Discussion of
"The Optimal Monetary Policy Response to Tariffs"
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Summary - What the paper is about

- **Question**: How should monetary policy respond to a tariff shock?
  1. Tighten monetary policy to keep inflation in check.
  2. Look through the tariff-induced inflation and keep the current monetary stance.
- **Answer**: Neither! Monetary policy should be expansionary.
- **Why**: Due to a **fiscal externality**. Private cost of imports > Social cost of imports.

  Aggregate Budget Constraint: $c_t^h + p(1+\tau_t)c_t^f - \underbrace{p\tau_t c_t^f}_{\text{Not internalized by households}} + \frac{b_{t+1}}{R^*} = b_t + \ell_t$

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Summary - What is special about the tariff shock

- Targets specific goods.
  - Different from a general consumption tax.
- Not a "fundamental" shock to the economy.
  - The cost of imports for the home economy (social cost) is unchanged.
  - Different from a terms-of-trade shock.
  - If the tariff revenues are wasted, equivalent to a terms-of-trade shock.
- In certain cases ($\sigma < 1$) the optimal policy increases output beyond the efficient level.
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Discussion

- Excellent paper using an intuitive yet rich model with novel results!
- The insight that tariff shocks lead to fiscal externalities is brilliant.
- Comments
  1. The role of exchange rates
  2. The role of monetary policy
  3. General questions

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  1. The role of exchange rates
  2. The role of monetary policy
  3. General questions

Comment 1 - The role of exchange rates

- Tariffs create a wedge in the relative demand for home and foreign goods.
- The current setup assumes a tight link between P_t^h and e_t.
- The expenditure switching impact of exchange rates is muted.

$$\frac{1-\omega}{\omega}\left(\frac{c_t^h}{c_t^f}\right)^{\frac{1}{\gamma}} = (1+\tau_t)p \tag{1}$$

- Disconnecting P_t^h and e_t would allow exchange rates to mitigate the tariff wedge.
- Appreciation can reduce the wedge and increase the consumption of imports.
- Is it still optimal to depreciate the currency?

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Comment 2 - The role of monetary policy

- Monetary policy works through the labor market rather than the goods market.
  - It impacts the exchange rate and through it the real wage.
  - Consumption is impacted indirectly via the income effect.
  - Disconnecting P_t^h and e_t would allow direct impact on c_t^h.
  - Allowing monetary policy to influence R^* (like the US), allows direct impact on consumption.
- How can other policy tools help?
  - First-best?
  - Can exchange rate management policies be a substitute?

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Comment 3 - General questions

- Can the results be generalized to any fiscal shock that implements differentiated taxes across goods?
  - Subsidies for home goods
  - Tariffs on a fraction of imports
- What would happen if all countries had a tariff shock?
  - Would tariffs increase global output under uncoordinated monetary policy?
  - What about under coordinated monetary policy?

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Conclusion

- Excellent paper.
- Intuitive model of tariffs and monetary policy.
- The fiscal externality result has potential to be generalized further.
- A must read!