

An Introduction to Stochastic Modeling

Third Edition

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Contents

| | |
|---|------------------|
| <i>Preface</i> | <i>ix</i> |
| I Introduction | 1 |
| 1. Stochastic Modeling | 1 |
| 2. Probability Review | 6 |
| 3. The Major Discrete Distributions | 24 |
| 4. Important Continuous Distributions | 33 |
| 5. Some Elementary Exercises | 43 |
| 6. Useful Functions, Integrals, and Sums | 53 |
| II Conditional Probability and Conditional Expectation | 57 |
| 1. The Discrete Case | 57 |
| 2. The Dice Game Craps | 64 |
| 3. Random Sums | 70 |
| 4. Conditioning on a Continuous Random Variable | 79 |
| 5. Martingales* | 87 |
| III Markov Chains: Introduction | 95 |
| 1. Definitions | 95 |
| 2. Transition Probability Matrices of a Markov Chain | 100 |
| 3. Some Markov Chain Models | 105 |
| 4. First Step Analysis | 116 |
| 5. Some Special Markov Chains | 135 |
| 6. Functionals of Random Walks and Success Runs | 151 |

*Stars indicate topics of a more advanced or specialized nature.

| | |
|---|------------|
| 7. Another Look at First Step Analysis* | 169 |
| 8. Branching Processes* | 177 |
| 9. Branching Processes and Generating Functions* | 184 |
| IV The Long Run Behavior of Markov Chains | 199 |
| 1. Regular Transition Probability Matrices | 199 |
| 2. Examples | 215 |
| 3. The Classification of States | 234 |
| 4. The Basic Limit Theorem of Markov Chains | 245 |
| 5. Reducible Markov Chains* | 258 |
| V Poisson Processes | 267 |
| 1. The Poisson Distribution and the Poisson Process | 267 |
| 2. The Law of Rare Events | 279 |
| 3. Distributions Associated with the Poisson Process | 290 |
| 4. The Uniform Distribution and Poisson Processes | 297 |
| 5. Spatial Poisson Processes | 311 |
| 6. Compound and Marked Poisson Processes | 318 |
| VI Continuous Time Markov Chains | 333 |
| 1. Pure Birth Processes | 333 |
| 2. Pure Death Processes | 345 |
| 3. Birth and Death Processes | 355 |
| 4. The Limiting Behavior of Birth and Death Processes | 366 |
| 5. Birth and Death Processes with Absorbing States | 379 |
| 6. Finite State Continuous Time Markov Chains | 394 |
| 7. A Poisson Process with a Markov Intensity* | 408 |
| VII Renewal Phenomena | 419 |
| 1. Definition of a Renewal Process and Related Concepts | 419 |
| 2. Some Examples of Renewal Processes | 426 |
| 3. The Poisson Process Viewed as a Renewal Process | 432 |

| | |
|--|------------|
| Contents | vii |
| 4. The Asymptotic Behavior of Renewal Processes | 437 |
| 5. Generalizations and Variations on Renewal Processes | 447 |
| 6. Discrete Renewal Theory* | 457 |
| VIII Brownian Motion and Related Processes | 473 |
| 1. Brownian Motion and Gaussian Processes | 473 |
| 2. The Maximum Variable and the Reflection Principle | 491 |
| 3. Variations and Extensions | 498 |
| 4. Brownian Motion with Drift | 508 |
| 5. The Ornstein–Uhlenbeck Process* | 524 |
| IX Queueing Systems | 541 |
| 1. Queueing Processes | 541 |
| 2. Poisson Arrivals, Exponential Service Times | 547 |
| 3. General Service Time Distributions | 558 |
| 4. Variations and Extensions | 567 |
| 5. Open Acyclic Queueing Networks | 581 |
| 6. General Open Networks | 592 |
| Further Reading | 601 |
| Answers to Exercises | 603 |
| Index | 625 |

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Preface to the First Edition

Stochastic processes are ways of quantifying the dynamic relationships of sequences of random events. Stochastic models play an important role in elucidating many areas of the natural and engineering sciences. They can be used to analyze the variability inherent in biological and medical processes, to deal with uncertainties affecting managerial decisions and with the complexities of psychological and social interactions, and to provide new perspectives, methodology, models, and intuition to aid in other mathematical and statistical studies.

This book is intended as a beginning text in stochastic processes for students familiar with elementary probability calculus. Its aim is to bridge the gap between basic probability know-how and an intermediate-level course in stochastic processes—for example, *A First Course in Stochastic Processes*, by the present authors.

The objectives of this book are three: (1) to introduce students to the standard concepts and methods of stochastic modeling; (2) to illustrate the rich diversity of applications of stochastic processes in the sciences; and (3) to provide exercises in the application of simple stochastic analysis to appropriate problems.

The chapters are organized around several prototype classes of stochastic processes featuring Markov chains in discrete and continuous time, Poisson processes and renewal theory, the evolution of branching events, and queueing models. After the concluding Chapter IX, we provide a list of books that incorporate more advanced discussions of several of the models set forth in this text.

Preface to the Third Edition

The purposes, level, and style of this new edition conform to the tenets set forth in the original preface. We continue with our objective of introducing some theory and applications of stochastic processes to students having a solid foundation in calculus and in calculus-level probability, but who are not conversant with the “epsilon–delta” definitions of mathematical analysis. We hope to entice students towards the deeper study of mathematics that is prerequisite to further work in stochastic processes by showing the myriad and interesting ways in which stochastic models can help us understand the real world.

We have removed some topics and added others. We added a small section on martingales that includes an example suggesting the martingale concept as appropriate for modeling the prices of assets traded in a perfect market. A new chapter introduces the Brownian motion process and includes several applications of it and its variants in financial modeling. In this chapter the Black–Scholes formula for option pricing is evaluated and compared with some reported prices of options. A Poisson process whose intensity is itself a stochastic process is described in another new section.

Some treatments have been updated. The law of rare events is presented via an inequality that measures the accuracy of a Poisson approximation for the distribution of the sum of independent, not necessarily identically distributed, Bernoulli random variables. We have added the shot noise model and related it to a random sum.

The text contains more than 250 exercises and 350 problems. Exercises are elementary drills intended to promote active learning, to develop familiarity with concepts through use. They often simply involve the substitution of numbers into given formulas, or reasoning one or two steps away from a definition. They are the kinds of simple questions that we, as

instructors, hope that students would pose and answer for themselves as they read a text. Answers to the exercises are given at the end of the book so that students may gauge their understanding as they go along.

Problems are more difficult. Some involve extensive algebraic or calculus manipulation. Many are “word problems” wherein the student is asked, in effect, to model some described scenario. As in formulating a model, the first step in the solution of a word problem is often a sentence of the form “Let $x = \dots$.” A manual containing the solutions to the problems is available from the publisher.

A reasonable strategy on the part of the teacher might be to hold students responsible for all of the exercises, but to require submitted solutions only to selected problems. Every student should attempt a representative selection of the problems in order to develop his or her ability to carry out stochastic modeling in his or her area of interest.

A small number of problems are labeled “Computer Challenges.” These call for more than pencil and paper for their analyses, and either simulation, numerical exploration, or symbol manipulation may prove helpful. Computer Challenges are meant to be open-ended, intended to explore what constitutes an answer in today’s world of computing power. They might be appropriate as part of an honors requirement.

Because our focus is on stochastic modeling, in some instances we have omitted a proof and contented ourselves with a precise statement of a result and examples of its application. All such omitted proofs may be found in *A First Course in Stochastic Processes*, by the present authors. In this more advanced text, the ambitious student will also find additional material on martingales, Brownian motion, and renewal processes, and presentations of several other classes of stochastic processes.

To the Instructor

If possible, we recommend having students skim the first two chapters, referring as necessary to the probability review material, and starting the course with Chapter III, on Markov chains. A one quarter course adapted to the junior–senior level could consist of a cursory (one-week) review of Chapters I and II, followed in order by Chapters III through VI. For interested students, Chapters VII, VIII, and IX discuss other currently active areas of stochastic modeling. Starred sections contain material of a more advanced or specialized nature.

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