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Inflation and Treasury Convenience

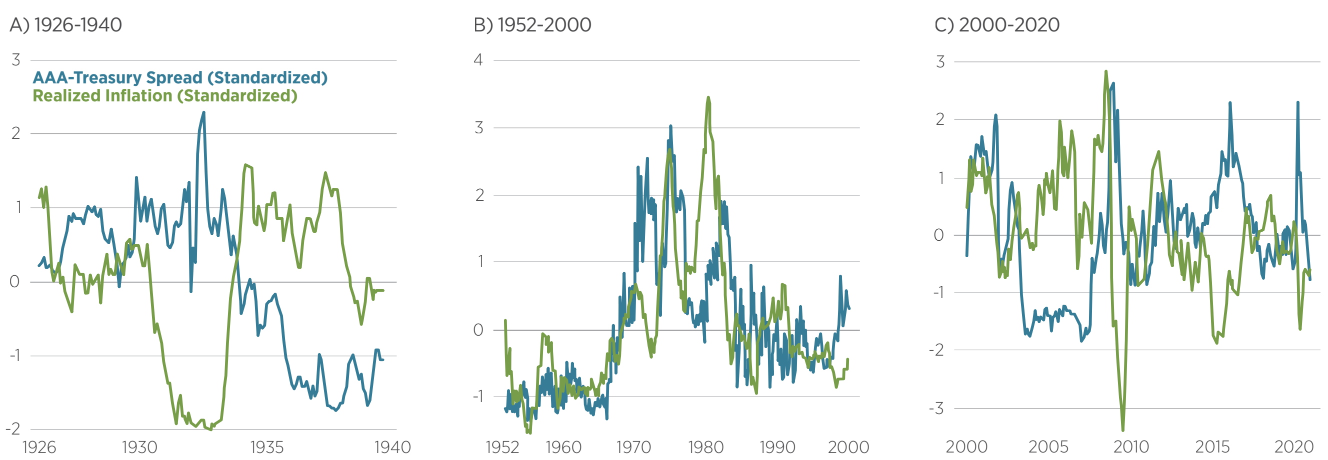
Based on BFI Working Paper No. 2024-108, "Inflation and Treasury Convenience," by Anna Cieslak, Duke University; Wenhao Li, University of Southern California; and Carolin Pflueger, University of Chicago

Treasury convenience yields and inflation were positively correlated during the inflationary 1970s-1980s, but negatively pre-WWII and post-2000. These findings are explained in a model where supply-driven inflation gives rise to a "money channel," raising the cost of holding money and the price of convenience for long-term Treasuries. Conversely, liquidity demand shocks—as during financial crises and panics—drive up Treasury convenience but lower inflation.

U.S. Treasury bonds are considered one of the safest investments. They're also convenient: easy to buy and sell (**liquid**), widely trusted, and often used in transactions or as collateral in loans. For those reasons, investors prefer holding Treasury bonds over other higher-yielding investments that are similarly safe. The extra premium that investors are willing to pay for U.S. Treasury bonds is known as their **convenience yield** and is measured as the difference between the actual yield that investors receive on Treasuries and the yield they could receive on similar, but less convenient, assets.

> **Liquid:** An asset that can be easily and quickly converted into cash without significant loss of value
>
> **Convenience yield:** The extra value or benefit of holding an asset, like U.S. Treasury bonds, due to its safety, liquidity, or ease of use in transactions

Figure 1 • Convenience Yield and Inflation



Note: These figures plot the Treasury convenience (measured as the AAA-Treasury spread) and the 12-month inflation during three subperiods: January 1926-August 1939, January 1952-December 1999, and January 2000-December 2020.

In this paper, the authors study how the convenience yield of U.S. Treasuries has moved with inflation over the past century. Their measure of Treasury convenience is the difference in yields on **AAA-rated** corporate bonds vis-à-vis Treasuries. Using data from 1926 to 2020, the authors document shifts in the relationship between Treasury convenience and inflation, which they link to macroeconomic drivers. They construct a model to explain the impact of different types of shocks on Treasury convenience over time. The findings highlight the following relationships:

- In periods of supply-side and persistent shocks to inflation (such as during the 1970s-1980s), higher inflation predicts higher Treasury convenience, as inflation increases the cost of holding money, and Treasury bonds become more valuable as liquid assets.
- In periods of demand-side and liquidity shocks (such as during the Great Depression and the financial crisis of 2008-2009), lower inflation is associated with an increase in Treasury convenience as investors seek liquid assets in periods of financial stress.
- Similar empirical results hold when decomposing inflation into its persistent, supply-driven components versus demand-driven fluctuations.

The study reveals two competing mechanisms driving Treasury bond convenience, which led to shifts in the Treasury convenience relationship with inflation over distinct historical periods. While intuition might suggest that episodes of high inflation erode the convenience benefits of Treasuries, this intuition has trouble explaining the empirical findings, in particular, why inflation was positively associated with Treasury convenience during the high-inflation 1970s and 1980s. Instead, the results of the paper highlight a more complex link between Treasury convenience and the macroeconomy through the interplay of money and liquidity demand channels, with substantial periods dominated by a positive inflation-convenience relationship.

AAA-rated: The highest credit rating assigned to a company's bonds, indicating an extremely low risk of default

READ THE WORKING PAPER

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ABOUT OUR SCHOLAR

Carolin Pflueger

Associate Professor,
Harris School of Public Policy

THE UNIVERSITY OF CHICAGO
HARRIS SCHOOL OF PUBLIC POLICY

Written by Abby Hiller • Designed by Maia Rabenold