Universidad Nacional Autónoma de México
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Problemas del DESARROLLO
REVISTA LATINOAMERICANA DE ECONOMÍA

Academic opinion format

Article: **A CB centered analysis of the price level, inflation and the neutral rate of interest**

Referee: **Evaluation 1**

1- What is your opinion about this article in the current form:

Positive	Subject to modifications	Negative
		x

2- Elaborate in detail the reasons for the previous answer:

While there are some aspects of the paper with which I am in agreement, such as the critique of the natural of neutral rate of interest, the critique of the loanable funds approach, and some of the descriptions of the monetary process, I fear that the paper is not sufficiently tight to warrant publication.

One of the main claims of the authors is that the 'price level therefore consists of prices dictated by the government pricing policy' (p. 3). I did not find the explanation of this claim convincing enough, especially within the context of an open economy such as that of Mexico, where there is a high passthrough, since Mexico is heavily dependent on imports and where foreign firms play an important role.

Associated to this is the claim that higher interest rates will generate an increase in aggregate demand. While there is some truth for this, as higher interest rates on public debt will generate an increase in consumer disposable income, as long as the debt is mainly held by Mexican units (is this the case?), higher rates are also likely to reduce investment demand, both for corporate and residential investment, which eventually will reduce aggregate demand. The fact that higher interest rates might act as 'a net expansionary force' (p. 12) might thus be irrelevant, unless the public debt to GDP ratio is really high. This being said, the claim that the target rate of interest ought to be at zero loses its strength, since this misses the possibility that overly low interest rates may generate inflation and eventually financial instability.

Another main claim, it seems, is the claim that the Bank of Mexico is free to set interest rates at the level of its choice. This may be so for short-term rates, but it seems that the Bank can do nothing about long-term rates. Looking at the balance sheet of the Bank, one sees that on the

asset side the Bank holds zero government securities, and hence no long-term bonds issued by the government. This also means that commercial banks acquire reserves by getting access to advances from the central bank, as briefly noted in footnote 9 of the paper, or when they sell foreign currency to the Bank. All in all, the paper brings no useful information about the peculiar aspects of the balance sheet of the Bank of Mexico, in particular what are the government securities (presumably short-term ones) that are part of the 'monetary regulation deposits', and how they can appear on the liability side of the balance sheet of the Bank. It would have been interesting to know how the authors interpret this peculiar feature of the Mexican monetary system, besides the brief reference to Cetes in the paper and the brief reference to repurchase agreements (pages 6-7). Also, no reference is made to the bonds issued by the central bank itself. What is their role within the sequence of monetary operations suggested by the authors?

Another dubious claim is the claim that in countries under a fixed exchange regime, the forward exchange market determines the (neutral) interest rate. Many bankers and cambists however suggest that the causality goes the other way: the forward rate, relative to the spot rate, is determined by the actual spread between the foreign and domestic interest rates, as a kind of arithmetic operation. Consequently, the analysis provided for the floating case is unclear.

To summarize, the paper repeats several arguments that have obviously been made previously by Mosler and his co-authors, apparently applying them to the case of Mexico. But the peculiar aspects of the Mexican monetary system, which would merit an investigation, are not explained and detailed enough to offer sufficient new and original material.