

Review of “The Portfolio Theory of Investment and Policy Effectiveness”, MS number, 3078.

General comments. The paper provides an interesting discussion of a relevant policy issue. I think it deserves a chance to be published, after some important modifications. I have a few concerns that I will list below.

1) Regarding the Literature Review and the relation between the proposed approach and other papers. The author claims that a novel theory is being proposed, so it is hard to find papers that touches on similar issues. I differ. There is a large literature on the “lack of credibility” of stabilization policies. The author may want to consider the different papers produced by Guillermo Calvo and colleagues during the 1980s and 1990s (for example Calvo 1991, 2007). Not only Calvo paper have similar concerns, they also similar implications (i.e., a high pass-through can be associated with low credibility). I think the literature review should be expanded accordingly, including not only the contributions by Calvo, but also papers by Dornbusch, Drazen, and so on.

2) I feel that the motivation and the way the contribution is presented should be reconsidered. I will star suggesting that the manuscript will improve a lot if the author provides some motivational stories. I am pretty sure that he can think of several examples (i.e., country cases) where the main plot described holds. Given that the problem of “lack of credibility” was explored by the literature, I do not think the paper should claim to have a presented “a novel theory”.

3) No simulation or graphical analysis is provided. I think this is a limitation, given that the results are supposed to be novel and the model is hard to read. To clarify, I do not think that the author should run simulations, but perhaps he can either: a) simplify the model (it was hard to follow the steps); b) put the entire derivation in an appendix.

Let me provide an example to clarify what I have in mind. I will propose “a model” to explain how credibility affects inflation.

Imagine a world where there is perfect capital mobility and perfect substitutability between two assets, domestic and foreign. Let us say that the uncovered interest parity holds up to a risk premium and the public is blessed with perfect foresight. Then we should have an equation like:

domestic rate = foreign rate + expected (and actual) rate of depreciation + risk premium

In this very simple model, the risk premium reflects endogenous credibility on macroeconomic policies. Let us say that credibility fall, so the risk premium goes up. The immediate effect is an increase on the rate of depreciation (given the domestic and the foreign rates). Furthermore, if there is only a tradable good, inflation accelerates. I am not saying that the author should use this formulation. I am suggesting that simple models (especially if a graphical presentation is used) can enormously help the reader to figure out what is going on exactly. Perhaps the author could provide a simpler model in the introduction and a full model later.

4) I think some equations deserve some elaboration. I am not sure if I understand why a higher expected money supply will increase the value of bonds (equation 1). This looks like the fiscal theory of the price level, which the author repudiates.

The specification of the supply side is scant, and the reader must figure out the details about pricing and about the determination of output mostly by himself. Is the country considered to be small in goods markets? Is PPP or the LOP assumed? Is output demand determined? Are prices sticky or flexible? I know for sure that the answers are somewhere in the manuscript, but a clarification may help. For instance, a clarification before the full model may greatly help.

5) The author claims that the world financial markets are perfectly integrated. Integration has increased a lot during the last decades, but it is still far from perfect (see Obstfeld and Rogoff, 2000, puzzles number 2 and 3). I suggest a more careful wording about this. I do agree that assuming a high degree of integration is a reasonable thing to do.

References

Calvo, Guillermo A., 1991. "Temporary stabilization policy : The case of flexible prices and exchange rates," *Journal of Economic Dynamics and Control*, Elsevier, vol. 15(1), pages 197-213.

Guillermo A. Calvo, 2007. "Interest Rate Rules, Inflation Stabilization, and Imperfect Credibility: The Small Open Economy Case," NBER Working Papers 13177, National Bureau of Economic Research, Inc.

Obstfeld, M., and Rogoff, K. 2000. "The Six Major Puzzles in International Macroeconomics: Is There a Common Cause?" NBER Working Paper No. 7777.