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An Introduction to
Continuous-Time
Stochastic Processes

*Theory, Models, and Applications
to Finance, Biology, and Medicine*

Birkhäuser
Boston • Basel • Berlin

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Preface

This book is a systematic, rigorous, and self-consistent introduction to the theory of continuous-time stochastic processes. But it is neither a tract nor a recipe book as such; rather, it is an account of fundamental concepts as they appear in relevant modern applications and literature. We make no pretense of it being complete. Indeed, we have omitted many results, which we feel are not directly related to the main theme or that are available in easily accessible sources. (Those readers who are interested in the historical development of the subject cannot ignore the volume edited by Wax (1954).)

Proofs are often omitted as technicalities might distract the reader from a conceptual approach. They are produced whenever they may serve as a guide to the introduction of new concepts and methods towards the applications; otherwise, explicit references to standard literature are provided. A mathematically oriented student may find it interesting to consider proofs as exercises.

The scope of the book is profoundly educational, related to modeling real-world problems with stochastic methods. The reader becomes critically aware of the concepts involved in current applied literature, and is moreover provided with a firm foundation of the mathematical techniques. Intuition is always supported by mathematical rigor.

Our book addresses three main groups: first, mathematicians working in a different field; second, other scientists and professionals from a business or academic background; third, graduate or advanced undergraduate students of a quantitative subject related to stochastic theory and/or applications.

As stochastic processes (compared to other branches of mathematics) are relatively new, yet more and more popular in terms of current research output and applications, many pure as well as applied deterministic mathematicians have become interested in learning about the fundamentals of stochastic theory and modern applications. This book is written in a language that both groups will understand, and in its content and structure will allow them to learn the essentials profoundly and in a time-efficient manner. Other scientist-practitioners and academics from fields like finance, biology, or medicine might

be very familiar with a less mathematical approach to their specific fields, and thus be interested in learning the mathematical techniques of modeling their applications.

Furthermore, this book would be suitable as a textbook accompanying a graduate or advanced undergraduate course or as a secondary reading for students of mathematical or computational sciences. The book has evolved from course material that has already been tested for many years for various courses in engineering, biomathematics, industrial mathematics, and mathematical finance.

Last but certainly not least, this book should also appeal to anyone who would like to learn about the mathematics of stochastic processes. The reader will see that previous exposure to probability, even though helpful, is not essential and that the fundamentals of measure and integration are provided in a self-consistent way. Only familiarity with calculus and some analysis is required.

The book is divided into three main parts. In part I, comprising chapters 1–4, we introduce the foundations of the mathematical theory of stochastic processes and stochastic calculus, thus providing tools and methods needed in part II (chapters 5 and 6), which is dedicated to major scientific areas of applications. The third part consists of appendices, each of which gives a basic introduction to a particular field of fundamental mathematics (like measure, integration, metric spaces, etc.) and explains certain problems in greater depth (e.g., stability of ODEs) than would be appropriate in the main part of the text.

In chapter 1 the fundamentals of probability are provided following a standard approach based on Lebesgue measure theory due to Kolmogorov. Here the guiding textbook on the subject is the excellent monograph by Métivier (1968). Basic concepts from Lebesgue measure theory are furthermore provided in appendix A.

Chapter 2 gives an introduction to the mathematical theory of stochastic processes in continuous time, including basic definitions and theorems on processes with independent increments, martingales, and Markov processes. The two fundamental classes of processes, namely Poisson and Wiener, are introduced as well as the larger, more general, class of Lévy processes. Further, a significant introduction to marked point processes is also given as a support for the analysis of relevant applications.

Chapter 3 is based on Itô theory. We define the Itô integral, some fundamental results of Itô calculus, and stochastic differentials including Itô's formula, as well as related results like the martingale representation theorem.

Chapter 4 is devoted to the analysis of stochastic differential equations driven by Wiener processes and Itô diffusions, and demonstrates the connections with partial differential equations of second order, via Dynkin and Feynman–Kac formulas.

Chapter 5 is dedicated to financial applications. It covers the core economic concept of arbitrage-free markets and shows the connection with martingales

and Girsanov's theorem. It explains the standard Black–Scholes theory and relates it to Kolmogorov's partial differential equations and the Feynman–Kac formula. Furthermore, extensions and variations of the standard theory are discussed as well as interest rate models and insurance mathematics.

Chapter 6 presents fundamental models of population dynamics such as birth and death processes. Furthermore, it deals with an area of important modern research, namely the fundamentals of self-organizing systems, in particular focusing on the social behavior of multiagent systems, with some applications to economics (“price herding”). It also includes a particular application to the neurosciences, illustrating the importance of stochastic differential equations driven by both Poisson and Wiener processes.

Problems and additions are proposed at the end of the volume, listed by chapter. More than being just exercises in a classical way, problems are proposed as a stimulus for discussing further concepts which can be of interest for the reader. Different sources have been used, including a selection of problems submitted to our students over the years. This is the reason why we can provide only selected references.

The core of this monograph, on Itô calculus, was developed during a series of courses that one of the authors VC has been offering at various levels in many universities. That author wishes to acknowledge that the first drafts of the relevant chapters were the outcome of a joint effort by many participating students: Maria Chiarolla, Luigi De Cesare, Marcello De Giosa, Lucia Maddalena, and Rosamaria Mininni, among others. Professor Antonio Fasano is due our thanks for his continuous support, including producing such material as lecture notes within a series that he has coordinated.

It was the success of these lecture notes, and the particular enthusiasm of the coauthor DB, who produced the first English version (indeed, an unexpected Christmas gift), that has led to an extension of the material up to the present status, including in particular a set of relevant and updated applications, which reflect the interests of the two authors.

VC also would like to thank his first advisor and teacher, Professor Grace Yang, who gave him the first rigorous presentation of stochastic processes and mathematical statistics at the University of Maryland at College Park, always referring to real world applications. DB would like to thank the Meregalli and Silvestri families for their kind logistical help while in Milan. He would also like to acknowledge research funding from the EPSRC, ESF, Socrates–Erasmus, and Charterhouse and thank all the people he worked with at OCIAM, University of Oxford, over the years, as this is where he was based when embarking on this project.

The draft of the final volume has been carefully read by Giacomo Aletti, Daniela Morale, Alessandra Micheletti, Matteo Ortisi, and Enea Bongiorno (who also took care of the problems and additions) whom we gratefully acknowledge. Still, we are sure that some odd typos and other, hopefully non-crucial, mistakes remain, for which the authors take all responsibility.

We also wish to thank Professor Nicola Bellomo, editor of the Modeling and Simulation in Science, Engineering, and Technology Series, and Tom Grasso from Birkhäuser for supporting the project. Last but not the least, we cannot forget to thank Rossana VC and Casilda DB for their patience and great tolerance while coping with their “solitude” during the preparation of this monograph.

Vincenzo Capasso and David Bakstein
Milan, November 2003

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