

# Optimal Monetary Policy, Tariff Shocks and Exporter Dynamics

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*The views expressed here do not necessarily reflect the position of Bank of Lithuania or Eurosystem*

- This is a very interesting paper on an important topic, where Hamano, Pappadà and Punzi (HPP below) provide insights that should be valued by both scholars and policymakers.
- The issue of interest is quite topical– what should be the optimal monetary policy in the presence of a foreign tariff shock?
  - Backlash against globalization has increased worldwide, US-China trade war, Brexit, etc.
- HPP develops a two-country DSGE model with wage rigidities and firm heterogeneity to answer this question

– Monetary policy should be expansionary when facing foreign tariff shock

– Expansionary policy helps to reduce the negative impact of foreign tariff shock

– Monetary policy should be expansionary

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⇒ Monetary policy should be expansionary when facing foreign tariff hikes

– Flexible wage: higher foreign trade barriers  $\rightarrow N_X \downarrow \rightarrow L_X^D \downarrow \rightarrow w \downarrow \rightarrow y \uparrow \rightarrow r \uparrow$

– Wage rigidity: selection is sharper

– Market size, openness, degree of firm heterogeneity

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- Comment on the big picture
- Comment on the model
- Comment on the Ramsey vs. Nash policy

- The effects of trade on incentives to cooperate across countries in monetary matters is a classic topic of **policy discussion** and **academic research**
- In the **policy arena**, the implementation of the European Single Market after 1985 was viewed as a crucial step toward the adoption of euro
  - The potential instability from the exchange rate manipulation (Eichengreen and Ghironi, 1996)
  - ⇒ More trade integration makes monetary cooperation more desirable is fully embraced
    - Frankel and Rose (1998, *EJ*), Clark and van Wincoop (2001, *JIE*)
- In the **academic realm**, researchers face important challenges when studying how trade affects monetary policy because benchmark IRBC models cannot reproduce key empirical regularities about the effects of trade integration
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  - No micro-level producer dynamics, no reallocation effects of trade integration

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- HPP and the references therein belong to an exciting agenda that incorporates the micro-level behavior of producers when evaluating international shock transmission
- This agenda answers a "call for research" from Paul Krugman in 1995, in a Princeton University Press book edited by Peter Kenen:

*I would like to know how the macroeconomic model that I more or less believe can be reconciled with the trade models that I also more or less believe. [...] What we need to know is how to evaluate the microeconomics of international monetary systems. Until we can do that, we are making policy advice by the seat of our pants.*

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- The full model is very rich, and the simplified model can deliver the key insights of the framework
  - Free entry vs. no entry
  - Calvo rigidity vs. 1-period rigidity
  - Financial integration vs. financial autarky
  - Heterogeneous quality vs. homogeneous quality
- What are the **sources of inefficiencies** in the model?
  - Firms have monopoly power in the goods market - **enabling firms to set prices**
  - Households have monopoly power in the labor market - **enabling households to set wages**
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- What are the possible **distortions** coming from these inefficiencies?
- **Markups in goods and wages imply**
  - Suboptimally low output and effort
  - Depending on the elasticities/subsidy, there might be a relative price distortion between output and effort
- **Wage rigidity affects the labor supply margin as the wedge between the real wage and MRS becomes endogenous to inflation**
  - In the steady-state, subsidy  $v$  ( $\xi$  in the simplified model) is able to undo the monopoly power of households, but not the Calvo rigidity ( $\lambda$ ).
  - Over the cycle, it's inefficiently time-varying

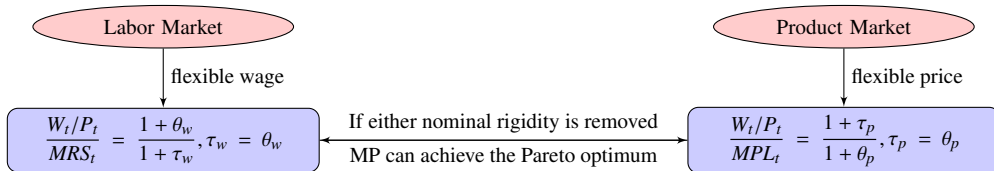


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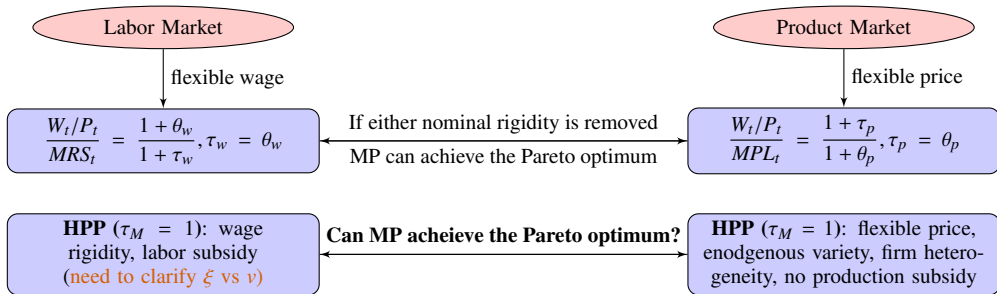


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## Comment 2: The Model

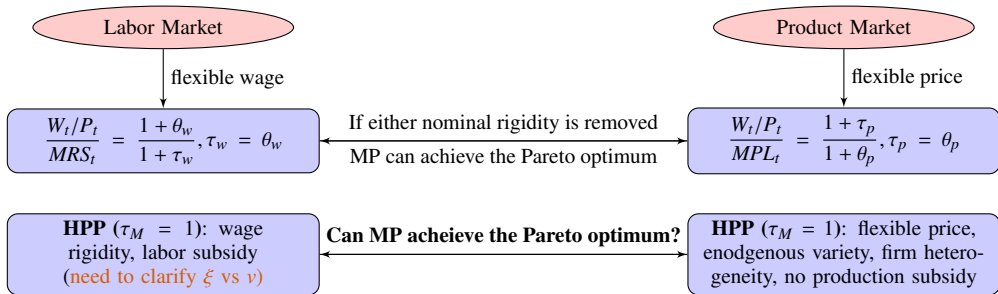
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- Without wage rigidity: might not need monetary policy here...
  - Labor market: efficient
  - Product market: efficient! Grossman and Helpman (1991, MIT Press), Bilbiie et al (2012, *JPE*)
- With wage rigidity: monetary policy faces tradeoffs
  - Labor market: inefficient.  $W/P \neq MRS$  both at steady-state and over the cycle
  - Product market: probably inefficient. How does wage rigidity interact with product creation margin?
- What about HPP with  $\tau_M \neq 1$ ? Tariffs will mess with the product creation margin

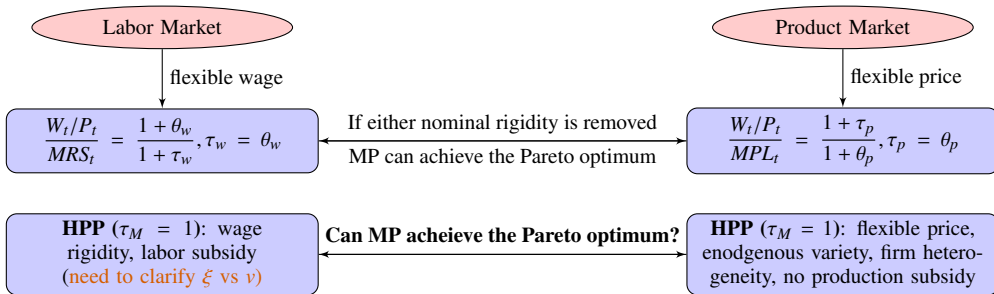
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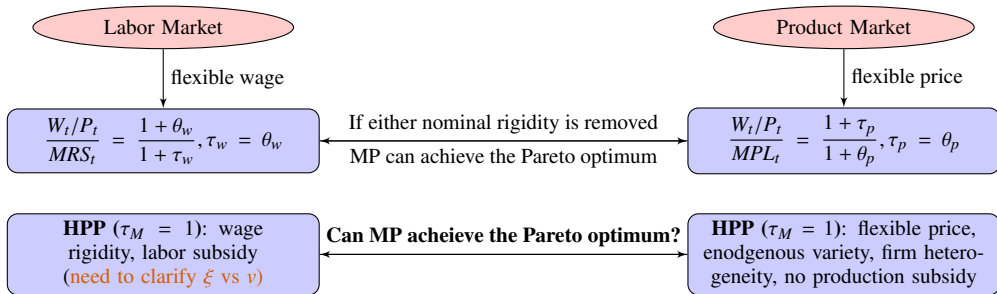
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- HPP compares the allocation between the following two scenarios:
  - Ramsey/cooperative optimal monetary policy
  - Nash/noncooperative optimal monetary policy: Taylor rule vs. fixed exchange rate
- Nash policies assume that each monetary authority takes the entire past and future of the other's money stance as given. This is quite unrealistic.
  - Central banks are acutely aware of the likely reactions of other central banks to their own policy actions
  - Few now make policy, or assume that others make policy, based on the time path of money stance
- Sims (2007, *Comment on "International Transmission and Monetary Policy Cooperation"*) argues
  - The reality is more sophisticated than Nash equilibrium
  - **Historically estimated policy rules** give rise to behavior much closer to fully cooperative equilibrium
  - So a more realistic comparison would be the allocation under **Ramsey vs historical rules**
  - See Cacciatore and Ghironi (2021, JIE) for an example

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- Super interesting paper!
- I would at least:
  - Have a more explicit discussion of the sources of inefficiency in the model and how they determine policy incentives
  - Focus on the historical behavior of monetary authority as a more realistic benchmark
- Looking forward to reading more papers from HPP!