

Monetary Trends



Did You Know That the Fed Holds TIPS?

The Treasury began issuing inflation-indexed notes in January 1997. These Treasury Inflation-Protected Securities (TIPS) provide a market-based measure of inflationary expectations.¹ Investors value TIPS as an inflation hedge. The Treasury values them as a source of funds that can reduce interest outlays when the inflation premium in non-indexed securities is higher than actual inflation over the maturity of the security. The Fed values them as providing another measure of expected inflation.

A total of \$47 billion of the new notes have been issued, with 5-, 10-, and, most recently, a 30-year maturity. On April 15, the Treasury issued \$8 billion of the latter, which can be stripped to create inflation-indexed zero-coupon derivatives with maturities up to 30 years. Even the Fed has accumulated some TIPS. As of April 30, 1998, it held \$2.45 billion of inflation-indexed U.S. government securities valued at original face amount. In addition the Fed had received \$27 million of compensation that adjusts for the effects of inflation on the principal of these securities. Fed holdings represent less than 5 percent of TIPS held by the public and a minuscule fraction of the Fed's roughly \$450 billion portfolio of government securities holdings.

Future inflation will determine whether the returns on the inflation-indexed securities turn out to be higher than returns on non-indexed nominal notes of comparable maturity. As shown in charts on page 11, 10-year indexed Treasury notes in mid-June were selling for an inflation-adjusted return of about 3.7 percent compared with about 5.5 percent on a non-indexed note of the same maturity. The 3.7 percent real return to investors

incorporates expectations of future real rates and prospective tax liabilities because the compensation for inflation paid to holders of TIPS is taxable.

In acquiring inflation-indexed securities, the Fed has purchased some insurance against the effect of inflation on its earnings. Such protection is reasonable for private investors who perceive future inflation risks, but what about for a central bank? Fed purchases of indexed bonds may have helped establish this fledgling market, but do its holdings of inflation-indexed securities interfere with their usefulness in providing a market measure of inflation expectations and inflation risks? Also, does the Fed lose inflation credibility by holding such securities? The answer to such questions is *probably* not.

One reason is that any extra earnings the Fed gets by holding TIPS are transferred to the Treasury. Another reason is that the Fed does not actively trade any longer-term issue including the new inflation-protected securities. Therefore, its holdings of longer-term issues simply represent claims on the federal government against which the Fed has issued currency and bank reserves, the total of which comprise the monetary base. Even though the Fed holds a lot of long-term government debt and now some inflation-indexed debt too, *as long as such securities are not actively traded*, Fed holdings of such securities would not exert a direct influence on the price, quantity, or composition of federal debt held by the public. By implication, Fed holdings of TIPS need not distort information about expected inflation coming from the market yields of these inflation-protected securities.

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¹ See William R. Emmons, "Indexed Bonds and Falling Inflation Expectations," *Monetary Trends*, August 1997.

