RESEARCH SUMMARY

The Role of Inflation-Indexed Debt in US Government Finances

Inflation-indexed bonds provide investors with a means to protect themselves against unexpected inflation. However, it is commonly argued that issuing such bonds is inherently a bad deal for the US Treasury and consequently for taxpayers. In "The Role of Inflation Linked Debt in US Government Finances" Joshua D. Rauh rebuts this claim. By reforming its inflation-linked debt programs, the Treasury could issue more-inflation-linked debt. This would simultaneously: (a) increase opportunities for Americans to protect their hard-earned savings and (b) reduce the incentive of government to incur excessive debt to be paid off with inflated money.

INFLATION IS A STEALTH TAX

In the past two years, the dollar has lost 14 percent of its purchasing power. This type of inflation operates as a stealth tax on the public: By pursuing policies that cause inflation, the government has effectively ripped off anyone with savings.

There are ways investors can protect their money, such as through inflation-linked bonds. These bonds protect investors from inflation uncertainty more than any other asset available in the market, and the demand for them increases with inflation expectations.

The Treasury issues two main types of inflation-indexed debt instruments: Treasury Inflation Protected Securities and I Bonds. But both programs are small compared to the overall magnitude of marketable US government debt and not very liquid. This illiquidity offsets one of the main advantages of inflation-linked debt, namely that it can generally be issued at lower real interest rates because it offers investors valuable inflation protection.

THE CASE FOR EXPANSION

The government could undertake simple measures to improve the liquidity of inflation-linked debt. These could include changing its tax treatment so that principal increases due to inflation indexation are not taxed upon accrual. Treasury could then reduce expected borrowing costs by issuing more inflation-linked debt.

The main advantages of expanding government issuance of inflation-indexed debt would be

- more accurate market-based inflation signals for the Federal Reserve and market participants,
- a reduction of the quantity of debt on which the Treasury has to pay an inflation risk premium,
- more access by market participants to inflation protection, and

- greater discipline by the federal government.

STRONGER INCENTIVES FOR CONGRESS AND FEDERAL AGENCIES

Inflation-linked debt provides strong incentives for Congress and federal agencies to care more about the inflationary effects of their policies. With more of this kind of debt, the desire to avoid rising inflation-linked interest costs would prompt budgetary action to reduce debt. Such disciplinary action could by itself encourage the government to run smaller deficits and—given the role fiscal policy plays in determining the price level—ultimately lead to less inflation as well as lower borrowing costs.