Discussion of

The Liquidity State-Dependence of Monetary Policy Transmission

By Tafti, Guimaraes, Pinter, and Wijnandts

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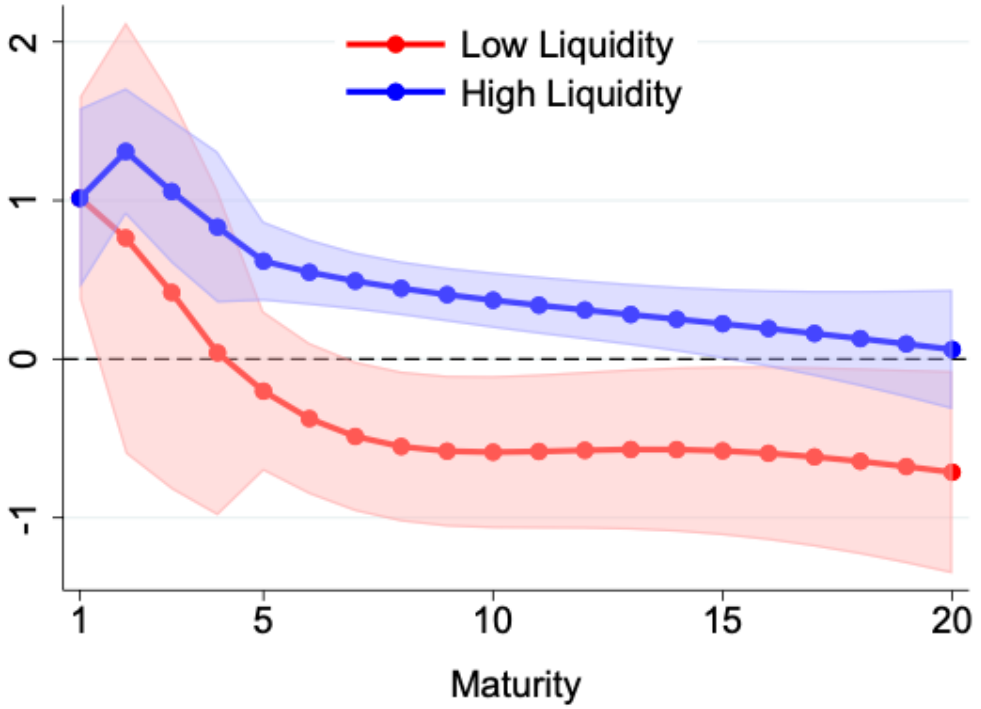
Paper summary

- Well-known: overreaction of long-term yields to monetary policy

- This paper documents a **new heterogeneity**:
  - More overreaction when Treasuries are more liquid (low pricing errors)

- Proposed mechanism:
  - When arbitrageurs are more active, that 1) creates more liquidity and 2) increases the long-term bond response

Key finding



- Data:
  - Nakamura and Steinsson (2018) shocks
  - Liquidity: Hu, Pan, and Wang (2013) measure of yield curve noise

The noise measure

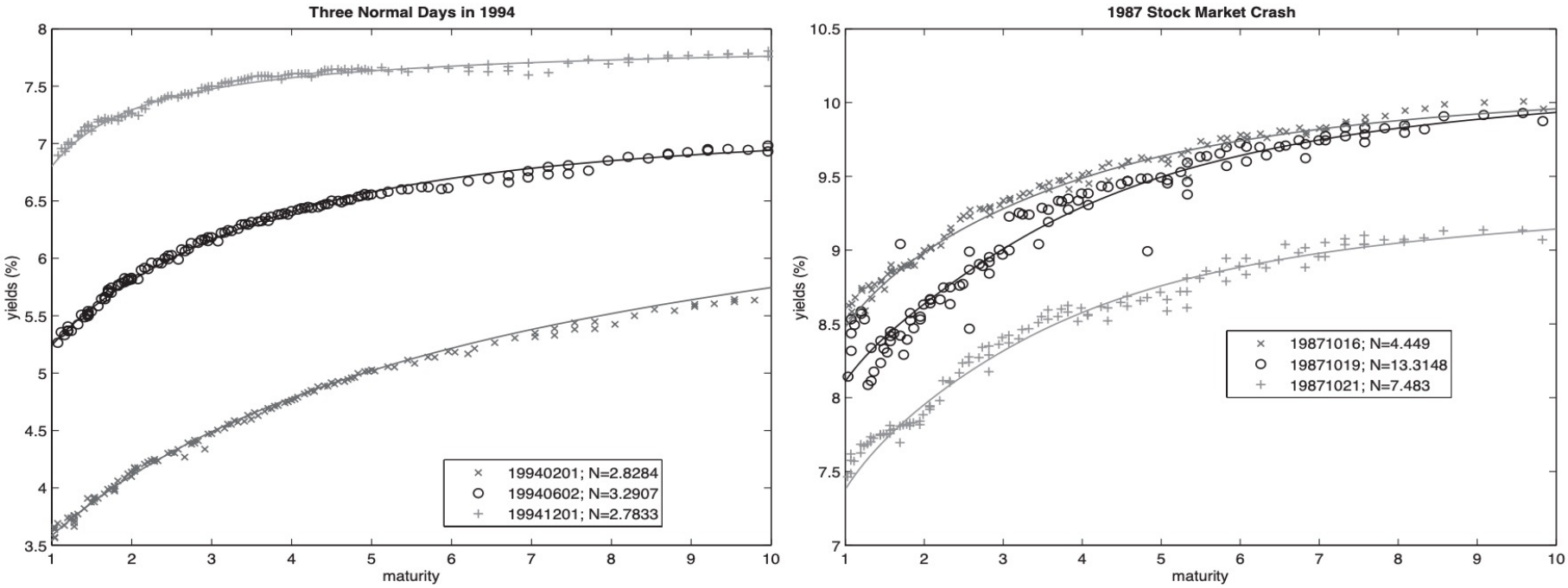


Figure 2 in Hu, Pan, and Wang (2013)

My impression

- 1) Very interesting/important fact

- 2) Questions about the mechanism

Comments

The proposed mechanism

- There are “arbitrageurs” who trade across maturities

- When “arbs” are more active:
  - 1) Yield curve noise is lower (8 vs 8.1 year bonds)
  - 2) Short -> long maturity substitution is stronger (short-rate vs 10-year)

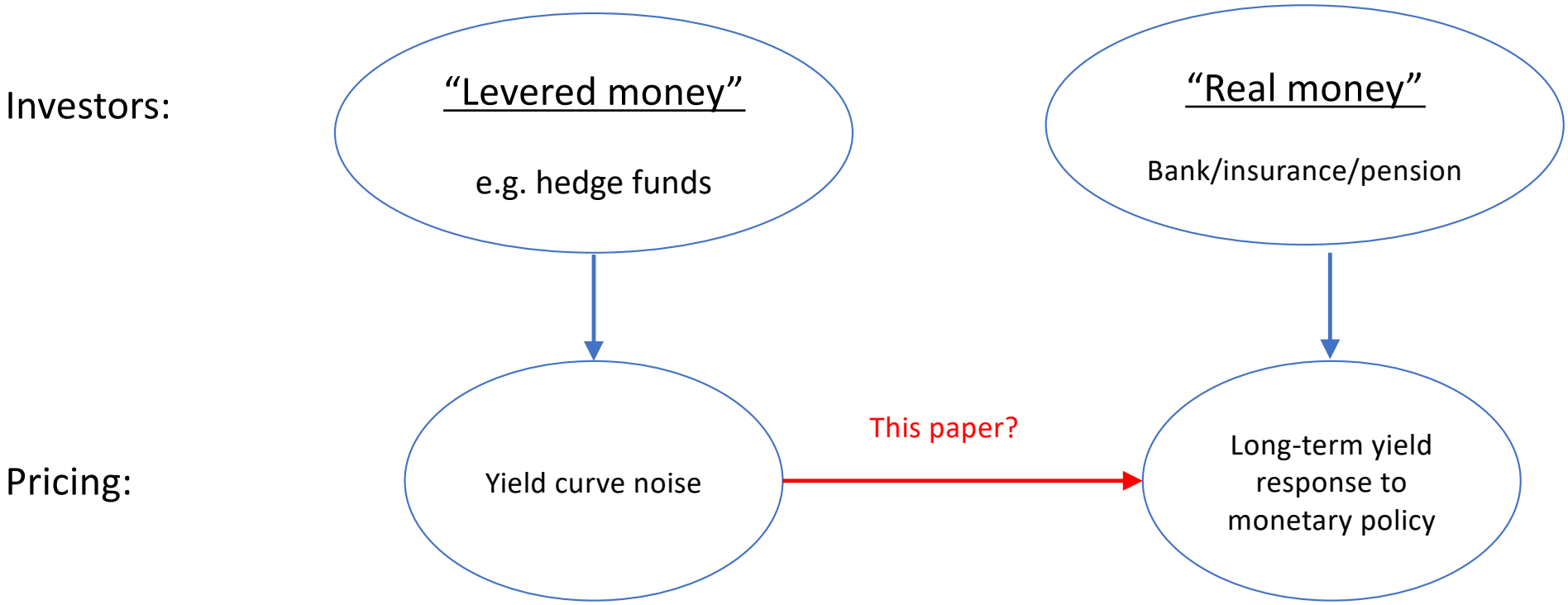
- However, are they the same set of market participants? Intuition:

The paper agrees that these are two different sets of investors

- Sec 6.1: arbs trade more around FOMC when noise is low
  - Arb identification: trade many maturities w/ low net duration exposure
  - Identified to be hedge funds, asset managers, some banks

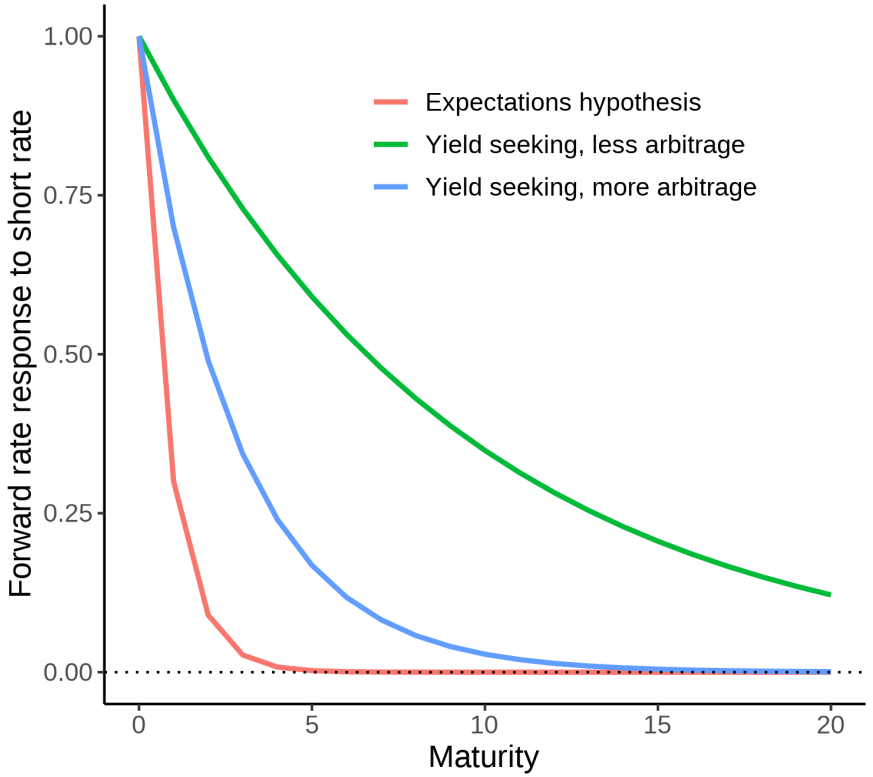
- Sec 6.2: reach-for-yield behavior found among banks, insurance, pension, and foreign official
  - Hanson Stein (2015): "yield-seeking investors"

Thus, the picture



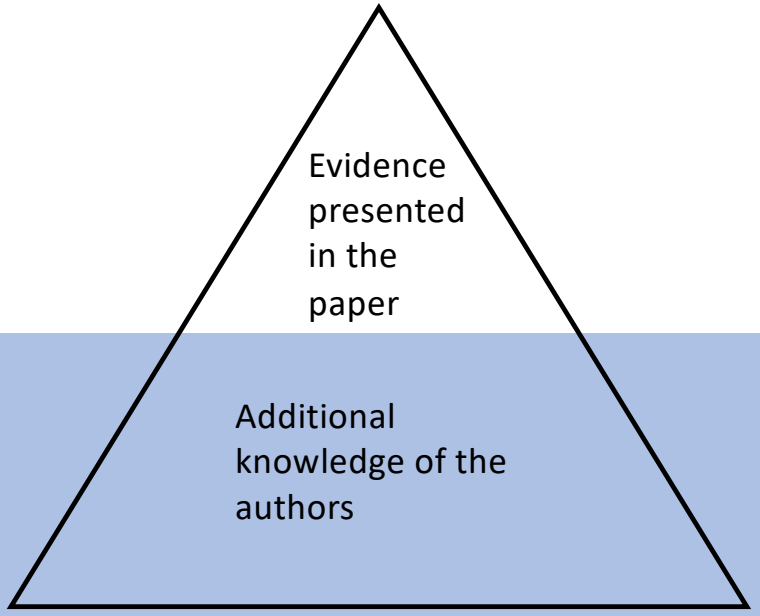
Interpretation via Vayanos Vila (2021)

- Investors:
  - Arbitrageurs, w/ variable mass
  - Preferred habitat (PH): yield-oriented
- PH investor behavior generates overreaction
- However, when there are more arbitrageurs (less noise), there should be less overreaction



My feeling so far

- I suspect the authors may have good reasons --- beyond the evidence in the paper --- to believe this type of mechanisms



Summary

- Very interesting paper and an important finding

- More can be done regarding the mechanism

APPENDIX

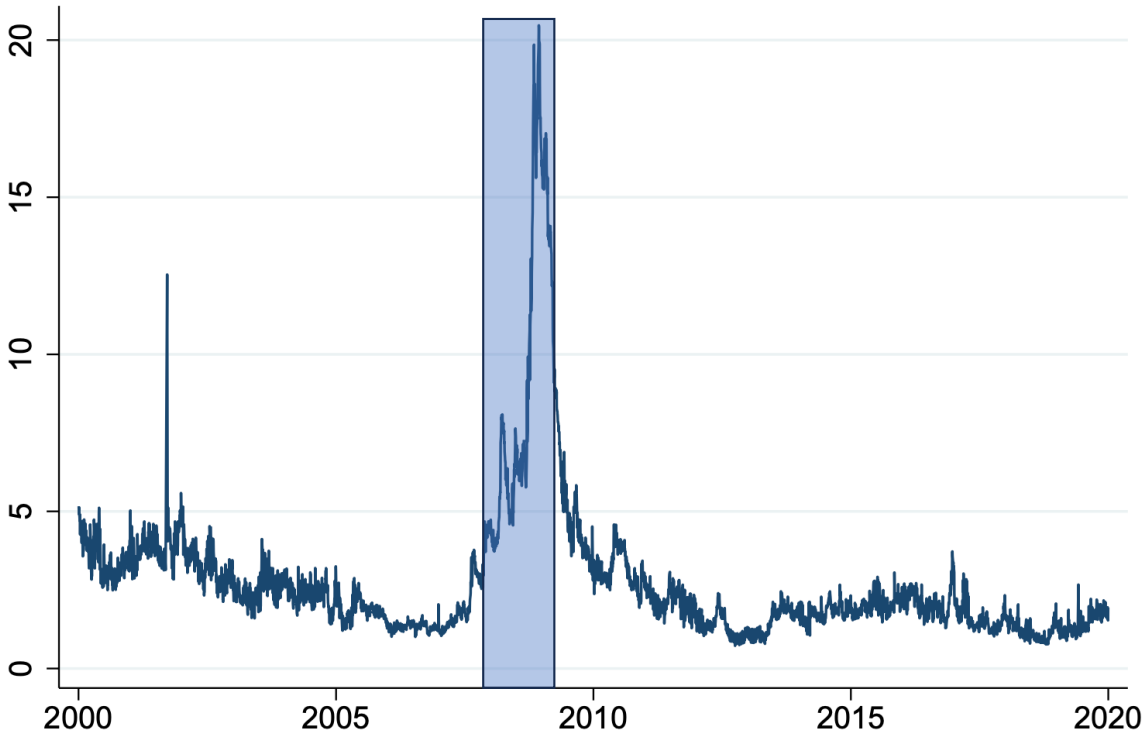
2) Quantification

- How large is the demand response of reach-for-yield investors' long-term bond demand response to monetary policy shocks?

- $\Delta P = Multiplier \cdot \Delta Q$

- Quantify a plausible price impact?
  - e.g. Kristy, Li, and Schmid (2024)

Time-series of the noise measure



- Dropped: second half of 2008 and the first half of 2009
- Correlated with dealer leverage, etc.