-t_j)$	
Jumps size PDF $h(\gamma_j)$	
Poissonian $\tau = t_{i+1} - t_i$ time interval PDF	
$\psi(\tau) = \lambda e^{-\lambda\tau}$	
If $\tilde{h}(-i/\alpha)$ is finite	$r_\infty = r_\infty^{(0)} + \lambda[1 - \tilde{h}(-i/\alpha)]$
If $\tilde{h}(-i/\alpha)$ is finite and $\tilde{h}(-i/\alpha) > 1$	$r_\infty < r_\infty^{(0)}$
If $\tilde{h}(-i/\alpha)$ is finite and jumps are symmetric	$r_\infty < r_\infty^{(0)}$
If jumps have two fixed amplitudes $\pm\gamma$	$r_\infty = r_\infty^{(0)} + \lambda[1 - \cosh(\gamma/\alpha)] < r_\infty^{(0)}$
Laplacian jumps with absolute jump average γ	
If $0 < \gamma < \alpha\sqrt{2}$	$r_\infty = r_\infty^{(0)} - \frac{\lambda}{2\alpha^2/\bar{\gamma}^2 - 1} < r_\infty^{(0)}$
If $\gamma > \alpha\sqrt{2}$	Not defined
	Critical explosive time
If jumps have one-fixed increasing amplitude	$r_\infty = r_\infty^{(0)} + \lambda\left(1 - e^{-\lvert\gamma\rvert/\alpha}\right) > r_\infty^{(0)}$
If jumps have one-fixed decreasing amplitude	$r_\infty = r_\infty^{(0)} + \lambda\left(1 - e^{\lvert\gamma\rvert/\alpha}\right) < r_\infty^{(0)}$
If jumps have two-fixed amplitudes $\pm\gamma$	$r_\infty = r_\infty^{(0)} + \lambda[1 - \cosh(\gamma/\alpha)] < r_\infty^{(0)}$
Continuous Time Random Walk	
$dr/dt = n(t)$	
Laplacian jumps with absolute jump average γ	Not defined
	Critical explosive time $t^* = \sqrt{2}/\gamma$

4. Discussion

In a series of recent works [1–5] we have analyzed the process of discounting using mostly methods borrowed from nonequilibrium statistical physics and stochastic processes. In these works we have considered three of the most popular stochastic models for the dynamics of interest rates: Ornstein-Uhlenbeck [26], Feller [27], and lognormal [28] processes, which are also very relevant in statistical physics. However, we are interested in real rates

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(that is, nominal rates corrected by inflation) which can be negative even during prolonged periods of time [1,4] and, since Feller and log-normal model deal exclusively with positive quantities, this leads to the Ornstein-Uhlenbeck (OU) process as the only model allowing for negative rates. Moreover, the asymptotic expression for discount provided by the OU model has an exponential decay with a long-run rate r_∞ that differs from historical average interest rates by being substantially smaller, zero or eventually negative [1–5].

The work presented here continues with such an undertaking but we go one step further and assume that, in addition to diffusive and continuous behavior, the sample paths of real rates $r(t)$ also exhibit discontinuities. That is, we will model rates by a jump-diffusion process as the economic evolution is known to occasionally have sudden bursts that hardly adjust to continuous diffusion-like evolution. We have thus wanted to elucidate the effect on the long-run discount of discontinuities which reflect the high-risk events that might occur in the future.

We have obtained a very general formula of the discount function for processes that combine an Ornstein-Uhlenbeck (OU) dynamics with the presence of Poissonian jumps with frequency λ. Equation (33) shows this key result. Two almost immediate questions are: how this general formula behaves for very long times? and which is the resulting long-run discount rate r_∞?. Thus, if $\tilde{h}(\theta)$ is the jump characteristic function, we have proved that as long as $\tilde{h}(-i/\alpha)$ exists one obtains a value for r_∞. Otherwise, the discount becomes infinite for a finite time horizon. An infinite discount is indeed catastrophic for the economy because it implies that any future value is zero. Furthermore, in case that $\tilde{h}(-i/\alpha) > 1$, the addition of jumps to the model results into a decrease of r_∞ (cf. Eqs. (42)-(43)). This latter case entails a call for a more immediate action to climate change and it applies to those processes with symmetric jump amplitude. The obtention of lower long-run discount rates r_∞ for symmetric jumps amplitude is of particular importance as it deepens in the idea already suggested by the OU process with no sudden jumps. That is to say, the fact that bounded unbiassed uncertainty, no matter whether continuous or not, increases the urgency for immediate action.

To go deeper in evaluating the effect of discontinuities, we have gone through three different scenarios. The simplest case refers to the existence of a fixed jumps amplitude. We have been able to obtain the exact formula for the discount which is represented in Fig. 1 by considering the parameters of the OU process for United States of America [4] for a single negative jump γ. We there show that even by considering a frequency λ of 1 jump every 50 years and small jumps ($\gamma = 0.5\alpha$) the effect is more than evident. As expected, sudden negative returns represent a quicker decrease in the discount function. Negative jumps of 5% return size (due to catastrophic news such as the COVID-19 outbreak) can already lead r_∞ to negative values which in practice is telling us that immediate actions with strong investment are unavoidable to face, even if they are unknown, climate effects in the future (see Fig. 2). In contrast, the assumption of having future sudden positive returns –due, for instance, to positive news or a major technological breakthrough– increments r_∞ thus releasing pressure for taking action rapidly. It is however important to mention that the increment is lower than the decrement observed for negative jumps of the same size (see Figure 2).

A more sophisticated scenario is to consider the possibility of having two jumps of the same amplitude but of opposite signs. This symmetric scenario also allows to obtain the discount function and this case always lowers the rate because of its symmetry. In the case of USA, as can also be shown in Figure 2, this drives r_∞ from 1.8% to 1% with jump amplitude $\gamma = 5$ % and frequency $\lambda = (1/50)$ year^{-1}.

A third scenario considers a symmetric and continuous distribution of jumps amplitude given by the Laplace density. Depending on the value of c, a scaled measure for jumps amplitude size defined in Eq. (63), we observe different behavior of the discount function. If $c < 1$, it is possible to obtain an analytical formula of the discount function which is carefully explored in Figures 3 with the OU estimated parameters with real interest rate datasets from USA and Sweden [4]. We there extend the analysis by exploring the effect

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of different values for jumps frequency λ and scaled jump amplitude c. However, when $c > 1$, the discount function becomes infinite for a critical time t^*. Figure 4 shows that the critical time t^* is quite sensitive to jumps amplitude size in a wide variety of cases and t^* can become rather small even for small jump amplitudes (For instance, few years, less than a decade, with jumps amplitude size about 7%, if we consider OU parameter from the case of USA).

Finally, it is also possible to obtain the discount function if we disregard the diffusion contribution. This scenario corresponds to the Continuous Time Random Walk and the results when assuming Laplacian jumps amplitudes are different depending on the critical time $\sqrt{2}/\gamma$. At short times, when $t < \sqrt{2}/\gamma$, the discount function decreases exponentially (cf. Eq. (78)). However, as $t > \sqrt{2}/\gamma$ the discount function becomes infinite.

The main results of this paper are summarized Table 1. Let us recall that the chief objective of the present work is to contribute to the mathematical modeling of discounting, within the context of environmental economics and climate action, by considering extreme situations or outliers. Although Martin Weitzman has introduced already the effect of fat tails in the economic evolution [31,32], our approach here is more dynamical and it is based not on fat tails but on the addition of discontinuities in the economic time evolution. As we have shown such discontinuities may result, under certain conditions, into an infinite discount, confirming what Weitzman foresaw few years ago. Let us emphasize that our approach (being complementary to that of Weitzman) provides a very general mathematical framework which allows for direct computation. We have also explored specific scenarios which show that discontinuities due to unexpected shocks (even if they represent downside shocks such as epidemics or a climate disaster or upside shocks due, for instance, to a new technological breakthrough) can severely affect current estimates of economic variables such as the long-run discount rate. Changes on this economic variables are shown to be strong enough to influence current decision mechanisms on whether and in which degree we shall take action today to face climate change.

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Appendix A. The method of characteristics

We here address the problem of solving Eq. (20),

$$\frac{\partial \tilde{p}}{\partial t} + (\alpha\omega_2 - \omega_1)\frac{\partial \tilde{p}}{\partial \omega_2} = -\left[\lambda - \lambda\tilde{h}(\omega_2) + i\alpha m\omega_2 + \frac{k^2}{2}\omega_2^2\right]\tilde{p}, \tag{A1}$$

with the initial condition (22),

$$\tilde{p}(\omega_1, \omega_2, 0|r_0) = e^{-i\omega_2 r_0}. \tag{A2}$$

Equation (A1) is a linear partial differential equation of first order and it can be solved by the method of characteristics [38]. Note that here t and ω_2 are the actual variables of Eq.

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(A1) whereas ω_1 is just a parameter. The method of characteristics consists in replacing the variable ω_2 by a function of time $\omega_2 \to \beta(t)$ (the characteristic) such that

$$\frac{d\beta}{dt} = \alpha\beta - \omega_1. \tag{A3}$$

With this replacement the distribution $\tilde{p}(\omega_1, \omega_2, t|r_0)$ is only a function of t, that is,

$$\tilde{p}(\omega_1, \beta(t), t|r_0) \equiv \tilde{p}(t),$$

and by the chain rule we have

$$\frac{d\tilde{p}}{dt} = \frac{\partial\tilde{p}}{\partial t} + \frac{\partial\tilde{p}}{\partial\beta}\frac{d\beta}{dt},$$

then using Eq. (A3) we see from Eq. (A1) that $\tilde{p}(t)$ satisfies the ordinary differential equation

$$\frac{d\tilde{p}(t)}{dt} = -\left[\lambda - \lambda\tilde{h}(\beta(t)) + i\alpha m\beta(t) + \frac{k^2}{2}\beta^2(t)\right]\tilde{p}, \tag{A4}$$

whose solution is

$$\tilde{p}(t) = \tilde{p}(0)\exp\left\{-\left[\lambda t - \lambda\int_0^t \tilde{h}(\beta(t'))dt' + i\alpha m\int_0^t \beta(t')dt' + \frac{k^2}{2}\int_0^t \beta^2(t')dt'\right]\right\}, \tag{A5}$$

where as initial condition we take

$$\tilde{p}(0) = e^{-i\beta(0)r_0}. \tag{A6}$$

Solving Eq. (A3) we get

$$\beta(t) = \frac{1}{\alpha}(\omega_1 + Ce^{\alpha t}), \tag{A7}$$

where C is an integration constant. Using this expression for $\beta(t)$ we have

$$\int_0^t \tilde{h}(\beta(t'))dt' = \int_0^t \tilde{h}\left[\frac{1}{\alpha}\left(\omega_1 + Ce^{\alpha t'}\right)\right]dt' = \int_{(\omega_1+C)/\alpha}^{(\omega_1+Ce^{\alpha t})/\alpha} \frac{\tilde{h}(\theta)}{\alpha\theta - \omega_1}d\theta,$$
$$\int_0^t \beta(t')dt' = \frac{\omega_1 t}{\alpha} + \frac{C}{\alpha^2}(e^{\alpha t} - 1),$$
$$\int_0^t \beta^2(t')dt' = \frac{1}{\alpha^2}\left[\omega_1^2 t + \frac{2C\omega_1}{\alpha}(e^{\alpha t} - 1) + \frac{C^2}{2\alpha}\left(e^{2\alpha t} - 1\right)\right]$$

and (cf. (A6) and (A7))

$$\tilde{p}(0) = \exp\left\{-i\frac{r_0}{\alpha}(\omega_1 + C)\right\}.$$

Collecting these expressions into Eqs. (A5) and (A6) we have

$$\begin{aligned}\ln\tilde{p}(t) \quad = \quad & -i\frac{r_0}{\alpha}(\omega_1 + C) - \lambda t + \lambda\int_{(\omega_1+C)/\alpha}^{(\omega_1+Ce^{\alpha t})/\alpha} \frac{\tilde{h}(\theta)}{\alpha\theta - \omega_1}d\theta \\ & -i\alpha m\left[\frac{\omega_1 t}{\alpha} + \frac{C}{\alpha^2}(e^{\alpha t} - 1)\right] \\ & -\frac{k^2}{2\alpha^2}\left[\omega_1^2 t + \frac{2C\omega_1}{\alpha}(e^{\alpha t} - 1) + \frac{C^2}{2\alpha}\left(e^{2\alpha t} - 1\right)\right],\end{aligned} \tag{A8}$$

On the other hand, solving for C in Eq. (A7) we have

$$C = [\alpha\beta(t) - \omega_1]e^{-\alpha t}.$$

Now reverting to the original variable ω_2 independent of t, i.e., $\beta(t) \to \omega_2$ and for which $\tilde{p}(t) \to \tilde{p}(\omega_1, \omega_2, t|r_0)$, we set

$$C = (\alpha\omega_2 - \omega_1)e^{-\alpha t},$$

and substituting this expression for C into Eq. (A8) we finally obtain

$$\begin{aligned} \ln \hat{p}(\omega_1, \omega_2, t|r_0) \quad = \quad & -i\frac{r_0}{\alpha}\left[\omega_1(1-e^{-\alpha t}) + \alpha\omega_2 e^{-\alpha t}\right] - \lambda[t + \phi(\omega_1, \omega_2, t)] \\ & -i\alpha m\left[\frac{\omega_1 t}{\alpha} + \frac{1}{\alpha^2}(\alpha\omega_2 - \omega_1)(1 - e^{\alpha t})\right] \\ & -\frac{k^2}{2\alpha^2}\left[\omega_1^2 t + \frac{2\omega_1}{\alpha}(\alpha\omega_2 - \omega_1)(e^{\alpha t} - 1)\right. \\ & \left. + \frac{1}{2\alpha}(\alpha\omega_2 - \omega_1)^2\left(1 - e^{2\alpha t}\right)\right], \end{aligned} \tag{A9}$$

where

$$\phi(\omega_1, \omega_2, t) = \int_{\omega_2}^{\chi(\omega_1,\omega_2,t)} \frac{\tilde{h}(\theta)}{\alpha\theta - \omega_1} d\theta \qquad \text{and} \qquad \chi(\omega_1, \omega_2, t) = \frac{\omega_1}{\alpha}(1 - e^{-\alpha t}) + \omega_2 e^{-\alpha t}.$$

After rearranging terms Eq. (A9) corresponds to Eq. (23).

Appendix B. Long-run discount rate for asymmetric jump distributions

We here draw some general conclusions about the properties of the long-run discount rate r_∞ given in Eq. (41) when up and down discontinuities are not equally likely. From the definition (cf. Eq. (21))

$$\tilde{h}(\theta) = \int_{-\infty}^{\infty} h(u)e^{-iu\theta} du,$$

we see that

$$\tilde{h}(-i/\alpha) = \int_{-\infty}^{\infty} h(u)e^{-u/\alpha} du. \tag{A10}$$

We will now assume that the jump distribution PDF $h(u)$, albeit being a continuous and non-singular function, is also non symmetrical around the origin and write

$$h(u) = \begin{cases} h_+(u)\Theta(u), \\ h_-(-u)\Theta(-u), \end{cases} \tag{A11}$$

where $h_\pm(u)$ are bounded functions and continuity at the origin implies $h_+(0) = h_-(0) \neq 0$. Hence, combining Eqs. (A10) and (A11), we can obtain

$$\tilde{h}(-i/\alpha) = \int_0^{\infty} h_+(u)e^{-u/\alpha} du + \int_0^{\infty} h_-(u)e^{u/\alpha} du. \tag{A12}$$

In order to gain further insight, we next replace $h_\pm(u)$ by

$$h_\pm(u) = p_\pm f_\pm(u), \tag{A13}$$

such that

$$\int_0^{\infty} f_\pm(u) du = 1. \tag{A14}$$

Clearly $p_+ + p_- = 1$ and, since $h_+(0) = h_-(0)$, we obtain

$$p_\pm = \frac{f_\mp(0)}{f_+(0) + f_-(0)}. \tag{A15}$$

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Substituting these expressions into Eq. (A12) we get

$$\tilde{h}(-i/\alpha) = \frac{1}{f_+(0)+f_-(0)}\left[f_-(0)\int_0^\infty f_+(u)e^{-u/\alpha}du + f_+(0)\int_0^\infty f_-(u)e^{u/\alpha}du\right], \tag{A16}$$

and returning to Eq. (41) we have

$$r_\infty = r_\infty^{(0)} - \lambda\left[\tilde{h}(-i/\alpha)-1\right] = r_\infty^{(0)} - \frac{\lambda}{f_+(0)+f_-(0)}\Bigg[f_-(0)\int_0^\infty f_+(u)e^{-u/\alpha}du$$
$$+f_+(0)\int_0^\infty f_-(u)e^{u/\alpha}du - f_+(0) - f_-(0)\Bigg],$$

so that,

$$r_\infty = r_\infty^{(0)} - \frac{\lambda}{f_+(0)+f_-(0)}\Bigg\{f_+(0)\int_0^\infty f_-(u)\left[e^{u/\alpha}-1\right]du$$
$$-f_-(0)\int_0^\infty f_+(u)\left[1-e^{-u/\alpha}\right]du\Bigg\}. \tag{A17}$$

Observe that the two integrals are positive definite which implies that we will obtain a diminution of the long-run rate with respect to the jump free case, $r_\infty < r_\infty^{(0)}$, if and only if the quantity within curly brackets is positive, that is

$$\frac{\int_0^\infty f_-(u)\left[e^{u/\alpha}-1\right]du}{\int_0^\infty f_+(u)\left[1-e^{-u/\alpha}\right]du} > \frac{f_-(0)}{f_+(0)}. \tag{A18}$$

Let us incidentally note that the numerator on the left-hand side of this inequality must be bounded, otherwise the expression of the long-run rate given in Eq. (A17) is no longer valid.

For symmetrical jumps around the origin we have

$$f_-(u) = f_+(u) \equiv f(u),$$

and Eq. (A17) reduces to

$$r_\infty = r_\infty^{(0)} - \frac{\lambda}{2}\int_0^\infty f(u)\left[e^{u/\alpha}+e^{-u/\alpha}-2\right]du = r_\infty^{(0)} - \lambda\int_0^\infty f(u)[\cosh(u/\alpha)-1]du,$$

that is,

$$r_\infty = r_\infty^{(0)} - 2\lambda\int_0^\infty f(u)\sinh^2(u/2\alpha)du,$$

which corresponds to the expression (47) of the main text.

Appendix C. Discount function for Laplacian jumps

As shown in the main text, the discount function is given by (cf. Eq. (33))

$$D(t) = D^{(0)}(t)e^{-\lambda[t+\phi(t)]}, \tag{A19}$$

where $D^{(0)}(t)$ is the discount in the absence of discontinuities (cf. Eq. (34)) and $\phi(t)$ is given by Eq. (35):

$$\phi(t) = -\frac{1}{\alpha}\int_0^{(1-e^{-\alpha t})/\alpha}\frac{\tilde{h}(-i\xi)}{1/\alpha-\xi}d\xi. \tag{A20}$$

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For Laplacian jumps we have shown in the main text that (cf. Eq. (61))

$$\tilde{h}(-i\xi) = \begin{cases} \frac{1}{1-\gamma^2\xi^2/2}, & |\xi| < \sqrt{2}/\gamma, \\ \infty & |\xi| \geq \sqrt{2}/\gamma. \end{cases} \tag{A21}$$

We will obtain the form of the discount function $D(t)$ depending on the values of the dimensionless c defined as $c = \gamma/(\alpha\sqrt{2})$ (cf. Eq. (63)). Let us have in mind that $(1-e^{-\alpha t})/\alpha$ is an increasing function of time such that

$$\frac{1}{\alpha}(1-e^{-\alpha t}) \to 0 \quad (t \to 0) \qquad \text{and} \qquad \frac{1}{\alpha}(1-e^{-\alpha t}) \to \frac{1}{\alpha} \quad (t \to \infty). \tag{A22}$$

We therefore have the following cases:

(i) $c < 1$: From Eq. (A22) we see that $(1-e^{-\alpha t})/\alpha < \sqrt{2}/\gamma$ for all $t \geq 0$. Hence looking at (A20) we conclude that in this case $\xi < \sqrt{2}/\gamma$ which allows us to use the first equation of (A21) for evaluating the integral of Eq. (A20). After performing the change of integration variable $u = \gamma\xi/\sqrt{2}$, we have

$$\phi(t) = -\frac{1}{\alpha}\int_0^{(1-e^{-\alpha t})/\alpha} \frac{1}{1/\alpha-\xi}\cdot\frac{1}{1-\gamma^2\xi^2/2}d\xi = -\frac{1}{\alpha}\int_0^{c(1-e^{-\alpha t})}\frac{1}{c-u}\cdot\frac{1}{1-u^2}du, \tag{A23}$$

Noticing that

$$\frac{1}{c-u}\cdot\frac{1}{1-u^2} = \frac{1}{1-c^2}\cdot\frac{1}{c-u} + \frac{1}{2}\left[\frac{1}{1+c}\cdot\frac{1}{1+u} - \frac{1}{1-c}\cdot\frac{1}{1-u}\right],$$

the last integral in (A23) is immediate and yields

$$\phi(t) = -\frac{t}{1-c^2} - \frac{1}{2\alpha}\left[\frac{1}{1-c}\ln\left(1-c(1-e^{-\alpha t})\right) + \frac{1}{1+c}\ln\left(1+c(1-e^{-\alpha t})\right)\right], \qquad (c<1). \tag{A24}$$

(ii) $c > 1$: Defining t^* such that

$$\frac{1}{\alpha}\left(1-e^{\alpha t^*}\right) = 0 \quad \Rightarrow \quad t^* = -\frac{1}{\alpha}\ln\left(1-\frac{1}{c}\right), \tag{A25}$$

we easily convince ourselves after looking at Eq. (A22) that

$$\frac{1}{\alpha}\left(1-e^{\alpha t^*}\right) < \frac{\sqrt{2}}{\gamma}, \quad (t<t^*); \qquad \frac{1}{\alpha}\left(1-e^{\alpha t^*}\right) > \frac{\sqrt{2}}{\gamma}, \quad (t>t^*).$$

Hence for $t > t^*$ the integral in (A20) can be split into

$$\phi(t) = -\frac{1}{\alpha}\int_0^{\sqrt{2}/\gamma}\frac{\tilde{h}(-i\xi)}{1/\alpha-\xi}d\xi - \frac{1}{\alpha}\int_{\sqrt{2}/\gamma}^{(1-e^{-\alpha t})/\alpha}\frac{\tilde{h}(-i\xi)}{1/\alpha-\xi}d\xi.$$

But the second integral considers $\xi > \sqrt{2}/\gamma$ and $\tilde{h}(-i\xi) = \infty$, hence $\phi(t) = -\infty$. For $t < t^*$, $\xi < \sqrt{2}/\gamma$ and we can proceed as in case (i) above with the result that $\phi(t)$ is already given by Eq. (A24). Therefore, when $c > 1$ and $t < t^*$ the function $\phi(t)$ is given by (A24) while if $t > t^*$ $\phi(t) = -\infty$.

(iii) $c = 1$: Setting $c = 1$ in Eq. (A24) yields an indeterminate result. We write the equation as

$$\phi(t) = -\frac{1}{1-c}\psi(c|t) - \frac{1}{2\alpha}\frac{1}{1+c}\ln\left[1+c(1-e^{-\alpha t})\right], \tag{A26}$$

where

$$\psi(c|t) = \frac{t}{1+c} + \frac{1}{2\alpha}\ln\left[1-c(1-e^{-\alpha t})\right].$$

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Expanding this function in Taylor series around $c = 1$, we obtain

$$\psi(c|t) = -\left[\frac{t}{4} + \frac{1}{2\alpha}\left(e^{\alpha t} - 1\right)\right](c-1) + O((c-1)^2)$$

which substituting into Eq. (A26) and after taking the limit $c \to 1$ yields

$$\lim_{c\to 1} \phi(t) = -\frac{t}{4} - \frac{e^{\alpha t} - 1}{2\alpha} - \frac{1}{4\alpha}\ln\left(2 - e^{-\alpha t}\right) \tag{A27}$$

and as $t \to \infty$ we have

$$\phi(t) \simeq -\frac{1}{2\alpha}e^{\alpha t}, \qquad (\gamma = \alpha\sqrt{2}), \tag{A28}$$

and discount will be eventually dominated by this term, leading to

$$D(t) \simeq \exp\left(\frac{\lambda}{2\alpha}e^{\alpha t}\right) \qquad (t \to \infty), \tag{A29}$$

which shows that the discount function increases in an explosive way.

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