Discussion of "The liquidity state-dependence of monetary policy transmission"

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An interesting fact

- Monetary policy transmission is stronger in higher market liquidity periods
- This liquidity state-dependence affects real yields and term premia
- Balance sheet constraints on both hedge funds and dealers appear to contribute to the liquidity state-dependence

Background

- US Treasury securities trade in a multi-dealer, OTC market.
- Primary government securities dealers are the main market makers.
- Dealers remain counterparties to most trades, making liquidity dependent on their balance sheet capacity.
- Large dealers, often BHC subsidiaries, face balance sheet limits due to capital and liquidity regulations.

An interesting fact

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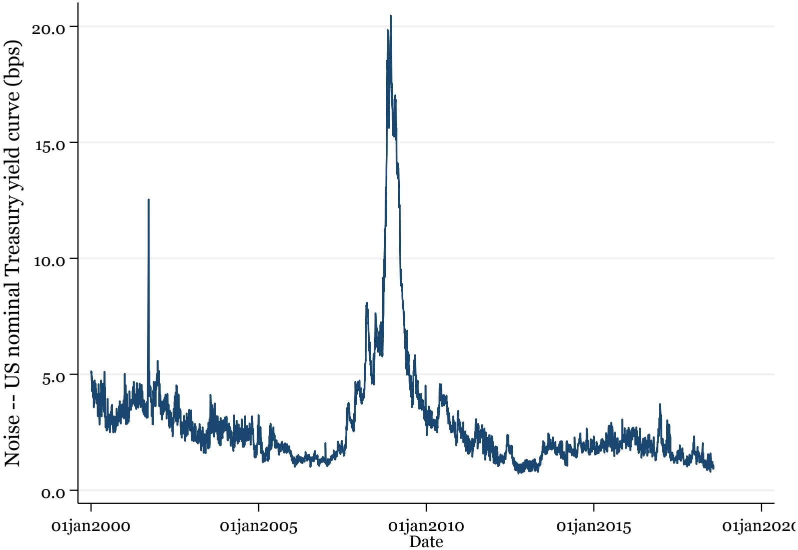
- An interesting finding with potentially important implications for policymakers
- Comments:
  1. What is the illiquidity dummy capturing ?
  2. What do we mean by "monetary policy transmission?"
  3. Transmission to mortgage rates

① – What is the illiquidity dummy capturing?

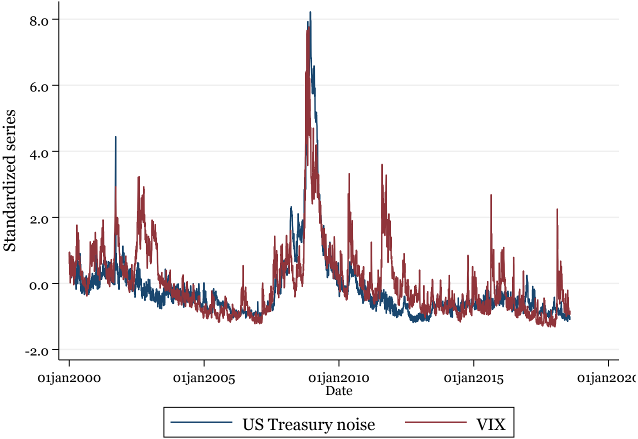
- Yield volatility is the main factor in Treasury market illiquidity (Duffie et al., 2024).
- Higher volatility, for instance, decreases supply of intermediation services at any given level of dealer compensation, thus raising costs of intermediation.
- Empirically, high dealer balance sheet utilization worsens liquidity beyond yield volatility predictions.
- Indicates binding constraints on bond market intermediation capacity.

① – What is the illiquidity dummy capturing?



① – What is the illiquidity dummy capturing?

Although the series looks like VIX or credit spreads, the correlation is a bit less than 70% with lots of the measure



① – What is the illiquidity dummy capturing?

- Does sorting by VIX yield the same results?
- Only 20 out of 106 observations differ between VIX and Treasury noise measure.
- I believe in the mechanism highlighting the role of primary dealers and the importance of their balance-sheet constraints in Treasury bond pricing
- Suggestion: Compute dealer balance sheet utilization measure (Duffie et al., 2024).

① – What is the illiquidity dummy capturing?

	Whole Sample	Low Noise	High Noise	Low VIX	High Vix
1Y	1***	1.48***	0.806***	1.51***	0.877***
	(0.138)	(0.116)	(0.176)	(0.143)	(0.166)
2Y	1.10***	1.83***	0.687*	1.86***	0.712*
	(0.326)	(0.234)	(0.412)	(0.229)	(0.398)
3Y	1.06***	1.92***	0.571	1.931***	0.616
	(0.362)	(0.270)	(0.434)	(0.265)	(0.423)
5Y	0.727***	1.68***	0.339	1.78***	0.477**
	(0.201)	(0.241)	(0.214)	(0.270)	(0.213)
10Y	0.382**	1.24***	0.032	1.264***	0.171
	(0.175)	(0.205)	(0.173)	(0.243)	(0.186)

② – What is "monetary policy transmission?"

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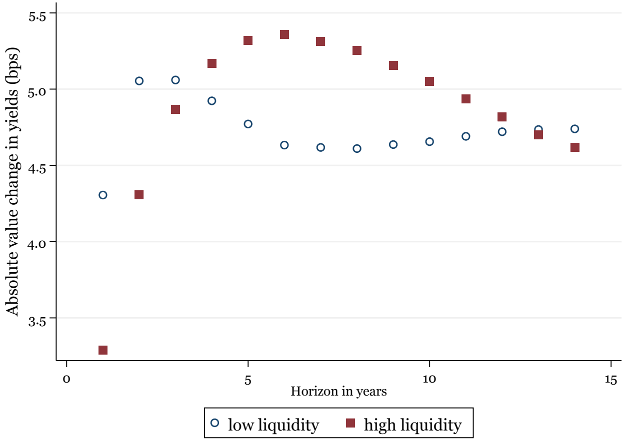
- Examines relation between short-term rate shocks (Nakamura-Steinsson) up to 1 year and yield changes up to 10/15 years.
- Different shock definitions yield different results.
- Monetary policy is multi-dimensional.
- Since 2011, with short-term rates at 0, Fed press conferences play a key role in monetary policy. They affect medium-term rates!

② – What is "monetary policy transmission?"

Mean absolute value of changes in daily yields on FOMC days in the small sample until 2014



② – What is "monetary policy transmission?"

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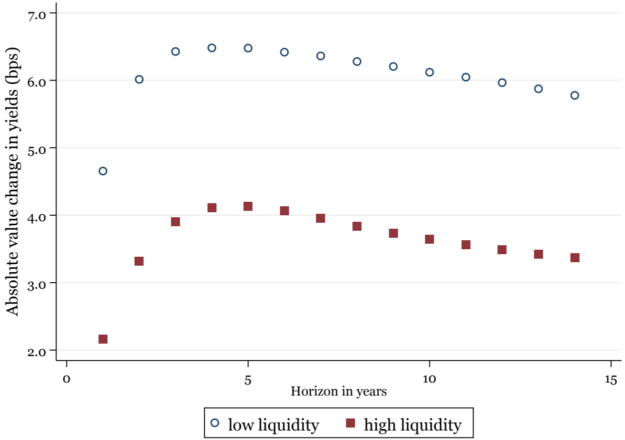
Mean absolute value of changes in daily yields on FOMC days in the larger sample until more recently



② – What is “monetary policy transmission?”

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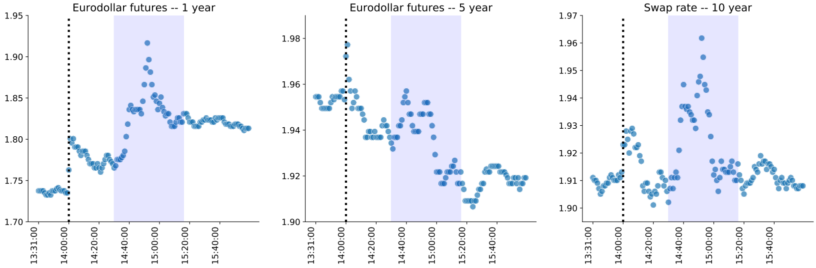
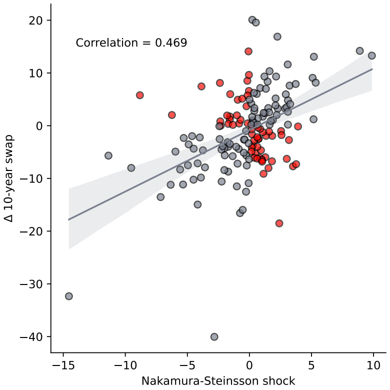
"**Monetary Policy Wedges and the Long-term Liabilities of Households and Firms**" with Jules van Binsbergen



The key moment was when Powell talked about a mid-cycle adjustment to policy (July 31, 2019)

② – What is “monetary policy transmission?”

”Monetary Policy Wedges and the Long-term Liabilities of Households and Firms” with Jules van Binsbergen



② – What is "monetary policy transmission?"

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- In summary, in both sample (until 2014 and until 2022) medium/long-term yields move more than short-term yields on FOMC days .
- They just do not move in level !
- Does it mean there is low monetary policy transmission?

③ – Transmission to mortgage rates

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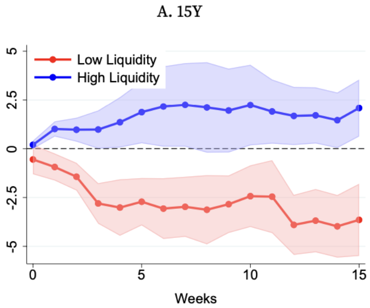
FIGURE 4. The Response of Mortgage Rates



This means that a positive interest rate surprise in a low-liquidity state is followed by a drop in mortgage rates

③ – NS shock

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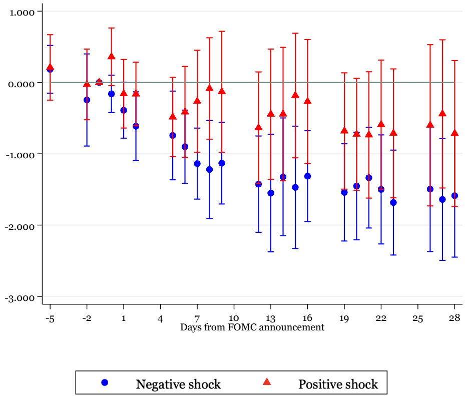
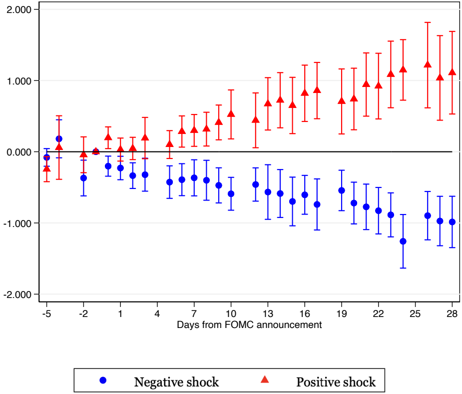


③ – High-frequency shock to swaps

Once the monetary policy shock is properly defined the puzzle goes away: the shock to the relevant rate that banks themselves advertise to use when pricing



Conclusion

- This is a paper with interesting results and important policy implications!
- I hope it's published well
- I wish the authors the best of luck