Review: “The portfolio theory of inflation and policy (in)effectiveness revisited: corroborating evidence”

The objective of the paper is to test the theoretical framework developed in Bossone (2019). However, the paper also replicates (literally, for some parts) that original paper and gives the impression to the reader that the authors have “copied and pasted” the previous work.

I will concentrate my comments on the so-called “Portfolio Theory of Inflation” (PTI) developed in Bossone (2019) and this paper. I would say that the authors do not realize a deep review of the previous literature. The authors are pretending to present a new theory approach that, in fact, is rooted in an old heterodox tradition. Broadly speaking, the thesis of the paper is that an economy “heavily indebted” can suffer capital outflows and, consequently, currency depreciations and higher inflation because of the exchange rate pass-through. The idea that currency devaluations are the principle cause of inflation is not new at all. In contrast to the neoclassical inflation theory based on the assumptions of excess demand, there is an old tradition of cost-push inflation theories. In the 20th century, the idea that currency devaluations cause inflation started to be debated in the context of the Germany ́s hyperinflation. In contrast to the monetarist view of Bresciani-Turroni (1937), also called the English Quantitative approach, there was the German Balance of Payments Theory (GBPT) or German Qualitative approach. The GBPT pointed out that Germany ́s hyperinflation was caused by the Mark devaluation, that was caused by the foreign currency payments of war reparations. This approach was supported by the Germany’s Central Statistical Office, the Reichsbank, and the Secretary of the Treasury Karl Helfferich (Bastos 2002).

In the 1950s, under the initiative of the Argentinian Raul Prebisch, the so-called Latin American Structuralist School developed a similar idea: inflation results from balance of payments crisis. Later, in the context of the Latin American external debt crisis and the hyperinflation process of the 1980s, that structuralist and German approach turned in a very important theoretical framework to understand the monetary disorders of those economies.

For this reason, broadly speaking, it would be difficult to justify that the "PTI is alternative to the conventional "demand-pull and "cost-push (structuralist) theories of inflation" (p. 37). However, I see as a new new insight the idea that "inflation follows the optimal (re)composition of country liabilities within global investor portfolios" (p. 37).

Also, the paper presents the idea that same economic policy could get different outcomes depending on degree of credibility of the policymaker. In my understanding, Keynes's concept of fundamental uncertainty fit very well to this analysis. However, in a "non-ergodic world" (in terms of Paul Davidson) it would be problematic to assume that the decision making process of global investors is based on probabilistic calculations and optimizations (rational expectations?).

Finally, in order to demonstrate the causation from the external financial commitments to the inflation rate through the exchange rate pass-through, the German Qualitative approach and the Structuralist view of the Latin-American hiperinfleation of the 1980s have focused in on the currency denomination of external debt: due to financial obligations are denominated in a foreign currency, the central bank cannot act as lender of last resort and, consequently, the currency depreciates if the central bank faces a shortage of foreign reserves. However, the paper refers to the "neutrality of currency denomination" because, under the author's view, what really matters are the financial commitments in real terms. I

don’t want to go further on this, but in some way, if we say that the currency denomination of the government debt is neutral we are implicitly saying that that “money is neutral” (as in the mainstream view).
The paper would contribute to the debate against the mainstream approach where inflation is always monetary phenomenon determined by an excess of aggregate demand. However, I think that the paper should review properly the literature of cost-push inflation theories as a background of the PTI.

References

Bastos, C. (2002) “Price Stabilization in Brazil: A Critical Review and a Classical Interpretation for an Indexed Nominal Interest Rate Economy.” Unpublished Ph.D. dissertation, New School University