Comments on Biais and Green "The Microstructure of the Bond Market in the 20th Century"

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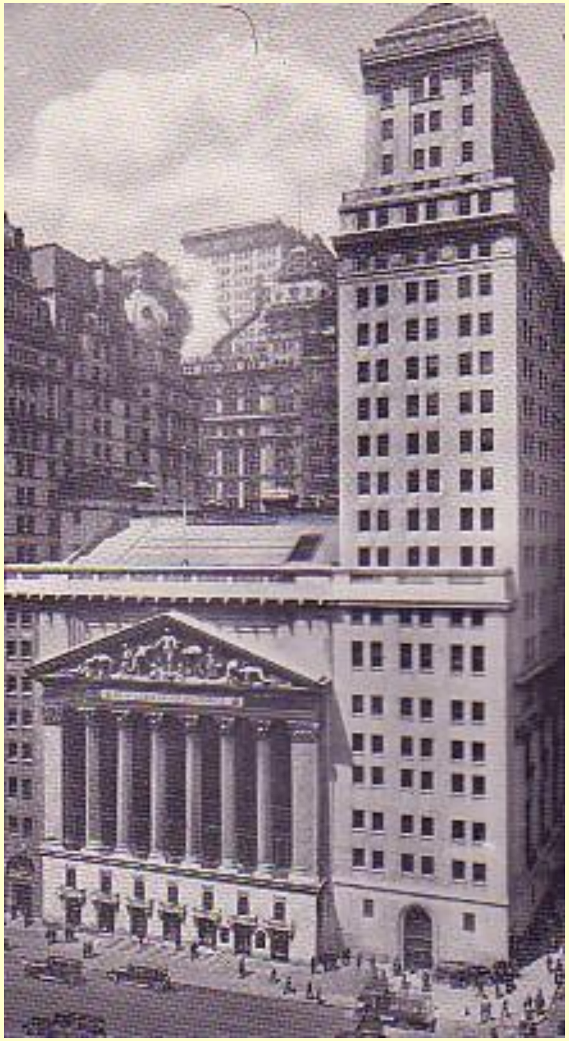
The Microstructure of the Bond Market in the 20th Century



I BUY IT!

AND I THINK THAT THE PAPER HIGHLIGHTS A MORE GENERALLY PROBLEM:

ACCEPTING AS THE “NATURAL DEVELOPMENT OF THE MARKET” CURRENT INSTITUTIONS & STRUCTURES

Technology Constantly Advancing!

- Shouldn’t this drive down trading costs and increase volume, perhaps even leading to one single trading venue?
- So, isn’t the location of bond trading on the OTC market a “natural” development of the market
- Problem: Often deluded that faster trading technologies actually cause trading costs to fall
  - Classic paper: Garbade & Silber (JF 1978) Domestic US Telegraph 1840s, Underwater NY-London Cable 1860s, US Consolidated Tape 1970s
- Problem: We underestimate the ability of special interests to resist change. Reasons for suspicion.

Gellerman (1957), securities broker: “*There is no record of transactions in the over-the-counter market, which puts the individual investor at a strong disadvantage. The professional or institutional investor can transact with an over-the-counter firm with some equality but the individual is more or less forced to rely on the integrity of the firm with which it is dealing…*

Biais and Green: Some Key points

1) Early 20th century bond market---large fraction on the NYSE and it worked better.

   a) How much and what part of bond market was located on the exchange?

   Good evidence that big portion on the NYSE

   b) It worked better: Spreads should be tighter now than 80 years ago: better communication & information technology

   B&G have excellent evidence that the spreads were smaller in the past.

2) Why it moved

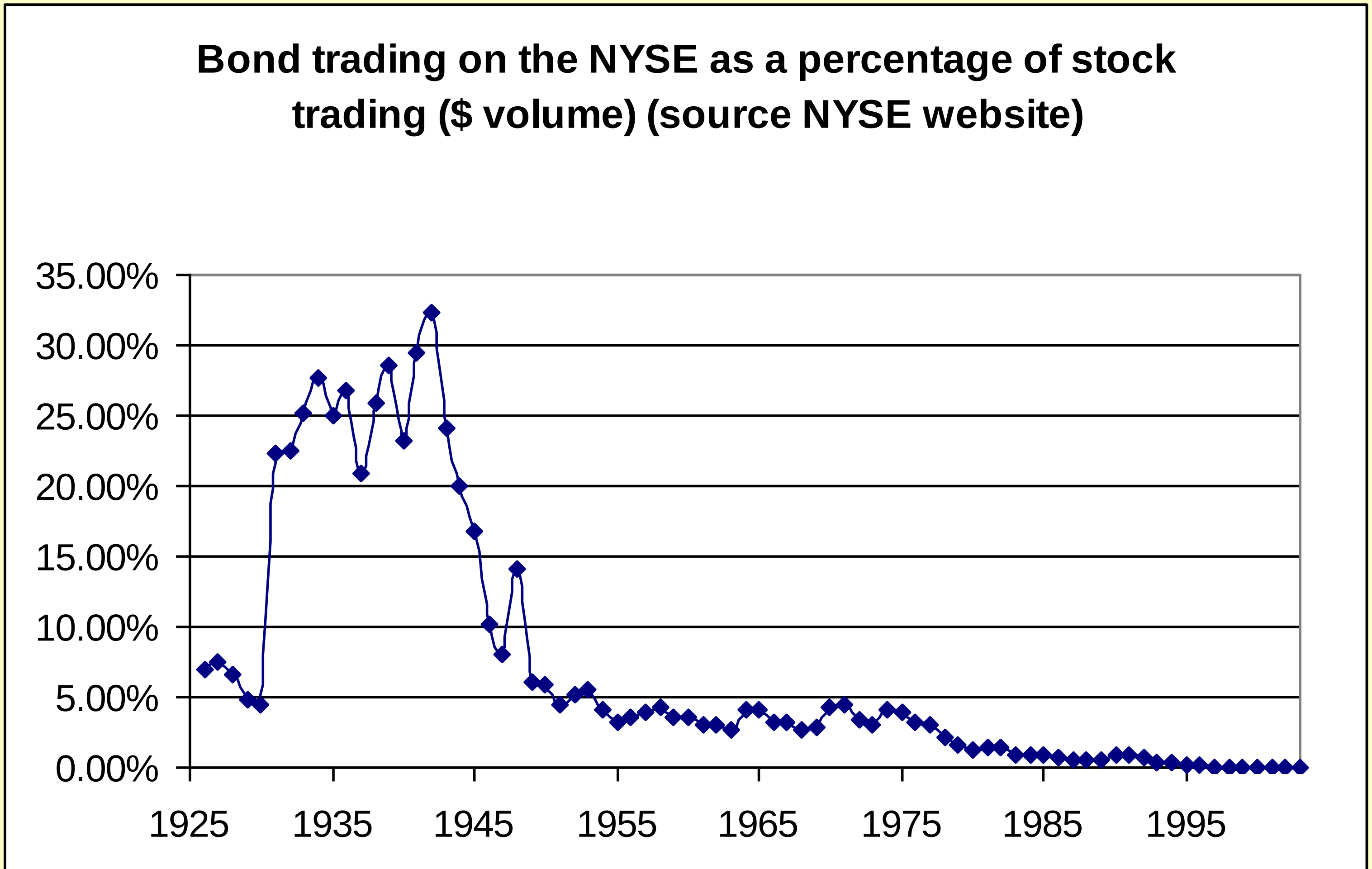
B&G have good evidence

3) Why it did not move back

B&G: How to find evidence? (Smoking gun? Trail of crumbs?)

Evidence: 1930-1945: NYSE bond trading > 20%

ENW Comment: Check 19th C data (Davis and Gallman?) Bonds are more important equities on NYSE in the RR age.



Securities Markets in the 1920s
A Broader picture of bond trading

- NYSE---B&G
- OTC---B&G
- New York Curb Exchange (AMEX) ???
- Regional Exchanges???
- See EWhite Financial History Review 2012, "Competition Among the Exchanges Before the SEC: Was the NYSE a natural hegemon"
- Brown, Mulherin, Weidenmier QJE 2008 on Consolidated Exchange

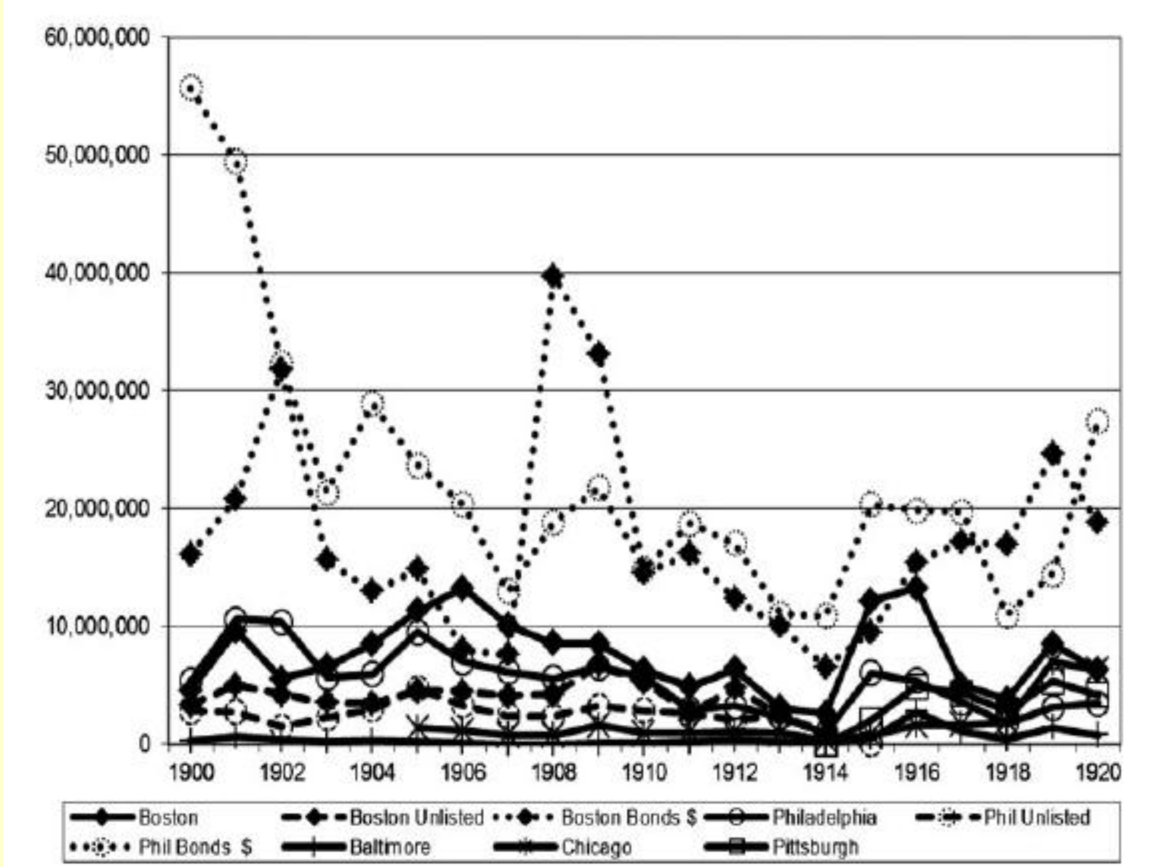
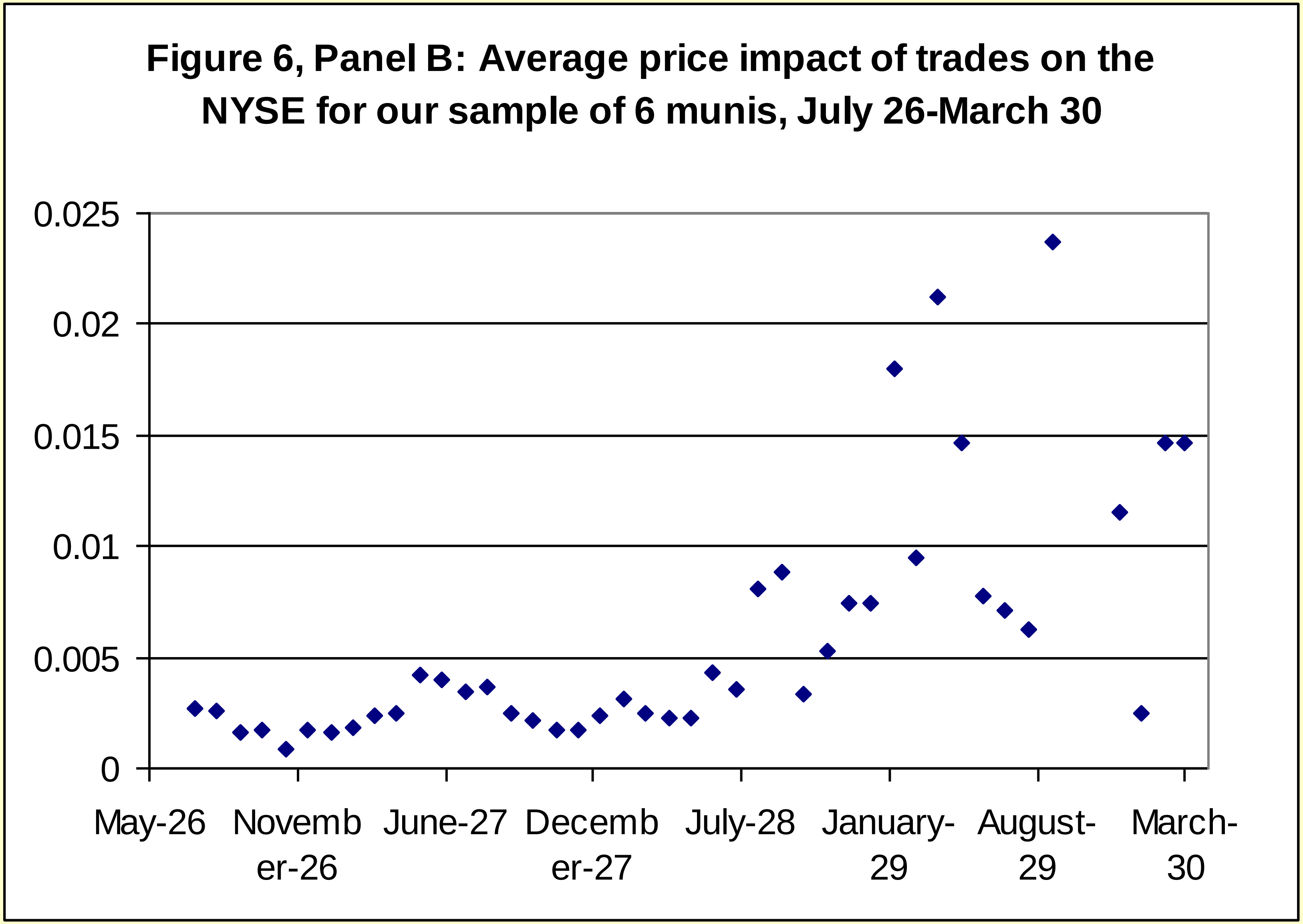


Figure 4. *Activity on the regional exchanges 1900–20 (shares – volume, bonds – dollar face value traded)*
Source: Commercial and Financial Chronicle.

Cost of trading bonds was lower…

- Excellent evidence: Mean price impact, spreads, etc….
- I worry that this only convinces "us."
- "statistically significant" "economically significant"
- What does this mean in terms of the individual investor for a year of trading? Or in aggregate for all trading? Something to motivate the public and the policy maker to care.
- Example: Under Regulation Q in the 1970s, deposits lost say 1%...but in aggregate…shows cost of financial repression….even if it is a back of the envelope calculation

Bonds suffer during the great (stock) bull market of the 1920s



Why are bonds moved off of the exchange?

- Fixed capacity of the exchange (Davis, Neal & White JEH 2007)
- Surge in trading of equities---effects everywhere
  - Bonds pushed off of the NYSE (to other exchanges or to OTC)
  - Commercial paper market and Foreign bond new issues collapse (Rapport and White, AER 1993)
- Does post-1929…1930s market volatility keep bonds off? Huge uncertainties in U.S. bond markets in Great Depression. And downgrading of the bonds
- Effects of New Deal's financial repression are complex and difficult to track, but they are pervasive.

Why don’t bonds move back to the exchange?

- A tougher question
- Tenacity of the OTC traders
- New Deal regulations
- Some agreement behind the scenes?

B&G Finding more universal….
Is getting cash more costly today in the U.S. than in the 1840s and 1850s?

- In the U.S. Standard "foreign" ATM fee is $2 for the "foreign" bank and $2 for your home bank for any size withdraw up to $300.   So the minimum fee is 1.3% though many people withdraw $50 or $100 (8% or 4%).
- Fees explained in terms transactions costs and risks to banks.
- 1840s & 1850s: Need to convert banknotes of "foreign" banks into local banknotes or coin.
- Example of Philadelphia---exchanging notes for New Jersey, New York, or Boston ……

TABLE 1

Discounts on Bank Notes at Philadelphia, Selected Dates, 1845–58 (Percents)*

State	November 1845	November 1850	November 1855	November 1856	November 1857	November 1858
New England	1/2	3/8	1/4	1/4	3/4	3/8
New York	3/4	3/4	1/2	1/2	1	1/2
New Jersey	3/4	0	1/4	1/4	3/4	1/4
Pennsylvania	0	0	0	0	0	0
Delaware	0	0	0	0	0	0
Maryland	1/4	1/2	1/2	1/2	5	1/2
Virginia	1	3/4	1	1	10	5/8
North Carolina	1-1/2	1-1/4	1-3/4	1-1/4	10	1
South Carolina	1-1/2	1	1	3/4	10	1
Georgia	2	1	1	1	10	1
Alabama	5-1/2	3-1/2	5	5	5	3-1/2
Mississippi†	80	75	?	?	?	?
Louisiana	2	1	1/4	1-1/4	5	3/4
Tennessee	2-1/2	2-3/4	2-1/2	5	20	1-1/2
Kentucky	1-1/2	1-1/2	1	1	10	3/4
Missouri	1-3/4	1-1/2	1	1	10	1
Ohio	2	1-1/2	1	1	10	3/4
Indiana	2	1-1/2	5	5	10	2
Illinois	70	75	2	2	20	1-1/2
Michigan	65	3	1-1/2	1-1/2	10	1-1/2
Wisconsin†	?	?	2	2	20	1-1/2