

Response of Author to the 2nd Review of “The Portfolio Theory of Investment and Policy Effectiveness”, MS number, 3078.

Bossone presents an insightful discussion of the role of global financial markets in determining the effectiveness of macroeconomic policy using the Portfolio Theory of Inflation (PTI) approach. This paper provides a relevant contribution to a highly significant policy issue and is therefore of interest for the related research community. However, I list some comments.

I am grateful to the Referee for the comments and suggestions received. I will consider them carefully and incorporate them in a new draft, with the specifications discussed below and marked in red (which only refer to the major comments).

Major comments

One important aspect of the paper is the level of policy credibility. Which is based on country's past track record. In equation (1) the credibility is represented by a discount factor. For me as a reader it is not clear, why this discount factor indicates credibility. How is credibility measured in your context? Is it an index, a risk premium, a probability,...?

Credibility factor $\beta_{j,t}|\omega_t$ should be understood as a scale factor that *corrects* the value of the IBC in the perception of the markets and reflects the credibility that investors attribute to country j 's policy based on the current information available. The factor could indifferently be thought of as an index that applies to the IBC, scaling down or up its value correspondingly; a probability measure that generates an expected value of the IBC; or a risk factor that adjusts the value of the IBC.

What exactly does the information set ω_t contain? For a better understanding of the proposed model it is essential to reveal more details for ω_t . For example: Where does the mentioned "new information set" discussed in the credibility and macro policies section comes from?

The information set ω_t comprises all the information that enables investors to assess and determine the policy credibility of a country government, and in particular all relevant economic, political and social factors, both internal and external to the country, which influence the achievability and sustainability of government's specific policy commitments. New factors or events that raise investors' concerns that country j 's government might face future challenges (which would eventually induce it to take such actions as defaulting on future obligations, inflating the debt away, or even repudiating it) would be incorporated in a new information set ω_t^1 and cause β_j to fall ($\beta_{j,t}|\omega_t^1 < \beta_{j,t}|\omega_t$) thus reducing IBC elasticity accordingly. A fall of credibility might result in such a tightening of IBC elasticity that investors would doubt the (economic, social and political) sustainability of the future primary surpluses required by the tightened IBC, until such a point where they might even stop buying and holding the country's debt altogether. This would cause the price of debt to collapse and, correspondingly, interest rates to rise abnormally to a level where fiscal dominance puts pressure on the monetary authorities to monetize and inflate the debt away. The relevant information set would capture also those developments (including, for instance, the evolution of local or global risks) that may induce investors to shift capital from lower-credible to higher-credible countries considered to be safer places for investment or issuers of safer liability instruments. In such instances, due to those developments, the credibility gap between countries (as perceived by the markets) may change and reflect in different relative dynamics of credibility factors $\beta_{j,t}|\omega_t$ for different countries over time. The role of the "credibility gap" will be appropriately analyzed in the study.

On page 6 you wrote that the PTI approach is consistent with different economic outcomes and can indeed explain them. Further you wrote on page 10 " ... the theoretical results of this study are in line with the empirical findings...". Which results and/or economic outcomes do you mean exactly? That would make it easier to see the strengths (and weaknesses) of this PTI approach.

The PTI shows that the effectiveness of macroeconomic policies varies with the credibility of the countries undertaking them. Thus, when investors deem a country's credibility to be low, the economy is tied to a tighter IBC and the issuance of public sector liabilities (in the form of money or debt under any currency denomination) aimed to stimulate output growth ends up in fact by causing the domestic currency to depreciate and domestic inflation to rise. On the other hand, if the same expansionary action is undertaken by a highly credible government, the more flexible IBC allows output to expand with no dissipative effects on nominal variables (i.e., currency depreciation and higher inflation).

It would be interesting to see how sensitive monetary policy is in regard to credibility and financial integration. You wrote on page 25 " ... high credibility raises the effectiveness of monetary policy..." and this is "...particularly relevant for highly financially integrated and highly indebted countries... ". How does this relation between credibility and effectiveness of monetary policy change for less financially integrated or less indebted countries?

The response to this comment is given (indirectly) by the following consideration, which will appear in the concluding section of the study. As a theory of policy (in)effectiveness, the PTI points to a general strategic and yet practical conclusion. A country that intends to maintain or recover space for the active use of the macroeconomic policy levers may pursue one of two alternative options – one desirable, the other one not quite so. The undesirable option would be for the country to isolate itself from the international financial markets and adopt a degree of domestic financial repression that would force its residents to hold all the liabilities (money and debt) that it issues. The superior option would be for the country to integrate itself in the global financial system but, also, to carefully prevent its stock of liabilities from growing inordinately large (in other words, it should keep the public debt low), thus avoiding having to surrender its policy sovereignty to the financial markets.