DEBT MANAGEMENT

Treasury Inflation Protected Securities Should Play a Heightened Role in Addressing Debt Management Challenges

What GAO Found

In January 1997, Treasury introduced an inflation-indexed security—TIPS. Treasury’s stated objectives were to both raise the national savings rate and to reduce the federal government’s cost of borrowing. TIPS offer inflation protection to investors who are willing to pay a premium for this protection in the form of a lower interest rate. In a functioning TIPS market, the difference between the interest rate on nominal Treasury securities and the interest rate on TIPS is expected to be approximately equal to the expected inflation rate.

Federal government actions in response to both the financial market crisis and the economic recession have added significantly to Treasury’s borrowing needs. Since the onset of the recession in December 2007, Treasury has borrowed more than $2.3 trillion, largely by issuing short-term nominal debt, which significantly changed the composition of Treasury’s debt portfolio. The challenges presented by increasing debt and the change in its composition take place in the context of the medium and longer term fiscal outlook and will not recede with the return of financial market stability and economic growth. The Congressional Budget Office (CBO) projects that, absent changes in current policy, debt held by the public will double in 5 years (from 2008 to 2013) and almost triple in 11 years (from 2008 to 2019)—reaching 82 percent of GDP. In order to meet these challenges Treasury needs to diversify its funding sources and lengthen the term-to-maturity of its debt portfolio. TIPS can contribute to this effort.

Treasury’s TIPS program has had varying degrees of liquidity (the ease with which investors can trade the security) since its inception. The major institutional investors that GAO interviewed perceived Treasury’s commitment to the TIPS program as having wavered in recent years, decreasing the liquidity of TIPS in the market. Investors demand a premium for holding less-liquid TIPS, which increases Treasury’s borrowing costs.

TIPS offer benefits to Treasury and measuring the cost against which to weigh these benefits requires both forward-looking and after-the-fact analysis. A more robust TIPS program could benefit Treasury by diversifying and expanding its funding sources and reducing the cost of nominal securities. Governments are well suited to bear inflation risk because periods of inflation are often associated with increased revenues. TIPS auctions also help provide a measure of market inflation expectations.

On July 1, 2009, GAO briefed Treasury’s Office of Debt Management on the findings from our analysis and interviews with major institutional investors. Treasury later posed questions about ways to improve the TIPS program to the Primary Dealers and the Treasury Borrowing Advisory Committee (TBAC). At the August 2009 TBAC meeting, members discussed TIPS. Following the meeting, Treasury’s Deputy Assistant Secretary for Federal Finance reaffirmed Treasury’s commitment to TIPS and announced plans to gradually increase issuance of TIPS.