

Search frictions and product design in the municipal bond market

by *Giulia Brancaccio* | *Cornell University*

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This paper studies product attributes as a driver of search frictions and studies the incentives of intermediaries to leverage this channel to increase their rent in the context of the US municipal bond market. Municipal bonds may be designed via negotiations between a local government and its underwriter, and upon issuance, they are traded in an over-the-counter market. Exploiting variations in state regulations to limit government officials' conflict of interests, we provide suggestive evidence that special bond attributes increase search frictions. Moreover, we show underwriters tend to increase their market share in the secondary market trades by including special provisions to a bond, which tends to decrease the bond's liquidity. Motivated by these findings, we build and estimate a model of bond design and trading to quantify market inefficiency and to discuss policy implications.