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Request for Information on the Evolution of Treasury Market Structure

Comment On: TREAS-DO-2015-0013-0001

RFI on U.S. Treasury Market Structure

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Comment from John Cochrane

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General Comment

I wish to comment on two areas, about which you asked numerous questions.

I. Structure of treasury securities, especially to enhance their liquidity.

Treasury securities suffer from a fragmented structure. If there were larger numbers of fewer issues, each one would be deeper. In a recent article, Cochrane (2015), I advocate a much simpler structure for federal debt that would substantially enhance its liquidity. Briefly, the Treasury should issue three kinds of perpetuities:

1) Fixed value perpetuities. These securities always have a value of \$1. They pay a floating rate, set by daily auction. Functionally, they are the same thing as interest paying reserves at the Fed, except anyone can hold them. The treasury pays interest by incrementing the number of securities held by each purchaser, and the Treasury accepts these securities at face value for payment of taxes.

2) Fixed coupon perpetuities. These securities pay \$1 coupon forever. The Treasury issues them at auction, and repurchases them also at auction when it is time to pay down the debt.

3) Indexed perpetuities. These securities pay \$1/ the current CPI.

In this structure, there are literally only three outstanding issues. On the run vs. off the run spreads would vanish. The market depth of each kind of security would be trillions of dollars.

The Treasury would also save the bid/ask spread currently harvested by dealer banks every time current debt is rolled over.

The fixed-value perpetuities would also provide extremely liquid securities that would be a benefit to financial stability, driving out some of the kinds of short-term debt that suffered runs during the financial crisis, and providing large depositors with a very safe security.

The treasury can introduce these securities to test the waters, and if they are successful slowly transition to them.

II. Trading market structure

Recent research in Finance traces Some of the illiquidity, flash crashes, and high speed trading glitches seen in many markets are traceable to poor market design, and that in turn at least partly due to unintended consequences of SEC rules. If prices must be quoted in discrete tics, but an order that arrives one nanosecond before another must get the full allotment, then there is an unnatural incentive to invest in high speed. Furthermore, regulations that require orders to be routed to the best offer across multiple exchanges don't work when orders come and go at the same millisecond time intervals that it takes to communicate.

Budish Crampton and Shim (2015) analyze these issues and conclude that at least allowing periodic batch auctions would solve a lot of the problems. Your computer works on a clock, collects signals, and then processes them periodically. The same structure could alleviate a lot of problems in markets.

The treasury should at least make sure such an exchange is allowed for Treasury securities.

References

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