State Dependent Effects of Monetary Policy: the Refinancing Channel

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Summary

• Recent lit documents heterogeneity in monetary policy pass-through to learn about aggregate transmission
  • House prices (Beraja et al., 2018)
  • Unemployment (De Fusco and Mondragon, 2018)
  • Mortgage segment (Di Maggio et al., 2018)

• **This paper**: a given rate cut only valuable for borrowers with in-the-money prepayment options

=> $r$ path matters for refinancing channel of MP

• Life-cycle model to study secular changes in fixed costs of refinancing
  • Refi costs down => more effective pass through
MBS industry all over this

• “Coupon gap” as measure of prepayment option incentive features prominently in every academic and industry model of mortgage valuation
• Prepayment function nonlinear \( f(\text{coupon gap}) \Rightarrow \) prevailing level of coupon gap matters
• Related to dynamic selection concepts of burnout, seasoning, vintage effects of MBS pools
• Hayre (1999) talks about 1990s changes in coupon-gap sensitivity due to lower fixed costs of origination
Classic path/state dependence

EXHIBIT 4.15 Mortgage Rates and the MBA Refinance Index, April 1997–December 1998

Rates drop 100bp from April to Year-End ’97, but nothing happens
Rates back to early 1998 lows but nothing happens
Rates hit multi-year low
Rates fall significantly below early 1998 lows

Sources: Mortgage Bankers Association, Freddie Mac, and Salomon Smith Barney.
“Dry powder” application

“We want to ensure that we have the ability to respond to adverse shocks by easing monetary policy by lowering the policy rate. Having more “dry powder” in the form of higher short-term interest rates seems more desirable than less dry powder and a smaller balance sheet.” – then-NY Fed President Bill Dudley, 2016

• Dry powder argument: need big Δr
• This paper: Stockpiling dry powder may shut down refinancing channel
• So does Dudley not talk to MBS people? incl. Haas MFEs?
• More likely: thinking about firms, first-time homebuyers, discount rates, other durables... and not refinancers
Claim: MP more effective with more responsive refinancing

Panel II. Effect of Refinancing on Car Purchases

Di Maggio Kermani Palmer (2018)
But $\Delta \text{Consumption} = f(\text{refi savings})$

Panel I. Effect of Refinancing on Mortgage Interest Payments

Di Maggio Kermani Palmer (2018)
Conclusion

1. Simple point with significant backup in MBS industry
2. Important implications for monetary policy passthrough: semi-elasticity of +/- 25bp is not some constant deep parameter
3. Blunts dry-powder argument, although maybe not about refi channel anyway
4. Key concern with partial equilibrium counterfactual: if state dependency less acute, MP would more consistently stimulate refinancing but with smaller consumption effects